Market study into personal banking services

I'm not averse to an inquiry into retail banking services in New Zealand, and I'm relatively open-minded as to what issues might be explored as part of this process. From my studies of the New Zealand banking sector, I'm not sure what might be done to improve the banking sector's performance, but there is merit in exploring the possibilities.

I don't, therefore, have specific views on a number of the questions posed in the preliminary Issues paper: my concerns are mainly with the related issues of competition and efficiency, and the relationship between efficiency and financial performance.

With regard to coverage I am, perhaps, a little surprised at the omission of credit cards from the study, as this is one area in which there might be legitimate concerns as to unreasonable or unfair pricing.

There seems to be a lack of any criteria for definition of an optimal level of competition, or of an approach to measurement of competition. Initial cruder approaches to measurement have used the market share of the largest x firms or the Herfindahl-Hirschman Index (HHI). These provide measures of concentration, and show the New Zealand banking market as relatively concentrated, but they do not tell us anything about behaviour, and whether firms behave competitively (or promote innovation in a way that would be consistent with Schumpeter's dynamics, as in a contestable markets model). This led to adoption of the Bresnahan-Lau and Rosse-Panzar approaches, although the Rosse-Panzar approach has now been somewhat discredited intellectually. More recent work has been inclined to focus on the Lerner Index, but with some application of the Boone indicator, both of which give some indication of market power. At least up until around 2015, the New Zealand market showed more competitive behaviour than the Australian market, but things may have changed in the intervening period. Some updating of the relevant analysis would be desirable.

There is certainly a question as to whether the New Zealand banking market continues to be contestable, in terms of it being easy for new firms to enter the market and compete successfully against existing market participants. There is an argument that regulatory requirements impose something of a barrier, and they appear also to have impacted on optimal scale in the banking sector. Whereas, prior to the GFC, smaller banks (such as TSB Bank) were not necessarily disadvantaged in competition with larger ones, this is no longer necessarily the case.

Regulatory factors are also believed to be the reason for HSBC's withdrawal from the New Zealand retail banking market, where new regulations would have required it to incorporate a New Zealand subsidiary if it were to continue to offer retail banking services.

To properly understand the performance of the New Zealand banking sector, it is appropriate to use multivariate efficiency analysis, rather than relying on simple ratio measures as proposed in the preliminary issues paper. My expectations would be that use of these approaches, which allow for specific measurement of scale effects, would show that the smaller banks in the New Zealand market were significantly disadvantaged in competing against the larger (and more profitable) banks.

I note also that some of the comparisons of bank performance provided in Appendix C look at pre-tax returns. These maybe because these are the data that are available, but the owners of a business (such as a bank) are in fact more interested in post-tax returns, as that is what they actually receive. Rates of tax paid by New Zealand banks are standard, with no significant concessions available, which may not always be the case in other jurisdictions, and which may thus undermine comparisons between the returns shown for different countries.

A further comment in respect of Appendix C is the use of net interest margin as a net interest measure. I have long preferred to use interest spread, defined as the difference between the average rate on interest-bearing assets and the average rate on interest-bearing liabilities. It is unfortunate that the Reserve Bank dropped the requirement for banks to report interest-bearing liabilities on a quarterly basis when the implemented the dashboard, but it is still possible to track the spread for the banking sector as a whole (as per Reserve Bank data table S20). Interestingly, for the March and June quarters of 2023, this shows a significant reduction, compared to the previous elevated levels. This reflects a catch-up of banks' funding costs, which are inclined to lag changes in the general level of interest rates. In this particular case we have seen depositors switch from low interest rate at call deposit accounts to higher interest rate fixed term deposits.

It should be noted that New Zealand banks generally earn less in the way of non-interest income from fees, etc, than do banks in many other jurisdictions, and that their non-interest income performance has weakened significantly in recent years. This means that earning higher levels of net interest income (as reflected in their net interest margins and interest spread) is important for New Zealand banks.

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