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Market Study into personal banking services – response to the Draft Report dated 21 March 2024.

Thank you for the opportunity to submit on the Commerce Commission's (**Commission**) Draft Report (**Report**). This is a joint submission of The Co-operative Bank Limited, Kiwibank Limited, SBS Bank and TSB Bank Limited. Each bank also may be providing an additional individual response to the Report. However, we consider it worthwhile reinforcing our support of the finding that the current regulatory ecosystem shapes the competitive environment. We are pleased to note that the Commission has considered the points made in our joint submission (**Submission**) dated 7 September 2023 in response to the Preliminary Issues Paper, particularly regarding:

- The capital advantages of the four Australian-owned banks (classified by the Reserve Bank of New Zealand (**Reserve Bank**) as Domestic Systemically Important Banks (**D-SIB**)).
- The disproportionate costs of banking regulation imposed on non-D-SIB banks, which materially constrains the ability to compete through investment and innovation.
- The ability for the D-SIBs to access more funding options which generally lead to a lower cost of funding, further entrenching the ability of D-SIBs to compete in an enhanced manner relative to smaller banks.

We consider that these factors have contributed to the constraint of growth for smaller providers likely resulting in the current two-tier oligopoly.

1. Capital advantages of the D-SIBs

As noted in the Submission, the approach taken over the past 20 years to implement changes to improve the resilience of the overall financial system has had the unintended consequence of creating a material capital advantage for the D-SIBs relative to smaller providers. This advantage has been further amplified over the past 15 years, as D-SIBs have been able to keep pace with the unprecedented market growth in home lending far more efficiently than smaller providers due to lower capital requirements. This has in turn increased scale advantages and ability to fund additional capital requirements, which widens the gap with smaller providers over time.

We acknowledged that the current changes to capital requirements that are being phased in through to 2028, included some measures to address this difference through the introduction of an 85% output floor and the D-SIB buffer. However, we agree with the Commission that even with these changes, and the increased transparency of the differences between the capital calculation methodologies through the introduction of new “dual-reporting” requirements, the D-SIBs are still able to hold less capital than smaller banks. We welcome additional consideration to bank regulatory capital requirements in the context of the relative system risks and the competitive disadvantage that still exists for smaller providers.

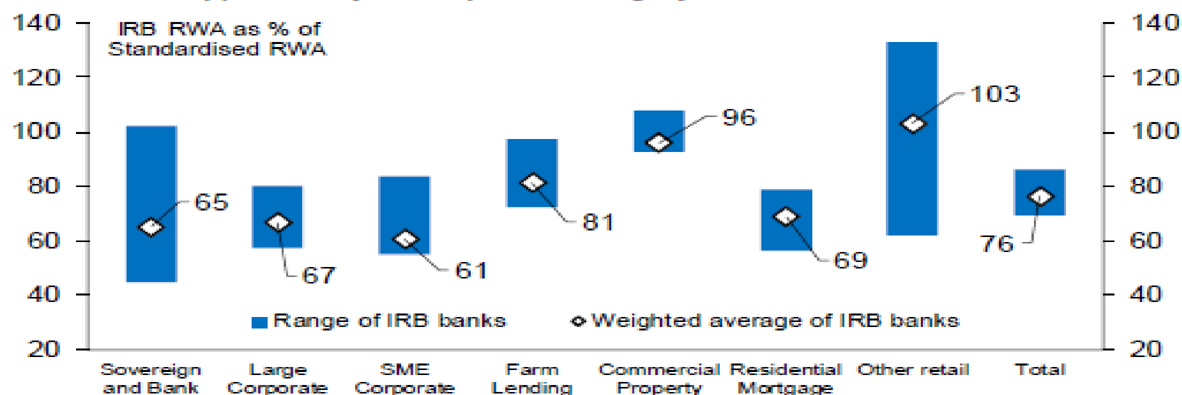
We also agree with the Commission's commentary that the 2% D-SIB buffer was actually designed to mitigate systemic risks and was not intended to be used to equalise capital requirements.

We thank the Commission for considering the points made in the Submission and subsequent consultation meetings/interviews in the Report's findings and recognition that the impact of the capital settings has given the D-SIBs a head start on growth since 2008 and continues to restrict the ability of small banks to compete.

We fully support the draft recommendation[1] for a review of the prudential capital settings and agree that this would open the door for a more even playing field. We would welcome the opportunity to further engage with the Reserve Bank to support such a review and to build upon recent work done in this area.

In particular, we encourage the alignment of capital risk weight requirements across all banks, especially for loan types with similar risk characteristics such as residential home loans, irrespective of the lender. We also note that the tables prepared by the Commerce Commission illustrating the capital requirements for banks before and after the Capital Review changes overlook an important weakness with the internal ratings-based (**IRB**) capital methodology. That being that not only did all the D-SIBs enjoy a substantial capital advantage over the smaller banks, but there were significant variations between the D-SIBs themselves.

Figure A1: RWA under the IRB approach as a percentage of RWA under the Standardised approach, by IRB exposure category



Source: RBNZ Quantitative Impact Study (2018). Data as at March 2018.

[1] Draft recommendation 1 – the Reserve Bank should review its prudential capital settings to ensure they are competitively neutral and smaller players are better able to compete.

Using this information, Table 7.1 in the Report should be restated as follows:

	Loan Value	% of Standardised Risk Weight	Raw Risk Weight	Adj Risk Weight by IRB Scalar of 1.06	Risk Weighted Assets ("RWA")	Required Capital at 7% of RWA	Capital Benefit compared to Standardised
Standardised	1,000,000		37%		370,000	25,900	
IRB Basis - High	1,000,000	80%	30%	31%	313,760	21,963	**3,937**
IRB Basis - Avg	1,000,000	69%	26%	27%	270,618	18,943	**6,957**
IRB Basis - Low	1,000,000	58%	21%	23%	227,476	15,923	**9,977**

This demonstrates that the standardised risk weighting is 37%, however the risk weightings for IRB models range from 23 – 31% for what is the same risk profile.

Housing is the New Zealand banking sector's largest risk exposure. It is also essentially a homogenous asset class so it would be reasonable to expect modelled outcomes to be fairly similar. The range of IRB outcomes illustrates how open to "optimisation" IRB modelling is. Additionally, there is no evidence that IRB capital modelling results in better credit risk management outcomes. The D-SIBs persistently report higher troubled loan balances as a percentage of their portfolios.

For these reasons, we believe the value and use of IRB modelling for prudential purposes should be revisited by the Reserve Bank: both for its contribution to financial system stability as well as a basis for competitive neutrality. The application of the 85% floor on modelled outcomes may act to reduce the range of outcomes but it does not address the validity of retaining a framework that entrenches a material competitive advantage for entities whose scale means they in no way require it and which continues to act as a barrier for smaller providers to meaningfully compete.

The key issue with IRB modelling[2] is that there is such variation in the outcomes that it does not provide a level playing field. In terms of the recommendations raised in para 7.59 of the Report, we disagree with the suggestion that accreditation criteria to become an IRB bank ought to be relaxed. In our view, the smaller banks do not currently have the large quantum of data, or resources to implement such modelling with the degree of robustness that prudential regulation should require. Therefore, we suggest the recommendation ought to be that, like it did with the previously allowed IRB modelling of operational risk, the Reserve Bank should disallow IRB modelling of credit risk in favour of a single standardised methodology for all banks, applying the more granular Basel III risk weights.

2. Disproportionate costs of banking regulation imposed on non-D-SIB banks

We thank the Commission for considering the points raised in the Submission, particularly in the Report's finding that the overall regulatory burden in personal banking services is high, and that smaller providers are disproportionately affected by this, constraining their ability to expand, innovate, grow, and ultimately compete harder against the major banks.

[2] Under Basel 2, if the bank is accredited then it may use the internal models-based approach (IRB) to calculate their capital requirements; otherwise, they must use the standardised approach.

The Report has rightly noted that the D-SIBs have significant economies of scale advantages over the smaller providers, which enables them to spread their fixed costs across more customers and products. As a result, they can commit more investment into change, innovation, marketing and competition than smaller providers without making trade-offs against cost and key resource allocation (including management time) toward regulatory change and maintenance activity.

The Report recognises the need for multi-faceted solutions to improve competition. Whilst this concept is supported, we highlight the need for caution when considering the rollout (how) and timeframe (when) of such recommendations, so as not to have the unintended consequence of further adding to the compliance change burden for smaller providers.

A number of the recommendations would require IT solution investment, amendment to systems and processes, and / or the production and maintenance of additional documentation. Whilst the degree of change will be variable between banks, broadly some examples include the acceleration of open banking, creation of an enhanced switching service, lending affordability safe harbour benchmark for expenses, standardised presentation of lending offers, and a process for pro-rating clawback amounts on a linear basis.

As noted in the Submission, the NZ Small Domestic Banks' Group has previously submitted to the Council of Financial Regulators on ways to address the disproportionate compliance burden, for example having staggered start dates for new legislation and taking a more proportionate approach to both regulation and enforcement. We would welcome further engagement and consultation on the proposed implementation for these recommendations.

We noted in the Submission that, other than the Deposit Takers Act (**DT Act**), no other legislative regime imposes an obligation on a regulator to have an explicit purpose of ensuring that the regime either improves competition or ensures that any obligation does not adversely impact competition. We are supportive of the spirit of draft recommendation[3] to amend the DT Act to enable the Reserve Bank to 'promote' competition.

However, the distinction between "promoting competition", "maintaining competition" and "not undermining competition" is critical. "Maintaining competition" preserves the status quo, which, as has been recognised by the Commerce Commission, is not a desirable outcome – particularly with regard to the Reserve Bank's capital settings. However, we question if it would be appropriate for the Reserve Bank's mandate to fully extend to the promotion of competition, meaning to encourage, further, or advance. Requiring the Reserve Bank to actively promote competition in the deposit taking sector when exercising its powers, functions and duties under the Act could contribute to a confused regulatory model. It could create overlaps with the Commerce Commission's core competition mandate and would therefore be inconsistent with the twin peaks supervisory model. The coalition government has recently announced changes to the regulation of conduct in the financial services sector which are intended to move the sector towards a purer twin peaks model so the adoption of the recommendation in its current form could work against those changes.

[3] Draft recommendation 8 – the Government should amend the DT Act to allow the Reserve Bank to promote competition, rather than maintain competition.

In our view, the requirement not to "undermine competition" might strike a better, and more appropriate, balance. It would enable the Reserve Bank to take competition into account in a more holistic way. The Reserve Bank would not be limited to maintaining the status quo when exercising its powers, functions and duties, but its mandate would not be broadened to such an extent that it duplicates the Commerce Commission's role and responsibilities.

We would also welcome consideration of expansion of this in relation to the proposed review of existing regulation[4], particularly to other empowering Acts (such as the Financial Markets Conduct Act (**FMCA**) and Credit Contracts and Consumer Finance Act (**CCCFA**)).

The Report offers a number of findings and recommendations relating to the AML/CFT regime. Whilst these are broadly supported, this is a highly complex area and we would encourage that further engagement and analysis is conducted with industry subject matter experts.

3. D-SIB's can access more funding options which generally lead to a lower cost of funding

The Report acknowledges the feedback provided in the Submission in relation to the advantages that D-SIBs have through their ability to access a variety of funding sources that may not be available to smaller providers due to their scale and/or credit ratings, such as international markets and wholesale funding.

We reiterate that credit rating agencies consider an implicit government guarantee for D-SIBs in setting credit ratings, which means D-SIBs have a more favourable rating for the equivalent risk. This is further exacerbated by the current regulatory capital environment which, as noted above, means D-SIBs can essentially report higher capital ratios for assets with the same underlying risk, again supporting more favourable credit ratings. This provides a number of advantages including a significant cost of funding benefit either in wholesale or institutional markets, or a diversification benefit through wider investor access. We acknowledge that this is difficult to solve for but highlight it as an important factor to understand when assessing the market dynamics.

We thank the Commission for their considered engagement in this important market issue. We are happy to discuss this further.

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[4] Draft recommendation 9 – the Government and policy makers should seek competitive neutrality across banks and other providers in their decision-making wherever possible, paragraph 10.47.2

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