HABILIS

Cross-submission on RBNZ submission

Market study into personal banking | 8 May 2024

Introduction

He tina ki runga, he tāmore ki raro.

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

This cross-submission is made in response to the submission[1] offered by the Reserve Bank of New Zealand | Te Pūtea Matua (RBNZ), dated 18 April 2024, as part of the Commission's market study into personal banking.

Our cross-submission notes that:

1. The Draft Report[2] from the Commission details the impact that RBNZ's legislative framework and policies have had on shaping the uncompetitive and expensive banking system in Aoetaroa.
2. In its submission, RBNZ fails to acknowledge the excessive and unjustified profitability of the Australian banks despite the extensive evidence in the draft report, and refuses to acknowledge its responsibility for this state of affairs.
3. The RBNZ states it does not wish to change or reform its current policy settings in any material way, which will lead to a continuation of the high margins, lack of competition, lack of innovation, and subsequent adverse impacts on Aotearoa's economy
4. The RBNZ is showing every sign of regulatory capture and is failing to act in our national interest.

We therefore urge the Commission to disregard RBNZ's submission when compiling the final version of the report.

About us

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

Habilis NZ Ltd is based in Tāmaki Makaurau.

Regulation is a key factor

As we have noted in our prior submission[3] on the Draft Report, the Commission has done an excellent job of characterising the type and extent of market failure in personal banking. And as we stated in that document, in our view there are two root causes of the issues described in the draft report:

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

This cross-submission deals with the first of these issues, and the apparent inability of RBNZ to take responsibility for its role in causing the market dysfunction that is negatively impacting our economy and our whānau.

The role of the Reserve Bank

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

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

In its submission, RBNZ states:

> Our vision for the financial system is that it is inclusive, trusted, and resilient, while also being efficient and competitive. A competitive banking system is an essential part of this.

And in its strategic documents, RBNZ's stated goal is "promoting the maintenance of a sound and efficient financial system". While it is clearly pursing the first goal – soundness – the Commission's market study confirms the "efficient" goal has been an object failure; there is no metric from the study or the documents that surround it that shows the New Zealand banking system is efficient or competitive in any believable way.

Further, there is little evidence to support RBNZ's assertions around its own actions on competition or efficiency. Despite our best efforts, we are unable to find any substantive policy work or programmes being directly undertaken by RBNZ that are actively promoting either outcome; there is also negligible work being undertaken by the Council of Financial Regulators[4] (CoFR) on these matters.

For instance, RBNZ publishes a Financial Stability Report[5] every six months. As far as we can ascertain, it has never published a Financial Efficiency Report, ever. Based on the activities it undertakes, the claim that the Reserve Bank is somehow promoting an efficient banking system seems a complete fiction.

It appears RBNZ thinks that an efficient and competitive banking system will arise spontaneously, much like intelligent life from the primordial soup, without either policy development or direct intervention from our central bank – despite two decades of evidence that this will never occur. The lack of both policies and programmes underlines this, and illustrates that RBNZ's statements about efficiency and competitiveness are largely theatrical in nature.

Stability at all costs

As RBNZ notes in its most recent Financial Stability Report:

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

As we noted in our submission on the draft report, the effective test for stability of the financial system appears to be the expectation that all commercial banks will be able to withstand a 1-in-200 year adverse event, without failure; in other words, a 0.5% risk of failure of a major component of the financial system is the desired policy goal.

As far as we can ascertain, the specific rationale for why the financial system stability threshold is set at this level is not described by RBNZ. While RBNZ adheres to the Basel Framework[6], the specific threshold does not appear to be enshrined in the Framework itself; rather, it appears to be indigenously developed.

The effect of this goal is pernicious – not because financial stability is a bad thing, but because its implementation has entrenched the dominance of the Australian banks and reinforced their high profitability. In effect, RBNZ has provided direct policy support for the adverse situation described in the market study.

The RBNZ rationale seems to be, having excessively profitable Australian banks is a good thing because it indicates the financial system is robust and stable – as if this was the only economic policy goal that matters in the entire country, and as if the profitability-equals-stability causation actually exists.

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

RBNZ's submission reads like it wishes to disclaim this responsibility, which is unhelpful.

The contrast between then and now

The impacts of RBNZ's policies in undermining competition in the banking market is best illustrated by comparing the policy settings from 20 years ago with those of today. Back in 2003, ANZ applied to acquire the National Bank, and the Commerce Commission's assessment[7] of the application had this to say about the then-current regulatory environment:

Capital Requirements

250. A new entrant wanting to be a registered bank would need to meet the Reserve Bank's minimum capital requirements. These are:

- Minimum capital of $15 million.
- Minimum capital of 8% of risk weighted assets
- Minimum tier 1 capital of 4% of risk weighted assets.

251. Non-bank financial institutions that choose not be registered would face lower capital costs, although the Commission found that these financial institutions could meet these requirements adequately.

252. The Commission is of the view that the capital requirements in the supply of transaction accounts market can be considered to be a moderate barrier to entry.

Regulatory Barriers

253. Regulatory barriers are considered to be low. Finance companies, savings institutions and fund managers operate in a lightly regulated market and are subject to Securities Act 1978 and Credit Contracts Act 1981 and Codes of Practice specific to the product market.

In the analysis of the 2003 merger application, the Commission does not put much emphasis on the regulatory barriers to entry for new competitors, as these are perceived to be low. It's safe to say the world has changed; now it takes an entire 20 page chapter of the market study to adequately convey the full extent of regulatory barriers. From the draft report:

> Regulation shapes competition in personal banking. The banking sector is highly regulated and we have heard that regulation is the single most important factor constraining providers' ability to enter and compete. New entry at scale from traditional offshore banks is unlikely because of the cost and time it would take to build sufficient market share to become profitable, particularly given the dominant position of the major banks. Smaller providers who do enter have been disproportionately adversely affected by the overall regulatory burden due to their lack of scale.
>
> Bank prudential capital requirements are the most significant regulatory barrier and have limited competition by constraining entry and particularly expansion. Since 2008, the Reserve Bank's prudential capital requirements have allowed the major banks to hold significantly less capital than smaller banks for some lending with a similar risk profile. This has given the major banks a material and entrenched competitive advantage over Kiwibank and smaller providers for the past 15 years.

And, of course, that's only the Executive Summary.

Profitability is a problem

The bulk of the issues identified in the draft report are therefore the direct responsibility of the RBNZ, and to pretend otherwise – as it attempts to do in its submission – is simply ludicrous.

And RBNZ seems intent on doubling down on the current *status quo* in our dysfunctional banking sector. From its submission:

> Like many jurisdictions around the world, the New Zealand banking market is characterised by a small number of large banks commanding a high market share. As the draft report notes, large banks are able to take advantage of significant scale, scope, risk diversification and funding cost advantages compared to smaller peers, particularly in the case of homogenous retail banking products. Larger banks can also be more able to sustain the investments required to offer innovative and attractive products and services for customers (e.g. new payment methods, and the increasing need for strong cyber security protections). Given this, a trend towards the industry being concentrated in a small number of large players appears common in developed markets.

Apparently RBNZ sees nothing wrong in this state of affairs, and seemingly has the view that banking oligopolies are more akin to a law of nature, about which nothing can or should be done. This is very concerning, given the widespread damage being done to the economy and whānau by the policy settings that are allowing systematic looting by the Australian banks.

And we take particular issue with this statement:

> Larger banks can also be more able to sustain the investments required to offer innovative and attractive products and services for customers (e.g. new payment methods, and the increasing need for strong cyber security protections).

It's instructive to note that Aotearoa has none of these putative benefits from the larger banks that dominate our financial system. In fact – as the draft report notes – the Australian banks have persistently under-invested in the very systems and processes that should enable innovation. As a result, our payments system is decades out of date, we have no viable fintech sector, the product offerings from banks have narrowed over time, and our banking networks are riddled with well-documented fraud that has been enabled by archaic systems and ineffective processes.

The statement from the RBNZ is out of touch with reality, and reads more like a media release from the Australian Bankers Association than a clear-eyed assessment from a regulator.

In fact, some of RBNZ's submission seems like open advocacy for the banking sector and its *status quo*. For instance:

> When combined with the increase in a scalar applied to credit risk RWA for IRB banks (from 1.06 to 1.2), our analysis indicated this would lead to RWA outcomes for IRB banks being approximately 90 percent of what would be calculated under the Standardised approach, an increase from a level of c. 70-75 percent in prior years. This was consistent with the purpose of promoting the maintenance of a sound and efficient financial system.

In effect, RBNZ is saying that a differential will continue to exist between the Australian banks and their competitors, which will undoubtedly lead to higher profits and sustain a barrier to entry, but somehow that's in our national interest. Again, it's hard to see how this is consistent with any claim that the RBNZ is promoting either competition or efficiency in the sector, but it's easy to see how the Australian banks will benefit from the (in)actions of the regulator.

There are very real harms being done

Concerningly, the RBNZ submission does not put any of its submission into the wider economic setting for which it is at least partly responsible; the banking study is seemingly viewed as a technical assessment of relatively esoteric policy settings, rather than an exploration of the impacts of strategic policy on the nation and its people. RBNZ needs to do better than this.

For instance, there is no recognition of the dead-weight drag effects from the export of so much capital to Australian bank shareholders; there is no concern for the effects of excessively high interest rates on the productive sector of the economy; there is no discussion of the over-weighting of property lending due to RBNZ policy settings.

It's almost as if the RBNZ's policies were merely prudential regulatory experiments being conducted on an inert laboratory subjects, not vital matters that affect the prosperity and wellbeing of every person in Aotearoa.

This is especially concerning given that the analysis frameworks have long existed to conduct wider economic assessments, and RBNZ clearly has the expertise to do exactly that. There is a very strong case to be made that simple cost-benefit analysis is not a useful tool for evaluating policy changes in a financial system that affects every New Zealander, and that wider measures such as Social Return on Investment[8] or a Four Wellbeings[9] analysis will return a much more balanced perspective.

For instance, the excessive profitability of the Australian banks arises because interest rates and fees and charges to customers are materially higher than would otherwise be the case in a competitive market. It is reported[10] that the four Australian banks extracted $7.18 billion in profits in the last financial year, and – based on the assessment in the draft report – this figure is 50%-100% higher than equivalent banks in the OECD. The excess profit was therefore between $1.5 billion and $3.6 billion, depending on how it's calculated.

The recent OECD country report[11] notes:

> The four Australian banks generated an average shareholder return of 15% over 2018-2022, compared to 7% for small New Zealand banks, 13% for large banks in Australia, and 11% for their counterparts overseas (RBNZ, 2023); the risk-adjusted return gap appears to be even higher. These high levels of profitability are unlikely to be explained solely by the riskiness of conducting a banking business in a small market like New Zealand, as the standard deviation of pre-tax returns in relatively low, suggesting low risk among banks.

The report adds that the profits of the Australian banks comprise 3% of Aotearoa's GDP, which is well in excess of the 1.2% of GDP captured by bank profits in Australia.

The reasons are easy to see: the net interest margin of the ANZ in its latest report is 2.54%, compared to the 1.65% of its Australian parent. This can only occur in a market dominated by oligopolies, and the formation of these oligopolies is directly attributable to RBNZ policy.

And as Monopoly Watch NZ has pointed out[12], it's a simple step from excessive returns at the sector level to excessive costs at the individual level; their analysis indicates most Kiwis will pay between $450,000 and $1,000,000 more in interest on their mortgage than borrowers in comparable jurisdictions, due to the excessive margins of the Australian banks.

These costs have human impacts. In a recessionary economy with high interest rates and rising unemployment, livelihoods will be destroyed, people will fall behind on payments, homes will be lost to foreclosure, relationships will end, poverty will result, and suicides will occur. All this is well known and well researched[13], and all of it has social and cultural and economic costs.

This is not to say that RBNZ's pro-bank policy settings are the sole cause of people taking their lives due to financial distress; but by the same token, neither can RBNZ disclaim the real-world impacts of its policy settings. And failing to even acknowledge the wider implications of its support for enriching bankers at the expense of New Zealanders in its submission and public statements is reprehensible.

Regulatory capture

As we noted in our submission on the draft report:

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

Our central bank needs to do a lot better than this. It is apparent that:

- The regulatory settings administered by RBNZ are a very large contributor to the excessive profitability of the Australian banks, and have created a very effective barrier to entry for any new competitors, as extensively detailed and evidenced in the draft report.
- RBNZ is very much the architect of these settings, and has chosen to implement our Basel III obligations in such a way as to entrench the position and profitability of the Australian incumbents, despite other approaches being both viable and effective.
- Based on its submission, RBNZ has no intention of making substantive changes to its current policy directions, irrespective of the damage done to Aotearoa's economy and whānau; the export of our national wealth for the enrichment of overseas shareholders will continue largely unabated.
- The proposed RBNZ amendments to the draft recommendations are mere window-dressing. The Reserve Bank is full of very smart people, and they know that hand-waving about open banking and digital identity and financial literacy will have no effect on the structure of the sector nor the profitability of the incumbents.

None of this is in our national interest. It is, however, very much in the interest of the Australian banks. Which – in the context of the discussion about where the costs and benefits of these policies really fall – leads to the entirely concerning question: who is the RBNZ working for, exactly?

In recent work on a regional economic development plan, we distilled the aspirations of the wider community into a statement of intent and two key principles:

> This Plan rests on the foundation of mana motuhake – the economic sovereignty of our region and its people. Our plan for achieving this is shaped by two principles:
>
> - **The economy is a wholly owned subsidiary of the taiao**. Our economy can only flourish if our environment is healthy, so we must invest wisely and well to protect and heal the taiao.
> - **The economy exists to serve the people**. The prosperity of our region is not measured solely in GDP figures, but is demonstrated by the ability of whānau, communities, and business to flourish.

If a region can recognise that the economy exists to serve the people and not the other way around, then RBNZ would be well served to think about how its current policy settings and its staunch advocacy for the financial enrichment of overseas bank shareholders is consistent with the best interests of our citizens and the mana motuhake of Aotearoa.

Our recommendations

Our recommendations are that the Commission acknowledges the aspects of the RBNZ's submissions that are "no regrets"; that is, the call for open banking and financial literacy improvements, the support for lending on Māori land, and the like. By any standard these are worthwhile initiatives, even if they will not address the structural issues.

However, we urge the Commission to stand its ground, and retain Recommendations 1, 4, 5, 6, 7, 8 and 9, despite the resistance from the Reserve Bank. And as noted in our submission, we ask that the final report strongly recommend the required actions from the RBNZ, rather than proposing them as items for an unresponsive and irresponsible regulator to merely consider.

Endnotes

1 https://www.rbnz.govt.nz/-/media/project/sites/rbnz/files/publications/information-releases/2024/rbnz-submission-commerce-commission-personal-banking-services-market-study.pdf

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