Personal Banking Services Market Study

Comments on the Commerce Commission's Draft Report and the Margaritis and Hasannasab paper on "Market Power in Banking"

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EXECUTIVE SUMMARY

1. The New Zealand 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). On 21 March 2024 the Commission published a draft report containing its preliminary findings regarding factors that, in its view, are affecting competition in personal banking, and options for recommendations to improve competition (Draft Report).

2. In the context of the preliminary findings in the Draft Report, ANZ has requested our economic opinion on the following questions.

    a. Does the evidence in the Draft Report support a view that competition for home loans and deposits has not always been effective?

    b. Is there any economic basis to expect a higher frequency of "more intense" competition in a competitive banking market?

    c. Does the evidence in the Draft Report support a view that there are "established patterns" of price matching behaviour in personal banking?

    d. Is there any economic basis to interpret price matching by banks as indicating ineffective competition?

    e. Does the Verian survey evidence support the findings in the Draft Report that rely on that evidence?

    f. Does the paper by Margaritis and Hasannasab titled "Market Power in Banking" contain evidence of ineffective competition, problematic market power or excessive profits in NZ banking, and does it support the findings in the Draft Report in those respects?

Does the evidence in the Draft Report support a view that competition for home loans and deposits is not always effective?

3. The Draft Report describes competition for home loans and retail deposits as sometimes more intense and at other times less intense.[1] The suggestion appears to be that competition is only occasionally effective rather than consistently constraining.

4. In our opinion, the evidence presented in the Draft Report in respect of competition for home loans and deposits does not support a contention that the major banks (as defined by the Commission) compete for customers only occasionally and do not face close constraints (i.e., effective competition) consistently over time.

5. The period of more intense price competition that the Draft Report observes, during 2022 and the first half of 2023, appears to have been one that was not financially sustainable for the banks. This period of apparently more intense price competition is consistent with continual effective competition and constraints in personal banking. It is also important to look beyond price and consider the extent to which the banks compete on non-price dimensions. There is no suggestion in the Draft Report that competition in these non-price dimensions has varied in intensity.

[1] For example, see Draft Report, paragraph 2.39.2, page 74 and paragraph 4.36.1. See also paragraph 4.40.

6. The fluctuations observed in the extent to which particular banks compete, and the fact that none of the major banks (including Kiwibank) consistently offer the lowest headline rates, do not alter our opinion. There should be no expectation that in effectively competitive markets the intensity with which individual firms compete will remain constant, nor that one single firm should consistently offer lower prices compared to the others.

Is there any economic basis to expect a higher frequency of "more intense" competition in a competitive banking market?

7. The Draft Report suggests that the Commission has an expectation that in effectively competitive markets there will be more periods of particularly intense competition and more movement in market shares than it observes in personal banking.[2]

8. In our opinion an expectation of a high frequency of bouts of "more intense" competition is not valid as a test for whether a market is competitive. We are not aware of any economic model that defines an appropriate frequency of "more intense" competition. We would expect firms in competitive markets to price competitively but sustainably most of the time, and we do not see an economic basis for an expectation that "more intense" competition should occur more frequently than the Draft Report has observed.

9. The evidence in the Draft Report of a period or more intense competition in home loans in 2022 and the first half of 2023 that appears to have been financially unsustainable should not be interpreted as evidence that the banks are not continually competing as strongly as would be expected in an effectively competitive market. If the intensity of competition during that period was financially unsustainable, there should be no expectation to observe it more often, let alone all the time.

Does the evidence in the Draft Report support a view that there are "established patterns" of price matching behaviour in personal banking?

10. In our opinion, based on a review of the evidence in the Draft Report on published home loan rates, "green" home loan top-up offers, discretionary discounts, cash back offers and retail deposit rates, the Draft Report does not contain evidence of "established patterns" of price matching.

Is there any economic basis to interpret price matching by banks as indicating ineffective competition?

11. The Draft Report appears concerned that rival banks only match the headline offers of other banks, "rather than beat" those headline rates.[3] The concern seems to be that banks only do the minimum necessary to compete with new offers from rivals and do not go further to beat those new offers.

12. A difficulty with this concern from an economic perspective is that it is difficult to distinguish whether price matching on headline rates, when it occurs, is evidence of intense competition or softer accommodating behaviour. When firms compete intensely, they are likely to respond to lower prices offered by their rivals by lowering their own prices. How far they will lower their prices will depend on a range of factors and there should be no expectation that they will beat their rivals' lower prices. Moreover, price beating cannot

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2 Draft Report, paragraphs 2.39.1 and 2.39.2.

3 Draft Report, paragraphs 2.47 and 2.50-2.51.

occur continuously, or else firms would quickly go out of business. It follows that, even if we agreed with the Draft Report's interpretation of the evidence on retail deposit rates that "major banks tend to match each others' offers" we would not agree with the Draft Report that they do so "rather than compete intensely on price".

13. At the same time, the Draft Report is concerned that price matching of headline offers reduces incentives to compete strongly because competitors will anticipate that "aggressive or ongoing price competition is unlikely to lead to sustained changes in share of supply".[4] The Draft Report also suggests that discretionary discounting of home loan rates is a form of "price matching" that "reduce the incentives to compete hard on interest rates, because all providers know that if they introduce a new promotion or lower interest rate, it will quickly be matched by competitors – eliminating the gains from the price strategy".[5]

14. A problem with this concern is that it is unclear what the Draft Report would prefer. There are just two alternatives to price matching better offers of rivals: (i) beating those offers; or (ii) not reacting or reacting but not so far as to match those offers. Neither seems clearly preferable from the Commission's perspective: beating better offers of rivals would *further* disincentivise rivals from making new better offers, whereas not reacting or not reacting as much would be worse for consumers and it would seem antithetical to competition policy to require firms not to lower their prices as far as they otherwise would in response to their rivals.

15. The economic literature on the incentive properties and consumer welfare effects of price matching produces a range of predictions, including that price matching can enhance consumer welfare. It has also been argued that anti-competitive explanations for price matching are not compelling given the wide range of markets in which it is observed. There is therefore no basis in the literature for an assumption that price matching has anti-competitive motivations or effects.

16. Further, to the extent that discretionary discounting involves offering low discretionary rates in a targeted fashion to individual customers, there is nothing to lose from offering a better rate to a customer of another bank. With nothing to lose, there only needs to be a positive chance of customers deciding to switch banks in response to a lower discretionary rate offer for there to be an incentive to make the offer. Discretionary discounting is also a pervasive feature of many industries other than banking that are considered to be effectively competitive (for example the retailing of insurance, electricity, electronics and white goods).

Does the Verian survey evidence support the findings in the Draft Report that rely on that evidence?

17. On the basis of the results of the Verian consumer survey, the Draft Report reaches a preliminary view that there is a significant degree of customer inertia in personal banking, which it appears to attribute to consumers having a relatively low level of confidence in their ability to access information, compare that information to decide on a provider, and act on

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4 Draft Report, paragraph 2.48. Similarly, the Draft Report states that "incentives to innovate […] might be dampened by the knowledge that competitors will quickly follow" (paragraph 2.51).

5 Draft Report, paragraph 4.65.

that information by switching.[6] These preliminary views are used to justify the Commission’s recommendation that home loan providers should present offers in a readily comparable manner.[7]

18. In our opinion the Draft Report’s preliminary views as to the reasons for customer inertia, and the difficulties of accessing information and comparing offers across banks, are not supported by the survey evidence. The main reasons for consumer inertia are because consumers are happy with their current provider or have simply not thought about switching. Perceived time and effort required to switch is also a significant factor, however difficulty accessing information explains only a small proportion of consumer inertia. Comparing information from multiple providers does not appear to be a major issue and mortgage brokers assist consumers to make informed comparisons.

19. The survey evidence therefore does not provide strong support for measures designed to standardise the information presented by providers in respect of their products to enable consumers to compare them more easily.

Margaritis and Hasannasab

20. The Draft Report refers to and in places relies on an academic paper prepared by Professor Dimitris Margaritis and Dr Maryam Hasannasab from the University of Auckland titled “Market Power in Banking: A Study of New Zealand Banks” (hereafter referred to as “the paper” or “Margaritis and Hassanasab”). The Draft Report states that the Commission has found the analysis “helpful”, and the Commission’s preliminary view is that, in several respects, it is supportive of the Commission’s qualitative findings.

21. While the paper presents a number of analyses related to competition and market power in banking, it does not contain evidence that would support a finding that competition in banking in New Zealand is ineffective or that the large New Zealand banks enjoy problematic market power or earn excessive profits. We also observe that a number of statements in the Draft Report that purport to rely on the paper do not appear to be supported by the paper.

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6 Draft Report, Summary of preliminary findings with respect to consumer search and switching behaviour, page 195 and paragraphs 8.27 - 8.28 and 8.72.

7 Draft Report, paragraphs 10.67-10.71.

1. INTRODUCTION

23. The New Zealand 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). On 21 March 2024 the Commission published a draft report containing its preliminary findings regarding factors that, in its view, are affecting competition in personal banking, and options for recommendations to improve competition (Draft Report).

24. In the context of the preliminary findings in the Draft Report, ANZ has requested our economic opinion on the following questions.

    a. Does the evidence in the Draft Report support a view that competition for home loans and deposits is not always effective?

    b. Is there any economic basis to expect a higher frequency of “more intense” competition in a competitive banking market?

    c. Does the evidence in the Draft Report support a view that there are “established patterns” of price matching behaviour in personal banking?

    d. Is there any economic basis to interpret price matching by banks as indicating ineffective competition?

    e. Does the Verian survey evidence support the findings in the Draft Report that rely on that evidence?

    f. Does the paper by Margaritis and Hasannasab titled “Market Power in Banking” contain evidence of ineffective competition, problematic market power or excessive profits in NZ banking, and does it support the findings in the Draft Report in those respects?

25. The remainder of this report sets out our economic opinions on these questions.

2. DOES THE EVIDENCE IN THE DRAFT REPORT SUPPORT A VIEW THAT COMPETITION FOR HOME LOANS AND DEPOSITS IS NOT ALWAYS EFFECTIVE?

26. The Draft Report describes competition for home loans and retail deposits as sometimes more intense and at other times less intense.[8] It associates this with the major banks having “greater or lesser growth ambitions” at any point in time, varying with their “individual circumstances and strategies”. The suggestion appears to be that competition is only occasionally effective rather than consistently constraining.

27. In our opinion, the evidence presented in the Draft Report in respect of competition for home loans and deposits does not support a contention that the major banks (as defined by the Commission) compete for customers only occasionally and do not face close constraints (i.e., effective competition) consistently over time.

[8] For example, see Draft Report, paragraph 2.39.2, page 74 and paragraph 4.36.1. See also paragraph 4.40.

28. The Draft Report primarily relies on an analysis of price competition for home loans in the rising interest rate environment from mid-2021 to the end of 2023.[9] The Draft Report 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. In our view, the period of apparently more intense price competition is consistent with continual effective competition and constraints in personal banking, rather than "sporadic" competition.

    a. The period of more intense price competition that the Draft Report observes appears to have been one that was not financially sustainable for the banks. As the Draft Report observes, some banks reported that in the first period their margins on new home lending fell "well below" their cost of capital, and the CEO of ASB's parent bank CBA is quoted as saying the pricing of New Zealand mortgage rates at the time was "difficult to reconcile" and offered "unsustainable returns".[10] The fact that there was a period when banks were more aggressive in their postures towards winning new business, apparently financially unsustainably, does not establish that competition is not continually an effective constraint on firms raising prices above workably competitive levels.

    b. It is also important to look beyond price and consider the extent to which the banks compete on non-price dimensions. The Draft Report has found that customers care about and banks compete on a range of non-price dimensions of bank offerings including products, service, perceptions of trust and security, digital capabilities and brand awareness.[11] The Draft Report has 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", and "smaller providers also focus on implementing strong non-price offerings to drive customer growth".[12] There is no suggestion or evidence in the Draft Report that competition in these non-price dimensions has varied in intensity.

29. The Draft Report also appears to suggest that competition in home loans is not always effective because it observes fluctuations in the extent to which particular banks compete from month to month and even week to week and that none of the major banks (including Kiwibank) consistently offer the lowest headline rates (no bank is a consistent "best in market" leader).[13] It appears from this that the Commission has expectations that in effectively competitive markets:

    a. there would be little or no fluctuation in the extent to which particular banks compete from month to month or even week to week; and

    b. a particular bank or banks will consistently offer the best prices.

30. There is no basis in economics for either expectation. First, there is no basis for interpreting fluctuations in the extent of aggressiveness of particular banks as indicating that

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9 The Draft Report does not present any separate evidence to support a contention that competition has not always been effective in relation to savings and term deposits.

10 Draft Report, pages 88-89 and footnote 267.

11 Draft Report, paragraph 2.55.

12 Draft Report, paragraph 2.55.

13 Draft Report, page 74 and paragraphs 4.36.1 and 4.40-4.41.

competition in an overall sense is inconsistent and not always effective. While individual banks may fluctuate to some extent in how aggressively they compete (depending on their individual circumstances including cost conditions and strategies) competition overall may remain consistently effective, precluding any firm from pricing above workably competitive levels.

a. The Draft Report acknowledges that some of the fluctuations in the intensity of competition observed for individual banks may be driven by bank-specific fluctuations in costs.[14] This is normal in competitive markets. Even at times when all major banks are experiencing high cost conditions and none are pricing particularly low, they will remain constrained by each other; a higher priced equilibrium reflecting higher costs should not be mistaken for an outbreak of ineffective competition.

b. Temporary price-promotions, including special efforts to appear as lowest priced for limited periods of time, are also normal in competitive markets, acting as a way to advertise services and develop a brand, as well as compete for customers.

31. In any event, the Commission's comparisons of ANZ's weighted average actual agreed interest rates with its headline rates [

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32. Second, 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 not effective. Firms may compete effectively and constrain each other in markets without a clear and consistent lowest price player.[15] The evidence in the Draft Report is that the various banks have all experienced times when they have been lowest priced. This 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 to try to gain share and none able to enjoy a "quiet life". 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. Finally, the Draft Report finds that "growth targets generally balance share of supply growth with protecting margins" and asserts that the major banks lack ambitious growth targets due to limited competition.[16] However, firms in effectively competitive markets will need to

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14 Draft Report, paragraph 4.43.

15 The absence of a systematically lowest price player is consistent with any symmetric model of price competition and all homogenous product Cournot models of quantity competition.

16 Draft Report, paragraph 2.39.3.

balance share growth with the need to remain profitable, so there should be no concern with the banks seeking to do this, and the Draft Report does not explain the benchmark that it uses to establish that the major banks' growth targets lack ambition, nor demonstrate that the major banks' targets are falling short of the benchmark.

3. IS THERE ANY ECONOMIC BASIS TO EXPECT A HIGHER FREQUENCY OF "MORE INTENSE" COMPETITION IN A COMPETITIVE BANKING MARKET?

34. The Draft Report suggests that the Commission has an expectation that in effectively competitive markets there will be more periods of particularly intense competition and more movement in market shares than it observes in personal banking.

    a. Paragraph 2.39.1: "if competition works well, we expect to see more movement in shares of supply generally over a longer term".

    b. Paragraph 2.39.2: "We would expect to see a higher frequency of more intense competition if there were stronger competition".

35. In our opinion an expectation of a high frequency of bouts of "more intense" competition is not valid as a test for whether a market is competitive. We are not aware of any economic model that defines an appropriate frequency of "more intense" competition. This seems to be a question of how often one should expect to see price wars in a competitive market. Given that price wars can be unprofitable, we would expect firms in competitive markets to price competitively but sustainably most of the time, and we do not see an economic basis for an expectation that "more intense" competition should occur more frequently than the Draft Report has observed.[17]

36. The evidence in the Draft Report of a period of more intense competition in home loans in 2022 and the first half of 2023 that appears to have been financially unsustainable[18] should therefore not be interpreted as evidence that the banks are not continually competing as strongly as would be expected in an effectively competitive market. If the intensity of competition during that period was financially unsustainable, there should be no expectation nor any desire to observe it more often, let alone all the time.

4. DOES THE EVIDENCE IN THE DRAFT REPORT SUPPORT A VIEW THAT THERE ARE "ESTABLISHED PATTERNS" OF PRICE MATCHING BEHAVIOUR IN PERSONAL BANKING?

37. In our opinion the Draft Report does not contain evidence of "established patterns" of price matching. We deal below with each type of pricing considered in the Draft Report. In each case we do not find evidence to support the Draft Report's preliminary view that there are "established patterns" of price matching.

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17 Standard economic models of competition look for equilibrium prices and quantities that will not change over time unless over time unless underlying demand or supply conditions change. Indeed, in order to explain movement in prices over time without changing demand and supply, economists need to build special models to deliver those results (e.g. models of Edgeworth cycles).

18 Draft Report, pages 88-89 and paragraph 8 above.

4.1. Published home loan rates

38. The evidence in the Draft Report does not reveal a pattern of price matching on published home loan rates. As the Draft Report states, "[e]ach of the major banks and Kiwibank have at different times take best in market positions in each of the key home lending products, reflecting their individual strategies at these times", "banks periodically take leading or mid-market positions", and "some banks take targeted positions on one or two key home loan products".[19] Figure 4.7 reveals many periods in which certain banks have had higher or lower rates than others, in particular for fixed loan rates, which represent the vast majority of home lending. Reflecting this, the Draft Report acknowledges "differences in headline rates".[20]

4.2. Green home loan top-up offers

39. The Draft Report presents "green" home loan top-up offerings as an example of the major banks "matching rather than beating each others' competitive offers".[21] Our own interpretation of these offers is that they illustrate banks iterating to a competitive equilibrium involving differentiated offers, with beating as well as matching along the way.

40. According to Figure 2.4 in the Draft Report, the development of "green" home loan top-up offers appears to have started in 2019 with Kiwibank's offer of cash bonuses for loans taken out for sustainable energy products. We understand that in fact ANZ first offered an interest free home loan top up product in 2018 (offering $5,000 of interest free lending for heat pumps and insulation) and that this should be viewed as the first competitive move.

41. We do not share the Draft Report's view that that Kiwibank's offer (and presumably ANZ's earlier offer) is not part of the "competitive playing field" because of its "narrow coverage, the lack of an interest rate that is unique to the offer, and because Kiwibank has not participated in matching the offers from other banks".[22] These points do not amount to an objective basis for excluding the Kiwibank offer. By ignoring Kiwibank's offer, the subsequent offers from other banks that "beat" Kiwibank's offer by offering lower interest rates and greater coverage are not recognised as better offers. The fact that Kiwibank did not respond by matching is also ignored. The result is an overstatement of the extent of matching of offers (by understating both the extent of beating and the extent of no reaction).

42. The next development appears to have been Westpac's initial "Warm up home loan" offer of 2020. It is unclear why the Draft Report appears at first to ignore this offer (the Draft Report describes ANZ's subsequent "Good energy" home loan offer of 2022 as the "initial competitive move", ignoring also ANZ's 2018 offering). Westpac's 2020 offer "beat" Kiwibank's 2019 offer with a higher value offering, a lower interest rate (0%) and coverage of heat pumps, insulation, double glazing and ventilation (in addition to solar power).

43. This was followed in 2022 by ANZ's "Good energy" home loan, which replaced ANZ's 2018 offering, and beat Westpac's offer in terms of value ($80,000 compared to $10,000), but with a slightly less attractive interest rate (1% compared to 0%) and a shorter interest rate term (three years compared to five years).

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19 Draft Report, paragraphs 4.54 and 4.56.

20 Draft Report, paragraph 6.42.

21 Draft Report, paragraph 2.49

22 Draft Report, footnote 112.

44. Westpac quickly responded to ANZ with an "expanded" offer covering EV chargers and with an increased loan value of $40,000. Westpac maintained its interest rate edge (0% compared to 1%) as well as a longer interest rate term (five years compared to three).

45. BNZ and ASB then entered into "green" home loan top-up offers that largely matched ANZ's loan value, interest rate, loan term and coverage. Westpac subsequently improved its value offering to $50,000, but maintained its better interest rate and interest rate term elements, rather than "matching" ANZ, BNZ and ASB.

46. Overall, while some matching occurred, particularly toward the end of the period by BNZ and ASB, this episode might be characterised as one of intense competition with differentiated offers and a number of instances of price and non-price "beating", with the major banks ultimately settling on similar but still differentiated offers.

4.3. Discretionary discounts

47. There is no question that banks engage in discretionary discounting. However, this behaviour does not necessarily result in "matching" of the actual rates offered by other banks.

    a. The Draft Report does not contain any evidence that when banks respond to discretionary rates offered by other banks they match what the other banks offer.

    b. It is possible if not likely that in many cases when banks respond to discretionary rates offered by other banks they do not exactly match and either do better or somewhat worse. In some cases, they may also or alternatively offer other price or non-price incentives to try to win or retain the home loan business.

    c. The Verian survey results suggest that the most common reason for customers switching between banks is price ("interest rates/fees" and "rewards/incentives").[23] This suggests that there must be occasions when actual rates after discounts are not matched.

4.4. Cashback offers

48. The Draft Report states that "cashback offers appear to move together across providers".[24] However, it provides no evidence of this or of "matching" of cashback offers. Indeed, the Draft Report raises a concern that cashbacks might make it more difficult for customers to compare offers between providers.[25] This would only be the case if banks offered different cashbacks. If this is really a concern, it would not be consistent for the Commission to maintain that banks are matching each others' cashback offers.

4.5. Retail deposit rates

49. For retail deposits, the Draft Report states that "major banks tend to match each others' offers rather than compete intensely on price".[26] However, the Draft Report provides no evidence of this. The Draft Report does include a comparison over time of weekly deposit

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23 Verian "Personal banking services market study – Research report" (February 2024), at page 22.

24 Draft Report, page 97.

25 Draft Report, paragraph 4.79.1.

26 Draft Report, page 119.

rates for saving and term deposit products across selected banks.[27] However, this analysis does not demonstrate an "established pattern" of price matching. For both savings accounts and term deposits, variation can be observed across the banks at various points in time.

5. IS THERE ANY ECONOMIC BASIS TO INTERPRET PRICE MATCHING BY BANKS AS INDICATING INEFFECTIVE COMPETITION?

50. We discuss, in turn, two issues that arise from the Draft Report's discussions of price matching. First, whether evidence of matching (rather than beating) may be interpreted as evidence of ineffective competition. Second, whether price matching should raise concerns for incentives to compete and innovate.

5.1. How to interpret evidence of price matching?

51. The Draft Report appears concerned that rival banks only match the offers of other banks, "rather than beat" those offers.[28] The concern seems to be that banks only do the minimum necessary to compete with new offers from rivals and do not go further to beat those new offers. The "green" home loan top-up offerings are provided as an example (although as explained above, this actually appears to have been an example of iterative beating of rates before the market settled on a level).

52. A difficulty with this concern from an economic perspective is that it is difficult to distinguish whether price matching, when it occurs, is evidence of intense competition or softer accommodating behaviour. When firms compete intensely, they are likely to respond to lower prices offered by their rivals by lowering their own prices.[29] How far they will lower their prices will depend on a range of factors and there should be no expectation that they will beat their rivals' lower prices. Many economic models exist in which firms in competitive markets do not "beat" lower prices offered by competitors.[30] Moreover, obviously, price beating cannot occur continuously, or else firms would quickly go out of business. In effectively competitive markets price matching may the best way for banks to manage to maintain sales and their prices above average cost (as they need to do).

53. It follows that, even if we agreed with the Draft Report's interpretation of the evidence on retail deposit rates that "major banks tend to match each others' offers" we would not agree

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27 Draft Report, paragraphs 5.42-5.43 and Figure 5.2.

28 Draft Report, paragraphs 2.47 and 2.50-2.51.

29 This is the standard result of strategic complementarity in price competition. For example, in the standard linear model of Bertrand duopoly with differentiated products the firms' reaction curves (i.e., the functions giving the firms' optional price for each price chosen by the rival) are monotonically increasing. See the discussion of Figure 13.11 on page 578 of David Besanko and Ronald Braeutigam (2002), *Microeconomics – An Integrated Approach*, John Wiley and Sons Inc.

30 For example, let us consider the standard Bertrand model of price competition with differentiated products and assume symmetric firms. Suppose a rival reduces its price, either because the rival's costs decreased or for some other exogenous reason (keeping demand and product qualities constant). Other firms will respond by reducing their prices, but not by as much as the rival's initial price cut. In other words, there is no support in economic theory for an expectation that competitive firms will react to rivals' price cuts by beating those cuts. While it is possible in some models (as is price matching) it should not be expected.

with the Draft Report that they do so "rather than compete intensely on price".[31] The matching of others' offers does not imply an absence of intense competition. On the contrary, it is consistent with intense competition. The suggestion that banks do not compete intensely on prices for retail deposits is also at odds with the Draft Report's preliminary findings that "[p]rice competition in the form of interest rates and/or fees appears to be the key driver of consumer choice for term deposits, and to a lesser extent for savings accounts"[32] and "[a]s consumers are price sensitive for savings accounts and term deposits, banks are able to attract deposits to meet their funding needs through adjusting interest rates on these interest bearing products".[33]

54. Similarly, we do not agree with the Draft Report's interpretation of no or low fees for transaction accounts as meaning that: there is "no price competition"; "price is not a significant feature of competition for transaction accounts"; and "the price that consumers pay (or earn) for transaction deposits is not a strong factor that consumers consider when choosing a transaction deposit account".[34] The Commission should not confuse competition resulting in zero prices for a lack of price competition. The Draft Report observes that "many account fees have been reduced or removed in recent years"[35] and presents data showing that transaction and call deposit account fees have fallen from more than 0.4% of average balances to around 0.1% from 2014 to 2022.[36] This is consistent with competition to attract retail deposits in the context of price sensitivity of retail deposit customers. The Draft Report appears to acknowledge this when it states that declining fees may be attributed to banks "reducing fees to attract retail deposits".[37] This would not make sense if price were not a significant factor for customers and for competition in retail deposits.

5.2. Should there be a concern for incentives to compete and innovate?

55. At the same time, the Draft Report is concerned that price matching of headline rates reduces incentives to compete strongly because competitors will anticipate that "aggressive or ongoing price competition is unlikely to lead to sustained changes in share of supply".[38] The Draft Report also suggests that discretionary discounting of home loan rates is a form of "price matching" that "reduce the incentives to compete hard on interest rates, because all providers know that if they introduce a new promotion or lower interest rate, it will quickly be matched by competitors – eliminating the gains from the price strategy".[39]

56. Regarding this concern, it is unclear what the Draft Report would prefer. There are just two alternatives to price matching better offers of rivals: (i) beating those offers; or (ii) not

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31 Draft Report, page 119.

32 Draft Report, paragraph 5.32.

33 Draft Report, paragraph 5.35.

34 Draft Report, page 119 and paragraph 5.19.

35 Draft Report, paragraph 5.19.

36 Draft Report, paragraph 5.21 and Figure 5.1.

37 Draft Report, paragraph 5.22.

38 Draft Report, paragraph 2.48. Similarly, the Draft Report states that "incentives to innovate […] might be dampened by the knowledge that competitors will quickly follow" (paragraph 2.51).

39 Draft Report, paragraph 4.65.

reacting or reacting but not so far as to match those offers. Neither seems clearly preferable from the Commission's perspective.

a. Beating better offers of rivals would *further* disincentivise rivals from making new better offers: either their ability to gain share would be reduced compared to a price matching reaction or to gain the same share they would have to respond themselves with lower prices than their original better offer. In the worst case (though unlikely) they may fear sparking an irrational price war that may be ruinous for them.

b. Compared to not reacting or not reacting as much, price matching benefits consumers. It is also, as mentioned, consistent with healthy competition: pro-competitive motivations for price matching include to retain customers and create consumer trust in a brand.

57. The economic literature on the incentive properties and consumer welfare effects of price matching produces a range of predictions, including that price matching can enhance consumer welfare. It has also been argued that anti-competitive explanations for price matching are not compelling given the wide range of markets in which it is observed.[40] There is therefore no basis in the literature for an assumption that price matching has anti-competitive motivations or effects.

58. To the extent that lowering prices in the context of discretionary discounting involves offering low discretionary rates in an individualised, targeted fashion to customers of other banks, there is nothing to lose from offering a better rate to a customer of another bank. This is different from a decision to lower list prices that will apply to all of a bank's customers including its own customers, which is commonly assumed to be the set-up in the literature on price matching. With nothing to lose, there only needs to be a positive chance of customers deciding to switch banks in response to a lower discretionary rate offer for there to be an incentive to make the offer. Discretionary discounting is also a pervasive feature of many industries other than banking that are considered to be effectively competitive (for example the retailing of insurance, electricity, electronics and white goods).

59. Finally, there is no evidence in the Draft Report that incentives to innovate and offer better terms have been materially dampened by matching where it has occurred. The "green" home loan top ups case study illustrates that innovation has not been discouraged in terms of new home loan offers. The Draft Report also observes that cashback offers "are an increasing feature of the market for new lending" and average cashbacks as a percentage of new home lending have increased from around 0.5% in 2017 to around 0.9% in August

40 Indeed, the paper cited by the Draft Report for its argument on incentive effects of price matching argues that the "dampening of incentives to compete" theory of harm is not compelling as an explanation for price matching. In summarising the literature on price matching guarantees, the authors of this paper observe that "[n]either of the theories of anticompetitive price matching is compelling as an explanation of the wide range of markets in which the guarantees are observed. Prices do not appear to jump to monopoly levels when price matching guarantees are offered, and the large number of firms in the markets where the practice is observed is also inconsistent with the basic cartel theory". The authors posit an alternative *consumer welfare enhancing* explanation: price matching guarantees can *enhance* consumer welfare by facilitating positive search externalities that active time-rich shoppers provide to time-poor shoppers: Sridhar Moorthy and Ralph A. Winter (2002), "Price matching guarantees", 2(1) *Review of Marketing Science Working Papers*.

2023.[41] The Draft Report also observes that published home loan rates vary across the banks.[42]

6. DOES THE VERIAN SURVEY EVIDENCE SUPPORT THE FINDINGS IN THE DRAFT REPORT THAT RELY ON THAT EVIDENCE?

6.1. Introduction

60. As part of the market study, Verian was commissioned to conduct a consumer survey to better understand consumers' current situation, behaviour and interaction with personal banking services and providers.[43] The survey considered issues including rates of switching as well as motivations for and barriers to switching.

61. On the basis of this survey, the Draft Report reaches a preliminary view that there is a significant degree of customer inertia in personal banking, which it appears to attribute to consumers having a relatively low level of confidence in their ability to access information, assess that information to decide on a provider, and act on that information by switching.[44] It considers that there are barriers to searching and switching that reduces competitive pressure on the major banks[45] and appears to conclude that search and/or switching costs are "significant", particularly in respect of home loans.[46] These findings are used to justify the Commission's recommendation that home loan providers should present offers in a readily comparable manner.[47]

62. In our opinion the Draft Report's interpretation of the survey evidence and its preliminary views as to the reasons for customer inertia and the significance of search and comparison costs are not supported.

6.2. Reasons for customer inertia

63. On our reading, responses to the consumer survey suggest that the main reasons for consumer inertia are because consumers are happy with their current provider or have simply not thought about switching. Perceived time and effort required to switch is also a

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41 Draft Report, page 97.

42 Draft Report, paragraphs 4.56-4.57 and 4.61.

43 Verian "Personal banking services market study – Research report" (February 2024), at page 5.

44 Draft Report, Summary of preliminary findings with respect to consumer search and switching behaviour, page 195 and paragraphs 8.27 - 8.28.

45 Draft Report, Summary of preliminary findings with respect to consumer search and switching behaviour, page 195 and paragraphs 8.27 - 8.28.

46 For example, the Draft Report states that "[f]aced with significant real or perceived search and/or switching costs, consumers may find it very difficult to navigate personal banking markets": Draft Report, paragraph 8.72.

47 Draft Report, paragraphs 10.67-10.71.

significant factor, however difficulty accessing information explains only a small proportion of consumer inertia.[48]

a. Of the 62% of survey respondents that have not considered switching any product at all in the last three years:

   i. Between 69% (in relation to home loans) and 85% (in relation to transaction and savings accounts) responded that they have had "no reason to" or "haven't considered it". As Verian reports, "the majority are happy with their current provider or the status quo, having not been prompted to think about switching".

   ii. Between 17% and 29% identified perceived difficulties in switching as their main reason for not considering switching. Most of these consumers identified "too much time/effort" as their perceived difficulty, but only between 1% and 5% identified that it was too hard to find information.[49]

b. Of the 23% that considered switching at least one product, but did not ultimately switch:

   i. Between 41% (transaction accounts) and 73% (term deposits and home loans) responded that they could not find a better deal, were locked into their existing product or were uncertain/concerned about switching.

   ii. Between 27% (for term deposits) and 52% (for transaction accounts) identified "too much effort" as the reason not to switch, including not wanting to set things up again and "too hard to find info", but only between 4% (term deposits) and 7% (savings accounts and home loans) responded that the reason they did not switch was that it was "too hard to find info".[50]

c. Therefore, if we look across all respondents that did not switch any product in the last three years – those that did not even consider doing so (62% of all respondents) and those that did consider it but did not ultimately switch (23% of all respondents) – between 62% and 81% could be understood to have not switched for reasons other than perceived time and effort [51] and *only between 2% and 6% did not switch because they found it too hard to access information*.[52]

64. Further, when asked how easy or difficult it was to find all the information needed to make an informed decision with respect to their current provider, 68% of respondents considered it to be easy or very easy with respect to their home loan provider and between 73% and 87% considered it to be easy or very easy with respect to the provider of their transaction,

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48 As Verian reports, of those who actually switched, 62% found it easy or very easy and only 8% found it difficult. The perception of difficulty is therefore greater than the reality. Verian "Personal banking services market study – Research report" (February 2024), at page 28.

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

50 Verian "Personal banking services market study – Research report" (February 2024), at page 27.

51 We calculate these percentages as follows: Lower bound: (0.69*0.62 + 0.41*0.23)/0.85 = 0.62; Upper bound: (0.85*0.62 + 0.73*0.23)/0.85 = 0.81. The category "perceived time and effort" includes difficulty accessing information, however difficulty accessing information is only a small proportion of the category.

52 We calculate these percentages as follows: Lower bound: (0.01*0.62 + 0.04*0.23)/0.85 = 0.02; Upper bound: (0.05*0.62 + 0.07*0.23)/0.85 = 0.06.

savings or term deposit account.[53] Only between 3% (term deposits) and 8% (home loans) considered it to have been difficult or very difficult. This evidence is consistent with the evidence on the reasons for consumer inertia discussed above. Taken together we read the evidence as saying that difficulty accessing information is an issue for only a small minority of consumers.

65. To make a case that access to information is an issue, notwithstanding the findings just mentioned, the Draft Report highlights Verian's findings regarding respondent's' views on *potential future switching* (in the next 12 months): in particular, 19% of survey respondents reported that it would be difficult or very difficult to access information and 22% reported that it would be difficult or very difficult to decide which provider is best.[54] In our opinion, evidence on respondent's hypothetical future perceptions is less reliable than the evidence on actual historical experiences and the actual causes of consumer inertia discussed above. In any event, over half of all respondents (51%) reported, prospectively, that they think it would be easy or very easy to access all the information they would need about different providers and their products, and a further 21% indicated that doing so was neither easy nor difficult. In other words, 72% do not consider accessing information would be difficult, with a further 9% having no opinion at all.[55] Similarly, 70% do not consider deciding which provider is best would be difficult, with a further 8% having no opinion at all.[56] We do not consider that this evidence justifies a conclusion that "customers have relatively low levels of confidence in their ability to access information in the market [or] assess that information to decide on a provider".[57]

6.3. Search and comparison costs

66. Based on its observation that customers have relatively low levels of confidence in their ability to access information in the market and decide on a provider, the Draft Report appears to consider the relatively low usage of independent websites that enable consumers to compare different banks and banking services to be an issue.[58] On consumer use of bank websites, the Commission considers that "*it can be difficult for consumers to compare across multiple websites because it takes extra time and effort to visit multiple sites, and because there is no standardised way of presenting key terms and conditions to consumers to enable a 'like-for-like' comparison across banks*".[59] Further, it considers that for home loans, search costs are significantly increased by opaque pricing / discretionary discounts and other "below the line" campaigns, such as cashbacks.[60]

67. In our view there is no support in the consumer survey to suggest that consumers have difficulty finding and comparing information from multiple providers or that search costs are particularly high in respect of home loans. As mentioned, only 8% of respondents

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53 Verian "Personal banking services market study – Research report" (February 2024), at page 37.

54 Draft Report, paragraphs 8.28 and 8.31.

55 Verian "Personal banking services market study – Research report" (February 2024), at page 44.

56 Verian "Personal banking services market study – Research report" (February 2024), at page 44.

57 Draft Report, paragraph 8.28.

58 Draft Report, paragraphs 8.29-8.33.

59 Draft Report, paragraph 8.34.

60 Draft Report, paragraph 8.35.

considered it difficult or very difficult to find all the information they needed to make an informed decision with respect to their current home loan provider.[61] The Draft Report also makes no reference in its discussion of search costs to the survey evidence that 40% of respondents with a home loan have used a mortgage broker when setting up or switching their loan and that two-thirds of respondents that switched a home loan recently used a mortgage broker.[62] As acknowledged in the Draft Report, mortgage brokers help to increase consumers' knowledge of loan products and assist customers to choose products that are a good fit for them.[63]

6.4. Summary

68. The Draft Report's preliminary views as to the reasons for customer inertia, and the difficulties of accessing information and comparing offers across banks, are not supported by the survey evidence. The main reasons for consumer inertia are because consumers are happy with their current provider or have simply not thought about switching. Perceived time and effort required to switch is also a significant factor, however difficulty accessing information explains only a small proportion (between 2% and 6%) of consumer inertia. Comparing information from multiple providers does not appear to be a major issue and mortgage brokers assist consumers to make informed comparisons.

69. The survey evidence therefore does not provide strong support for measures designed to standardise the information presented by providers in respect of their products to enable consumers to compare them more easily.

7. MARGARITIS AND HASANNASAB

7.1. Introduction

70. The Draft Report refers to and in places relies on an academic paper prepared by Professor Dimitris Margaritis and Dr Maryam Hasannasab from the University of Auckland titled "Market Power in Banking: A Study of New Zealand Banks" (hereafter referred to as "the paper" or "Margaritis and Hasannasab"). This paper has a byline: "An investigation into cost and profit efficiency, economies of scale, market concentration, and market power for New Zealand banks".

71. This paper was prepared at the request of the Commission for the purpose of the market study because the Commission wanted "a different view to that offered by the standard measures of profitability in banking like return on assets, return on equity and net interest margin" and to inform the Commission's assessment of the reasons for the profitability the Commission observes using these standard measures.[64]

72. The Draft Report states that the Commission has found the analysis "helpful", and the Commission's preliminary view is that, in several respects, it is supportive of the

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[61] Verian "Personal banking services market study – Research report" (February 2024), at page 37.

[62] Verian "Personal banking services market study – Research report" (February 2024), at page 39.

[63] Draft Report, paragraph 4.124.1.

[64] Draft Report, paragraphs 1.47.3 and 1.69.

Commission's qualitative findings, although the Commission has "not relied heavily on it" in arriving at its preliminary findings and draft recommendations.[65]

73. As explained below, the paper contains no evidence of ineffective competition, problematic market power or excessive profits in NZ banking. We also observe that a number of statements in the Draft Report that purport to rely on the paper do not appear to be supported by the paper.

7.2. Terminology (market power, pricing power and the Lerner index)

74. Before discussing the findings (and non-findings) of the paper, it is useful to clarify some terminology. In particular, it is useful to clarify the meanings of the terms "market power" and "pricing power" as used in the paper, and the nature of the Lerner index measure of "market power".

75. The authors use the terms "market power" and "pricing power" *descriptively* to refer to prices that are above marginal cost. The authors do not use these terms *pejoratively* to imply market power associated with ineffective competition. Prices can and usually will be above marginal costs in effectively competitive markets (i.e., there can be "market power" in effectively competitive markets, in the purely descriptive sense that term is used by the authors), due to firm-level efficiency or where there are fixed costs that need to be recovered. Indeed, where there are fixed costs that need to be recovered, prices need to be above marginal cost or else firms will be unprofitable and go out of business. Therefore, prices above marginal cost do not necessarily indicate problematic market power due to a lack of effective competition or anti-competitive behaviour.

76. It follows that when using the term "market power" in this way a distinction needs to be drawn, at least conceptually, between market power that would be present in an effectively competitive market and market power that goes further and is problematic due to a lack of effective competition or anti-competitive behaviour.

77. The Lerner index is a measure of the extent to which prices are above marginal cost. Specifically, it is the difference between price and marginal cost divided by the price ($L = (P - MC)/P$). A positive Lerner index is often (loosely) considered to indicate "market power" in the pejorative sense. Strictly speaking, however, it is *only describing the deviation from marginal cost pricing*. Since prices will usually exceed marginal costs in effectively competitive markets, positive Lerner index values will usually be observed in effectively competitive markets.[66] Elzinga and Mills (2011) put it well.

> *Economists generally agree that, outside the textbooks, almost all firms have positive price cost margins. Robert E. Hall's examination of these margins in a large sample of 2-digit U.S. industries for the period 1953-1984 found "a large gap [between price and marginal cost] in many industries" (1988, p. 946). More often than not, firms with Lerner Indices large enough to indicate significant market power are not "monopolies" in the traditional antitrust sense that emphasizes heavy-handed output constraints and the absence of competition. Rather, these firms' price-cost margins may reflect "superior skill, foresight and industry" that is*

65 Draft Report, paragraph 1.70.

66 This has been referred to as "the most important limitation of the Lerner index": Elzinga, Kenneth G. and David E. Mills (2011), "The Lerner Index of monopoly power: origins and uses," *American Economic Review*, May 2011, 558-564 at 559.

> *the very result of competition. Or, a relatively high Lerner Index may reveal nothing more than the necessity of covering fixed costs. […]*
>
> *This makes the Lerner Index an unreliable stand-alone indicator of the "degree" to which a firm's market power represents a genuine monopoly problem. While acknowledging that the Index is informative about a firm's ability to control its own price, Ben Klein (1993) cautions that it may not be informative about a firm's ability to raise market price and constrain market output.*[67]

7.3. No evidence of ineffective competition or problematic market power

78. While the paper presents a number of analyses related to competition and market power in banking, there is no evidence in the paper that would support a finding that competition in banking in New Zealand is ineffective or that the large New Zealand banks enjoy problematic market power or earn excessive profits.

79. The paper begins by presenting an analysis that the authors interpret as evidence of that "banks tend to respond faster to increases in the OCR".[68] As we explain later, this analysis actually suggests that banks respond *symmetrically* to increases and decreases in the OCR in terms of speed. There are also aspects of the authors' model specification and findings for example, cumulative pass through declining after four months and tending toward zero) that are not well explained in the paper and that give cause to question the analysis and findings in relation to pass-through of changes in the OCR.

80. The paper also observes "moderate" concentration in the New Zealand banking industry, based on levels of the Herfindahl-Hirschman Index (HHI) a little below 2,000. However, as the authors explain, the empirical banking literature has long recognised that concentration might not accurately reflect the degree of competition in banking markets" and "concentration measures focus on how markets are proportioned between firms", whereas the questions of real interest are whether there is the ability to price above marginal cost ("market power" or "pricing power") and if so whether this is the result of efficiency, the need to recover fixed costs or ineffective competition.[69]

81. In relation to efficiency, the authors find that the large New Zealand banks operate with high cost efficiency (meaning that they are highly efficient in minimising their costs given their level of outputs and input prices) and high profit efficiency (meaning that they are highly efficient at utilising their inputs and outputs to generate profits for given input prices) and that most banks operate under cost economies of scale. The evidence on efficiency does not support a conclusion that the large New Zealand banks are enjoying a "quiet life" whereby high market power shelters them from the need to operate efficiently.

82. Their direct measures of market power (in the descriptive sense) also do not provide any evidence of ineffective competition or problematic market power. The authors report that Lerner index and Panzar-Rosse H-statistic values for the major NZ banks are at "moderate" levels. As explained, this should not be interpreted as evidence that competition in the New Zealand banking market is ineffective and that the major banks enjoy problematic levels of market power. The "moderate" levels of market power that the authors find are consistent

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67 Elzinga, Kenneth G. and David E. Mills (2011), "The Lerner Index of monopoly power: origins and uses," *American Economic Review*, May 2011, 558-564 at 561.

68 As explained later, the analysis does not find asymmetric pass-through of changes in the OCR in the long-run, contrary to the statement to this effect in the paper and in the Draft Report.

69 Margaritis and Hasannasab, page 2.

with effective competition in markets in which there are economies of scale and fixed costs that need to be recovered.[70]

83. The authors do not purport to have assessed whether banks earn excessive profits.[71] They observe that this would require further analysis. While they have found "moderate" pricing power, they have also found evidence that most banks are operating with cost elasticity of scale, suggesting the presence of fixed costs that would have to be recovered by pricing above marginal cost. Since pricing power can arise from both cost efficiency and the need to recover fixed costs, there is no basis for interpreting the "moderate" pricing power of New Zealand's banks as problematic or "excessive".

84. The authors conclude that their findings "are aligned with the "efficient structure hypothesis" that claims that competitive pressures lead firms to operate at their most efficient levels, as they seek to gain market share and maximise profits", leading to inefficient firms being driven out and concentrated market structures populated by efficient firms. They also conclude that their analysis suggests that "the incumbents, even the larger banks, are efficient firms operating under constant or increasing returns to scale".[72] Their findings are therefore consistent with the New Zealand banking sector being effectively competitive, and do not support a finding that the banking market is characterised by abnormal or problematic levels of market power.

7.4. A number of statements in the Draft Report that purport to rely on the paper are not supported by the paper

7.4.1. Pass-through of changes in the OCR

85. The Draft Report states that in relation to home loans, "banks tend to respond faster to increases in the OCR and […] this asymmetry holds for both the short- and the long-run".[73]

86. Although this statement is a direct quote from the paper,[74] it does not reflect the paper's findings in two respects. First, Figure 1 of the paper, if correct, suggests that banks respond *symmetrically* in terms of speed to increases and decreases in the OCR. After one and two months, the responses are similar: for example, after two months around 50% of OCR changes are passed through, whether the changes are positive or negative. If Figure 1 is correct, asymmetry in responses to positive and negative changes occur in months three and four, but the asymmetry is in terms of the magnitude of pass-through rather than the speed of pass-through.

87. Second, Margaritis and Hasannasab observe that they find that the asymmetry "fades after a few months" and their analysis "indicates an asymmetry in the short run but *not the long run*" (emphasis added), with the absolute difference in the cumulative response paths

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70 To put this another way, there is no evidence in the values of the Lerner index and Panzar-Rosse H-statistic suggesting that prices are significantly higher than needed to keep NZ banks in business. The evidence in the paper that most banks operate with cost economies of scale suggests one should expect prices above marginal costs and positive Lerner index values in order to recover fixed costs.

71 They are transparent about this in their concluding remarks (Section 11).

72 Margaritis and Hasannasab, pages 27-28.

73 Draft Report, paragraph 4.35.

74 See Margaritis and Hasannasab, page 5.

approaching zero.[75] There is therefore no basis in the Margaritis and Hasannasab analysis to conclude that asymmetric responses to changes in the OCR continue beyond the short term.

88. It is also important to bear in mind that the vast majority of home loans are fixed rate loans (more than 90% in August 2023 according to Figure 4.4 of the Draft Report). Margaritis and Hasannasab's analysis is of floating (variable) rates. These are relevant only for a small minority of home loan customers and a small proportion of the home loan portfolios of the banks. Therefore, if the statement in the Draft Report is made on the basis of Margaritis and Hasannasab's paper, it can only be made with respect to rates affecting less than 10% of home loans.

89. More fundamentally, perhaps, the findings of the paper's OCR pass-through analysis give cause to query whether the underlying model has been well specified. In particular, it is unclear to us why the cumulative pass-through effect would not continue to increase over time, converging on some value close to 1 (having reached 0.9 after four months for positive OCR changes). Instead, it appears to decrease after the fourth month. The authors provide no explanation for this counterintuitive finding.

7.4.2. Market Concentration

90. The Draft Report considers that there has been "some reduction in concentration" over the period 2016 to 2022, but Herfindahl-Hirschman Index (HHI) measures for total deposits, total loans, and total assets "have remained at all times during this period at the level of concentration that is usually described as moderate to high". [76]

91. Margaritis and Hasannasab find HHI measures for deposits, loans and assets to be less than 2,000 for each year from 2018 to 2022 inclusive (Margaritis and Hasannasab, Figure 2). They interpret these HHI levels as indicating "*moderate* concentration" (emphasis added).[77] This reflects usual competition agency practice and does not support the Commission's interpretation that these HHI levels are "usually described as moderate *to high*" (emphasis added).

92. The basis for the Commission's view appears to be the US Department of Justice (DOJ) and Federal Trade Commission (FTC) recently released 2023 Merger Guidelines, which describe an HHI above 1,800 as indicating "high" concentration.[78] However, the US DOJ and FTC's current position on HHIs in US markets differs from its own recent historical position and the positions of other competition agencies on HHIs for markets in their jurisdictions:

    a. The previous DOJ and FTC Merger Guidelines (published in 2010) described HHI levels between 1,500 and 2,500 as "moderately concentrated";[79]

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75 Margaritis and Hasannasab, page 5, and see also pages 33-35.

76 Draft Report, paragraph 2.39.1.

77 Margaritis and Hasannasab, pages 6-7. Margaritis and Hasannasab refer to HHI levels between 1,500 and 2,500 as indicating "modest" concentration (consistent with the US Department of Justice and Federal Trade Commission's 2010 *Horizontal Merger Guidelines*).

78 Draft Report, footnote 98.

79 US Department of Justice and Federal Trade Commission, *Horizontal Merger Guidelines*, 2010, Section 5.3.

b. The UK CMA recently described HHI levels between 1,000 and 2,000 as "moderately concentrated";[80] and

c. The ACCC's Merger Guidelines state that "[t]he ACCC will generally be less likely to identify horizontal competition concerns when the post-merger HHI is less than 2,000".[81]

93. We therefore consider that Margaritis and Hasannasab's conclusion that the HHI levels in New Zealand banking (below 2,000) indicate "moderate" concentration is consistent with usual antitrust agency interpretation of HHI levels historically and in other jurisdictions.

94. We also agree with the caution of Margaritis and Hasannasab that "the empirical banking literature has long recognised that concentration might not accurately reflect the degree of competition in banking markets". As Margaritis and Hasannasab explain, concentration measures focus on how markets are proportioned between firms, whereas the questions of real interest are whether there is the ability to price above marginal cost ("pricing power") and if so whether this is the result of efficiency, economies of scale or uncompetitive behaviour.[82]

7.4.3. Profitability and market power

95. According to the Draft Report the Commission considers "that at least part of the profitability [of the New Zealand banking sector] is explained by the market power of some participants and that New Zealand's banking sector profits are higher than what would be expected if the major banks faced greater competition".[83]

96. After making this statement, the Draft Report refers to Margaritis and Hasannasab as finding "evidence of what they described as 'moderate market power' in the market for loans, and across the banking sector more generally based on their estimates of the Lerner Index and the Panzar-Rosse H statistic respectively".[84] As explained earlier, the paper's finding of moderate "market power" in the purely descriptive sense of prices above marginal cost is not a basis for finding ineffective competition or problematic market power. Prices above marginal cost are consistent with an effectively competitive market in which there are economies of scale and fixed costs that need to be recovered.

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80 UK CMA, *The State of UK Competition*, 2022, paragraph 2.74.

81 ACCC, *Merger Guidelines*, 2008 (as amended in 2017), paragraph 7.14.

82 Margaritis and Hasannasab, page 2.

83 Draft Report, paragraph 6.59.

84 Draft Report, paragraph 6.60.