Personal Banking Services Market Study

Comments following Conference

4 June 2024

Prepared for

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1. INTRODUCTION AND SUMMARY

1. The Commerce Commission (Commission) is undertaking a market study into factors that may affect competition for the supply or acquisition of personal banking services (Market Study). The Commission published a draft report containing its preliminary findings on 21 March 2024 (Draft Report). CRA provided comments on the Draft Report on 17 April 2024 in a submission titled "Comments on the Commerce Commission's Draft Report and the Margaritis and Hasannasab paper on "Market Power in Banking" (Comments on Draft Report). On 13-15 May 2024, the Commission held a consultation conference (Conference) at which participants discussed, among other things, the Commission's preliminary view that competition between the four largest banks is sporadic rather than strong and sustained, evidenced, among other things, by high and stable shares of supply.[1]

2. Following the Conference, ANZ has requested that we comment on a number of matters to assist in understanding the reasons for observed market behaviour and outcomes. In particular, we have been asked to comment on the following matters.

   a. The reasons for the apparent "fluctuations in the intensity of competition in home lending" during 2022 and 2023 observed by the Commission,[2] and whether these fluctuations should be interpreted as evidence that competition is only occasional ("sporadic") and is otherwise weak, or if pricing observed in the 2022-2023 period is consistent with sustained effective competition.

   b. Whether the observed pattern of banks having "sporadic" or "intermittent" strategies of offering best in market interest rates, with none of the largest five banks consistently offering the lowest headline interest rates,[3] is consistent with sustained effective competition.

   c. Whether stable market shares and stable offerings in the market are consistent with effective competition; and

   d. Deloitte's suggestion that prices in New Zealand banking markets are determined by the costs of small banks.

3. The following sections address each matter in turn. Our comments can be summarised as follows.

   a. The period of more intense competition for home loans observed in 2022 and early 2023 was a function of an unusual temporary confluence of external factors – including a surplus of low-cost domestic deposits – and since those external factors were not sustained, the pricing of home loans that they allowed was not sustainable. It would be wrong to infer from this abnormal period that in more normal times competition between the banks must be weak or ineffective. We consider that the experience of 2022 and 2023 is consistent with sustained effective competition before, during and afterwards between banks that are simultaneously constrained by the need to manage their risks by keeping their books balanced and by competition from other banks.

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1 Transcript of Session 1 of the Conference on 13 May 2024, page 6, lines 21-25.

2 Draft Report, pages 88-89.

3 Draft Report, paragraph 4.41.

b. The varying intensity of competition from individual banks over time, and the jostling for headline price leadership (no consistent "best in market" player) that the Draft Report observes, are consistent with effective competition overall. Banks need to balance growth on both sides of their balance sheets, and since they will not always be "in sync" together, there will be times when some are looking to grow on one side and others are looking to moderate. At the same time, little can be understood about competition for home loans from analysis of headline rates in isolation: competition occurs also in terms of actual rates offered as well as other price and non-price terms, including policy settings. When competition is examined holistically, intermittent periods of being "best in market" in terms of headline rates is a small part of the overall picture, relating in part to brand and product marketing. More relevant to competitiveness are the actual rates that banks offer customers as well a range of other price and non-price terms including policy settings.

c. Stable market shares and stable offerings, even over long periods of time, do not imply that competition is not working well, and there should be no expectation of greater movement in market shares or in the terms of particular offerings (such as good energy home loans, once they stabilised) in an effectively competitive market.

d. We do not agree with Deloitte that prices in New Zealand banking markets are determined by the costs of small banks. The underlying economic model that Deloitte appears to have in mind appears not to reflect banking markets. Instead, it appears to us that prices are being determined as a function of competition between the large five banks as well as smaller banks, with all of them supplying somewhat differentiated products, and each seeking to set prices and non-price terms independently given the other price and non-price terms in the market and their respective needs to balance their books.

2. UNDERSTANDING COMPETITION IN HOME LENDING IN 2022 AND 2023

2.1. Introduction

4. The Draft Report presents an analysis of price competition for home loans in the rising interest rate environment from mid-2021 to the end of 2023.[4] It observes two distinct periods that it characterises as having different intensities of competition: a period of intense competition during 2022 and the first half of 2023, followed by a period of less intense competition in the second half of 2023. The Draft Report characterises this episode as an example of "sporadic" rather than sustained competition in home loans. In the Conference, Commission Chair John Small explained that the Commission had seen "outbursts of more intense competition" that the Commission is finding difficult to reconcile with arguments that the market is workably competitive with a tendency toward strong competition.[5] We assume that he was referring again to the 2022 and early 2023 period.

5. In our previous report we proposed that the period of apparently more intense price competition identified by the Commission in 2022 and 2023 was consistent with sustained effective competition and constraints in personal banking, and that this episode should not

4 Draft Report, pages 88-89.

5 Transcript of Session 1 of the Conference on 13 May 2024, page 8, lines 16-20.

be interpreted as evidence that competition is only "sporadic". In particular, based on contemporaneous commentary by market participants detailed in the Draft Report, we noted that the period of more intense price competition was not financially sustainable for the banks.[6]

6. Following further conversations with ANZ we remain of this view. Our understanding of competition for home loans in this period is set out in the following sub-sections. In brief, we understand the fluctuations in intensity observed by the Commission to have been the result of an unusual confluence of external factors in 2022 and early 2023 that produced the conditions for more intense price competition at that time. As those external factors were not sustained, the degree of price competition experienced at that time was not sustainable.

2.2. The importance of balancing the books

7. Before getting to the external factors that were responsible for the 2022-2023 experience, it is important to appreciate the incentives that banks have to balance growth across both sides of their balance sheet (deposits and loans).[7] At times when its loans have grown faster than deposits, a bank will be concerned that it may become over-reliant on wholesale funding and will have incentives to moderate its growth on the loan side while accelerating growth on the deposit side. Conversely, at times when deposits have grown faster than loans, a bank will have incentives to grow its loan book and moderate growth in deposits. This should not be interpreted as "sporadic" or "weak" competition. It is simply a reality of competitive banking markets in which banks must deal with dual constraints: the need to keep deposits and loans in balance to remain financially sustainable as well as competition from other banks.

8. At times when all banks are in similar positions with similar incentives, it may appear that competition overall is more or less intense, however banks at these times will be seeking to balance their books and will remain constrained by each other. In particular, a period in which competition for lending appears less intense is likely to coincide with bank concerns to avoid over-reliance on wholesale funding (and potentially the deterioration of their credit ratings, which would raise their costs) and should not be mistaken for an outbreak of ineffective competition. To view this as "sporadic" or "weak" competition would overlook the inter-related nature of deposits and loans.

2.3. The 2022-2023 period

9. With that in mind, the 2022-2023 period was one in which the banks faced somewhat unprecedented conditions due to a number of external factors.

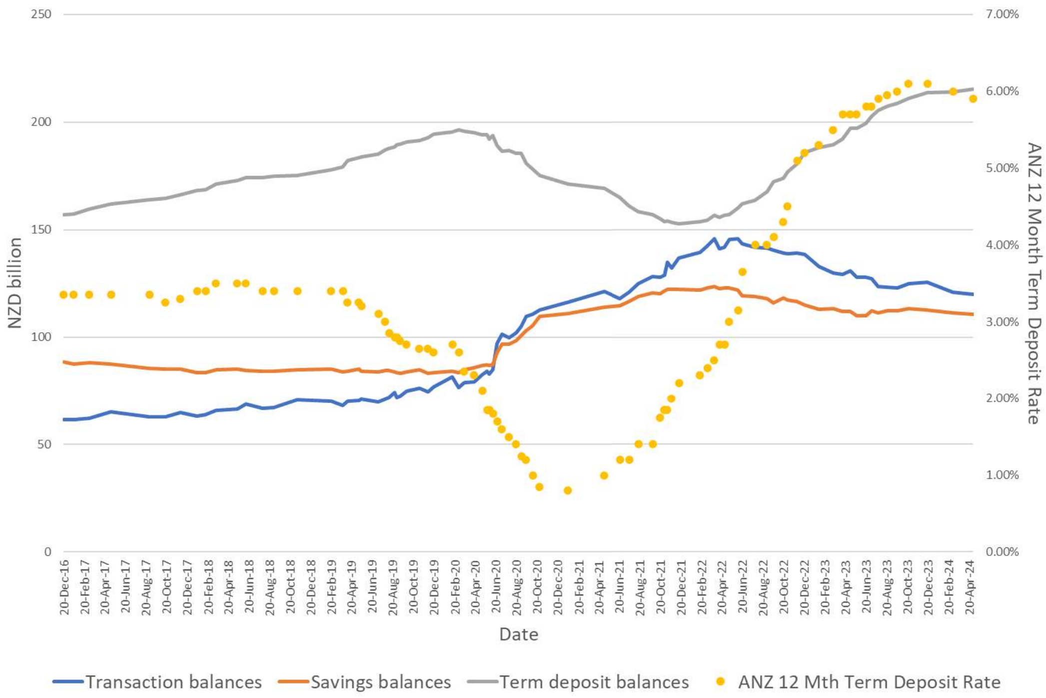
10. First, during 2020 the Covid pandemic (which coincided with a low interest rate environment) generated a significant increase in low and zero interest paying deposits in savings and transaction accounts, as can be seen in Figure 1 below. Home lending increased in 2020 and 2021, driven by very low interest rates and relaxations of Reserve Bank loan to value (LVR) restrictions in May 2020. However, there remained a surplus of low-cost domestic deposit funding available to the banks going into 2022. Banks had strong incentives to put this low-cost source of funds to use (to balance their books) by increasing

6 CRA, Comments on the Draft Report, paragraph 28(a).

7 The Commission acknowledged these incentives in its Draft Report (paragraph 4.43).

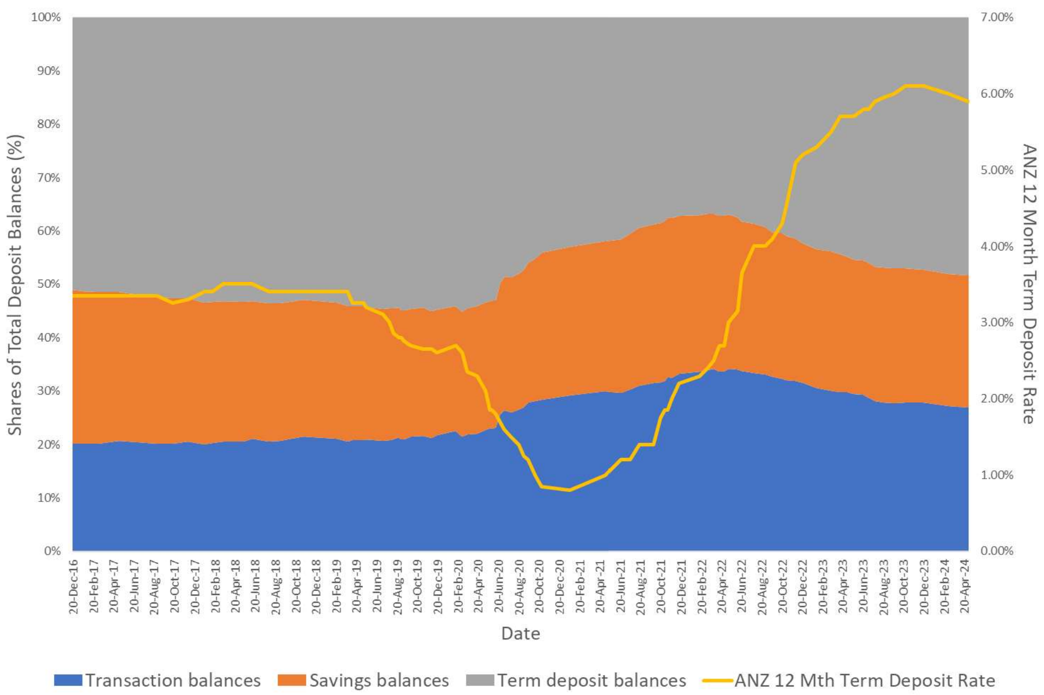
loans. Low-cost transaction and savings balances remained an unusually large share of deposits well into 2023, as can be seen in Figure 2 below.

Figure 1: Deposit balances for transaction accounts, savings accounts and term deposits (January 2017 – March 2024)



Sources: RBNZ S10 for deposit balances and ANZ for ANZ's historical 12 month term deposit rates

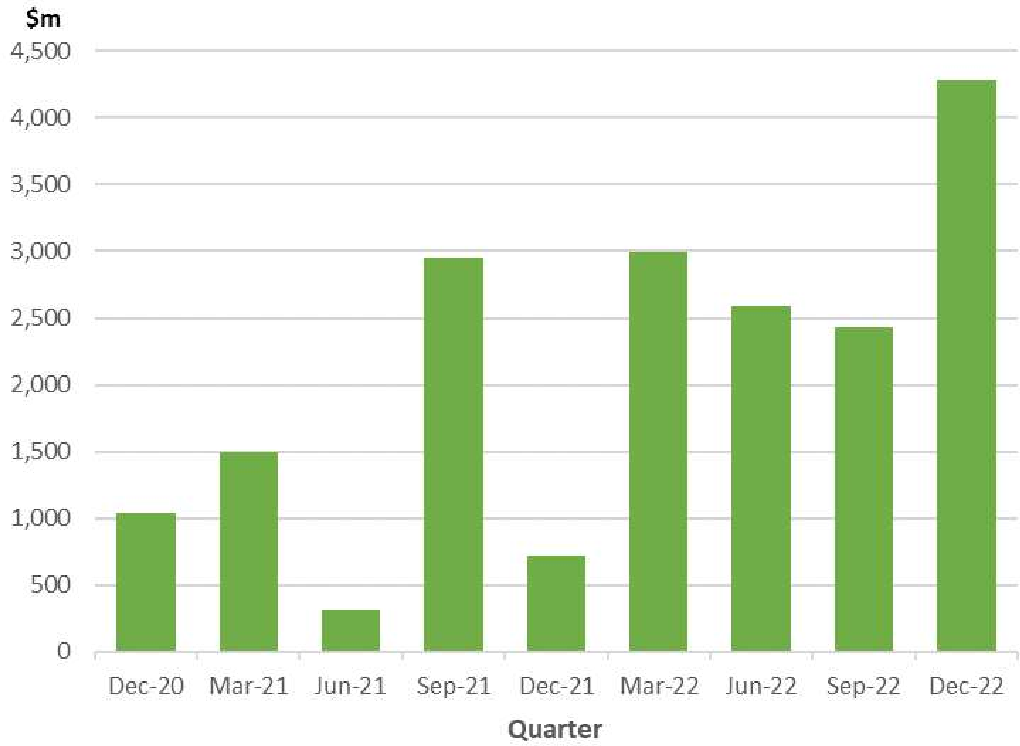
Figure 2: Shares of deposit balances (transactions, savings and term deposits) (January 2017 – March 2024)



Sources: RBNZ S10 for deposit balances and ANZ for ANZ's historical 12 month term deposit rates

11. Second, the Reserve Bank's funding for lending programme (FLP) enabled banks to access funding for home lending at the official cash rate (OCR).[8] This provided further access for banks to relatively low-cost domestic funding until the end of 2022. As can be seen in Figure 3, relative to 2021 the banks drew heavily on FLP funds during 2022 (particularly toward the end of 2022), which supplemented their ability to write loans at relatively low costs for the first half of 2023.

Figure 3: FLP Borrowings by Quarter (Q4 2020 – Q4 2022)



Source: ANZ (based on public information)

12. Third, as can be seen in Figure 4, in 2022 demand for home loans fell back from a peak in 2021, as inflation, interest rates and cost of living pressures rose and house prices fell. There was significantly less loan business than in 2021 for banks to compete for.

8 The FLP was introduced on 7 December 2020 and ceased on 6 December 2022. See: https://www.rbnz.govt.nz/monetary-policy/monetary-policy-tools/funding-for-lending-programme

Figure 4: Change in home loan balances and demand for new lending (January 2017 to March 2024)

Sources: RBNZ S31 and C31

13. These external factors, together, produced a period in 2022 and early 2023 when banks, in their efforts to balance their books and with ready access to low-cost domestic funding, had the ability and incentive to price loans particularly aggressively.

14. In 2023, external conditions started to normalise. Access to low-cost FLP funding had ceased (the program was only open to the end of 2022), and the mix of deposit balances continued to shift from low-cost (low or zero interest) transaction and savings accounts to higher interest-bearing term deposits (see Figure 1 and Figure 2), raising the costs to banks of deposit funding. Surplus deposit funds had also reduced, reducing incentives to increase lending to balance the books.

15. While the result was an appearance of less intense competition in the second half of 2023, this should not be mistaken for ineffective competition. Banks remained constrained by each other in an environment in which their costs to fund their lending were higher and their books were more in balance. It would not have been sustainable to continue to price loans in the way that they were priced in 2022 and early 2023. Not only had funding costs increased, but with books more balanced, to continue to grow loans significantly faster than deposits would not have been financially prudent.

16. The period of more intense competition in 2022 and early 2023 was only possible when these external factors dominated. It was in fact precisely what the Reserve Bank had intended to achieve with the FLP. According to the Reserve Bank's website:

> *The FLP works by lowering interest rates and encouraging households and businesses to spend and invest.*
>
> *The programme allows eligible banks to borrow directly from us at the official cash rate (OCR). The borrowing rate will adjust over the term of the transaction if the OCR changes, whether up or down.*
>
> *As banks will be less reliant on more expensive deposits and wholesale borrowing, the programme lowers their overall funding costs. Banks can then pass these*

reductions on to their customers through lower mortgage and business lending rates.[9]

17. In summary, our view is that the period of more intense competition for home loans observed in 2022 and early 2023 was a function of an unusual temporary confluence of external factors – including a surplus of low-cost domestic deposits – and since those external factors were not sustained, the pricing of home loans that they allowed was not sustainable. It would be wrong to infer from this period that in other times competition between the banks must be weak or ineffective. We consider that the experience of 2022 and 2023 is consistent with sustained effective competition before, during and afterwards between banks that are simultaneously constrained by the need to manage their risks by keeping their books balanced and by competition from other banks.

3. SPORADIC OR "INTERMITTENT" STRATEGIES OF INDIVIDUAL BANKS

3.1. Varying intensity of competition from individual banks over time is consistent with effective competition overall

18. The Draft Report also suggests that the extent to which individual banks compete is "sporadic". Specifically, the Draft Report observes that "the extent to which banks compete […] can vary significantly from month to month or even week to week" with the banks having "greater or lesser growth ambitions at any point in time, reflecting their individual circumstances and strategies".[10]

19. In our opinion there is no basis for interpreting this dynamic as evidence of weak or ineffective competition. On the contrary, we consider this dynamic to be consistent with effective competition.

20. As we explained in our Comments on the Draft Report, it appears that the Commission has an expectation that in effectively competitive markets there will be little or no fluctuation in the extent to which particular firms compete over time.

21. We are not aware of any basis in economics for interpreting fluctuations in the extent of competitiveness of particular firms as indicating that competition in an overall sense is inconsistent and ineffective. While individual banks may fluctuate to some extent in how aggressively they compete (depending on their individual circumstances including cost and funding conditions and strategies) competition overall may remain consistently effective, precluding any firm from pricing above workably competitive levels.

    a. The Draft Report acknowledges that fluctuations in the intensity of competition at the individual bank level may be driven by the need to balance growth across both sides of the balance sheet (where the majority of lending is funded by deposits).[11] Banks' costs of funding loans may also vary and may not always be in-sync with other banks. This is normal in competitive markets, where firms must adjust their pricing and other terms to reflect their underlying cost conditions and any other factors that they need to take into consideration.

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9 https://www.rbnz.govt.nz/monetary-policy/monetary-policy-tools/funding-for-lending-programme

10 Draft Report, paragraphs 4.36.1 and 4.40.

11 Draft Report, paragraph 4.43.

b. Price-promotions, including special efforts to appear as lowest priced for limited periods of time, are also normal in competitive markets, acting to advertise products and develop a brand.

22. As explained above, and as acknowledged in the Draft Report, banks need to balance growth on both sides of their balance sheets. Since banks will not always be “in sync” together, there will be times when some banks are looking to grow on one side and others are looking to moderate. This is consistent with a market that is, overall, workably competitive, in which banks are consistently seeking to operate subject to dual constraints of remaining financially responsible and competition from other banks.

3.2. Little can be understood about competition for home loans from analysis of headline rates in isolation

23. The Draft Report places emphasis on analysis of advertised “headline” home loan rates. It claims that this analysis is consistent with banks having “intermittent strategies of offering best in market interest rates (or not)” and highlights that “none of the major banks or Kiwibank are consistently offering the lowest headline interest rates”.[12]

24. In our view, the Draft Report places more weight on this analysis than it deserves. This is because headline rates are only one dimension of competition for home loans. To properly understand the intensity of competition for home loans, all competitive dimensions should be considered holistically. The following considerations are particularly relevant.

25. First, headline rates are an important part of brand and product marketing, but they are not always an indicator of competitiveness. Being above other banks on headline rates will harm a bank’s brand if such a situation continues in the long-term, while being below other banks could be a strategy timed to coincide with marketing campaigns (e.g. “lowest rate” campaigns). What really matters for consumers in terms of prices is the actual prices and offerings that banks put to them, tailored to their individual circumstances and risk profiles. We understand that most customers are offered discretionary rates below the headline rates,[13] and that the banks compete intensely on these rates, as the broker session of the Conference confirmed.[14] A bank that has a relatively high headline rate may be matching or beating competitors in terms of the discretionary rates it offers, and a bank with the lowest headline rate may not lead the market when it comes to the actual rates it offers. Mortgage brokers act as intermediaries to assist customers to find the best rates and other terms that are suited to their individual circumstances.[15] And at least at ANZ, discretionary discounts are automatically provided to existing customers when they refix their home loan via GoMoney or internet banking.

12 Draft Report, paragraph 4.41.

13 The Draft Report notes that “discretionary discounts for individual borrowers are common amongst many home lending providers – our analysis of home loan data found that recently 50-60% of lending (by volume) was associated with a discount”: Draft Report, paragraph 4.26.

14 According to Sarah Curtis: “If somebody’s got a market leading two-year rate, it doesn’t normally take 24 hours for the other banks to be matching that market rate. They realise that consumers want choice and that they have the ability to make that choice to move”: Transcript of Session 8 of the Conference on 15 May 2024, page 11, lines 7-10.

15 We understand that a large proportion of home loan business comes through mortgage brokers: see for example ANZ Submission following the Draft Report, 18 April 2024, paragraph 115.

26. Second, as also confirmed in the broker session of the Conference, banks compete for home loan customers not just in terms of interest rates, but also on other price and non-price dimensions.[16] A focus on interest rates in isolation, rather than a holistic assessment that includes other price and non-price terms and conditions, will miss much of the competitive dynamics in the market.

27. Cash contributions are an example of a secondary price term that customers will take into account in terms of the overall cost to the customer of the loans they are offered. Banks may also offer other incentives that translate into lower costs for customers, for example free conveyancing, waiving of fees, offset accounts and Airpoints.[17]

28. Regarding non-price dimensions of competition, the Draft Report found that banks compete on a range of non-price dimensions including "range of products, service, perceptions of trust and security, digital capabilities and brand awareness" to meet customers' diverse needs and preferences.[18] It also found that the major banks "place much focus on non-price offerings, for example approval times for home loan approvals, because it makes a difference to customers' needs".[19] There is no suggestion or evidence in the Draft Report that competition in these non-price dimensions has varied in intensity. Other non-price dimensions that banks compete on and that matter for customers include credit policy settings (in particular, the interest rates they use to assess serviceability and the amounts that they are willing to lend), home loan check in services, prompts to refix loans, and options to access other loan offers such as good energy home loans.[20]

29. We understand from ANZ that it would quickly lose significant volumes if the non-price elements of its home loan offers were out of line with its competitors, and that it consistently offers a competitive mix of price and non-price terms, including when its headline rate is not the lowest.

30. In summary, when competition is examined holistically, intermittent periods of being "best in market" in terms of headline rates is a small part of the overall picture, relating in part to choices of brand and product marketing. More relevant to competitiveness are the actual rates that banks offer customers as well a range of other price and non-price terms

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16 For example, according to Patricia Marsden "when you quantify the pricing and compare between lenders, and this will take into account fees, cash contributions and interest rates over the period of time that a client fixes their loan for, generally most mainstream banks will come out equal": Transcript of Session 8 of the Conference on 15 May 2024, page 9, lines 32-34. And according to Sarah Curtis "[l]ots of those conversations that we have start with price, they do start with price because people normally see something that triggers them to have a conversation with us. But its not something that ends up being the deciding factor between going to one of the providers": Transcript of Session 8 of the Conference on 15 May 2024, page 12, lines 24-27.

17 See again the comments of Patricia Marsden, Transcript of Session 8 of the Conference on 15 May 2024, page 9, lines 32-34, above note 16.

18 Draft Report, paragraph 2.55.

19 Draft Report, paragraph 2.55.

20 Jeff Royle from iLender explained the importance of policy settings during Session 8 of the Conference: "I still believe that price is inherently important and it's often the starting point of a conversation. That very quickly leads into policy. And as one of your previous speakers said, policy varies significantly between product providers, and not only does it vary today, it will change tomorrow and maybe the day after that. So just because a product provider comes in saying you can have 6%, it may well be 27 that the trade-off of that product might be you can only borrow $500,000 whereas actually 28 you need to borrow $600,000. So although the price point was the starting point, it's very rare that it ends up being the finishing point": Transcript of Session 8 of the Conference on 15 May 2024, page 19, lines 23-30.

including policy settings. There is therefore little that can be understood about competition for home loans from analysis of headline rates in isolation.

3.3. The absence of a consistent "price leader" is consistent with effective competition

31. In our response to the Draft Report we noted that there is no basis in economics for an expectation that an effectively competitive market will have a consistent "best in market" lowest priced player, and so there is no basis for interpreting the lack of a consistent lowest priced player in home loans as indicating that competition for home loans is weak or ineffective.[21] As we explained, firms may compete effectively and constrain each other in markets without a clear and consistent lowest price player, and the evidence in the Draft Report that the various banks have all experienced times when they have been lowest priced, with no clear and consistent leader, should be viewed positively, as evidence tending to suggest that competition is vigorous, with all of the major banks (including Kiwibank) motivated at times to offer lower prices than their rivals, and none able to enjoy a "quiet life".

32. Indeed, a market with a consistent lowest priced player would not necessarily be more competitive: in such a case it might be that the other banks price higher because they are not constrained by the lowest priced player.

33. Our earlier observation about headline rates as just one part of the competitive landscape applies here. Whether or not there is a clear "best in market" leader in terms of headline rates has little bearing on whether competition is weak or strong. Even if the Commission were to interpret the absence of a clear and consistent leader as problematic (notwithstanding our comments above), an analysis based of headline rates in isolation would not justify a conclusion that competition is ineffective. To reach such a conclusion would require holistic consideration of all dimensions of competition rather than headline rates alone.

4. STABLE MARKET SHARES AND STABLE OFFERINGS

34. The Draft Report suggested that the Commission's expectation is that in effectively competitive markets there would be more movement in market shares than it observes in personal banking.[22] Similarly, in the Conference Commission Chair Dr John Small pointed to "high and stable shares of supply" as evidence that the major banks do not face strong and sustained competition.[23]

35. In our opinion, stable market shares, even over long periods of time, do not imply that competition is not working well, and there should be no expectation of greater movement in market shares in an effectively competitive market.

36. The fact that shares in a market remain fairly stable for long periods of time does not provide any indication about the competitiveness of the market. Indeed, standard economic theory suggests that we would only expect changes in shares in a competitive market if the firms

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21 CRA, Comments on the Draft Report, paragraph 32.

22 For example, at paragraph 2.39.1 the Commission states: "if competition works well, we expect to see more movement in shares of supply generally over a longer term".

23 Transcript of Session 1 of the Conference on 13 May 2024, page 7, lines 21-23.

in the market were affected differentially by changes in underlying market fundamentals, such as shifts in consumer preferences towards the products of certain firms and away from the products of other firms, or a change in the cost of an input used more by some firms in the market than by others. Without fundamental changes of these kinds, we would expect shares to be stable even as firms compete intensely to maintain their share and their scale. As ANZ has observed, just to maintain its market share its offers need to be sufficiently appealing to attract around one-third of new customers and customers looking to switch.[24]

37. There is also the fact that, as found in the Verian consumer survey, a large proportion of New Zealanders with a home loan are happy with their home loan provider and/or have no reason to switch.[25] Therefore, in any year, a large proportion of a bank's share of home loans is made up of customers that are sufficiently happy that they are not actively looking to switch. At the same time, customers that are new to the market are small in number relative to the total. With new customers and customers actively looking to switch together representing only a small proportion of the total, the Commission should not expect rapid changes in market shares, even if some banks were to become relatively uncompetitive. Of course, the fact that most customers are happy with their existing bank and are not actively looking to switch does not mean that these customers are paying higher rates, and that only the customers actively looking to switch are being offered low rates. Most home loans are fixed for one or two years, and when customers roll off these, they will be offered competitive rates at those points in time, even if they are not inclined to switch banks.

38. Regarding the good energy home loans experience, Dr Small asked at the Conference whether "green loan top-ups have reached a kind of equilibrium…?"[26] and "should we expect to see firms reaching settled or stable equilibria in workably competitive markets, or […] conversely, should competition be an ongoing struggle […] rather than something that begins and ends?".[27]

39. As we explained in our Comments on the Draft Report, the good energy home loans experience looks to us like healthy competition with banks innovating and iterating to an equilibrium involving differentiated offers, with beating as well as matching of each other along the way.[28] Innovation occurred, competition followed with a period of evolving offers, and while the situation now, following that evolution, appears more "stable", we interpret it as an effectively competitive equilibrium in which banks are offering the best terms that they can in their struggle to attract and retain customers. The answer to the first question therefore appears to be "yes".

40. The second question seems to be premised on a false dichotomy. The "ongoing struggle" that characterises effective competition does not preclude stable equilibria, and stable equilibria should not be seen as an "end" to competition. When new products are developed, innovation may continue for a period until the products that are offered reach a point where further scope for innovation is limited. The Commission should not expect

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24 ANZ Submission following the Draft Report, 18 April 2024, paragraph 48.

25 Verian "Personal banking services market study – Research report" (February 2024), at page 32.

26 Transcript of Session 1 of the Conference on 13 May 2024, page 17, line 20.

27 Transcript of Session 1 of the Conference on 13 May 2024, page 16, lines 13-16.

28 CRA, Comments on the Commerce Commission's Draft Report and the Margaritis and Hasannasab paper on 'Market Power in Banking'", 17 April 2024, paragraphs 39-46.

innovation in terms of lower prices or larger loan values will necessarily continue forever – there will come a point even in an effectively competitive market where there is limited scope for further improvements in offers. If the Commission is concerned about this kind of stability, it would find a lot of products and markets in New Zealand that are in need of investigation as this is a normal, to be expected, outcome of competition.

5. HOW PRICING IS DETERMINED IN NEW ZEALAND BANKING MARKETS

41. Deloitte has suggested that prices in New Zealand banking markets are determined by the highest cost "marginal" bank (presumably a bank smaller than the largest banks).[29] We understand Deloitte to be suggesting that the largest banks are earning above normal returns because they have lower costs than smaller "marginal" banks that are the price setters.

42. Deloitte seem to have in mind a model of competition in which goods are homogenous and price is determined by where demand intersects with a rising supply curve, where the supply curve is rising because it is made up of many small capacity constrained firms with varying marginal costs. In this model, firms with low costs ("inframarginal" firms) sell all their output and earn economic rents (i.e., above normal returns) and only the marginal firm with relatively high cost makes normal returns.

43. That model might reflect some real-world markets (e.g. electricity generation) but not banking. In banking, products are differentiated, non-price dimensions of competition are important, banks are not obviously tightly capacity constrained, and it is also not obvious that marginal costs differ much. We also understand that ANZ, a large bank, does not earn above normal profits.[30] And we have not seen evidence that small banks set prices and large banks follow. In short, Deloitte seem to have a theory based on an economic model that does not fit the evidence or the characteristics of New Zealand banking markets.[31]

44. What then is the mechanism by which prices are set in New Zealand banking markets? New Zealand banking markets appear to us to be best characterised by differentiated product competition among five large players and a large number of smaller competitors. These firms will each set prices and non-price terms subject to the pricing and non-price terms of all of these competitors, their own costs (including funding costs) and the needs they each have to balance their books.

45. In summary, we do not agree with Deloitte that prices in New Zealand banking markets are determined by the costs of small banks. The underlying economic model that Deloitte appears to have in mind appears not to reflect banking markets. Instead, it appears to us that prices are being determined as a function of competition between the large five banks as well as smaller banks, with all of them supplying somewhat differentiated products, and

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29 Deloitte Access Economics, Report prepared for BNZ, 18 April 2024, paragraphs 109-110 and 118. See also Transcript of Session 1 of the Conference on 13 May 2024, pages 22-23.

30 Incenta Economic Consulting, *Benchmarking the profitability of the New Zealand banks against international peers*, September 2023.

31 Elsewhere in its report Deloitte itself observes that New Zealand banking markets have "no apparent price leader" and are "differentiated" product markets where non-price factors are key dimensions of competition (page 5). These observations do not fit Deloitte's "marginal producer determines price" theory.

each setting prices and non-price terms independently given the other price and non-price terms in the market and their respective needs to balance their books.