Personal banking services market study

Draft report – Executive summary

21 March 2024

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Executive summary

Our draft report for the personal banking services market study sets out our preliminary findings on factors affecting competition, and draft recommendations to improve competition.

The draft report is the result of a detailed process of information gathering and engagement with a wide range of stakeholders, including providers of personal banking services, consumers and Māori. We thank all parties for the information they have provided and for their ongoing engagement in this study.

The major banks do not currently face strong competition

Our preliminary view is that New Zealand's four largest banks – ANZ, ASB, BNZ and Westpac (the major banks) – do not face strong competition when providing personal banking services.

The major banks and Kiwibank are the main providers of personal banking services, particularly for the products that we have focused on in the study (home loans and deposit accounts).[1] Between them, the major banks hold around 90% of the assets of all registered banks in New Zealand.

Competition between the major banks is sporadic rather than strong and sustained.

There is a stable oligopoly with no "maverick" provider

The four major banks have high and stable shares of supply for personal banking services, particularly for deposit accounts and home loans. There is a two-tier market, with the major banks in a stable oligopoly at the first tier, smaller providers in the second tier, and Kiwibank "stuck in the middle".

No new entrants have meaningfully increased competition faced by the major banks since the establishment of Kiwibank in 2001. None of the existing smaller providers, including smaller banks, non-bank deposit takers and financial technology companies (fintechs), have been able to exert any meaningful constraint on the major banks.

Kiwibank imposes some constraint on the major banks but currently lacks the capital backing to consistently drive stronger competition in the market.

There is currently no "maverick" – a particularly aggressive or innovative provider – that exerts disruptive competitive pressure on the major banks. Smaller providers lack the scale to compete with the major banks and tend to focus their effort on specific regions, products or consumer groups. The major banks typically do not closely monitor these providers, indicating that they are not regarded as a significant competitive threat.

Competition is sporadic, not sustained

Competition amongst the major banks and Kiwibank appears to be sporadic for deposit accounts and home loans. We have observed some periods of relatively intense competition, and other periods where some or all of the major banks pull back and put more focus on maintaining profit margins than seeking to gain market share.

1 We have focused on deposit accounts (transaction, savings, and term deposits) and home loans because they are focal points for competition in personal banking services and because they matter to many New Zealanders.

The major banks have broadly similar cost structures and can see and respond rapidly to each other's changes in interest rates and other credit settings. We have seen a willingness to match (rather than beat) each other's offers (for example, discretionary discounts for home loans) to maintain market share.

Established patterns of price matching behaviour reduce the incentives to compete hard on interest rates. Providers know that if they introduce a new promotion or better interest rate, this will likely be quickly matched by competitors (limiting the gains from the offer).

For home loans, discretionary discounting and price matching enables banks to selectively compete to win or retain more valuable customers, while increasing their interest rates for less price-sensitive customers. This means that the benefits of competition only accrue to those customers who are willing and able to shop around for the best deals – but people seldom do.

Limited investment in innovation by the banks

We have been surprised by the limited investment by the major banks and Kiwibank in their core banking systems and the low prioritisation given to this. Legacy systems constrain the ability of these banks to innovate and compete. They also limit the role of fintechs, who generally need to interface with banks' systems.

As a result, we have seen limited innovation across the industry. Innovation has tended to occur "around the edges" of the customer experience, such as enhancements to mobile apps, rather than at the core of product and pricing structures. In a competitive market we would expect to see greater investment in innovation so competitors could stay ahead of their rivals.

The major banks have told us that their limited investment in core systems is largely due to the need to keep pace with changing regulatory requirements. While we acknowledge the pace of regulatory change and the associated need for investment, fully depreciated core systems indicate sustained under-investment. This appears to reflect a lack of competitive pressure over an extended period.

The NZ banking sector has sustained high levels of profitability

The major banks make significant profits each year. However, the dollar value of profits (on its own) tells us little about competition, because the major banks are among New Zealand's largest companies.

Measures of profitability (ie, returns in percentage terms), on the other hand, can provide an indication of the intensity of competition.

The New Zealand banking sector has demonstrated sustained high levels of profitability relative to international peers. Between 2010 and 2021, New Zealand's banking sector has, on average, performed in the upper quartile relative to peer nations on three important measures: return on assets, return on equity, and net interest margin.

We consider that at least part of the profitability we have observed is explained by the market power of the major banks. New Zealand's banking sector is relatively low risk because it is more heavily weighted towards traditional ("vanilla") banking activities (like home lending) than many peer nations which have a greater proportion of institutional and investment banking. Because these activities are lower risk, if competition was working well, we would expect the New Zealand banking sector to derive lower returns relative to riskier banking sectors overseas.

New Zealand's major banks have also experienced high average returns on equity relative to other New Zealand banks since 2018, and in most cases have performed well on return on assets. This is consistent with the two-tier market we have observed.

Some groups are not well served by competition alone

Some consumers are particularly vulnerable to financial exclusion and find it difficult to access personal banking services, like a basic bank account.

We have also heard about barriers to accessing personal banking services that are unique to Māori. These include lack of Māori representation in the banking sector and difficulty accessing finance for housing on Māori freehold land.

Four main factors are limiting competition

We have identified four main factors which are limiting competition. These factors overlap and can be mutually reinforcing.

Structural advantages of the major banks

The major banks have scale, scope and funding cost advantages, which make it very challenging for smaller providers to compete with them. They also have nationwide networks with broad reach and established brand recognition. Consumers perceive large banks as safer and more stable, so are more likely to trust them to look after their money.

Retail deposits (funds held in deposit accounts) are crucial to bank funding and are typically the lowest cost source of funding available to banks. Because the major banks hold a higher proportion of deposits in transaction accounts (which generally do not pay interest), they have a significant funding cost advantage over smaller banks. This reflects advantages the major banks have in winning and maintaining "main bank" relationships.[2]

Regulatory barriers to entry and expansion

Regulation shapes competition in personal banking. The banking sector is highly regulated and we have heard that regulation is the single most important factor constraining providers' ability to enter and compete. New entry at scale from traditional offshore banks is unlikely because of the cost and time it would take to build sufficient market share to become profitable, particularly given the dominant position of the major banks. Smaller providers who do enter have been disproportionately adversely affected by the overall regulatory burden due to their lack of scale.

Bank prudential capital requirements are the most significant regulatory barrier and have limited competition by constraining entry and particularly expansion. Since 2008, the Reserve Bank's prudential capital requirements have allowed the major banks to hold significantly less capital than smaller banks for some lending with a similar risk profile. This has given the major banks a material and entrenched competitive advantage over Kiwibank and smaller providers for the past 15 years.

Barriers to consumer switching and engagement

Our consumer survey (undertaken by Verian) found that consumers of personal banking services tend to be "sticky" – they often remain inactive or disengaged, never having switched banks.[3] This favours the major banks who hold most of the main bank relationships with customers.

It can also be hard to find the best deals. Comparing offers from different banks is challenging for consumers due to the various strategies employed by banks to market their interest rates, fees, cash back incentives, and quality of mobile apps.

There are both real and perceived difficulties with the logistics of switching providers, which reduce the competitive pressure on the major banks. The industry-led account switching service is not working well. Some consumers are also deterred by regulatory requirements driven by the Anti-Money Laundering and Countering Financing of Terrorism Act (AML/CFT Act) and/or the Credit Contracts and Consumer Finance Act (CCCF Act). This includes the customer identification processes to open a new account or processes to demonstrate affordability of a loan.

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2 Main bank relationships (where customers do most of their day-to-day banking) are valuable for providers. Our consumer survey (undertaken by Verian) found that 92% of customers consider one of the five largest banks (the major banks and Kiwibank) to be their main bank.

3 Our consumer survey found that 54% of respondents have never switched their main bank.

Impediments to innovation by fintechs

Fintechs are a potential source of innovation and competition, but they face a number of impediments such as: opening and maintaining a business bank account, meeting the costs and complexity of regulatory requirements, obtaining sufficient capital, and gaining access the consumer data they need to provide their services.

Open banking has helped tip the scale for fintechs in the UK and Australia. However, progress towards open banking in New Zealand has been too slow because the major banks have been left to set the nature and the pace of change. As a result, New Zealand is falling behind other countries.

Multi-faceted solutions are needed to improve competition

There is no single quick fix to improve competition. Overseas experience suggests that the scale and brand advantages of large banks and consumer inertia are difficult to overcome, even where open banking is well-established.

A multi-faceted approach to lifting competition for the long-term benefit of consumers is required. This is reflected in the range of our draft recommendations, which are grouped into four themes.

Improve the capital position of smaller providers and Kiwibank

Access to capital is one of the key constraints affecting the ability of smaller providers and Kiwibank to grow and compete. The Reserve Bank should review its new prudential capital settings to take account of competition, which may include levelling the playing field when it comes to the capital required to be held for some types of home loans.

Standing back, Kiwibank has the greatest potential to be a disruptive competitor in the short to medium term. Kiwibank appears to be best positioned to put more competitive pressure on the major banks because it is already materially larger than the smaller providers. Smaller providers also often have structures that limit their ability to attract capital (for example being trust owned) and new entry at scale from offshore banks is unlikely.

However, Kiwibank is not yet positioned to disrupt the major banks. To change this, Kiwibank's owner should consider increasing its access to capital and supporting a strategic refocus of Kiwibank's efforts (which could involve significant systems development) to compete more strongly with the major banks.

Accelerate progress on open banking

Open banking has the potential to revolutionise banking by driving ongoing innovation and competition in personal banking. Fintechs are a potential source of disruptive innovation and competition over the medium to long-term, and are important to realising the full benefits of open banking.

Steps are underway to create an open banking eco-system that will enable fintechs to compete, but progress to date has been too slow compared to Australia and the UK.

There are some minimum requirements for open banking to become fully operational. These include the development of standardised application programming interfaces (APIs) to enable the exchange of information between banks and fintechs, the agreement of commercial partnering terms with banks and the development of a trusted digital identity for consumers.

Setting a clear deadline and having regulatory backstops available so these minimum requirements are delivered will support the acceleration of open banking. We recommend that the Government target having open banking fully operational by mid-2026.

We also recommend the Government do more to reduce the barriers imposed by the AML/CFT regime on banks working with fintechs.

Ensure the regulatory environment better supports competition

Regulatory policy impacts competition. Policy makers and regulators responsible for the personal banking sector should explicitly and transparently consider the competitive effect of their decisions. This will reduce the risk of unintended consequences of decisions on competition, which we have seen with the historic approach to prudential capital requirements.

This would include the Reserve Bank placing a competition lens in its final decisions on how to fund the new Depositor Compensation Scheme and whether it could provide wider access to its exchange settlement account system (ESAS) – both of which may assist smaller providers to compete.

We also recommend that the Government amend the Deposit Takers Act (DT Act) to require the Reserve Bank to take into account the promotion of competition, rather than the maintenance of it.

Empower consumers to better access the benefits of competition

Lifting consumer engagement and confidence is an essential part of improving competition. Consumers will directly benefit from reduced barriers to switching, including better tools and services to help them find the best deal, and an enhanced switching service. Several of our proposed recommendations have this focus.

We also propose draft recommendations aimed at ensuring mortgage advisors help consumers get the best deal and support greater competition for home loans.

For consumers who may be marginalised, ensuring widespread availability to basic bank accounts is important.

For Maori specifically, we recommend more active promotion and development of the initiatives to unlock the use of Māori freehold land for housing, including simplification of the burden on Māori trusts from the AML/CFT Act. We encourage initiatives by providers to build trust and confidence by Māori in the banking sector, particularly through Māori-led solutions.

Next steps and how you can have your say

We invite feedback on our draft report. You can have your say by emailing us at marketstudies@comcom.govt.nz or by completing the feedback form that will be on our website shortly. Written submissions are due by **4pm, Thursday 18 April 2024.**

We will hold a conference in central Auckland and online to discuss the draft report in the week beginning Monday 13 May 2024. After a further opportunity for post-conference submissions, we will finalise our report by 20 August 2024.

For more information on how to make a written submission, and on the conference, see Attachment A of the draft report.

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