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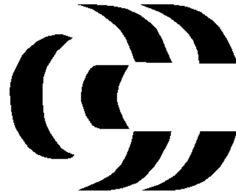

COMMERCE COMMISSION

Decision No. 439

Determination pursuant to the Commerce Act 1986 in the matter of an application for clearance of a business acquisition involving:

PMI MORTGAGE INSURANCE AUSTRALIA (HOLDINGS) PTY LTD

and

CGU LENDERS MORTGAGE INSURANCE LIMITED

The Commission: MJ Belgrave
PR Rebstock
DF Curtin

Summary of Application: The acquisition by PMI Mortgage Insurance Australia (Holdings) Pty Ltd or one of its interconnected bodies corporate of up to 100% of the shares in or assets of CGU Lenders Mortgage Insurance Limited and/or any of its interconnected bodies corporate.

Determination: Pursuant to section 66(3)(a) of the Commerce Act 1986, the Commission determines to give clearance for the proposed acquisition.

Date of Determination: 30 July 2001

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THE PROPOSAL

1. On 2 July 2001 PMI Mortgage Insurance Australia (Holdings) Pty Ltd (PMI) registered a notice with the Commission seeking clearance under section 66 (1) of the Commerce Act 1986 to acquire up to 100% of the shares in, or assets of, CGU Lenders Mortgage Insurance Limited and/or any of its interconnected bodies corporate (CGU).

THE PROCEDURES

2. Section 66(3) of the Act requires the Commission either to clear or to decline to clear a notice given under section 66(1) within 10 working days, unless the Commission and the person who gave notice agree to a longer period. An extension of time was sought by the Commission and agreed to by the applicant. Accordingly, a decision on the application was required by Monday 30 July 2001.

3. In its application, PMI sought confidentiality for specific aspects of the application. A confidentiality order was made in respect of the information for a period of 20 working days from the Commission's determination notice. When that order expires, the provisions of the Official Information Act 1982 will apply.

4. The Commission's determination is based on an investigation conducted by staff.

5. The Commission's approach is based on principles set out in the Commission's *Practice Note 4*.[1]

THE PARTIES

PMI

6. PMI is a lenders' mortgage insurance (LMI) company operating in both New Zealand and Australia. Its New Zealand operations are a branch of the Australian LMI company, PMI Mortgage Insurance Ltd—which is a wholly owned subsidiary of PMI Mortgage Insurance Australia (Holdings) Pty Ltd—and is registered as an overseas company in New Zealand.

7. PMI Mortgage Insurance Ltd is ultimately a wholly-owned subsidiary of The PMI Group, Inc., a US-based mortgage insurance group. The PMI Group, Inc. entered Australasian markets by acquiring MGICA Ltd from AMP Limited in August 1999 via its Australian-based holding company, PMI Mortgage Insurance Australia (Holdings) Pty Ltd, as part of its international expansion and diversification strategy.

8. PMI's business activity in New Zealand is the supply of LMI. PMI's New Zealand-based LMI operations, which were established in 1988 (as MGICA), are a branch of its Australian-based LMI business. Senior executives of PMI are based in Australia and staff

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[1] Commerce Commission, *Practice note 4: The Commission's Approach to Adjudicating on Business Acquisitions Under the Changed Threshold in section 47 – A Test of Substantially Lessening Competition*, May 2001.

presence in New Zealand is small. Business decisions are dictated by the Australian-based LMI company.

9. PMI has no other operations in New Zealand, and specialises solely in LMI. Its customers in New Zealand include the following: ANZ Banking Group (New Zealand) Ltd (ANZ), National Bank of NZ Ltd (NBNZ), Sovereign Limited (Sovereign), AMP Banking (AMP), Australian Mortgage Securities (NZ) Ltd (AMS), Medical Mortgages, Origin Mortgage Management (Origin) (which is owned by ANZ), and Southland Building and Investment Society. Most of these companies are owned by overseas parents.

10. PMI's ratings in Australia are stable, being (AA-) from Standard & Poors, (AA) from Fitch and (A1) from Moody's.

CGU

11. CGU is a wholly-owned subsidiary of CGNU plc, a UK-based globally diversified insurance group. CGU's immediate parent company, CGU Insurance Limited, also a wholly-owned subsidiary of CGNU plc, is a general insurer in Australia and New Zealand.

12. CGU is an LMI company, which has operated a branch in New Zealand since 1991. Like PMI's New Zealand operations, CGU is registered as an overseas company in New Zealand. It has a small staff presence in New Zealand and business decisions are dictated by the Australian-based parent.

13. CGU's customers in New Zealand include: WestpacTrust (Westpac), NBNZ, Bank of New Zealand (BNZ), AMP, AMS and Sovereign.

14. CGU has ratings in Australia from Fitch (AA), Standard & Poors (AA-) and Moody's (A2).

15. CGU advised that the proposed acquisition reflects CGU's strategy of focusing on expanding its general insurance business in the Australian and New Zealand markets, rather than further developing its LMI business as a stand-alone operation.

OTHER RELEVANT PARTIES

16. In addition to PMI and CGU, the New Zealand LMI industry also includes two other participants: Royal & SunAlliance (RSA) and GE Capital Mortgage Insurance Corporation (Australia) Pty Ltd (GEMICO).

RSA

17. RSA has operated in New Zealand since 1992 as a subsidiary of its Australian-based LMI business, Royal & SunAlliance Lenders Mortgage Insurance Limited. The Australian-based company is a wholly-owned subsidiary of Royal & SunAlliance Insurance Group Plc, a diversified, global, UK-based insurance company.

18. RSA has ratings from Moody's (A2) and Standard & Poors (AA-).

19. RSA's main customers are Origin, Interstar Securities and Home Mortgage Company.

GEMICO

20. GE has two mortgage insurance companies in Australia: GE Capital Mortgage Insurance Corporation (Australia) Pty Limited (GEMICO), rated AA by Standard &Poors and Aa2 by Moody's; and GE Mortgage Insurance Pty Limited, rated AAA by Standard & Poors and Aa1 by Moody's. Both are wholly-owned subsidiaries of General Electric Capital Corporation, which is US-based.

21. General Electric Capital Corporation entered the Australian LMI market when it acquired the Housing Loans Insurance Corporation in December 1997, following its restructuring and sale by the Australian Government. GEMICO is an overseas registered company in New Zealand, and is the entity which operates the New Zealand GE branch. GEMICO commenced LMI operations in New Zealand in 1999. It has a small staff presence in New Zealand and its business decisions are made in association with its Australian parent.

22. GEMICO's main customers in New Zealand are AMS and Origin.

INDUSTRY BACKGROUND

Lenders Mortgage Insurance (LMI)

23. LMI is the provision of insurance to protect a lender of a residential mortgage against the risk of loss in the event that the borrower defaults on the loan. If the property securing the mortgage loan is sold and the proceeds are not sufficient to repay the balance of the loan, the LMI supplier will make up the shortfall, to the extent of the cover under the policy. The insurance can also protect the lender against missed payments between default and recovery. In New Zealand, LMI policies usually cover only a proportion of the balance of the loan (e.g.: the top 20%, 30% or 50% claimed for each policy), unpaid interest and enforcement costs.

24. Premium rates payable are directly dependent upon the loan-to-value ratio (LVR) of the mortgage. The LVR represents the percentage of the value of loan that is funded by the lender. For example, an LVR of 80% signifies that 80% of the value of the loan is funded by the lender and 20% by the customer. In New Zealand, lenders do not lend over a 95% LVR, and some operate with a lower ceiling; the median LVR of all mortgages is about 66%. Factors such as property locations and the borrower's credit quality are taken into consideration when determining the premium rates payable for each LVR.

25. LMI premiums are usually a once-off payment at the beginning of the loan. As the insurance cover is provided for the life of the loan, LMI suppliers only take a portion of the gross premium onto their accounts each year. For example, [

] The bell-curve accounting distribution of the earned premiums mirrors the risk exposure of the mortgages, as most of the claims occur between the second and fourth year of the life of the loan. In New Zealand, the average life of a mortgage is 3½ to 5 years.

Relevant Legislation and Regulations

26. The insurance market in general is regulated by two Acts, the Insurance Companies' (Ratings and Inspections) Act 1994 and the Insurance Companies' Deposits Act 1953 ("Deposits Act"), and Non-Lender LMI suppliers must comply with the obligations in these statutes to establish and conduct an LMI business in New Zealand

27. However, the Insurance Companies' (Ratings and Inspections) Act will not apply to a Non-Lender LMI that delivers a notice to the Registrar of Companies electing not to be rated.

28. The Deposits Act requires any insurance company carrying on any class of insurance business in New Zealand to lodge approved securities with a market value of not less than $500,000 with the Public Trustee. This applies to local, commonwealth or foreign companies, and therefore overseas insurance companies are constrained in the same way as New Zealand businesses, provided they are "carrying on insurance business in New Zealand."

29. However, exemptions on payment of the $500,000 may be granted to insurers engaged in a mortgage guarantee business (such as Non-Lender LMI suppliers) by the Minister for Economic Development, who is responsible for the administration of the Deposits Act.

30. If the Minister grants an exemption, the company must make a deposit with the Public Trustee of such amount as the Minister shall specify, being not less than $10,000. Each year, the Minister must review the financial position of the company to which he has granted the exemption to ensure that the grounds upon which the exemption was granted are still valid.

Purchasers

31. LMI providers supply LMI to residential mortgage lenders. The lenders are either Approved Depository Institutions ("ADIs"), such as banks, building societies and credit unions, or Mortgage Managers ("MMs").

32. In New Zealand, banks are the main providers of mortgages and purchasers of LMI, accounting for about 95% of the market. MMs entered the New Zealand market four to five years ago and currently hold about 5% of the residential mortgage market. They are slowly increasing their market penetration, but people are still used to going to the bank to get a mortgage, and New Zealand banks are very competitive with lower margins as compared with Australian banks.

33. Although the New Zealand banks are separate New Zealand legal entities, all except the National Bank have Australian parent companies and accordingly their decisions regarding LMI or self-insurance involve an assessment of their groups' activities in both New Zealand and Australia. [

].

34. MMs and ADIs do not fund borrowers' loans in the same way. Whereas ADIs, as traditional providers of housing loans, fund from balance sheet deposits, MMs borrow funds and on-lend them to borrowers. Mortgage backed securities (MBSs) provide the funds to MMs to lend to borrowers. These MBSs are sold to institutional investors on the domestic market or world-wide. MBSs are also used by ADIs for existing ("seasoned") loans, as a means to off-load risk from their balance sheet, liquefy some capital and improve their return on capital.

35. Between 15% and 20% of mortgages are currently backed by securities. The securitisation market is very competitive with very low margins. A bank's decision as to whether or not it will securitise a pool of mortgages is driven by interest rates and, for global issues, exchange rates. Furthermore, mortgages must comply with very stringent criteria to be eligible for securitisation.

Insurance of ADIs' Balance Sheet Funded Mortgages

36. Only balance sheet funded mortgages perceived as being of high risk, usually those with an LVR greater than 80%, are insured.

37. For loans with an LVR above 80%, those banks which use an LMI supplier will purchase LMI from a Non-Lender LMI supplier, currently either PMI, CGU, GEMICO or RSA. The cost of LMI is usually passed on to the borrower. The majority of lenders only seek top cover insurance, usually limited to 20% or 50% of the loan value (compared to Australia, where generally LMI is for a 100% cover). For example, [

]

38. In New Zealand, two of the major bank mortgage lenders, ASB and NBNZ, currently self-insure all of their loans [

]

39. Essentially, self-insurance can be undertaken in two ways:

- the entity lending to the borrower bears the default risk itself and in turn charges the borrower a risk fee and/or higher interest, as just described; or

- the lender retains a chosen amount of default risk and fees in a wholly-owned LMI company (called a "captive") and uses a Non-Lender LMI or other types of (re)insurer for the remainder. The borrower is charged to cover the costs associated with the risk and any third party insurance.

40. New Zealand lenders only use the first option, whereas a number of large banks in Australia insure via captives.

41. In New Zealand, the insurance of a borrower's default risk is optional, and there are no regulatory requirements or explicit incentives for mortgage lenders to purchase LMI.

Insurance of ADIs' and MMs' Securitised Mortgage Portfolios

42. Securitised mortgage portfolios are usually insured 100%, regardless of their LVR.

43. LMI provides credit enhancement to increase the credit rating of securitised mortgage receivables. When an ADI or an MM wishes to "securitise" a mortgage pool, it generally needs to include "credit enhancement" of its loans in order to secure high enough credit ratings to attract MBS investors' interest. Rating agencies will give partial or complete credit to the level of LMI cover supporting any part of loans to be securitised, having regard to the LMI supplier's claims paying ability. The credit rating assigned to an LMI provider depends, amongst other factors, on its financial strength, its willingness to pay (i.e. the historical claims payment record), and its internal policies and procedures.

44. LMI providers also often provide cash flow cover for MBSs. Claims under mortgage insurance policies are normally paid at the end of the mortgage security realisation period, once any losses are realised. However, if a number of borrowers are in default at the same time, the delay in interest payment can create cash flow strain on a transaction and undermine the issuer's ability to make timely payment to the security holders. The risk of a cash flow shortfall results in the requirement for a liquidity enhancement.

The Policies

45. LMI providers offer three different forms of insurance policies, as follows:

- The primary mortgage insurance policy requires the insurer to approve the insurance policy for each loan after the lender has completed its initial approval process. The dual underwriting process provides an additional level of credit enhancement and minimises occurrence of claim payments. The turn-around time of each application by the LMI provider is an important aspect of the service.

- An "open policy" does not require the insurer to go through the underwriting process. Instead, it relies on the lender's representations that each loan complies with the insurer's policy guideline. Lenders opt for that policy to shorten the approval time of applications, although it normally is applied only to less risky loans.

- Pool policies are used by lenders who are able to fund loans on-balance sheet to cover a pool of mortgages that will be securitised. The insurance policy is taken for the portion of the pool that does not already have LMI cover, or may include loans already covered.

Lenders' LMI Provider Selection

46. Banks have traditionally used a single LMI supplier, a situation that is unique to New Zealand, or have self-insured. However, one of the banks is intending to change to using two insurers.

47. MMs usually use a panel of LMI suppliers to maintain competition for their business, and also to widen their choices as different suppliers often have different risk sensitivities.

48. The criteria customers use when selecting an LMI supplier are the following:

- the quality of the relationship,
- the quality of the service,
- the credit rating,

- the turn-around time of applications (particularly important for individual policies),
- the provider's appetite for risk,
- the premiums, and
- the technology capabilities.

As indicated, choice of supplier is not purely price-driven, although price is important, along with service quality and the supplier-customer relationship.

MARKET DEFINITION

49. The Act defines a **market** as:

> *. . . a market in New Zealand for goods or services as well as other goods or services that, as a matter of fact and commercial common sense, are substitutable for them.*

50. For the purpose of competition analysis, a relevant market is the smallest space within which a hypothetical, profit-maximising, sole supplier of a good or service, not constrained by the threat of entry, could impose at least a small yet significant and non-transitory increase in price, assuming all other terms of sale remain constant (the '*ssnip* test'). For the purpose of determining relevant markets, the Commission will generally consider a *ssnip* to involve a five percent increase in price for a period of one year.

51. It is substitutability at competitive market prices which is relevant in defining markets. Where the Commission considers that prices in a given market are significantly different from competitive levels, it may be necessary for it to assess the effect of a *ssnip* imposed upon competitive price levels, rather than upon actual prices, in order to detect relevant substitutes.

52. The Commission will seek to define relevant markets in terms of four characteristics or dimensions:
    - the goods or services supplied and purchased (the product dimension);
    - the level in the production or distribution chain (the functional level);
    - the geographic area from which the goods or services are obtained, or within which the goods or services are supplied (the geographic extent); and
    - the temporal dimension of the market, if relevant (the timeframe).

53. The Commission will seek to define relevant markets in a way that best assists the analysis of the competitive impact of the acquisition under consideration. A relevant market will ultimately be determined, in the words of the Act, as a matter of fact and commercial common sense.

54. Where markets are difficult to define precisely, the Commission will initially take a conservative approach. If the proposed acquisition can be cleared on the basis of a narrow market definition, it would also be cleared using a broader one. If the Commission is

unable to clear the proposed acquisition on the basis of the narrower market, it will be necessary to review the arguments and evidence in relation to broader markets.

Product Dimension

55. The delineation of relevant markets as a basis for assessing the competitive effects of a business acquisition begins with an examination of the goods or services offered by each of the parties to the acquisition. Both demand-side and supply-side factors are generally considered in defining market boundaries. Broadly speaking, a market includes products that are close substitutes in buyers' eyes on the demand-side, and suppliers who produce, or are able easily to substitute to produce, those product on the supply-side.

56. The Commission takes the view that the appropriate time period for assessing substitution possibilities is the longer term, but within the foreseeable future.[2] The Commission considers this to be a period of one year, which is the period customarily used internationally in applying the 'ssnip' test (see below) to determine market boundaries. The Commission will take into account recent, and likely future, changes in products, relative prices and production technology in the process of market definition.

57. The Applicant submits that the relevant product market is that for the supply of LMI to lenders of residential mortgage products. Other market participants broadly agreed with this market definition, although there was disagreement as to whether or not self-insurance should be included.

Demand-side substitution

58. Close substitute products on the demand-side are those between which at least a significant proportion of buyers would switch when given an incentive to do so by a small change in their relative prices.

59. Initially, markets are defined for each product supplied by two or more of the parties to an acquisition. Unequivocal substitutes are combined. For each initial market so defined, the Commission will examine whether the imposition of a ssnip would be likely to be profitable for the hypothetical monopolist. If it were, then all of the relevant substitutes must be incorporated in the market. If not, then the next most likely substitute good or service will be added to the initial market definition and the test repeated. This process continues until a combination of products is found which defines the product dimension of a relevant market, namely, the smallest combination of goods or services for which a ssnip would be profitable.

60. On the demand-side, the technical viability of one good or service as a substitute for another must be assessed. However, even where another product may technically be

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[2] In *Tru Tone Ltd v Festival Records Retail Marketing Ltd* [ ] 2 NZLR 351 Smellie J and the Court of Appeal on appeal approvingly quoted an earlier decision of the Commerce Commission in *Edmonds Food Ind Ltd v W F Tucker & Co Ltd* (Decision 21, June 1984) where the Commission had ruled: "A market has been defined as a field of actual or potential transactions between buyers and sellers amongst whom there can be strong substitution, at least in the long run, if given a sufficient price incentive". See also *News Limited v Australian Rugby Football League Limited &Ors* (1996) ATPR at 41,687, where Burchett J stated: "Long term prospects that can be more or less clearly foreseen are, to that extent, a present reality, from the point of view of identifying the constraints upon commercial action. This fact emphasises the importance of the principle . . . that substitution possibilities in the longer run may be very significant for market delineation." Also *Re Tooth & Co Ltd v Tooheys Ltd* (1979) 39 FLR 1 emphasises longer run substitution possibilities.

suitable as an alternative for the product in question, its price may be so much higher that it may be a poor substitute in an economic sense, at least for the great majority of buyers. In judging economic substitutability between products, the Commission will have regard to relative prices, quality and performance when assessing whether they are, in fact, close substitutes in the eyes of buyers.

61. The Applicant claimed, and CGU agreed, that self-insurance should be included in the product market for reasons set out in the Commission's discussion of near entry below (paras 110-114).

62. Other industry participants disagreed. They explained that traditionally self-insurance is not considered as being part of the LMI market. They pointed out that self-insurance is not available to mortgage lenders to insure their mortgage, and therefore is not part of the LMI market.

63. Moreover, the banks that self-insure do not compete for business externally. [ ] Furthermore, ANZ and Westpac have both said that [ ]

64. Although self-insurers are seeking to protect themselves against exposure to risk, as do those using LMI, the two mechanisms are inherently different. In the first case the risk is carried internally, whereas in the latter it is laid off. In addition, the LMI suppliers protect themselves through reinsurance, whereas the self-insurers do not.

65. The Commission is therefore of the view that the relevant product market does not include self-insurance.

Supply-side substitution

66. Close substitute products on the supply-side are those between which suppliers can easily shift production, using largely unchanged production facilities and little or no additional investment in sunk costs, when they are given a profit incentive to do so by a small change in their relative prices.

67. The Applicant claims that alternatives for LMI which are used for the purpose of securitisation include over-collateralisation, subordination, excess spread accounts and financial guarantee swaps. These products, however, are not used to date in New Zealand, and in any case are not substitutes for LMI for loans that are not securitised. As already noted, securitisation currently makes up only a small proportion of the LMI market.

Undifferentiated/Differentiated Products

68. In some instances, market definitional problems arise because of the differentiated nature of the goods or services involved in a business acquisition, caused by differing technical specifications, branding, packaging, warranties, distribution channels and other factors.

69. Where a significant group of buyers within a relevant market is likely to be subject to price discrimination, the Commission will consider defining additional relevant markets based on particular uses for a good or service, particular groups of buyers, or buyers in particular geographic areas. In other cases, the primary focus may switch to the extent to

which a business acquisition eliminates competition between the products brought together by the acquisition.

70. The Applicant claims (paras. 12.1-12.3) that price is “the primary driver” when customers choose between alternative LMI suppliers, and that other characteristics that can differentiate the product—such as the degree of cover, and the nature of the contractual relationship—can easily be copied by other providers. However, in the discussion in the context of co-ordinated market power, the Applicant notes (para. 23.1) that “the ‘characteristics’ of the LMI product can distinguish the participants”.

71. The Commission’s inquiries with other LMI providers and their customers have found that while the ‘product’ narrowly defined is standardised, in the sense that all suppliers can provide the differing levels of cover, credit enhancement and the like, the associated service quality is also valued by customers. This includes the following factors: the relationships at a personal level between the staff in the LMI supplier and the customer’s mortgage managers; the technology systems used by the supplier; the market knowledge and advice offered by the supplier; and the “turnaround time” (the time taken to approve an application for insurance on a particular loan request). The last requirement reflects the competitiveness of the home mortgage market, and the unwillingness of borrowers to wait long while loan applications are being processed.

72. The LMI product is thus differentiated to a degree. The large banks clearly do value the “relationship” they have built up with their chosen LMI supplier, which is reflected in the fact that they rarely switch between providers. Moreover, securitisers typically use a panel of two or more LMI suppliers, usually in part to create an internal quasi-market for LMI, and to allow internal relationships and service quality to determine the allocation of the LMI business between them. In these cases, while the intention is often for the business broadly to be shared evenly between suppliers, considerable discrepancies in shares can emerge in practice.

73. The differentiation just discussed is indicated by the fact that premiums do vary, when like product is compared with like. CGU has suggested that customers would tolerate a range of $20-$30 on a premium of around $700 for a $100,000 loan, implying a maximum premium variation of about 3-4%. Anything larger would likely be sufficient to cause the disadvantaged customer to switch to another supplier.

74. As both price and product quality are taken into account by customers in choosing between LMI suppliers, the product is differentiated to a degree, and this has to be incorporated into the market analysis. However, it is clear that the product is not so differentiated as to cast doubt on there being a single, well-defined, market for LMI.

75. The Commission therefore concludes that for the purpose of assessing the competition implications of the proposed acquisition, the appropriate product market is the supply of LMI to lenders of residential mortgages.

Geographic Extent

76. The Commission will seek to define the geographical extent of a market to include all of the relevant, spatially dispersed, sources of supply to which buyers can turn should the prices of local sources of supply be raised. For each good or service combination, the overlapping geographic areas in which the parties operate are identified. These form

initial markets to which a ssnip is applied. Additional geographic regions are added until the smallest area is determined within which the hypothetical monopolist could profitably impose a ssnip.

77. Generally, the higher the value of the product to be purchased, in absolute terms or relative to total buyer expenditure as appropriate, the more likely are buyers to travel and shop around for the best buy, and the wider the geographic extent of the market is likely to be.

78. Where transport costs are high relative to the final value of a product, a narrower geographic market is more likely to be appropriate. Where product perishability and other similar practical considerations limit the distance that a product may be transported, this may limit the geographic extent of the market. The timeliness of delivery from alternative geographic sources is similarly relevant.

79. Although buyers and sellers of a particular good or service may interact in markets that are apparently local or regional in extent, those markets may themselves overlap and interrelate so as to form a market covering a larger geographical area. In these situations, the larger market is likely to be the appropriate one for analysing the competitive effects of a business acquisition.

80. The Commerce Act defines a market to be a "market in New Zealand". However, in many markets New Zealand buyers purchase products from both domestic and from overseas suppliers. Where imported products are close substitutes for domestic products, the overseas suppliers will be part of the relevant market. In such circumstances the Commission, in order to comply with the wording of the Act, is likely to define a national market and then, as discussed later in the competition analysis, to consider the extent to which overseas suppliers exercise a competitive constraint on the participants in the domestic market.

81. The Applicant has submitted that the LMI market is a New Zealand-wide market. As all arrangements between LMI suppliers and customers are nation-wide, the Commission concludes that the geographic market is a national one.

Functional Level

82. The production, distribution and sale of a product typically occurs through a series of functional levels – for example, the manufacturing/import level, the wholesale/distribution level and the retail level. It is often useful to identify the relevant functional level in describing a market, as a proposed business acquisition may affect one horizontal level, but not others.[3] Alternatively, some acquisitions, such as those involving businesses at different vertical levels, may raise issues related to vertical integration. Generally, the Commission will seek to identify separate relevant markets at each

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[3] *Telecom Corporation of New Zealand Ltd v Commerce Commission* (1991) 4 TCLR 473, 502 The High Court (Greig J, Shaw WJ, Prof M Brunt) noted: "If we ask what functional divisions are appropriate in any market definition exercise, the answer, …, must be whatever will best expose the play of market forces, actual and potential, upon buyers and sellers. Wherever successive stages of production and distribution can be co-ordinated by market transactions, there is no difficulty: there will be a series of markets linking actual and potential buyers and sellers at each stage. And again, where pronounced efficiencies of vertical integration dictate that successive stages of production and distribution must be co-ordinated by internal managerial processes, there can be no market."

functional level affected by an acquisition and assess the impact of the acquisition on each.

83. The Applicant has submitted that a functional level distinction is not relevant to the LMI market. The Commission agrees that while delineating the functional level of the market adds nothing in this case, it notes for completeness that the appropriate level is the wholesale one.

The Timeframe

84. Generally, the Commission will view markets as functioning continuously over time. However, where a market is characterised by, for example, infrequent transactions, the Commission may seek to define a separate time dimension as part of its market definition process. Time considerations are also important where there are long-term contracts, and where there are depletable resources.

85. A characteristic of the LMI market is that the LMI premium is an up-front payment which covers the risk throughout the term of the mortgage. However, this issue, which is dealt with under the discussion on market shares (paras 124-25), is not one that affects the market definition.

Conclusion on Market Definition

86. The Commission concludes that the relevant market is the national market for the wholesale supply of LMI to lenders of residential mortgages ("the LMI market").

COMPETITION ANALYSIS

Substantially Lessening Competition

87. Section 47 of the Act prohibits particular business acquisitions. It provides that:

> A person must not acquire assets of a business or shares if the acquisition would have, or would be likely to have, the effect of substantially lessening competition in a market.

88. Section 2(1A) provides that substantial means "real or of substance". Substantial is taken as meaning something more than insubstantial or nominal. It is a question of degree.[4] What is required is a real lessening of competition that is not minimal. The lessening needs to be of such size, character and importance to make it worthy of consideration.[5]

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[4] *Commerce Commission v Port Nelson Ltd* (1995) 6 TCLR 406, 434; *Mobil Oil Corporation v The Queen in Right of NZ* 4/5/89, International Centre for Settlement of Investment Disputes, Washington DC, International Arbitral Tribunal ARB/87/2 (paras 8.2, 19, 20).

[5] *Dandy Power Equipment Ltd v Mercury Marina Pty Ltd* (1982) ATPR 40-315, 43-888; *South Yorkshire Transport Ltd v Monopolies & Mergers Commission* [ ] 1 All ER 289.

89. Section 3(2) provides that references to the lessening of competition include references to the hindering or preventing of competition.[6]

90. While the Act defines the words "substantial" and "lessening" individually it is desirable to consider the phrase as a whole. For each relevant market, the Commission will assess:

- the probable nature and extent of competition that would exist in a significant section of the market, but for the acquisition (the counterfactual);
- the nature and extent of the contemplated lessening; and
- whether the contemplated lessening is substantial.[7]

91. In interpreting the phrase "substantially lessening competition", the Commission will take into account the explanatory memorandum to the Commerce Amendment Bill (No 2). The memorandum notes that:

> Two of the 3 key prohibitions are strengthened to bring New Zealand into line with Australian competition law, which will facilitate a more economic approach to defining anti-competitive behaviour.

and, in relation to s47:

> This proposed new threshold is the same as the threshold for these types of acquisitions in section 50 of the Trade Practices Act 1974 (Australia).

92. For the purposes of the analysis, the Commission takes the view that a lessening of competition and a strengthening of market power may be taken as being equivalent, since they are the two sides of the same coin. Hence, it uses the two terms interchangeably. Thus, in considering whether the acquisition would have, or would be likely to have, the effect of substantially lessening competition in a market, the Commission will take account of the scope for the exercise of market power, either unilaterally or through co-ordination between firms.

93. When the impact of enhanced market power is expected predominantly to be upon price, the anticipated price increase relative to what would otherwise have occurred in the market has to be both material, and able to be sustained for a period of at least two years, for the lessening, or likely lessening, of competition to be regarded as substantial. Similarly, when the impact of increased market power is felt in terms of the non-price dimensions of competition, these also have to be both material and able to be sustainable for at least two years for there to be a substantial lessening, or likely substantial lessening, of competition.

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[6] For a discussion of the definition see *Commerce Commission v Port Nelson Ltd*, supra n 6, 434.

[7] See *Dandy*, supra n 5, pp 43–887 to 43-888 and adopted in New Zealand: *ARA v Mutual Rental Cars* [ ] 2 NZLR 647; *Tru Tone Ltd v Festival Records Retail Marketing Ltd* [ ] 2 NZLR 352; *Fisher & Paykel Ltd v Commerce Commission* [ ] 2 NZLR 731; *Commerce Commission v Carter Holt Harvey*, unreported, High Court, Auckland, CL 27/95, 18/4/00.

The Counterfactual

94. The Commission will continue to use a forward-looking, counterfactual, type of analysis in its assessment of business acquisitions, in which two future scenarios are postulated: that with the acquisition in question, and that in the absence of the acquisition (the counterfactual). The impact of the acquisition on competition can then be viewed as the difference between those two scenarios. It should be noted that the status quo cannot necessarily be assumed to continue in the absence of the acquisition, although that may often be the case. For example, in some instances a clearly developing trend may be evident in the market, in which case the appropriate counterfactual may be based on an extrapolation of that trend.

95. In the present case, PMI and CGU both operate branch operations in New Zealand from corporate offices based in Australia. The merger in question is thus an Australasian merger, and is subject to the controls (and the uncertainty as to outcome) on business acquisitions in both countries. A further consideration is that CGU [ ].

96. If the acquisition by PMI were not to proceed, then it may be that [ ]

97. The present state of competition in a market can be referred to in order to illuminate the future state of the market where there is a range of possible scenarios should a merger not proceed.[8] The Commission considers that the status quo is the most appropriate approximation for the counterfactual given the following considerations: (a) the uncertainty of what changes, if any, there will be in the market in the absence of the proposed merger proceeding, and (b) the fact that the market is currently characterised by effective competition from existing participants. The Commission therefore proposes to use the status quo as the counterfactual.

Potential Sources of Market Power

98. Two types of market situation conducive to the exercise of substantial unilateral market power are now considered. These involve making the distinction between undifferentiated and differentiated product markets. That distinction may also have a bearing on the scope for co-ordinated behaviour in a market.

99. In undifferentiated product markets, where buyers make their purchases largely on the basis of price, and the production capacities of firms are an important element in competition, a business acquisition may have the potential to substantially lessen competition when the combined entity has acquired a market share below that required for dominance. This is especially likely in circumstances where the rivals of the combined entity cannot easily expand production to offset its output contraction within a

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[8] *Stirling Harbour Services Pty Ltd v Bunbury Port Authority* (2000) ATPR 41 at paras 113 & 114.

one year time frame.[9] The inability of rivals to expand may result either from their facing binding capacity constraints, or because additional capacity is significantly more expensive to operate.

100. In differentiated products markets, where the product offerings of different firms vary, and in which buyers make their purchase decisions on the basis of product characteristics as well as of price, the products of firms are by definition not perfect substitutes for each other. The substitutability between products will vary depending upon differences in their various characteristics, which may include their physical specifications, brand image, associated services and location of sale. In simple terms, differentiated products can be thought of as being arranged in a "chain of substitutes", where those in adjacent positions in the chain tend to be close substitutes, and those positioned further apart are less close substitutes.

101. The supply-side characteristics of differentiated products markets are important, as the potential market power of the combined entity may be offset by the actions of rivals. However, rivals may not be able to offer a competitive constraint where they are unable either to re-position their products closer to that of the combined entity to replace the lost localised competition, or to strengthen the promotion of existing products. A further possible constraint would be lost if it were not possible for new products to be added through new entry.

102. In the context of the LMI market as defined, where both price and product quality are taken into account by customers in choosing between LMI suppliers, the product is differentiated to a degree, and this has to be incorporated into the market analysis. However, the Commission considers that the product is not so differentiated as either to cast doubt on there being a single, well-defined, market for LMI, or to require the special analysis associated with fully differentiated product markets.

Conclusion – Competition Analysis Principles

103. The Act prohibits business acquisitions that would be likely to have the effect of substantially lessening competition in a market. The Commission makes this assessment against a counterfactual of what it considers would be likely to happen in the absence of the acquisition. In the present case the counterfactual is considered to be the status quo. A substantial lessening of competition is taken to be equivalent to a substantial increase in market power. A business acquisition can lead to an increase in market power by providing scope either for the combined entity to exercise such power unilaterally, or for the firms remaining in the market to co-ordinate their behaviour so as to exercise such power.

104. In broad terms, a substantial lessening of competition cannot arise from a business acquisition where there are sufficient competitive constraints upon the combined entity. The balance of this Decision considers and evaluates the constraints that might apply in the LMI market under the following headings:

- existing competition;
- potential competition from entry; and

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[9] See, for example, Roger D Blair and Amanda K Esquibel, "The Roles of Areeda, Turner and Economic Theory in Measuring Monopoly Power" (1996) *Antitrust Bulletin*, 781, especially pp 791-95.

- other competition factors.

ANALYSIS OF EXISTING COMPETITION

Introduction

105. One consequence of a merger between competitors is that the number of firms competing in a market is reduced or, put another way, concentration is increased. This raises the possibility that competition in the market may be substantially lessened through the exercise of unilateral or coordinated market power. These are the subject of the analysis in this section.

Scope for Unilateral Market Power

Introduction

106. An examination of concentration in a market post-acquisition can provide a useful guide to the constraints that market participants may place upon each other, including the combined entity. Both structural and behavioural factors have to be considered. However, concentration is only one of a number of factors to be considered in the assessment of competition in a market. Those other factors are considered in later sections, as noted above.

107. Market shares can be measured in terms of revenues, volumes of goods sold, production capacities or inputs (such as labour or capital) used. All measures may yield similar results in some cases. Where they do not, the Commission may, for the purposes of its assessment, adopt the measure which yields the highest level of market share for the combined entity. The Commission considers that this will lead to an appropriately conservative assessment of concentration, and that the factors which lead to the other different market share results are more appropriately considered elsewhere during the assessment of the acquisition.[10]

108. In determining market shares, the Commission will take into account the existing participants (including 'near entrants'), inter-firm relationships, and the level of imports. This is followed by a specification of the Commission's 'safe harbours', an estimation of market shares, and an evaluation of existing competition in the market. Each of these aspects is now considered in turn.

Existing Participants

109. The existing suppliers in the defined LMI market are four: PMI, CGU, RSA and GEMICO.

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[10] For example, where market share measured in terms of capacity produces a significantly lower share of the market in the hands of participants than a measure in terms of sales volumes, the constraint on a combined entity from that unemployed capacity might be taken into account when identifying near entrants or the constraint from new market entry. In some cases, the model of market power being used may influence the choice as to which market share measure is used.

110. The Commission considers that, along with existing suppliers in the market, the supply-side criterion requires that other businesses that can, and would, quickly enter the market in response to an attempt by existing suppliers to raise prices or reduce output or quality should be included in the consideration of market participants.

111. These firms, called 'near entrants', must already possess the facilities and/or knowledge required to produce the products sold in the relevant market. Entry by such companies must result either from redeployment of existing capacity, or expansion involving minimal sunk costs, and a delay of no more than one year.[11] The Commission will consider the extent to which near entrants could modify their production or distribution arrangements to supply the product in question, even though they do not do so at the time. For this reason, such firms are generally credited with a zero market share.

112. The Applicant contends that the self-insuring banks (the ASB and National Bank)—which it calls mortgage "lender" LMI suppliers—should be included amongst the suppliers in the market (paras. 7.1, 22.12). The reasons variously given are as follows:

- self-insurance is the equivalent of LMI and is readily substitutable for it;
- any customer of an LMI supplier who is dissatisfied by the premium rates or service can easily self-insure;
- for loans involving an LVR of above the industry benchmark 80%, the mortgage lender has to consider whether to use LMI or to self-insure, whereas for loans below 80% LVR all lenders in a sense self-insure (unless securitisation is used), implying that all lenders self-insure to some degree;
- [ ]
- a lender supplier is regarded as being as significant a rival as a non-lender supplier like PMI, especially in New Zealand because of the substantial proportion of residential mortgages that are subject to self-insurance;
- the absence of prudential rules requiring the use of LMI, and the relative lack of securitisation (which necessitates use of LMI), in New Zealand; and
- the fact that lender suppliers retain the premiums paid is financially attractive.

113. However, although self-insurers are seeking to protect themselves against exposure to risk, as do those using LMI, the two mechanisms are inherently different. In the first case the risk is carried internally, whereas in the latter it is laid off. In addition, the LMI suppliers protect themselves through reinsurance, whereas the self-insurers do not. For these reasons, self-insurance could be seen as a riskier option, although that could at least partially be off-set by the use of more conservative mortgage lending criteria. [ ].

[11] The Commission considers that if a firm is to be taken into account as a near entrant, one of its characteristics should be the ability to redeploy or expand within this period.

114. It is true that the self-insurers, being large banks, reduce the LMI market available to the non-lender suppliers. Moreover, they can indirectly influence that market by the aggressiveness with which they pursue new business in the residential mortgage lending market. For example, the NBNZ claimed that it had been particularly competitive over the last year, and in the last month had [

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115. Nonetheless, the self-insurers are not competitors in the normal sense of that word, in that they do not compete for business externally. [
] It would appear that they regard self-insurance as an internal risk-management tool, linked to their mortgage lending criteria, and not a mechanism that could readily be adapted for handling business generated externally. In addition, other banks, which might be potential customers, have in the main expressed reservations about the possibility of their using another bank as an LMI supplier, given the sensitivity of the information (e.g., customer lists and details) to which it would have access. Their responses mainly ranged from "out of the question" to "confidentiality would have to be assured by the use of an arm's length company".

116. Taking all of these factors into consideration, the Commission has come to the conclusion that the self-insuring banks cannot be seen as competitors to the LMI suppliers. Rather, they should be considered to represent a source of countervailing power on the buyers side of the market. They could, if they wished, use their ability to self-insure as a lever to negotiate a good deal with an LMI supplier. Similarly, self-insurance remains an option for lender buyers in their negotiations with LMI suppliers. Their ability to 'opt out' of the market could be used as a means of securing improved terms. This issue is discussed further below in the analysis on countervailing power in "Other Competition Factors".

Inter-firm Relationships

117. Companies that are part of the same corporate grouping, or that have similar strong relationships, cannot be relied upon to provide an effective competitive constraint to one another. Other less formal relationships between companies may also give rise to limitations on the extent of rivalry between them. Relationships between persons in the relevant market and other businesses may also affect rivalry in a market.

118. The four existing suppliers listed above are New Zealand branches of Australian incorporated companies. The Commission understands that there are no formal or other relationships between these companies that might prejudice their competitive behaviour.

Imports

119. In markets where imports are present, the Commission will consider whether actual competition from imported products is the equivalent to that from domestic supply. In undertaking this evaluation, the Commission will take into account the existence of any limits on quantities of imported product (the price elasticity of supply), and the effects on trade of various factors. Imports channelled through the parties to an acquisition, or persons associated with them, will be added to their domestic production in assessing market share, rather than being treated as independent sources of supply.

120. Potential imports may also provide a constraint on domestic suppliers. This is considered as part of the assessment of the constraint from market entry below.

121. The Applicant has stated (p. 14) that "(i)mports, in the technical sense, are not relevant to the LMI market." However, it did note the potential to use an overseas "captive" as a form of self-insurance, and attach significance to the role of the overseas parents of the New Zealand-based operations.

122. The existing LMI suppliers operate in New Zealand as branches of their Australian operations. Hence, they cannot be said to be fully 'self-contained' operations. For example, their credit ratings depend in part upon that of their Australian parents, and they may reinsure overseas. To that extent, the service they provide is buttressed substantially by what might be regarded as imported components. However, as already noted, relationships and service are considered to be important, and those are supplied within the country.

123. From the perspective of the customers, imports are not a relevant consideration.

Safe Harbours

124. Once the relevant market has been defined, the participants have been identified, and their market shares estimated, the Commission's 'safe harbours' can be applied. Under these safe harbours, a business acquisition is considered unlikely to substantially lessen competition in a market where, after the proposed acquisition, either of the following situations exist:

- where the three-firm concentration ratio (with individual firms' market shares including any interconnected or associated persons) in the relevant market is below 70%, the combined entity (including any interconnected or associated persons) has less than in the order of a 40% share; or

- where the three-firm concentration ratio (with individual firms' market shares including any interconnected or associated persons) in the relevant market is above 70%, the market share of the combined entity is less than in the order of 20%.

125. As noted below, market shares by themselves are insufficient to establish whether competition in a market has been lessened. Other relevant issues are discussed in later sections.

Market Shares

126. The service that a mortgage lender buys is protection against exposure to risk. Hence a measure of insurance output often used is premium income. However, with LMI the premium (the so-called "gross premium") is a single, initial payment whose coverage equals the term of the mortgage insured. This means that the single dollar amount is a measure of the risk protection over a period of time into the future. In recognition of this, premium income is brought into an LMI provider's accounts incrementally (as "earned premium") following a bell-curve-like distribution over a period of eight to ten years so as to reflect the actuarial risk exposure for each of those years. The bulk of this risk falls in years two to four, and hence the bulk of the premium is accounted for in those years. Beyond eight to ten years the risk (in terms of having to meet claims for payments) is

slight, as mortgage repayments by the borrower and house price inflation will typically have reduced the LVR.

127. The earned premiums of an LMI company in any one year will therefore include elements from premiums paid on insurance written over a number of previous years. With a steady flow of business over the years, the bulk of the earned income in any year will accrue from premiums paid two to four years previously. Although this measure of premium income would reflect the risk actually borne by the LMI supplier in the year in question, and hence in some way reflect their output appropriately, it is argued that it will distort size comparisons between companies. Those that have been in the market for a long time will appear larger than those that have entered more recently, even if both are writing the same volumes of new insurance. On the other hand, because of the economies of scale inherent in the provision of LMI (see below), arguably measuring company market shares on the basis of earned premiums provides a better way to assess their ability to compete on a cost basis.

128. However, in terms of assessing existing competition using market shares as a proxy, the better measure is probably provided by gross premiums. This is the approach favoured by the Applicant. This indicates the success of existing participants in competing for new business. It is important to note that since existing LMI policies generally do not change hands, even when a customer switches to another supplier, market shares based on earned premiums provide little indication of the current competitiveness of suppliers. This is reflected in the fact that securitisers that have recently entered the market, and that use panels of suppliers which then compete for their business, can generate a distribution of market shares that differs quite markedly from 'historic' shares, albeit on a relatively small volume of business. For example, [ ]

129. On the basis of the preceding discussion, the Commission proposes to use gross premium in the most recent year as its primary measure of market share and concentration, and earned premium as a supplementary measure to indicate historic share and overall size. The resulting shares are shown in Table 1.

TABLE 1
Market Shares in the LMI Market for 2000 Financial Year

Company	Gross Premiums		Earned Premiums	
	NZ$ 1,000	Market share	NZ$	Market share
PMI	[ ]	[ ]	[ ]	[ ]
CGU	[ ]	[ ]	[ ]	[ ]
Sub-total: merged entity	[ ]	[ ]	[ ]	[ ]
GEMICO	[ ]	[ ]	[ ][12]	[ ]
RSA	[ ]	[ ]	[ ]	[ ]
Total	[ ]	100%	[ ]	100%

130. The data in Table 1 show that the market is highly concentrated. The three-firm concentration ratio is [ ] currently, and would increase to [ ] post-acquisition. The merged entity would have a market share of [ ] These percentages fall well outside the Commission's safe harbours given above.

131. As already noted, market shares are insufficient in themselves to establish whether competition in a market has been lessened. It is the interplay between a number of competition factors, of which seller concentration is only one, that has to be assessed in determining the impact of a business acquisition on competition. Other competition factors include entry conditions; the presence of an aggressive, innovative or maverick firm; countervailing power of buyers or suppliers; rapid innovation in the market; and others. These are considered for the relevant market in subsequent sections.

State of Existing Competition

132. As just indicated, the combined entity would have a [ ] market share, and face two competitors with market shares of only [ ] (GEMICO) and [ ] (RSA). However, the Applicant has argued (para. 22.4) that the "size of an LMI supplier's market share does not influence or determine the competitive constraints it will impose on other market participants", providing that it has the necessary attributes to compete in the market. As it considers that both GEMICO and RSA have all of those attributes, and are proportionately and absolutely much larger in the Australian market, the Applicant views them as vigorous competitors despite their small market shares in the New Zealand market.

133. Apart from the number of competitors being few, the limited evidence appears to suggest that market shares have been relatively static, in the period since the early 1990s following the development of the LMI market in the private sector with the entry of three

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[12] [

]

of the four present participants (or their forerunners). Certainly, there has been little switching of the major bank customers between LMI suppliers, except where bank mergers have taken place. For example, the Countrywide Bank used LMI cover until it was taken over by the National Bank, which uses self-insurance.

134. The banks have historically formed long-term relationships with their LMI suppliers, usually through a single supplier arrangement that is unique to New Zealand. This relationship appears to reflect a variety of factors: a satisfaction with the prices and services provided by incumbent suppliers, which presumably reflects the present competitive state of the market; the potential difficulties that would arise if a panel of suppliers were used, and they quoted different premium rates; and the costs (including those arising from the disruption to normal business and to relationships) of switching. [ ] Hence, it is perhaps not surprising that CGU and others have commented that the market is generally a very profitable one, (although CGU is [ ]). On the other hand, the loose contractual arrangements between supplier and customer do not restrict a bank from switching new business overnight to a different supplier if it chose to do so.

135. It is easier for entrants to win market share from securitisers, as these typically like to use a panel of suppliers. However, as securitisation remains a small part of the market in New Zealand, and the large suppliers are also active in the area, there is no scope at present for accumulating a significant share. For example, GEMICO entered the market nearly two years ago on a de novo basis, and has so far managed to gain business only from securitisers, [ ].

136. GEMICO has [ ]

137. Market inquiries by the Commission suggest that RSA [ ]

138. There are a number of changes in prospect for competition in the LMI market. First, the trend in Australia for the major banks to include LMI supply in their periodic tender rounds for externally provided services could appear here (these tenders have not so far extended to their New Zealand operations). Whether this actually leads to banks switching between suppliers, or simply is a mechanism for getting the best out of existing relationships is unclear, although the effect may be the same.

139. Secondly, the Commission has found two instances where the traditionally rather static market shares may be about to change:

- [

  ]. This change was initiated in 2000, and was not connected with the present merger; and

- [

  ]

This information suggests that [

]

140. In addition, the Applicant claimed (pp. 20-21) that existing competition will be promoted by the merger itself which, through a "cannibalisation effect", will cause the merged entity to lose market share and the independents to gain. It claims that the negotiated purchase price which PMI has offered CGU assumes [
] This suggests that the pre-merger market shares are not a good guide to the post-merger shares, as was implicitly assumed in Table 1.

141. There appears to be some substance to this argument. Although the [
], the Applicant quoted the case of the merger to form Radian in the United States. That merger of LMI suppliers, it is claimed, has lost 35% of its combined market share to competitors since it announced the merger in 1999, and 26% since it completed its merger.

142. In the New Zealand context, where the three large banks that do not self-insure constitute a substantial part of the market, a switch by one of them would lead to a substantial change in market shares. Alternatively, a switch to using a second supplier would have a more gradual, but still significant, impact on market shares. The merger would have the effect of eliminating the CGU brand from the market. Consequently, CGU customers at least would be forced to consider whether they wished to switch to PMI, or to some other supplier.

143. [

]

144. AMP, [

]. Westpac, [
].

145. In short, banks in general expressed a desire to have a choice of supplier, in order to be able to trade off one against the other "to keep them honest". In addition, some felt that there was a risk that if all insured with the same PMI supplier, their competitors could indirectly get information about their mortgage portfolio and operations.

146. As already noted, securitisers operate by using panels of LMI providers, so that the merger of PMI and CGU would likely cause them to make more use of GEMICO and / or RSA. However, this would have only a small impact on market shares as securitisers generate a small amount of business currently.

Conclusions – Unilateral Market Power

147. The immediate effect of the merger would be that the combined entity would have a large share of the market, at least on the basis of pre-merger market shares. However, it is likely that the disappearance of a major supplier from the market, and the desire of customers to retain a choice between alternative suppliers, will see GEMICO and RSA gain market share at the expense of the merged entity. [ ].

Several industry participants, including major customers, stated that the proposed acquisition will provide opportunities for them to obtain significant new business. A further potential option is self-insurance.

148. Any increase in the size of the two independents would increase the competitive constraint they impose upon the combined entity by existing competition, making it more difficult for it to exercise unilateral market power.

Scope for the Exercise of Coordinated Market Power

Introduction

149. A business acquisition may lead to a change in market circumstances such that coordination between the remaining firms either is made more likely, or the effectiveness of pre-acquisition coordination is enhanced. Firms that would otherwise compete may attempt to coordinate their behaviour in order to exercise market power by restricting their joint output and raising price. In extreme cases, where all firms in the market are involved and coordination is particularly effective, they may be able to behave like a collective monopolist. Where not all firms are involved, and market share in the hands of the collaborators is reduced, coordinated market power becomes more difficult to exercise because of competition from the independent firms in the market.

150. In broad terms, successful coordination can be thought of as requiring two ingredients: ‘collusion’ and ‘discipline’. ‘Collusion’ involves the firms individually coming to a mutually profitable expectation or agreement over coordination; ‘discipline’ requires that firms that would deviate from the understanding are detected and punished (thereby eliminating the short-term profit to be gained by the firm from deviating).

151. When assessing the scope for coordination in the market during the consideration of a business acquisition, the Commission will evaluate the likely post-acquisition structural and behavioural characteristics of the relevant market or markets to test whether the potential for coordination would be materially enhanced by the acquisition. The intention is to assess the likelihood of certain types of behaviour occurring, and whether these would be likely to lead to a substantial lessening of competition.

Collusion

152. "Collusion" involves firms in a market individually coming to a mutually profitable expectation or agreement over coordination. Both explicit and tacit forms of such behaviour between firms are included.

153. The structural and behavioural factors that are usually considered to be conducive to collusion are set out in the left-hand column in Table 2. The significance of these is explained more fully in the Commission's *Practice Note 4*. The right-hand column of the Table then assesses the extent to which those factors are present, or are likely to be enhanced post-merger, in the LMI market. A high proportion of 'yes' responses would suggest that the market was particularly favourable to 'collusion'; a high proportion of 'no' responses the reverse.

TABLE 2
Testing the Potential for 'Collusion' in the LMI Market

Factors conducive to collusion	**Presence of factors in the market**
High seller concentration	Yes - seller concentration is high
Undifferentiated product	Uncertain - product slightly differentiated
New entry slow	Uncertain - entry swift, but unlikely to occur (see below)
Lack of fringe competitors	No - GEMICO and RSA significant competitors
Price inelastic demand curve	Uncertain
Industry's poor competition record	No – no problems apparent
Presence of excess capacity	Not relevant in this industry
Presence of industry associations/fora	Yes - industry association in Australia

154. The assessment of the relevant structural and behavioural conditions in the LMI market in Table 2 suggests that the market is not particularly likely to be susceptible to collusion, even after the acquisition. Although the seller concentration is high, and the share of the largest firm would increase substantially post-merger, the considerable disparities in the sizes of the firms would count against collusion. Collusion often tends to have the affect of stabilising market shares, but that would be unlikely to be acceptable to the two small firms in the market.

155. The Applicant also stated that the industry meetings involving non-lender LMI companies in Australia only concern industry regulation issues, and do not enhance the possibility of co-ordination between the participants.

Discipline

156. For coordination to be successful, deviations of individual firms from the collusive behaviour have to be discouraged by being detected swiftly and punished by the other firms.

157. The structural and behavioural factors that are usually considered to be conducive to 'discipline' in co-ordinated markets are set out in the left-hand column in Table 3. Again, the significance of these is explained more fully in the Commission's *Practice Note 4*. The right-hand column of the Table then assesses the extent to which those factors are present, or are likely to be enhanced post-merger, in the LMI market. A high proportion of 'yes' responses would suggest that the market was particularly favourable to 'discipline; a high proportion of 'no' responses the reverse.

TABLE 3
Testing the Potential for "Discipline" in the LMI Market

Factors conducive to discipline	Presence of factors in the market
High seller concentration	Yes - seller concentration is high
Sales small and frequent	No – sales usually 'lumpy'
Absence of vertical integration	No – no vertical integration
Demand slow growing	Uncertain - demand growth probably variable over time.
Firms have similar costs	No – costs probably vary because of scale economies
Price transparency	Probably no

158. The assessment of the relevant structural and behavioural conditions in the LMI market in Table 3 suggests that the market is not one where discipline could readily be maintained, should a collusive understanding or arrangement be attained. Although the high degree of seller concentration post-merger indicates that the number of firms to be monitored would be small, all other factors appear to be unfavourable. The lumpiness of sales, variations in firms' costs, and the lack of price transparency would all make monitoring difficult.

Conclusions – Co-ordinated Market Power

159. The preceding analysis suggests that the increase in seller concentration that would result from the proposed acquisition in the LMI market is unlikely significantly to increase the likelihood of co-ordinated market power. An overview of the relevant structural and behavioural factors suggests that the remaining firms would be unlikely to be able to reach a collusive arrangement or understanding, and even if they were able to do so, they would be unlikely to maintain the internal discipline that would be needed to keep the understanding intact. Moreover, a further discouraging factor not so far mentioned is that explicit forms of collusion are illegal under sections 27 and 30 of the Act.

Conclusions – Existing Competition

160. The Commission considers that the scope for the exercise of co-ordinated market power would not be enhanced by the acquisition.

161. The position with unilateral power is less clear-cut. On balance, the Commission considers that independent competitors will exercise some constraint on the merged entity. However, in the absence of any further constraint from other sources, the Commission does not believe it would be sufficient to prevent a substantial lessening of competition. Further constraints are considered below.

CONSTRAINTS FROM MARKET ENTRY

Introduction

162. A business acquisition is unlikely to result in a substantial lessening of competition in a market if behaviour in that market continues to be subject to real constraints from the threat of market entry.

163. Where barriers to entry are clearly low, it will not be necessary for the Commission to identify specific firms that might enter the market. In other cases, the Commission will seek to identify likely new entrants into the market.

164. The Commission will consider the history of past market entry as an indicator of the likelihood of future entry. The Commission is also mindful that entry often occurs on a relatively small scale, at least initially, and as such may not pose much of a competitive constraint on incumbents within the relevant time frame.

Barriers to Entry

165. The likely effectiveness of the threat of new entry in constraining the conduct of market participants, following a business acquisition that might otherwise lead to a substantial lessening of competition in a market, is determined by the nature and height of barriers to entry into that market.

166. The Commission considers that, for the purpose of considering this issue, a barrier to entry is best defined as an additional or significantly increased cost or other disadvantage that a new entrant must bear as a condition of entry. In evaluating the barriers to entry into a market, the Commission will generally consider the broader 'entry conditions' that apply, and then go on to evaluate which of those constitute entry barriers.

167. It is the overall obstacle to entry posed by the aggregation of the various barriers that is relevant in determining whether entry is relatively easy or not, and therefore whether or not potential entry would prevent a substantial lessening of competition.

168. Industry participants spoken to advised that in order to enter the LMI market a company must have the following:

- a very high credit rating with a reputable rating agency, which in turn implies a high capital backing, financial skills and reputation;
- an outlay of about [ ] for consultants, premises, staff, and infrastructure;
- a further $500,000 as a security deposit required by the regulations; and
- a presence in New Zealand to provided the required level of service..

169. All participants agreed that these requirements are not particularly onerous, although some of the entry costs are likely to be sunk, and therefore to constitute an entry barrier. A more significant barrier is the difficulty of obtaining sufficient market share on entry to make entry profitable. Given the small size of the securitisation part of the business, a new entry would need to obtain a contract with a bank in order to gain the scale to be competitive with the merged entity. By way of example, a one per cent market share equates with a 2000 gross premium income of roughly $[ ]. This shows that with a low share drawn from the securitisation area only, because of an inability to win bank custom, it would take an entrant some years to recover its entry costs (after deducting annual expenses).

170. The Applicant has indicated that there are scale economies in the provision of LMI, and that a major motive for the proposed acquisition is to gain further such efficiencies. CGU stated that the economies derive from two sources: the insurance benefit from the claims risk being proportionately smaller with a larger pool, all else being the same; and from expenses, of which the two main categories are people and systems. Once the basic infrastructure is established, expenses (e.g., staff expenses) tend to increase less than proportionately with the scale of the business. In addition, automated systems are becoming more sophisticated and expensive (e.g., for automated underwriting), so that the costs can be more easily borne by a larger company. That said, CGU noted that GEMICO had already incurred the major system development costs in Australia, and these would not need to be duplicated for its New Zealand operation.

171. GEMICO pointed out that because of the initial set-up costs, and the delays before premiums are accounted for as earned premium, [ ]

172. RSA advised that when it entered New Zealand in the early 1990s, [ ] However, [ ]

173. For entry to act as an antidote to a substantial lessening of competition stemming from a business acquisition, it must constrain the behaviour of the combined entity and others in the market.

The "LET" Test

174. In order for the threat of market entry to be such a constraint on the exercise of market power as to alleviate concerns that a business acquisition could lead to a substantial lessening of competition, entry of new participants in response to the exercise of market power must be likely, sufficient in extent and timely (the *let* test). If they are to act as a

constraint on market participants following a business acquisition which might otherwise lead to a substantial lessening of competition in a market, entry must be relatively easy, or to put it another way, barriers to entry must be relatively low.

Likelihood of Entry

175. The mere possibility of entry is, in the Commission's view, an insufficient constraint on the exercise of market power to alleviate concerns about a substantial lessening of competition. In order to be a constraint on market participants, entry must be likely in commercial terms. An economically rational firm will be unlikely to enter a market unless it has a reasonable prospect of achieving a satisfactory return on its investment, including allowance for any risks involved.

176. In general, it is the pre-merger price that is relevant for judging whether entry is likely to be profitable. That in turn depends upon the reaction of incumbents to entry in terms of their production volume, together with the output volume needed by the entrant in order to lower its unit costs to the point where it can be competitive.

177. The applicant, in the application, claimed that there are a number of potential new entrants to the LMI market, including overseas companies.

178. Industry participants advise that, because the LMI market is so small, the only possibility of entry into the New Zealand market would be through Australia. As all existing Australian LMIs already have a presence in New Zealand, a new entrant would have first to enter Australia. There have been no new entrants into Australia for 12 years, and CGU stated that whether there is room for another LMI in Australia will depend on expansion in the market over the next few years.

179. The Applicant, when interviewed, stated that competition from expansion by existing LMIs is more likely than from a new entrant. It stated that entry into Australia, and from there into New Zealand, would most likely be done by the acquisition of an existing provider such as RSA, if it were to exit the market. There is no evidence of any intention by RSA or GEMICO to exit the LMI market in the relevant future period.

180. It appears, therefore, that there is no more than a mere possibility of a new entrant in the LMI market.

Extent of Entry

181. If entry is to constrain market participants, then the threat of entry must be at a level and spread of sales that is likely to cause market participants to react in a significant manner. The Commission will not consider entry that might occur only at relatively low volumes, or in localised areas, to represent a sufficient constraint to alleviate concerns about market power.

182. Small-scale entry into a market, where the entrant supplies one significant customer, or a particular product or geographic niche, may not be difficult to accomplish. However, further expansion from that "toe-hold" position may be difficult because of the presence of mobility barriers, which may hinder firm's efforts to expand from one part of the market to another. Where mobility barriers are present in a market, they may reduce the 'extent' of entry.

183. Both companies that have entered the LMI market over the last ten years, RSA and GEMICO, have [ ] Neither company has [ ]. It seems likely that another entrant would face the same difficulties as have been experienced by RSA and GEMICO, in what would become an increasingly over-supplied market.

184. Because of the presence of the merged entity, and GEMICO and RSA, it would be very difficult for a new entrant to enter at a level that would cause the incumbent market participants to react in a significant manner.

Timeliness of Entry

185. If it is effectively to constrain the exercise of market power to the extent necessary to alleviate concerns about a substantial lessening of competition, entry must be likely to occur before customers in the relevant market are detrimentally affected to a significant extent. Entry that constrains must be feasible within a reasonably short timeframe from the point at which market power is first exercised.

186. In some markets where goods and services are supplied and purchased on a long-term contractual basis, buyers may not immediately be exposed to the detrimental effects stemming from a potential substantial lessening of competition. In such cases, the competition analysis, in a timing sense, begins with the point at which those contracts come up for renewal.

187. The Commission considers that, for most markets, entry which cannot be achieved and have a significant effect within two years from initial planning is unlikely to be sufficiently timely to alleviate concerns about market power.

188. There is no evidence of any company being likely to enter the LMI market on a scale that would constrain the merged entity within the next two years. However, it would appear that entry could be timely if it were to be attempted.

Conclusion on Barriers to Entry

189. The Commission concludes that the barriers to entry are sufficiently high to prevent the possibility of the merged entity facing effective competition from new entrants.

OTHER COMPETITION FACTORS

Elimination of a Vigorous and Effective Competitor

190. Sometimes an industry contains a firm that is in some way non-typical, or has different characteristics, or is an innovator, or is regarded as a maverick. The independent or less predictable behaviour of such a firm may be an important source of competition in the market, and may undermine efforts by other firms to engage in coordination. Such a firm need not be large to have an impact on competition out of proportion to its relative market size. Should it become the target of a business acquisition, the resulting elimination of a vigorous and effective competitor could have the effect of substantially lessening

competition in the market (especially if there are barriers preventing the entry of new, effective competitors).

191. The proposed acquisition would not have the effect of eliminating a vigorous and effective competitor as defined above. CGU is a competitor, but no more so than other participants in the market.

Constraint from Buyers or Suppliers

192. The potential for a firm to wield market power may be constrained by countervailing power in the hands of its customers, or alternatively, when considering buyer (oligopsony or monopsony) market power, its suppliers. In some circumstances, it is possible that this constraint may be sufficient to eliminate concerns that a business acquisition may lead to a substantial lessening of competition.

193. Where a combined entity would face a purchaser or supplier with a substantial degree of market power in a market affected by the acquisition, the Commission will consider whether that situation is such as to constrain market participants to such an extent that competition is not substantially lessened.

194. The Applicant submitted that if the customers of the merged entity were unhappy with the services offered them by the merged entity they would have a number of options available to them, as follows:

- self-insurance;
- switch to another LMI supplier; or
- utilise alternative credit enhancement options.

195. Given the availability of these options, an examination of market shares on the buyers side of the LMI market suggests that countervailing power is likely. The three largest customers for LMI are [ ] Their ability to switch must impose a considerable leverage upon their LMI suppliers, for whom the loss of a major bank customer would cause a substantial reduction in market share – [ ]%.

196. Westpac stated that it believes that the larger LMI customers would have considerable countervailing power against the merged entity. It advised that [ ]

197. BNZ advised that if the acquisition were to proceed [ ]

198. ANZ advised that [ ], and that this was not a reaction to the merger.

199. The mortgage managers use a panel of insurers to increase their options. Sovereign explained that some insurers are not interested, for example, in exposures over $500,000. AMS [

]

200. AMP stated that [ ] Sovereign [

]

201. Industry participants advised that there are no formal written contracts between LMI providers and their clients and that it is relatively easy for an acquirer to switch LMI provider. They stated that switching would involve relatively minor matters such as changing processes and documentation, and training of staff, and would not involve significant expense.

202. It is the Commission's view that the acquirers of LMI have a high degree of countervailing power, and that this would constrain the merged entity.

Efficiencies

203. The Commission recognises that there may be circumstances where efficiencies are relevant to an application for clearance.[13] In the context of a business acquisition, the combined entity might be able to make efficiency gains that are not obtainable by other means, such that its unit cost of production would decline. This could result in the entity reducing its price below that obtaining prior to the acquisition, even though with the acquisition it would otherwise be considered to have substantially lessened competition, and would be able to raise price above costs.

204. Where the applicant can make a sound and credible case that such efficiencies will be realised, that they cannot be realised without the acquisition, and that they will enhance competition in the relevant market, the Commission will include them in the broader analysis of all of the competitive effects of the acquisition in the course of assessing whether or not competition is likely to be substantially lessened. However, the Commission envisages that efficiency claims of the required magnitude and credibility will only very rarely overturn a finding that competition would otherwise be substantially lessened.

205. The applicant has not argued that efficiencies are relevant to this application for clearance. The Commission does not consider that it is necessary to form a view on efficiency gains in the context of this application.

[13] In *Fisher & Paykel*, considered under s 27, the Court held that in assessing "substantial lessening of competition", a net approach to assessing anti-competitive effects was required: "The majority correctly accepted that it had to 'net out' the pro and anti-competitive effects and that, if it could be shown that the net effect of the EDC was to promote competition, then there could be no substantial lessening of competition." *Fisher & Paykel v Commerce Commission* [ ] 2 NZLR 731 at 740. See also: *Commerce Commission v Port Nelson*, supra n 6,433; *Shell (Petroleum Mining) Company Ltd v Kapuni Gas Contracts Ltd*, (1997) 7 TCLR 463, 531.

OVERALL CONCLUSION

206. The Commission has considered the probable nature and extent of competition that would exist in the market for the wholesale supply of LMI to lenders of residential mortgages, but for the acquisition. The Commission considers that the appropriate benchmark for comparison is the status quo, in which the market is characterised by effective competition from existing participants.

207. The Commission has considered the nature and extent of the contemplated lessening. The proposed acquisition would result in the merged entity obtaining a market share which falls outside the Commission's safe harbour guidelines.

208. The Commission has also considered the nature and extent of the contemplated lessening, in terms of the competitive constraints that would exist following the merger from:

- existing competition;
- potential competition from entry; and
- other competition factors.

209. The Commission believes that new entry would not provide constraint on the merged entity, and that the constraint provided by existing competition would not in itself be sufficient to constrain the merged entity.

210. However, the Commission considers that the strong countervailing power of the purchasers of LMI, together with the potential for expansion by clearly identifiable market participants, would be sufficient to constrain the merged entity. The potential for such expansion has been clearly demonstrated by [ ] The Commission considers that such a constraint would, in comparison to the constraints provided in the current market by existing competitors, be sufficiently effective to ensure that any lessening of competition following the acquisition would not be substantial.

211. The Commission notes that none of the banks, or other lenders, have objected to the proposed acquisition. The Commission considers that this reflects the effectiveness of the constraints identified above.

212. The Commission is therefore satisfied that the proposed acquisition would not have, nor would be likely to have, the effect of substantially lessening competition in the market for the wholesale supply of LMI to lenders of residential mortgages.

213. This acquisition is likely to be unusual in that clearance has been granted despite the merged entity having a [ ] market share, and entry not being expected to offer a constraint. However, the buyers' side of the market is concentrated too, with the large banks being able to exert countervailing power through their ability to switch to alternative suppliers. While those suppliers are currently small, the countervailing power of buyers will enhance the opportunities for expansion. The Commission expects that they will have opportunities to expand their businesses significantly

following the merger, particularly when considering the strong position of their parent companies in the Australian market.

DETERMINATION ON NOTICE OF CLEARANCE

214. Accordingly, pursuant to section 66(3)(a) of the Commerce Act 1986, the Commission determines to give clearance for the proposed acquisition by PMI Mortgage Insurance Australia (Holdings) Pty Ltd or one of its interconnected bodies corporate of up to 100% of the shares or assets of CGU Lenders Mortgage Insurance Limited and/or any of its interconnected bodies corporate.

Dated this 30th day of July 2001

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MJ Belgrave
Chair