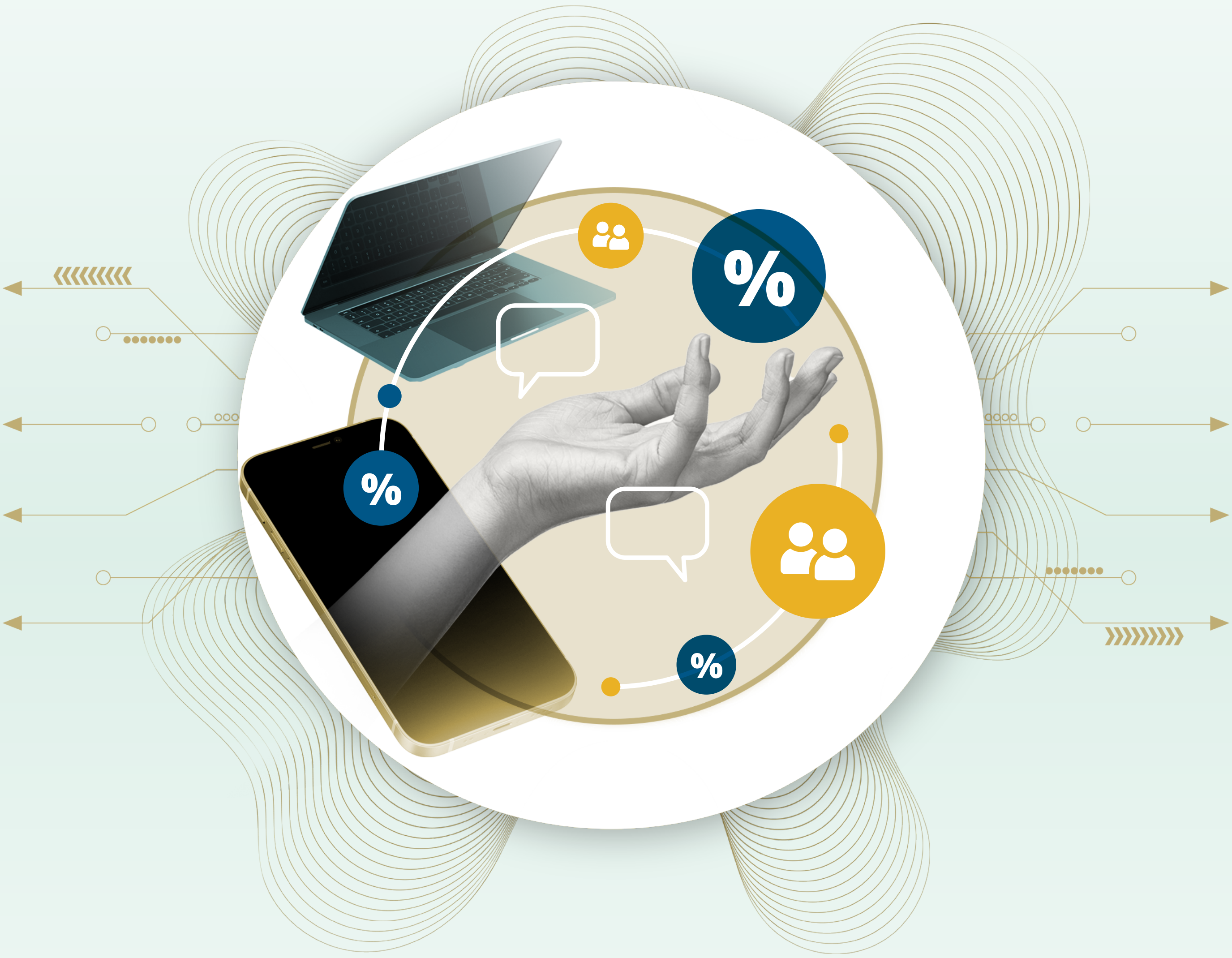
Deloitte.



Personal banking services: Consumer switching, conditions of entry and expansion, profitability and innovation

A report for BNZ
07 September 2023

Deloitte Access Economics

Contents

Table of Tables

Table of Figures

Glossary

Acronym	Full name
ACCC	Australian Competition and Consumer Commission
ADI	Authorised Deposit-taking Institution (in Australia)
AML	Anti-Money Laundering
API	Application Programming Interface
APRA	Australian Prudential Regulation Authority
BNZ	Bank of New Zealand
BOB	Bank of Baroda (New Zealand)
BOC	Bank of China (New Zealand)
BOI	Bank of India (New Zealand)
CAPM	Capital Asset Pricing Model
CCB	China Construction Bank (New Zealand)
CCCFA	Credit Contracts and Consumer Finance Act 2003
CDR	Consumer Data Right
CMA	Competition and Markets Authority (UK)
Commission	Commerce Commission New Zealand
Co-op	The Co-operative Bank
DAE	Deloitte Access Economics
D-SIB	Domestic Systemically Important Banks (as defined by the RBNZ)
ESAS	Exchange Settlement Account System
FCA	Financial Conduct Authority (UK)
FMI	Financial Market Infrastructure
FTP	Fund Transfer Pricing
GFC	Global Financial Crisis
ICBC	Industrial and Commercial Bank of China (New Zealand)
KYC	Know Your Customer/Client
LSAP	Large Scale Asset Purchase programme
NBDT	Non-bank Deposit Taker (as defined in the Non-bank Deposit Takers Act 2013)
NIM	Net Interest Margin
OCR	Official Cash Rate
OECD	Organisation for Economic Co-operation and Development
PIP	Preliminary Issues Paper (for the market study into personal banking services, unless stated otherwise)

RBNZ	Reserve Bank of New Zealand
[ ]	[ ]
ROA	Return on Assets
ROACE	Return on Average Capital Employed
ROE	Return on Equity
S&P	Standard and Poors
SBS	Southland Building Society
TSB	Taranaki Savings Bank

Scope and introduction

Purpose

1. This independent report presents analysis on competition in personal banking services in New Zealand, with a focus on consumer switching, innovation, conditions of entry, expansion and exit and measures of profitability. Deloitte Access Economics (**DAE or we**) has been engaged by the Bank of New Zealand (**BNZ**) to undertake this report in response to the Commerce Commission's (**the Commission**) Preliminary Issues Paper (**PIP**) on the market study into personal banking services (**Market Study**), released on 10 August 2023.

Competition in the context of financial stability

2. Regulation in banking services is important for stability and trust. A focus on financial stability is paramount given the systemic importance of the banking sector in any economy. A large bank or system failure would have material consequences compared to a failure of a provider of other services to the New Zealand economy. To this end, the Reserve Bank of New Zealand (**RBNZ**) and other organisations are tasked with ensuring financial institutions are appropriately regulated and supervised.[1]

3. Regulation provides an important setting within which to view the nature of competition in the market for personal banking services. The regulatory system is structured in such a way that systemic risks to the stability of New Zealand's financial sector are minimised, but this has implications for competitive dynamics. The regulatory system is designed primarily to ensure financial stability objectives are met and that consumer protections are embedded.

Considerations in reading this report

4. This report examines competition within personal banking services, given the context of the current regulatory settings.

5. Typically, competition analysis focuses on a relevant market, defined by a product and a geographic space in which competition takes place. For the purposes of this report, our focus is on in-scope personal banking services[2] overall, rather than analysis of separate relevant markets.

6. Our framework for analysis focusses on "workable competition" as set out by the Commission in its market studies guidelines, which notes that:[3]

> "[a] workably competitive market is one that provides outcomes that are reasonably close to those found in strongly competitive markets…" and that "[w]hat matters is that workably competitive markets have a tendency towards generating certain outcomes".

7. Our focus is therefore on the long-term features, trends and outcomes seen for in-scope personal banking services and how they are likely to evolve into the future.

Structure of this report

8. With this in mind, this report analyses consumer switching, innovation, conditions of entry, expansion and exit and measures of profitability and comparative indicators of bank performance. It analyses the implications of these for the Commission's market study into the provision of personal banking services.

---

[1] RBNZ "Our approach to ensuring financial stability" (accessed 31 August), available at https://www.rbnz.govt.nz/financial-stability/our-approach-to-ensuring-financial-stability
[2] The Commission indicates in its PIP that it intends to focus predominantly on deposit accounts and home loans.
[3] Commerce Commission "Market study guidelines" (November 2020) at [15], available at https://comcom.govt.nz/__data/assets/pdf_file/0029/228476/Market-studies-guidelines.pdf

9. The remainder of the report is structured as per Table 1 below.

Table 1: Report structure and content

Chapter	Content
Consumer switching	• The importance of the *ability* to switch • Strong consumer engagement and perceptions of switching • There are multiple layers of consumer switching • There are numerous tools and alternative channels that support switching • Consumer switching in personal banking is evolving in New Zealand
Innovation	• Innovation is a wide concept • There are a number of drivers of innovation • Open Banking can further support innovation and consumer switching
Conditions of entry, expansion and exit	• Economies of scale matter in a small economy • Economies of scope are changing in the digital era • Diminishing importance of retail branches • Branding and reputation • Regulation matters for financial stability, with implications for competition • Differing wholesale costs matter for firms looking to enter and expand • The shift towards digital channels has lessened commercial requirements for entry • Evidence of entry and expansion for in-scope products
Profitability and comparative indicators of bank performance	• Issues with cross-country profitability analysis • Issues with cross-firm profitability analysis • Issues with firm-wide profitability analysis

Source: Deloitte Access Economics

Authors of the report

Liza Van Der Merwe (Partner), Dr Ric Simes (Principal, Australia), John Raven (Director, UK), Mayuresh Prasad (Associate Director), Elri Pienaar (Manager) and Ayden Dickins (Analyst)

Consumer switching

Key points

- In a workably competitive market, the ability of consumers to switch between firms heightens the extent of competition in a market. **It is the *ability* to switch, rather than the act of doing so** that provides competitive pressures. The ability to switch and an engaged consumer base also eases the conditions of entry and expansion for new and existing firms.

- While there may be **some perceived impediments to switching**, a lack of switching is itself not symptomatic of weak demand side pressures. **Evidence points to consumers in personal banking services being engaged and satisfied** with their current providers of in-scope products, **with both price and non-price characteristics of personal banking services being relevant**.

- The **process of switching is nuanced** for personal banking services and **extends beyond being considered only at significant life events.** Consumers engage in the process of switching for several other reasons, including, but not limited to, when a product is up for review (e.g., the expiry of a fixed rate on a mortgage), when a consumer is not satisfied with their current provider, when new products or product features are introduced that better suit the consumer's needs, when consumers become aware of a better rate or when consumers re-evaluate their purchase or change features of their existing product.

- **Multihoming is a significant feature** of consumer switching in personal banking services. While it is true that switching can encompass entirely moving providers, it is more nuanced. For example, a consumer may replace (wholly or in part) one personal banking product with a similar one at another provider; replace (wholly or in part) one personal banking product with a different personal banking product, with the same or different provider, or remain with the existing provider and maintain multiple personal banking products but add and use similar personal banking products at another provider. Given the minimal cost of holding multiple current or savings accounts, it would not be unusual for consumers to continue to hold multiple accounts with different providers.

- There are **tools** (such as interest.co.nz) and **different channels** that make consumer switching in personal banking services easier, with both the **digital channel** and **brokers playing an increasingly important role in facilitating the ability to switch**.

- **Switching trends continue to evolve in New Zealand**, with switching playing an increasing role for in-scope products. For example, the proportion of new mortgage commitments due to a change in provider has been trending upwards since 2021, suggesting consumers are actively shopping around amid increasing interest rates. Consumer switching is likely to evolve even more given market developments, such as the introduction of payments between banks being processed 7-days a week from May 2023, developments in the digitalisation of personal banking services, forthcoming Open Banking reforms and reforms around consumer data rights.

Purpose

10. This chapter highlights areas that deserve particular focus when it comes to assessing consumer switching for personal banking services.

11. We consider that switching is nuanced for personal banking services, and the Commission will need to accurately consider all aspects of switching. Switching must be understood in the wider context of choice in banking. The extent to which consumers can make informed choices, and the extent to which they are satisfied with these choices, can provide contextual evidence to inform analysis of switching and competition for personal banking services.

12. A key element of switching is the distinction between main bank consumer-provider relationships and individual products. Switching can occur at either or both levels, but the dynamics of switching at each is likely to be different (e.g., consumers may switch products for both price and non-price factors).

The importance of the *ability* to switch

13. In a workably competitive market, the ability of consumers to switch between firms heightens the extent of competition in a market. An engaged consumer base adds to competitive tension, adding to the incentive to, amongst other outcomes, reduce prices, innovate, and increase product and service quality.

14. It is *the ability to switch, rather than the act of doing so,* that should be the focus.[4] Consumers can secure better service or better deals from their banks by threatening to switch, without necessarily having to do so.

15. The ability to switch serves the dual purpose of giving consumers a product that better suits their needs and to broadly support competition in the overall market.[5] The ability to switch and an engaged consumer base also eases the conditions of entry and expansion for new and existing firms. A consumer base that is engaged will likely be aware of new entrants and the products or services they offer, ensuring new entry and expansion is not deterred.

Observations on switching in personal banking services

Perceptions may overstate impediments to switching

16. The Commission notes in the PIP:[6]

> "[T]here are some indications that searching for, and switching account providers may be difficult. Features of some deposit accounts, particularly transaction accounts, may mean switching providers is complicated. For example, transaction, income, and payment card arrangements may need to be re-established". It further states that "Payments NZ offers an account and recurring payment transfer service to facilitate switching banks, although it does not appear to overcome all transaction costs (for example, there is a five-day timeframe for the service, incoming payments are not redirected, and the need to change account number remains)".

17. Some impediments, perceived or real, could include:

    17.1. Switching costs, both physical and opportunity and/or convenience costs, such as porting processes, the inconvenience of setting up another account and communicating new payment details to relevant parties and exit or establishment fees.

    17.2. Regulatory requirements (for example, significant identification and financial background and affordability requirements for Anti-Money Laundering (**AML**), Know Your Customer/Client (**KYC**) and the Credits Contracts and Consumer Finance Act 2003 (**CCCFA**)).

    17.3. Consumers overestimating the cost and time involved in switching providers and underestimating the benefit from opening another account.

    17.4. The effort required by consumers to keep an eye on the market for a better deal.

---

[4] As noted by the CMA, low levels of switching can be due to the threat of switching providing a sufficiently "strong competitive constraint on banks" – See Competition and Markets Authority "Retail banking market investigation – Final report" (9 August 2016) at [6.17] to [6.20].
[5] DAE "Choice in banking – Australian Banking Association" (2019) at i, available at https://www.ausbanking.org.au/wp-content/uploads/2022/06/Choice-in-Banking-Report-Deloitte-2019.pdf
[6] Commerce Commission "Market study into personal banking services – Preliminary Issues paper" (10 August 2023) at [147] and [148].

17.5. Familiarity with their current provider and its processes, apps and other online tools and not wanting to change.

18. While there may be perceptions that the process of switching is difficult, other evidence points to the actual process of switching being reasonably easy. For example, a Consumer NZ survey found that there is a perception that switching is difficult, but that 75% of those who switched banks in 2022 said the process was easy.[7]

19. DAE research in Australia suggests that the perception of difficulty may matter more than the actual difficulty. A perception that switching is difficult may deter people from trying to switch or create a view that those who managed to switch have a higher ability or willingness to overcome time and administrative costs. However, in Australia we found that although there are perceived impediments to switching, the overwhelming majority of people who considered switching ultimately chose to stay because they were comfortable with their current bank.[8]

20. UK regulators have acted to reduce the time and inconvenience of switching accounts, which can be efficiently completed in an online environment. The focus of the Competition and Markets Authority (**CMA**) was much more on the lack of consumer engagement[9], such that there was a lack of switching even though it is easy.

There is evidence of high levels of satisfaction in New Zealand

21. Evidence suggests consumers in New Zealand are generally satisfied with their existing providers.

22. A 2022 survey conducted by Consumer NZ, indicated that 60% of consumers were very satisfied with their bank's service.[10] Furthermore a recent [ ].[11]

Figure 1: [ ]

[ ]

Source: [ ]

23. A similar observation is evident based on consumer satisfaction for in-scope products. For example, [ ].[12]

[7] Consumer NZ "Consumer NZ: Trust in banks diving sharply amid soaring profit announcements" available at https://www.consumer.org.nz/articles/consumer-nz-trust-in-banks-diving-sharply-amid-soaring-profit-announcements.
[8] DAE "Choice in banking – Australian Banking Association" (2019) at 21, available at https://www.ausbanking.org.au/wp-content/uploads/2022/06/Choice-in-Banking-Report-Deloitte-2019.pdf
[9] CMA "Retail banking market investigation – Final report" (9 August 2016) at [65].
[10] Consumer NZ. "Bank satisfaction survey 2022" (22 April 2022), available at https://www.consumer.org.nz/articles/bank-satisfaction-survey-2022#article-full-results
[11] [ ]
[12] [ ]

Figure 2: [ ]

[ ]

Source: [ ]

Non-price factors matter

24. We note that attracting and retaining consumers is driven by factors beyond price. For example, for transactional accounts that are relatively standard in offering (e.g., no monthly base and activity fees, free to open/join), the differentiation comes from the experience in online channels, and other features such as savings goals, spend tracking, payments experience and user experience. Providers would, for example, be incentivised to differentiate themselves along quality dimensions, such as the experience consumers have online.

25. It is evident that such non-price factors are an important element in driving customer satisfaction in New Zealand. A recent Canstar survey found the main drivers of overall satisfaction were customer service (23%) and an ability to meet banking needs (23%). Communication was also an important (12%) driver of overall satisfaction.[13]

Consumer switching for personal banking services is nuanced

26. The Commission notes that, as a generalisation, it is significant life events (such as taking out a first loan, starting wage earnings, buying a house, marriage or separation) that prompt consideration of banking arrangements and the prospect of switching providers as it relates to transaction accounts.[14]

27. Switching for personal banking services is layered. The reasons for switching are not limited to life events. For example, other reasons for switching could include:

    27.1. When a product is up for review, such as the end of the fixed interest term on their mortgage or the end of the term of a fixed deposit.

    27.2. When a consumer is not satisfied with something at their current provider. A wide range of factors could have this impact including, but not limited to, pricing considerations, service levels, media coverage of the provider and changes introduced to the existing product features that consumers experience as negative.

    27.3. When new products or product features are introduced in the market that better suit the consumer's perceived needs.

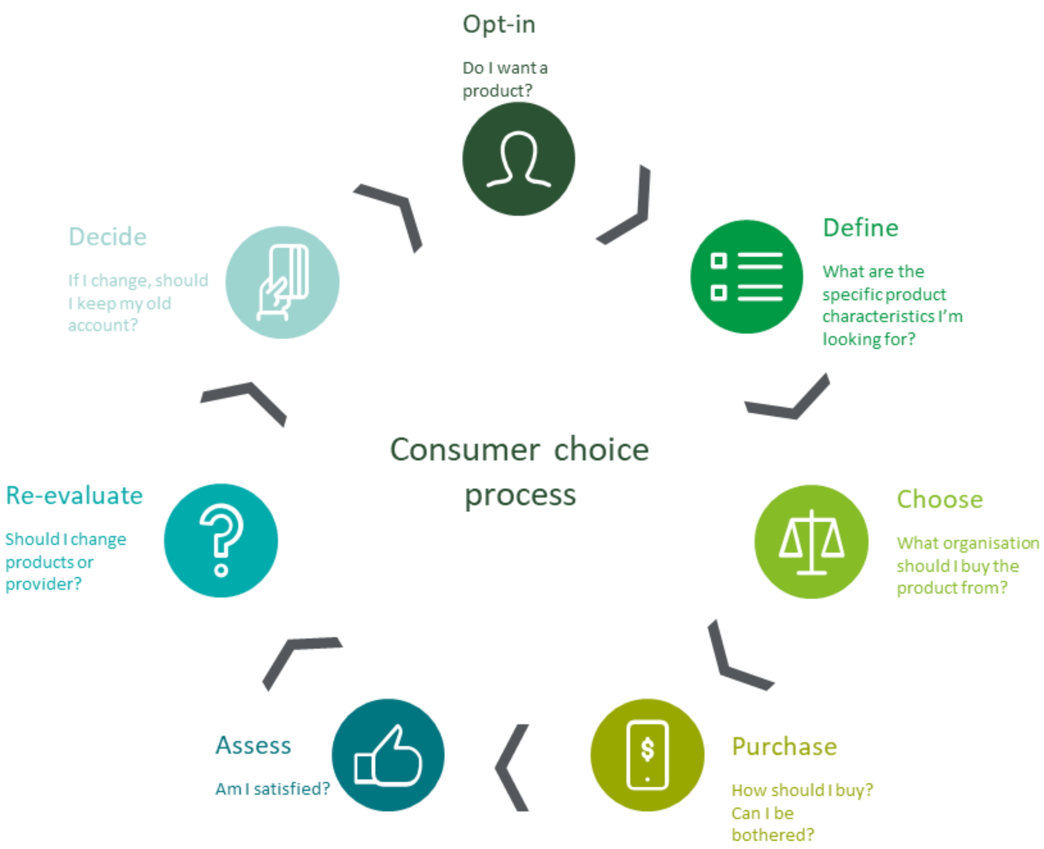
    27.4. When consumers shop around or are made aware of a better rate, or some other appealing feature.

    27.5. When consumers re-evaluate their purchase or change features of their existing product, or purchase different products offered by the same provider or from a different provider or choose to cease having a product.

[13] Canstar "Most Satisfied Customer Banking Award 2022", available at https://www.canstar.co.nz/banking-satisfaction/
[14] Commerce Commission "Market study into personal banking services – Preliminary Issues paper" (10 August 2023) at [155].

28. Previous research we conducted in the Australian market for personal banking services, based on a representative survey sample of 1,017 individuals, noted that consumer choices can be iterative, as demonstrated by the figure below. This iterative choice process could be triggered by any one of the reasons we have discussed above.[15]

Figure 3: Choice process across a consumer-bank relationship



Source: Deloitte Access Economics

Mortgages as a triggering event

29. Another aspect of the market for personal banking services in New Zealand that impacts consumer engagement is the combination of the relatively high proportion of income that is spent on servicing mortgages and the relatively short duration of mortgage terms.

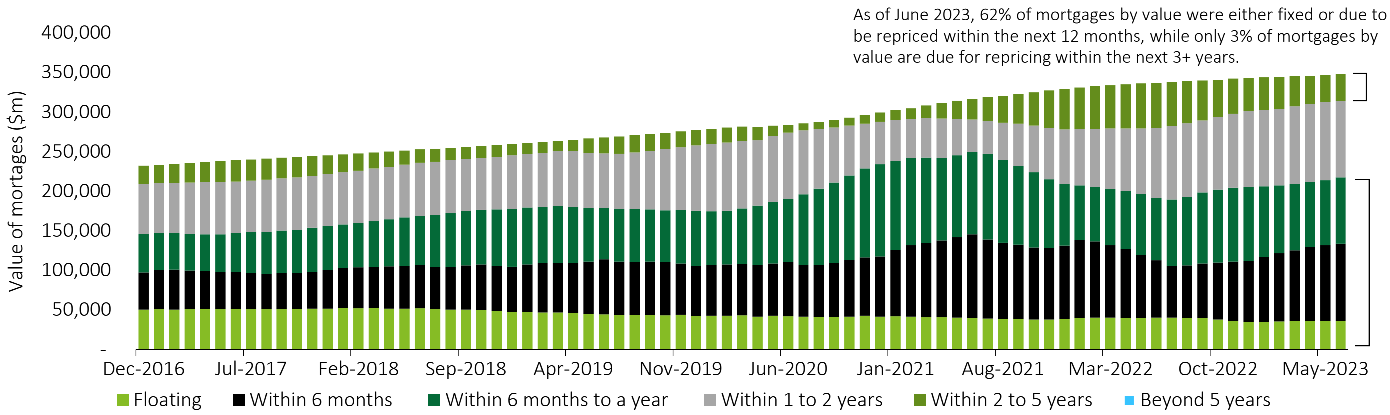
30. Over the longer term, the percentage of gross household income required to service a mortgage has amounted to 37%. This has fluctuated over time and regionally, with recent estimates suggesting that in Auckland, Hamilton, Tauranga and Dunedin, it is absorbing at least 50% of gross annual average household income, and in Wellington, 47%.[16]

31. In New Zealand, the choice of mortgage provider comes up for consideration relatively frequently, given the short-term nature of the fixed rate term structure of most mortgages. This is demonstrated by the figure below, which shows that the majority (around 90%) of mortgage loans by value have been either floating or fixed for less than 2 years between December 2016 and June

[15] DAE "Choice in banking – Australian Banking Association" (2019) at 5, available at https://www.ausbanking.org.au/wp-content/uploads/2022/06/Choice-in-Banking-Report-Deloitte-2019.pdf
[16] Radio New Zealand "Mortgages absorbing bigger chunk of household income – CoreLogic" (26 August 2022), available at https://www.rnz.co.nz/news/business/473527/mortgages-absorbing-bigger-chunk-of-household-income-corelogic

2023. Mortgage terms of 5 years or beyond are rare, only averaging 0.02% of the total value of mortgages between December 2016 and June 2023.

Figure 4: Value of mortgages by time until next repricing



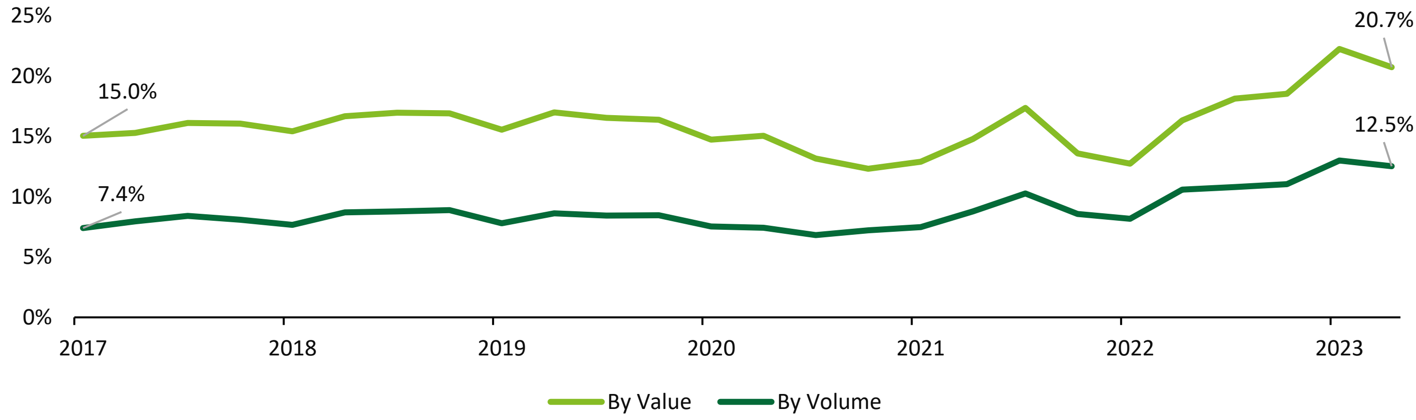
Source: Deloitte Access Economics analysis based on RBNZ data. This data is confined to mortgages held by registered banks.

32. The relatively high proportion of income spent on mortgage payments, and the relatively high frequency in which the mortgage terms are up for review, means that a large proportion of consumers for personal banking services engage actively and frequently with their home loan banking arrangements. For example, [ ] data shows that over [ ] of all new home lending customers had a pricing discussion with another institution.[17]

33. This is further supported by RBNZ data, which shows that switching is a significant driver of new mortgage commitments, with 20.7% of new commitments by value and 12.5% by volume being due to a change in provider in the June quarter of 2023, as demonstrated by Figure 5 below. The proportion of new commitments due to a change in provider has been generally trending upwards since 2022, suggesting consumers are actively shopping around amid increasing interest rates.

[17] [ ]

Figure 5: New mortgage commitments due to changing provider as a proportion of all new commitments (percentage, quarterly)



Source: Deloitte Access Economics analysis based on RBNZ data

Multihoming is an important aspect in assessing consumer switching

34. The PIP overlooked multihoming, which is an important aspect of switching in personal banking services.

35. In the PIP, the Commission notes that "[e]ngaged consumers that actively search the market for the best offers and *switch providers* in response to that offer can play an important role in the competitive process" (emphasis added).[18]

36. While we agree with the view of an engaged consumer, switching is not limited to entirely moving providers, but also includes situations where the consumer may:[19]

    36.1. Replace (wholly or in part) one personal banking product with a similar one at another provider.

    36.2. Replace (wholly or in part) one personal banking product with a different personal banking product, with the same or different provider.

    36.3. Remain with the existing provider and maintain multiple personal banking products but add and use similar personal banking products at another provider.

37. The above forms of switching may be termed as multihoming. As the Australian Competition and Consumer Commission's (**ACCC**) ongoing Retail Deposits Inquiry issues paper points out: [20]

> "[m]any consumers will also maintain multiple retail deposit accounts, including accounts at different ADIs [**Authorised Deposit-taking Institutions**]. Any assessment of the level and impact of consumer switching needs to take this account."

38. Unlike other industries, where consumers are locked into service contracts, personal banking consumers can hold relationships with multiple financial institutions. In fact, it is considered normal for consumers to have multiple provider relationships as they shop around for the best deals for their home loans, term deposits and everyday banking. This is further enabled by the fee

[18] Commerce Commission "Market study into personal banking services – Preliminary Issues paper" (10 August 2023) at [147].
[19] Consumers may also remain with their existing provider but adjust features of their product, such as the repayment terms on their mortgage or negotiate better rates. Although the consumer does not technically switch providers, the impact of the negotiation is the same, which is to heighten the competitive tension the existing provider faces.
[20] ACCC "ACCC Retail Deposits Inquiry – Issues Paper" (21 April 2023) at 22.

structure of various providers in New Zealand, with very low to no fees on transaction accounts for example.[21]

39. There is evidence that multihoming is a prominent feature for personal banking services in other overseas jurisdictions and the extent of multihoming is dependent on the underlying product:

 39.1. In a recent survey in the United States by PYMNTS there is evidence of consumers using multiple banks to cater for their banking needs, with 37.2% having a credit card and 21.1% having a mortgage at a bank different to the bank where they hold their current account. [22]

 39.2. Previous work we conducted in Australia found that, on average, individuals who have at least one everyday transaction account hold accounts with 1.4 providers and mortgage holders with at least one mortgage have 1.2 mortgages with different banks.[23]

 39.3. Pay.uk reports in a 2022 survey that "42% of consumers who have more than one current account (multi-bankers) say they do not close bank or building society current account that they are not using".[24]

40. Similarly in New Zealand, consumers have products and relationships with multiple providers:

 40.1. In its Most Satisfied Customers Banking Award 2022 survey results, Canstar notes that 35% of consumers surveyed in New Zealand have all their banking products with one provider,[25] implying that 65% of those surveyed had products across multiple providers.

 40.2. According to the 2022 study by the Boston Consulting Group, while New Zealanders have a lower number of banking relationships compared to other countries studied, on average they have at least 2 banking relationships (compared to the UK for example who have 3.4) and hold an average of 5 products, which is broadly in line with international counterparts.[26]

 40.3. A recent survey by [ ]. [27]

41. Figure 6 shows the number of relationships that surveyed consumers of each bank and financial institution have with other banks and financial institutions (each line represents one "relationship" where one consumer may have many or no relationships with other institutions). Note that this only includes consumers who have a relationship with another institution, which according to the [ ] is the majority [ ] of consumers surveyed.[28]

42. The large number of relationships surveyed consumers have with a diverse range of banks and institutions of various sizes presents strong evidence that multihoming is an important aspect of how consumers interact with personal banking products.

---

[21] RBNZ "Financial Stability Report" (05/2022) at Box B, available at https://www.rbnz.govt.nz/hub/-/media/project/sites/rbnz/files/publications/financial-stability-reports/2022/fsr-may-22.pdf
[22] PYMNTS "42% of Consumers Would Switch Banks to Get Bundled Banking Products" (20 July 2022), available at https://www.pymnts.com/news/banking/2022/42-pct-consumers-would-switch-banks-to-get-bundled-banking-products/
[23] DAE "Choice in banking" (2019) at 6, available at https://www.ausbanking.org.au/wp-content/uploads/2022/06/Choice-in-Banking-Report-Deloitte-2019.pdf
[24] Pay.uk "Exploring the future of switching" at 10, available at https://newseventsinsights.wearepay.uk/media/tprokfwh/payuk_davieshickman_report1v142.pdf
[25] Canstar "Most satisfied customers banking award 2022", available at https://www.canstar.co.nz/banking-satisfaction/
[26] Boston Consulting Group "Retail banking in New Zealand: Customer satisfaction, use and perception compared with the rest of the world" (November 2022) at 7, available at https://web-assets.bcg.com/43/fe/5892fa1e47d4abb4e44d425269ce/nz-retail-banking-report-nov-2022.pdf
[27] [ ]
[28] [ ]

Figure 6: [ ]

[ ]

Source: [ ]

43. The figures below illustrate evidence of multihoming in New Zealand for certain in-scope products for the Market Study, [ ][29] The figures show that multihoming for personal banking products can go beyond simply having a different provider for each product category, with a significant proportion of consumers choosing to have the same product with multiple providers.

[29] [ ]

Figure 7: [ ]

[ ]

Source: [ ]

Figure 8: [ ]

[ ]

Source: [ ]

Figure 9: [ ]

[ ]

Source: [ ]

44. From a competition perspective, consumers with duplicate product holdings may be able to exert demand-side pressure through product usage. In this way, consumers signal whether products meet their needs through their decisions to use or not to use the products they hold. Correspondingly, providers can gather information about consumers' willingness to use products or what product attributes consumers value based on usage data.

45. More generally, the presence of multihoming can impact the dynamics of competition in a market. For instance, in the context of the digital economy, it has been recognised that multihoming can lower consumer lock-in and impediments to entry. It can be easier for new digital services to enter a market and encourage users to test it out while not having to deactivate their existing services. It can also allow for multiple differentiated platforms to exist in a market

(so that users may use different products for different purposes, for example), improving consumer welfare.[30]

46. When it comes to consumer switching in personal banking services, the evidence presented in this report shows there are a number of additional nuances to take into account, particularly considering the presence of multihoming in the market.

Tools and alternative channels supporting switching

47. As noted by the Commission, the Market Study will consider the quality and nature of information, services and tools available to personal banking consumers in relation to comparing different banks and banking services, whether on price or quality of service, so as to choose an appropriate option.[31]

48. There are already a range of tools available to help consumers to assess personal banking products. For example, interest.co.nz provides interest rate comparisons between 35 bank and non-bank home lenders.[32] In general, all banks keep their own websites up to date with their product features, rates, costs and services for consumers to review and compare offerings. Other external sites include canstar.co.nz and sorted.org.nz who allow consumers to compare rates, services or returns on products.

49. We note consumers are more likely to search on their own when it comes to products that are lower cost to establish and switch, such as transaction accounts. In contrast, consumers are more likely to ask for advice when it comes to assessing available options for more complex products.

The increasing role of brokers

50. Brokers are intermediaries whose main role is to match prospective borrowers and lenders in the residential home lending market. They are especially common in markets where consumers infrequently buy goods and services and are less likely to know how the market works. Brokers can make personal banking services more competitive by increasing consumers' knowledge of loan products and exerting competitive pressure on lenders on behalf of consumers.

51. Mortgage brokers generally have access to loan products from a range of lenders, and endeavour to find one or more appropriate loan products for their client based on their client's income, needs and lifestyle plans.

52. As noted by the Commission in the PIP, mortgage brokers can play an important role in matching home loan providers and consumers.[33] This was recognised recently by the ACCC who noted: [34]

> "[b]rokers can also contribute to customers switching banks more easily in some product markets by reducing search and switching costs".

53. In this context, the ACCC noted the presence of brokers also helps new-to-market players get a foothold in the market and has: [35]

> "contributed to reducing certain barriers to switching, by reducing search and switching costs, and that they do, to a degree at least, facilitate price competition when negotiating by putting competitive pressure on lenders".

---

[30] OECD "The Evolving Concept of Market Power in the Digital Economy, OECD Competition Policy Roundtable Background Note" (2022) at 13.

[31] Commerce Commission "Market study into personal banking services – Preliminary Issues paper" (10 August 2023) at [208.1].

[32] The 35 providers include a range of providers comprising non-bank financial institutions such as Bluestone, Resimac and Basecorp Finance, Paraloan (home loans for people with physical disabilities), Kainga Ora (a Crown agency), AIA (an insurance company), and mortgage trusts, along with banks and NBDTs.

[33] Commerce Commission "Market study into personal banking services – Preliminary Issues paper" (10 August 2023) at [161].

[34] ACCC "Reasons for determination – Application for merger authorization lodged by Australia and New Zealand Banking Group Limited" (4 August 2023) at [4.111], available at https://www.accc.gov.au/system/files/public-registers/documents/Reasons%20for%20determination%20-%2007.08.23%20-%20PR%20-%20MA1000023%20ANZ%20Suncorp.pdf

[35] ACCC "Reasons for determination – Application for merger authorization lodged by Australia and New Zealand Banking Group Limited" (4 August 2023) at [6.79], available at https://www.accc.gov.au/system/files/public-registers/documents/Reasons%20for%20determination%20-%2007.08.23%20-%20PR%20-%20MA1000023%20ANZ%20Suncorp.pdf

54. In New Zealand, the role of mortgage brokers is increasing. The proportion of mortgages facilitated by mortgage brokers has significantly increased and is now estimated to account for 50% of all new residential loans.[36] [ ][37]

55. Even though the share of mortgage brokers is still increasing in New Zealand, it is already at a comparable level to other overseas jurisdictions. For example, in the UK, 47% of those who had taken out a new mortgage said they based their decision on a recommendation by a mortgage broker in 2022. [38] A similar level of mortgage broker share is observed in Australia. In its submission to the ACCC, the Mortgage and Finance Association of Australia noted that brokers facilitate more than two thirds of all new residential loans, having grown Australian loan market share from 59.4% to 69.3% in the two years ending December 2022. [39]

56. [ ][40] This example serves to highlight the importance of brokers as a significant source of business for lenders, and the willingness of consumers to act via an intermediary.

Figure 10: [ ]

[ ]

Source: [ ]

57. The above evidence demonstrates the important role brokers can have in incentivising consumer switching for home loans and personal banking services more broadly.

Increasing importance of digital channels

58. Post Covid-19, there is evidence across the globe of digital channels (i.e., internet and mobile banking) becoming more popular and embedded for most basic banking services.

59. For example, The Canadian Bankers Association's (**CBA**) survey results published in 2022 revealed that of the 4,000 Canadians surveyed:[41]

    59.1. 78% are using digital channels to conduct most of their banking transactions versus 68% in 2016)

    59.2. 89% used online banking in the last year, while 65% used mobile app banking (versus 44% in 2016)

    59.3. 75% intend to keep to these habits post-Covid-19

[36]New Zealand Adviser "How advisers can boost market share" (14 September 2022), available at https://www.mpamag.com/nz/news/general/how-advisers-can-boost-market-share/420310

[37] [ ]

[38] Financial Conduct Authority "Financial lives 2022 survey - Mortgages" (26 July 2023) at 29, available at https://www.fca.org.uk/publication/financial-lives/fls-2022-mortgages.pdf

[39] Mortgage & Finance Association of Australia "Response: ACCC request for call – ANZ Suncorp application for merger authorisation" (26 May 2023) at [6],[7[and [9], available at https://www.accc.gov.au/system/files/public-registers/documents/Submission%20by%20Mortgage%20%26%20Finance%20Association%20of%20Australia%20in%20response%20to%20ACCC%20RFI%20dated%2010%20May%202023%20-%2026.05.23%20-%20PR%20-%20MA1000023%20ANZ%20Suncorp.pdf

[40] [ ]

[41] Canadian Bankers Association "Surging use of digital banking accelerates during the pandemic: CBA survey" (31 March 2022), available at https://cba.ca/surging-use-of-digital-banking-accelerates-during-the-pandemic-cba-survey

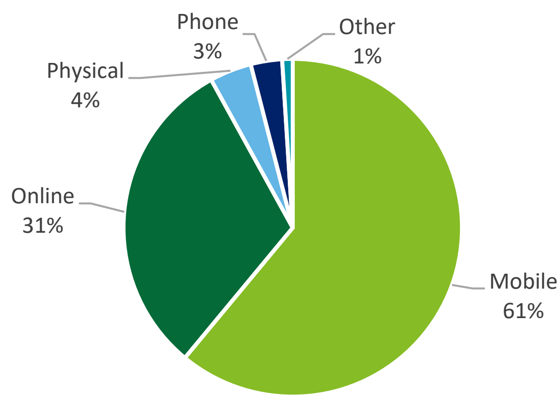
60. According to Anthony G. Ostler, President and CEO of CBA, “The pandemic proved to be a major catalyst for change as Canadians moved more of their daily activities online, including a large-scale uptake of digital banking and contactless transaction methods.”[42]

61. This consumer behaviour is also evident in New Zealand. Bancorp notes that post-Covid-19 for New Zealanders: [43]

> “[f]rom a consumer perspective, digital and mobile wallets are becoming more mainstream, and the uptake has been particularly strong in younger generations. There is also a clear shift from credit to debit over recent years as well as the rise in ‘buy now pay later’ alternatives to credit.”

62. This is supported by Canstar research. As illustrated by the figure below, consumers now prefer digital channels when accessing their bank accounts.

Figure 11: How New Zealanders access banking services



Source: Canstar 2022 banking satisfaction survey (N = 4,034)

Switching in personal banking is evolving

63. Consumer switching is likely to evolve even more given recent market developments. These include:

    63.1. The introduction of payments between banks being processed 7 days a week from May 2023.

    63.2. Digitalisation of personal banking services. This is changing the way consumers make decisions and providers are increasingly tailoring their services in innovative ways. There has been an increase in consumers’ digital use, particularly since the Covid-19 pandemic. In response, consumers’ behaviour, and their expectations of the services they receive, is evolving.

    63.3. Forthcoming Open Banking, which will create a data transferring regime to allow accredited third parties to receive consumers’ banking data. This may lead to greater ease of switching, by simplifying processes such as transferring payments from existing bank accounts to new banks. Open Banking is discussed further in the Innovation chapter of this report.

    63.4. Broader reforms that are in train have the potential to improve active consumer engagement in financial services markets — such as the introduction of the new Consumer Data Right (**CDR**). These reforms can improve any imbalance between providers and

---

[42] Canadian Bankers Association “Surging use of digital banking accelerates during the pandemic: CBA survey” (31 March 2022), available at https://cba.ca/surging-use-of-digital-banking-accelerates-during-the-pandemic-cba-survey

[43] Bancorp “Trends in transactional banking and the race to digital” (2 December 2021), available at https://www.bancorp.co.nz/2021/12/02/trends-in-transactional-banking/

consumers by helping consumers navigate the market and make decisions relating to their financial affairs.

Innovation

Key points

- The concept of **innovation** as it applies to in-scope products needs to be a **broad one** in order to properly capture its impact on personal banking products. The OECD recently set out a definition of innovation as the *"successful development and application of new knowledge"*. We believe this is a more suitable lens through which to study the nature and impact of innovation.

- This **broader definition** of innovation brings into picture the impacts of **ongoing improvements to both processes and existing products,** which can streamline the process by which consumers acquire new products and enhance the experience of existing ones.

- The link between innovation and competition is complex, and careful consideration of the factors by which the two are linked will be important. There are **various potential drivers of innovation** and how certain market characteristics can support or hinder it.

- **Open Banking** has begun rolling out overseas, and will progress in New Zealand, which will enable digital challengers to gain market share and further foster improved consumer choice, experiences and ultimately competition in New Zealand.

- In addition to looking at current and past innovation, it is important to consider whether personal banking services in New Zealand are **well placed to take advantage of innovative opportunities in the future**, and whether there are appropriate **regulatory settings and incentives to foster innovation in New Zealand.**

Purpose

64. As the Commission notes, in a well-functioning market, investment in innovation can bring benefits to consumers in the form of new services, diversity of choice, cost efficiencies and enhanced service levels. Conversely, a lack of innovation may suggest firms are not subject to competitive pressure and therefore have reduced incentives to innovate, or that there are barriers to innovation in the market.[44] Innovation can also be a parameter of competition, providing a way for firms to gain a competitive advantage over rivals.

65. Digital disruption is a phenomenon that is occurring across many sectors and affecting many aspects of the global economy. There is a lot of scope for innovation in banking services, particularly ones that relate to making payments and managing finances. Big technology has moved into payments in New Zealand with, for example, Google Pay and Apple Pay (and Apple has recently launched a white-label savings product in the USA).[45] It is possible that big technology firms could become the ones that manage the account interface with the consumer, and so hold the consumer relationship, whilst traditional banks are relegated to being utility deposit takers.

66. The purpose of this chapter is to consider the unique nature of innovation in the personal banking sector. The chapter explains:

---

[44] Commerce Commission "Market study into personal banking services – Preliminary Issues paper" (10 August 2023) at [213].

[45] See Apple, Apple Card's new high-yield Savings account is now available, offering a 4.15 percent APY (17 April 2023), available at https://www.apple.com/newsroom/2023/04/apple-cards-new-high-yield-savings-account-is-now-available-offering-a-4-point-15-percent-apy/

66.1. It is necessary to adopt a broader definition, which allows for the continuous incremental nature of innovation.

66.2. The key drivers impacting on the ability of firms to innovate.

66.3. The progress of Open Banking (both from a demand and supply perspective).

Innovation is a wide concept

67. The Commission expects that digital disruption would impact the New Zealand banking sector. However, it notes that New Zealand has not yet seen similar levels of digital disruption occurring in its banking industry as seen in other countries.[46]

68. We consider the Commission should avoid making *a priori* assessments of innovation by only looking at new offerings and whether or not New Zealand may have been impacted by digital disruption.

69. The concept of innovation is broad. As recently noted by the Organisation for Economic Co-operation and Development (**OECD**), innovation can be defined as the "successful development and application of new knowledge". In particular:[47]

69.1. Innovation can include invention, but also other stages up to the practical application of such inventions.

69.2. Innovation can also take the form of an improvement in production and distribution technologies, which in turn result in cost reduction.

69.3. Innovation can either be disruptive or sustaining.

69.3.1. Disruptive innovations drastically alter markets, normally reducing or significantly altering market shares of incumbent firms in existing markets or creating new markets or business models.

69.3.2. Sustaining innovations, on the other hand, maintain a rate of improvement on attributes that add value to products.

69.4. Innovation can be either product or process innovations, the former improving existing products or bringing new ones to the market, while the latter implying improvements in productivity.

70. Rather than adopting a narrow view of innovation, the Market Study will need to consider all forms of innovation in coming to a view on levels of innovation in personal banking services and whether markets for personal banking services are workably competitive.

71. Examples of innovations introduced in New Zealand's financial services sector over the last five years can be split into three key types of innovation:

71.1. Process improvements, which are innovations which improve the efficiency for banks to provide products or streamline the interactions consumers have with banks. For example, a shift to online digital identity verification has significantly reduced the need for new consumers to interact with their provider in-person at a branch to purchase a new banking product. This is further expanded upon below.

71.2. Product improvements, which are significant changes to existing personal banking products and serve to highlight the ongoing nature of innovation in the banking sector (as opposed to generational releases of new products). For example, many online banking platforms now offer personalised financial insights, allowing users to track their spending and other financial metrics.

[46] Commerce Commission "Market study into personal banking services – Preliminary Issues paper" (10 August 2023) at [123] and [127].
[47] OECD "Competition and Innovation, Part 1: a theoretical perspective – Background Note" (2 May 2023) at 6.

71.3. New products, which is where an entirely new line of personal banking services is established. An example is the recent push towards developing sustainable finance products, such as a discount on home loan 'top-ups' used for home upgrades with the objective of reducing emissions.[48]

Figure 12: Examples of innovation that can be defined as new products, process improvements or product improvements

Source: Deloitte Access Economics

72. Broader innovations, such as those which can be classed as process improvements, are often incremental in nature (rather than generational) but can deliver benefits to consumers, such as providing an alternative means of identity verification. For example, between July 2022 and June 2023 [ ].[49] This example demonstrates both the willingness of consumers to engage with process innovations, and the benefit to consumers due to the reduction in time for onboarding.

Figure 13: [ ]

[ ]

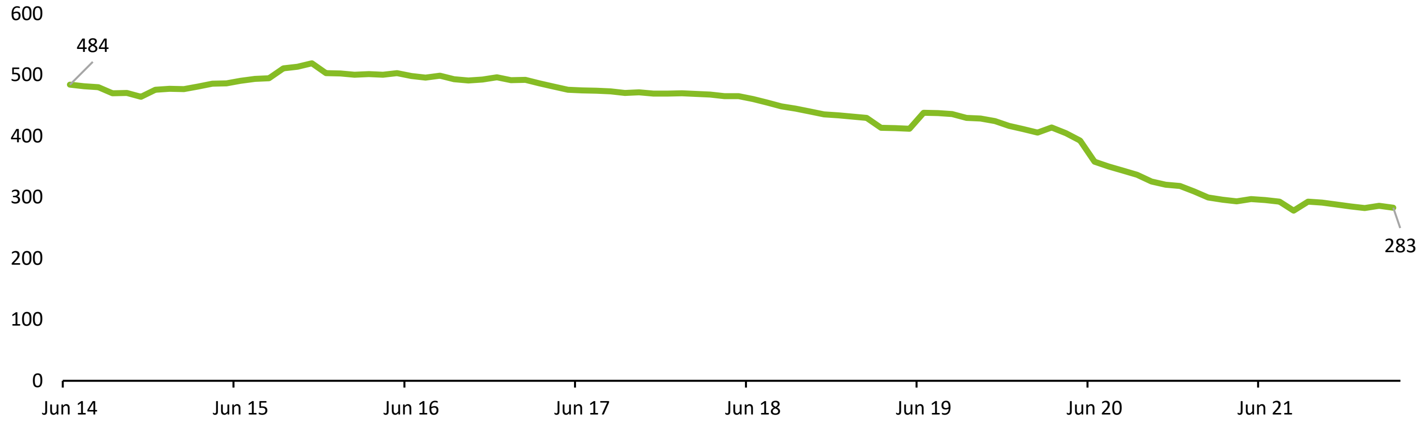
Source: [ ]

[48] BNZ "BNZ Green Home Loan top-ups", available at https://www.bnz.co.nz/personal-banking/home-loans/manage-your-loan/top-ups/green-home-loan-top-ups

[49] [ ]

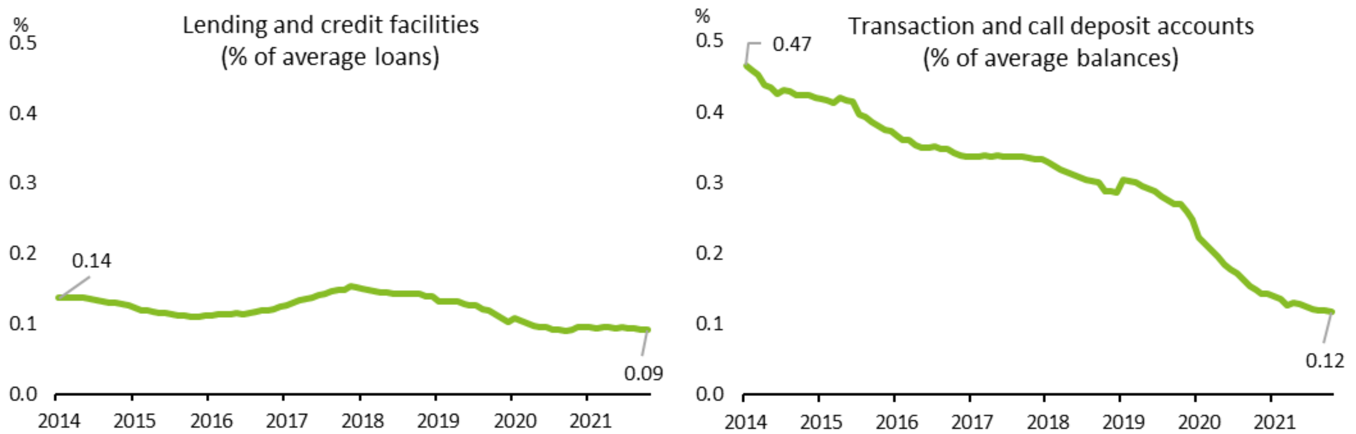
73. In addition, as observed by the RBNZ, process improvements as a result of digitalisation have resulted in benefits for consumers. The RBNZ notes that "[t]o a large extent, the declining value of bank fees in New Zealand reflects ongoing declines in banks' operating costs due to the digitalisation of banking and economies of scale". Between 2014 and 2022, annual fees both overall and for in-scope products, have been steadily declining, which illustrates that savings from these innovations are being passed to consumers. [50]

Figure 14: Banks fee income from transaction and deposit accounts ($m)



Source: RBNZ. Products presented in the figure include both personal and non-personal banking products. We note that there are mostly no banking fees on personal deposit accounts.

Figure 15: Annual fees on both personal and non-personal lending and deposit products (% of average loans/balances)



Source: RBNZ. Products presented in the figure include both personal and non-personal banking products. We note that there are mostly no banking fees on personal deposit accounts.

[50] RBNZ "Financial stability report – May 2022" (May 2022) at 39, available at https://www.rbnz.govt.nz/hub/-/media/project/sites/rbnz/files/publications/financial-stability-reports/2022/fsr-may-22.pdf

There are a number of drivers of innovation

74. The relationship between competition and innovation is complicated. Competitive markets generate greater incentives for firms to differentiate themselves to gain a competitive advantage and earn economic profits.[51] However, too much competition can discourage innovation, as it can decrease the short-term extra profits a firm can earn by catching up with a leading firm.[52]

75. While there is growing consensus on the role that competition might play for innovation[53], there are many other drivers of innovation. These factors can also interact with competition. As the OECD notes, it is important to recognise the different factors that affect innovation, including how competition interacts with such drivers.[54] The table below provides a summary of some of the additional drivers of innovation noted by the OECD.

[51] This is typically referred to as the 'escape effect' put forward by Kenneth Arrow – see Rowley (ed.) "Readings in industrial economics – Economic welfare and the allocation of resources for invention" (November 1972).

[52] In this sense, too much competition can lead to short-term thinking and discourage firms investing in longer-term, risker research and development projects. In contrast, profits that can be made by firms that catch-up with rivals are larger in markets with less competition, increasing the incentive to pursue such innovations. This is typically referred to as the 'Schumpeterian Effect' – see Schumpeter "Capitalism, socialism and democracy" (1942).

[53] That is, innovation is encouraged when markets are contestable, where firms can appropriate profits from innovation and where there is a possibility of combining assets to innovate – see OECD "Competition and Innovation, Part 1: a theoretical perspective – Background Note" (2 May 2023) at 11.

[54] OECD "Competition and Innovation, Part 1: a theoretical perspective – Background Note" (2 May 2023) at 34.

Table 2: Other factors that may impact innovation

Factor	Relationship	Reference
Size	Studies have shown positive correlations between the age of firms, their size and the propensity to introduce new products, is partially explained by experience, economies of scale and better access to external finance.	OECD "Innovation in Firms: A Microeconomic Perspective" (2009)
Business model and the role of experience and maturity	The diversity of skills and a firm's workforce can influence innovation performance, as it can stimulate (or hamper) the exchange and dissemination of knowledge and the generation of ideas.	Christian Østergaard, Bram Timmermans and Kari Kristinsson "Does a different view create something new? The effect of employee diversity on innovation" (2011) 40(3) 500-509
Access to venture capital	Venture capital is associated with some of the most high-growth and influential firms in the world. However, there are limits to venture capital, stemming from the narrow nature of technological innovations that fit the requirements of institutional venture capital, the relatively small number of investors who hold and shape capital deployment and the relaxation of intense corporate governance by venture capital in recent years.	Josh Lerner and Ramana Nanda "Venture Capital's Role in Financing Innovation: What We Know and How Much We Still Need to Learn" (2020) 34(3) 237-261
Innovation policies	Innovation policies can provide indirect financial support on outputs of the innovation activity (such as reduction in taxes or subsidies on innovative products) as well as sponsoring transfers of technology and knowledge. Support can also be provided through the adequate award of intellectual property rights.	OECD "Competition and Innovation, Part 1: a theoretical perspective – Background Note" (2 May 2023)
Proximity to inputs and labour markets	A firm's location affects proximity to input and labour markets and determines the size of the demand it faces. While assets, input and skill sets needed for developing a new product depend on its characteristics and industry, inputs tend to be specific and technology related, while human resources tend to be highly skilled.	OECD "Competition and Innovation, Part 1: a theoretical perspective – Background Note" (2 May 2023)
Differences in R&D spend	Differences in the levels of public and private spending can also affect incentives to innovate, or at least, determine where innovations would take place.	OECD "Competition and Innovation, Part 1: a theoretical perspective – Background Note" (2 May 2023)

Source: OECD

76. It is important to take a broad and holistic view of innovation, and the drivers of innovation, when making any assessment of the levels of innovation in personal banking services. In addition to looking at current and past innovation, it must be considered whether the personal banking services sector in New Zealand is well placed to take advantage of innovative opportunities in the future, and whether there are the right incentives for innovation.

Open Banking can support innovation and consumer switching

77. More innovations are likely to come in response to Open Banking. With Open Banking being relatively established in the UK, learnings and impacts are starting to become evident.

77.1. In their 2023 paper celebrating 10 years of CASS (Current Account Switch Service, and subsequent innovations such as Open Banking and FinTechs), pay.uk indicates the expected or observed impact on switching, including:[55]

77.1.1. Allowing price comparison websites to extend their services, which is expected to lead to increased switching activity.

77.1.2. Increased competition from challenger banks and FinTechs, "there is medium agreement that the 'New FinTechs and challenger banks compete' trend will increase switching".

77.1.3. Big Tech to disrupt traditional finance, with 50% of Gen Z and Millennials being willing to switch to providers such as Amazon and Google. Pay.uk concludes that "Big Tech will offer banking products that compete on convenience and may be easier to use than traditional banks" and that "there is high agreement that the 'Big Tech disrupts traditional finance' trend will increase switching".

77.1.4. "Financial services platforms will enable customers to see and manage multiple accounts on one screen. They will make comparisons easier for consumers and SMEs and possibly enable better and faster decisions about switching or opening new accounts."

78. From a New Zealand perspective, to achieve these benefits, it is important that regulatory settings are fostering innovation and balancing the risk of certain capital and other requirements with competition objectives.

Progress of Open Banking and regulatory settings

- In November 2022 the Minister of Commerce and Consumer Affairs, David Clark, announced that banking would be the starting point for the Consumer Data Right (**CDR**) in New Zealand, stating that implementation would take at least 2 years.[56] He stated that "Open Banking ensures that banks must share customer information if they request it, making it easier for New Zealanders to compare mortgage rates, apply for loans and switch banks."

- "With considerable experience in standards development, management, and governance, and having facilitated the Application Programming Interface (**API**) standards initiative, Payments NZ was asked to set up and manage the API Centre on behalf of the industry. The vision was that the centre would develop and publish API standards and pave the way for banks and third parties to form partnerships so they can deliver Open Banking innovation for Kiwi."[57]

- In May 2023 Payments NZ published their Minimum Open Banking Implementation plan, which requires ANZ, ASB, BNZ and Westpac to be ready with their APIs related to payment initiation by 30 May 2024, and Kiwibank following two years later. The account information API implementation follows on 30 November 2024 and 2026 respectively.[58]

- As at 22 August 2023, BNZ had already completed the first phase of the technical implementation.[59]

[55] Pay.uk "Exploring the future of switching", available at https://newseventsinsights.wearepay.uk/media/tprokfwh/payuk_davieshickman_report1v142.pdf

[56] Interest "Clark announces banks will be first designated for 'consumer data framework' to allow easy shifting of data and accounts, but implementation still 'two years away'" (10 November 2022), available at https://www.interest.co.nz/banking/118397/clark-announces-banks-will-be-first-designated-consumer-data-framework-allow-easy

[57] Payments NZ "API centre – About" (accessed 22 August 2023), available at https://www.apicentre.paymentsnz.co.nz/about/

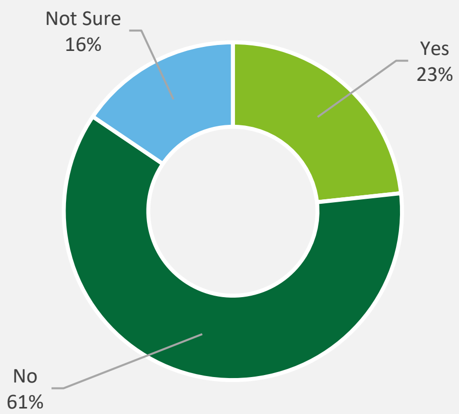
[58] Payments NZ "Minimum Open Banking implementation plan" (accessed 22 August 2023), available at https://www.apicentre.paymentsnz.co.nz/standards/implementation/minimum-open-banking-implementation-plan/

[59] Payments NZ "Minimum Open Banking implementation plan" (accessed 22 August 2023), available at https://www.apicentre.paymentsnz.co.nz/standards/implementation/minimum-open-banking-implementation-plan/

- By 30 June 2023 there was already evidence of non-bank start-ups who are getting ready for Open Banking. Qippay, which has a payment solution for merchants, recently signed an agreement with BNZ and are working with Westpac and ANZ. Blinkpay, a bill tracker, also has an agreement with BNZ, Westpac and ASB and is working with ANZ. Both businesses have stated that the implementation deadline given to the larger banks has provided "much needed certainty".[60]

- From a demand perspective, increasing the awareness of Open Banking has a long way to go. A recent survey by Payments NZ shows that only 23% of New Zealanders are aware of what Open Banking involves, which whilst up from 14% in 2020, is still relatively low. [61]

Figure 16: Percentage of surveyed New Zealanders aware of what Open Banking involves



Source: Payments NZ (N=1,000)

- Further, only 27% of those surveyed are comfortable with their bank sharing their data with other organisations, while 36% are unsure or not comfortable. Key concerns cited were security, trust of other organisations and loss of control over their financial information.[62]

- This serves to highlight the demand-side considerations for innovation. Whilst some New Zealanders recognised the benefits that Open Banking could yield, they also recognise the risks. Trust is an important part of banking and how consumers interact with financial institutions. This provides a demand-side constraint to the speed with which new innovations, especially ones as significant as Open Banking, can be brought to New Zealand.

---

[60] Good Returns "Two start-ups already positioned for open banking" (30 June 2023), available at https://www.goodreturns.co.nz/article/976521920/two-start-ups-already-positioned-for-open-banking.html
[61] Payments NZ "Consumer research 2022" (2022), available at https://www.paymentsnz.co.nz/resources/research-reports/
[62] Payments NZ "Consumer research 2022" (2022), available at https://www.paymentsnz.co.nz/resources/research-reports/

Conditions of entry, expansion and exit

Key points

The following table sets out important considerations for conditions of entry, expansion and exit across all in-scope personal banking services:

Conditions of entry, expansion and exit	Observation
Economies of scale and scope	New Zealand has **a small banking sector** in absolute terms, **compared to international counterparts**. This is likely to impact entry and expansion for personal banking services. Economies of scale and scope may be changing, as changing preferences of consumers take effect. The relevance of economies of scale and scope should be considered alongside other trends in consumer preferences, such as the diminishing importance of a physical presence which has led to the decline of commercial impediments to enter or expand in a market. We note economies of scale and scope can also evolve with new technology and solutions. For example, **firms adopting technology-centric business models to expand and enter into in-scope products** over recent years.
Branding and reputation	Investments in branding **and reputation** are hallmarks of the competitive process, to **differentiate products** from competitors to **gain brand preference, trust and loyalty**. This condition is **not insurmountable and as illustrated by expansion in personal banking and recent entry.**
Regulation	It is unsurprising that the regulatory system is designed primarily to ensure that financial stability objectives are met and consumer protections are embedded. Yet, although personal banking services are provided by a diverse range of firms, they are **not all regulated equally**. **Higher capital adequacy requirements** provide **greater stability** to the financial sector and can improve how investors and credit rating agencies view the riskiness of banks in New Zealand, but they also **increase the funding required by banks** to carry out operations. Given there are some areas where New Zealand regulation imposes a higher standard than international markets (for example, BPR100: Capital Adequacy), applying learnings from offshore experience and identifying whether similar conditions exist in the New Zealand context may be a worthwhile focus for the Commission.
Access to funding	**Access to, and the price of, wholesale funding** is an important consideration. It serves to highlight the **complexity of how banks fund themselves** in the light of the various operating models and prudential regulatory requirements. In the context of expansion and entry, **access to wholesale funding is a key consideration for challenger firms** given New Zealand's relatively low domestic savings rate.

Purpose

79. The conditions of entry, expansion and exit in personal banking must be understood in the context of New Zealand's size relative to other markets, differing regulatory requirements and access to funding. The conditions of entry, expansion and exit in any market, and how they are likely to evolve, provide important context within which to view the level of competition and outcomes currently and into the future.

80. This chapter focuses on additional conditions of entry, expansion and exit that we consider the Commission should take into account, as well as expanding on factors mentioned in the PIP. This chapter also explores evidence of recent entry and expansion for personal banking services in New Zealand.

81. Our consideration of conditions of entry, expansion and exit for personal banking services is informed by the Commission's Merger and Acquisition Guidelines.[63] For purposes of this report, we focus our analysis across the in-scope personal banking services overall. We note that conditions of entry, expansion and exit will differ for distinct in-scope personal banking services.

Economies of scale matter in a small economy

82. Economies of scale refer to the situation where per unit costs fall as production increases. In markets characterised with economies of scale, existing competitors and entrants face the task of gaining a sufficient share of the market to drive costs lower. Alternatively, entry may not be profitable (or at least risky) if, in the process of achieving sufficient scale, prices are driven down to such an extent that returns do not justify entry in the first place.[64]

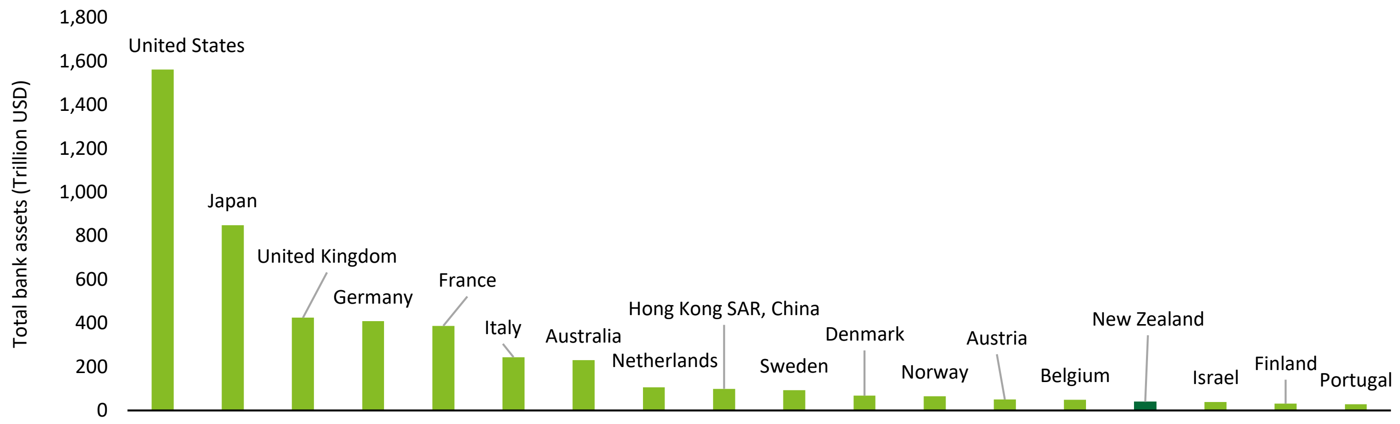
83. Economies of scale can be seen as 'exogenous' conditions of entry, expansion and exit. In other words, these are underlying market conditions independent of the conduct of the firms in a market.[65]

84. New Zealand's banking sector is small in absolute terms, compared to many other countries. As the RBNZ notes, in March 2022, New Zealand banks had total assets of just over $667 billion NZD. It noted that this was around 188% of New Zealand's GDP and is at the lower end of the range for OECD countries.[66]

85. The small scale of New Zealand's banking sector, compared to international counterparts, is confirmed using the World Bank Database. The figure below is restricted to the same set of countries the Commission included in its review of profitability contained in the PIP and contains data on sector wide bank assets (i.e., it is not confined to in-scope products).

[63] Commerce Commission "Mergers and acquisition Guidelines" (May 2022) at [3.107] to [3.112].
[64] Commerce Commission "Mergers and acquisition Guidelines" (May 2022) at fn 97.
[65] See, for example, the discussion of economies of scale in the Retail Fuel Market Study – Commerce Commission "Market study into the retail fuel sector – Final Report" (5 September 2019) at [4.15.1].
[66] RBNZ "The banking sector" (18 May 2022), available at: https://www.rbnz.govt.nz/financial-stability/about-the-new-zealand-financial-system/the-banking-sector

Figure 17: Bank assets (2021*)



Source: World Bank Dataset (*latest datapoint for US is 2020)

86. The small scale of New Zealand's banking sector is likely to impact entry and expansion for personal banking services. When combined with sunk costs, such as the need to invest and maintain a brand, technology and compliance spend, the small scale of New Zealand's banking sector may naturally limit the nature and extent of entry and expansion and introduces an inherent trade-off between productive and allocative efficiency.[67]

87. Despite the smaller scale of New Zealand's banking sector, the concentration of asset ownership by New Zealand's 5 largest banks relative to GDP is relatively in line with that of international peers.

Figure 18: Proportion of bank assets owned by 5 largest banks

Source: World Bank database

88. We would note that the relevance of economies of scale is not static. As we discuss further below, other trends in consumer preferences, such as the declining preference for physical retail branches, increasing preference for digital products and services by consumers, may lessen the extent to which economies of scale impact entry, expansion and exit.

[67] See, for example, Michal S Gal "Size Does Matter: General Policy Prescriptions for Optimal Competition Rules in Small Economies" (2001) 73 SCLR at 15.

89. The scale of New Zealand banking sector should therefore be considered in addition to the factors outlined in the Commission's PIP when assessing conditions of entry, expansion and exit, as well as contextualising the competitive outcomes seen for personal banking services to date.

Economies of scope are changing in the digital era

90. Economies of scope refers to the situation where per unit costs fall when more than one product is produced. Like economies of scale, economies of scope may impact entry and expansion as it may require producing a minimum range of products to be an effective competitor. Studies overseas have noted that the supply of personal banking services is generally characterised by the economies of scale and scope.[68]

91. Economies of scope could be in part seen as an 'exogenous' condition of entry, expansion and exit. For example, once a bank has set up a credit-scoring facility to assess credit worthiness for potential customers, it can spread the cost of establishing this facility across a range of personal banking services, such as home loans and overdraft facilities. A firm offering a narrower range of personal banking services may not have the same ability to spread costs across multiple personal banking services.

92. Economies of scope can evolve with new technology and solutions. New competitors are appearing in the payment space, suggesting economies of scope are changing. For example, both Apple and Google have introduced payment products called 'Apple Pay'[69] and 'Google Pay'[70] respectively.

93. There is also a declining preference for physical retail branches and a move towards digital products and services. As we discuss in further detail below, there is evidence that entry is occurring for particular personal banking products, such as digital providers of mortgage lending. This suggests that both economies of scale and scope may be changing, as changing preferences of consumers take effect.

The diminishing importance of retail branches

94. Historically, the presence of physical retail branches was an important aspect of the supply of personal banking services. As noted in previous studies, historically customers interacted with banks solely through high street branches and by post.[71]

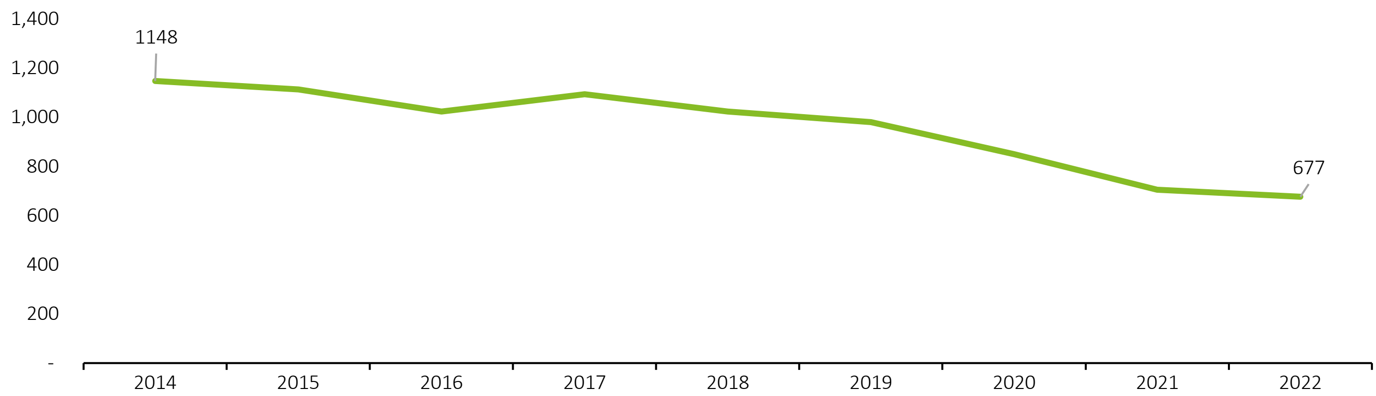
95. The need to have a physical retail network would raise the costs of entry and expansion. While these costs may not necessarily be sunk in their entirety (some costs of establishing a retail physical network may be recouped on exit) maintaining a physical retail network is likely to involve substantial fixed and ongoing costs, with previous studies noting they could amount to 30% to 40% of an offshore bank's retail costs.[72]

96. The diminishing importance of physical branches is well documented. The CMA noted in 2016 that branch usage had declined significantly in recent years and that entrants are able to adopt alternative business models, including the use of digital channels. Ultimately, it found that access to a branch network was not a barrier to entry and / or expansion.[73] More recently (August 2023), the ACCC found that with the advent of online banking in the last two decades, and the increased penetration of brokers in some segments, the relative importance of branches has been in decline.[74]

[68] See, for example, CMA "Retail banking market investigation – Final Report" (9 August 2016) at [9.6(b)].
[69] Apple 'Apple Pay', available at https://www.apple.com/nz/apple-pay/ These allow customers to load their debit or credit cards onto their mobile device and use their device in-store and online to make payments. However, neither Apple nor Google own the payment infrastructure or manage the transfer of funds. In the US market, Apple has gone a step further by offering a credit card product called 'Apple Card', but similarly the credit card itself is issued by Goldman Sachs and payment processing is handled by Mastercard.
[70] Google "Google Pay', available at https://pay.google.com/intl/en_nz/about/
[71] CMA "Retail banking market investigation – Final Report" (9 August 2016) at [2.22].
[72] CMA "Retail banking market investigation – Final Report" (9 August 2016) at [9.181].
[73] CMA "Retail banking market investigation – Final Report" (9 August 2016) at [9.291].
[74] ACCC "Reasons for Determination – Application for merger authorisation lodged by Australia and New Zealand Banking Group Limited in respect of its proposed acquisition of Suncorp Bank" (4 August 2023) at [4.122].

97. This decline in the importance of physical branches is evident in New Zealand. For example, there is evidence that only around 3% of consumers in New Zealand are using branches once or more a week[75] and that there has been a significant reduction of the number of branches over time across all banks, as demonstrated in the figure below.

Figure 19: Number of physical branches



Source: KPMG Financial Institutions Performance Survey, 2014 to 2022

98. This decreasing use and presence of branches is also demonstrated when looking at [ ].

Figure 20: [ ]

[ ]

Source: [ ]

[75] Boston Consulting Group “Retail Banking in New Zealand: Customer Satisfaction, Use and Perception Compared with the Rest of the World” (November 2022) at 6.

99. The decreasing use and presence of physical branches is likely to be driven by an increasing preference and use of digital means of accessing personal banking services. This is confirmed by recent survey evidence which suggests that 58% of consumers used online and mobile means of banking more than once a week.[76] A recent [ ] survey conducted also suggests that online or mobile methods are preferred for certain personal banking services or situations, as demonstrated by Figure 21 below:

Figure 21: [ ]

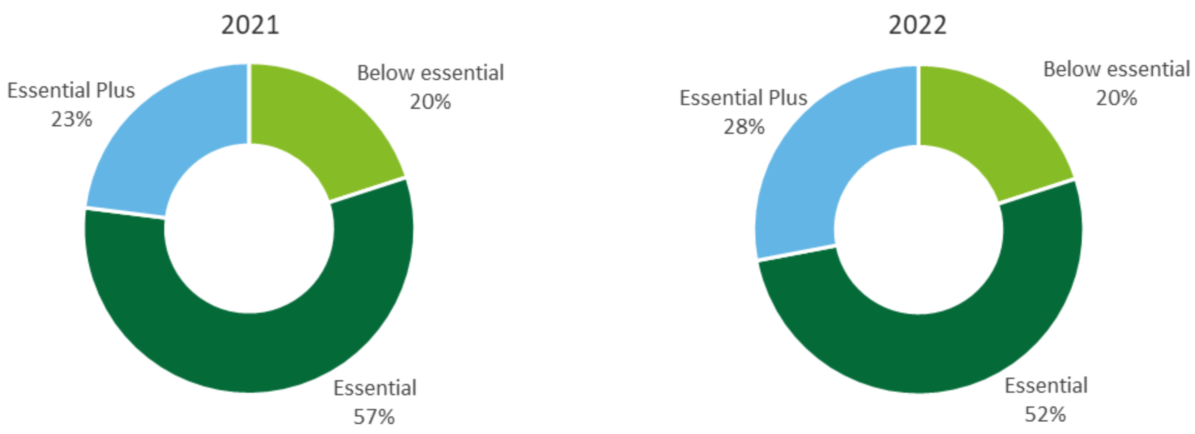
[ ]

Source: [ ]

100. A 2022 BNZ commissioned study on digital skills further supports this. Between 2021 and 2022, the study found that the number of surveyed New Zealanders with digital skills classed as "essential plus" has risen from 23% to 28%, with 20% of New Zealander's found to have "below essential" digital skills in both 2021 and 2022, as illustrated in Figure 22 below. However, the study found that even out of those surveyed with "below essential" digital skills, 70% were using online banking in 2022, up from 59% in 2021, as illustrated in Figure 23 below.[77] This suggests that the digital literacy barrier to accessing banking services online is falling, even for those in the population identified as less technologically literate.

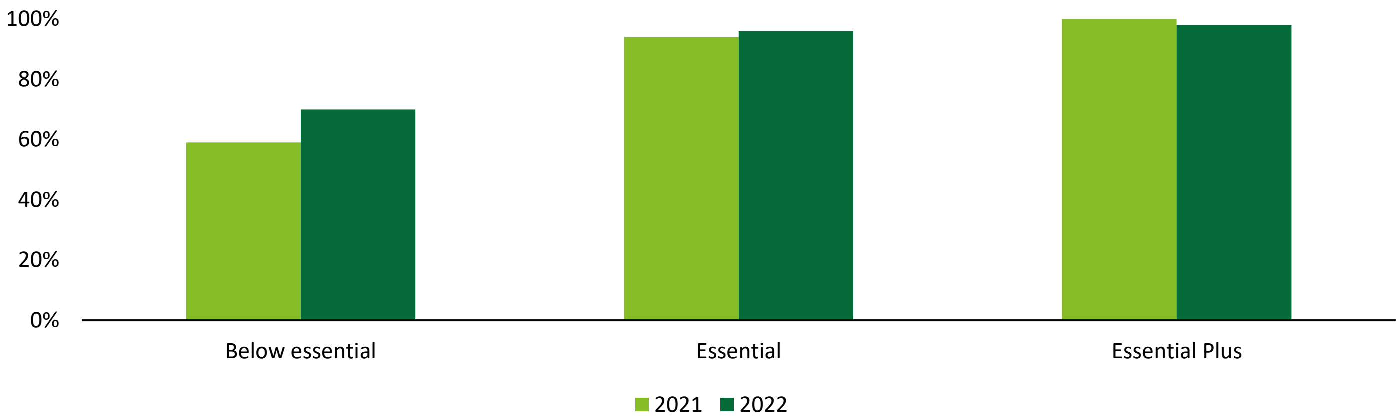
[76] Boston Consulting Group "Retail Banking in New Zealand: Customer Satisfaction, Use and Perception Compared With the Rest of the World" (November 2022) at 6.
[77] BNZ "Digital skills report 2022" (2022), available at https://blog.bnz.co.nz/wp-content/uploads/2022/04/BNS0692-Digital-Skills-Report-20224.pdf

Figure 22: Percentage of surveyed New Zealanders in each digital skills group



Source: BNZ (N=1,204 in 2022 and N=1,001 in 2021)

Figure 23: Percentage of New Zealanders using online banking by digital skill level



Source: BNZ (N=1,204 in 2022 and N=1,001 in 2021)

101. The declining importance of physical branches suggest that establishing an extensive physical branch network is not a necessary requirement for entry and expansion and so is likely to lower the cost of entry and expansion for personal banking services.

102. It is important to consider how the easing of the need to establish and maintain a physical retail branch interacts with other conditions of entry and exit, as it is likely to reduce the extent of scale and scope needed to effectively enter and expand in markets for personal banking services. As we discuss further below, there is evidence of recent entry and expansion into particular personal banking services, which suggests that the commercial conditions for entry and expansion are reducing.

Branding and reputation help consumers build trust in their institutions

103. Brand and reputation play an important role when consumers choose banking relationships and/or products. While it may impose conditions for entry and expansion for new entrants, it is also an important dimension of competition.

104. Further, we would note that investments in branding and reputation are also hallmarks of the competitive process. It is typically done to differentiate products from competitors to gain brand preference and loyalty. Branding in itself does not raise competition concerns.

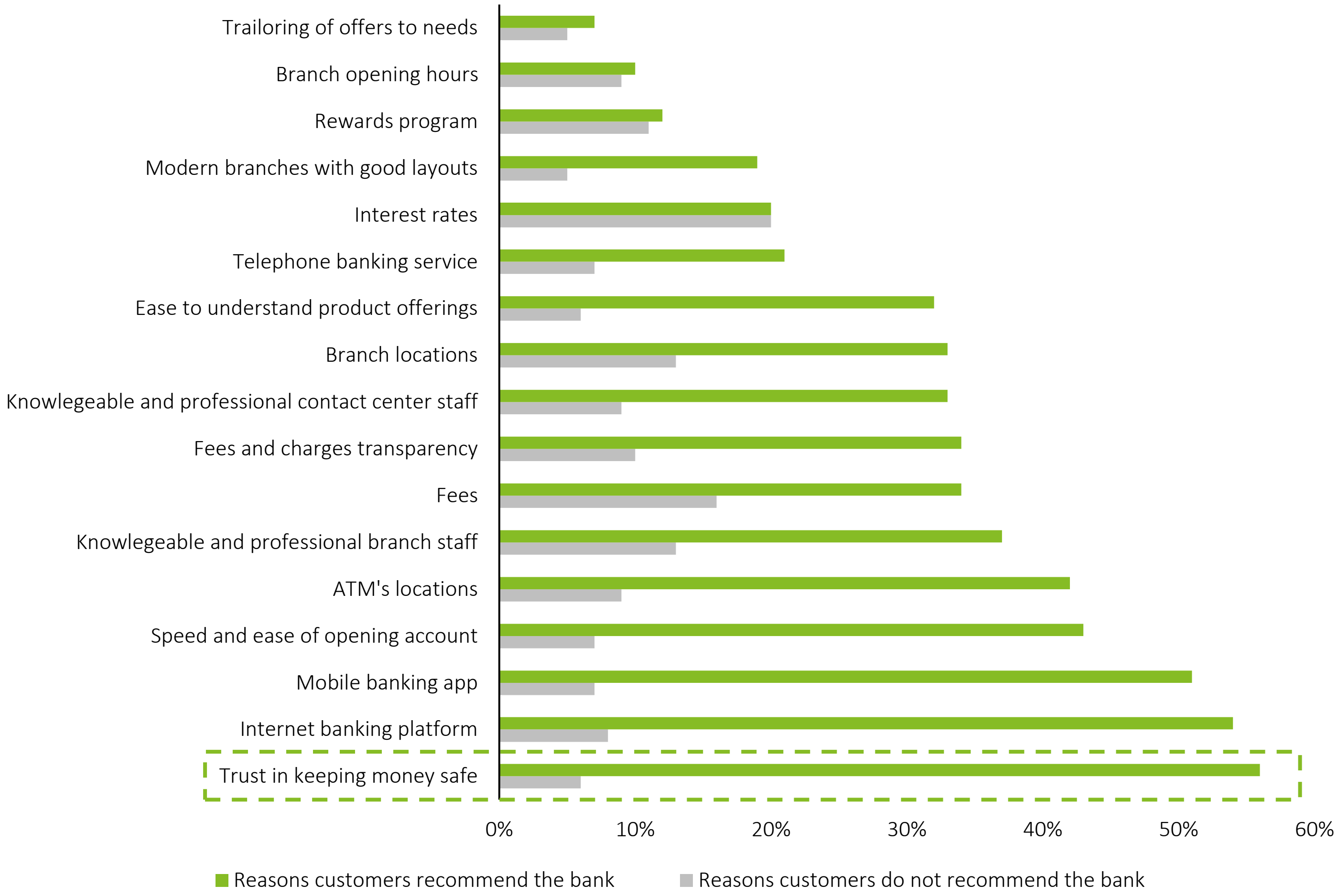
105. There is evidence that brand and reputation are important dimensions across which consumers make decisions for personal banking services:

105.1. According to the American Bankers Association (**ABA**) "[i]n trying times, reputation, trust and strong branding keep customers engaged and dedicated" and that "[n]early one in four consumers rank trustworthiness as the top attribute they consider when choosing a financial institution, outranking factors such as security, size, branch proximity and digital capabilities". [78]

105.2. The ACCC has noted that "brand and trust is an important consideration for customers in choosing which bank to deposit their funds, particularly for savings and term deposits".[79]

106. 2022 research by the Boston Consulting Group also indicated that New Zealanders are likely to recommend their banks to others based on their ability to keep money safe (trust in the bank), digital capabilities (internet and mobile) and speed and ease of opening an account[80], as illustrated by Figure 24 below.

Figure 24: Reasons New Zealanders would or would not recommend their bank



Source: Boston Consulting Group survey data (N=1,206)

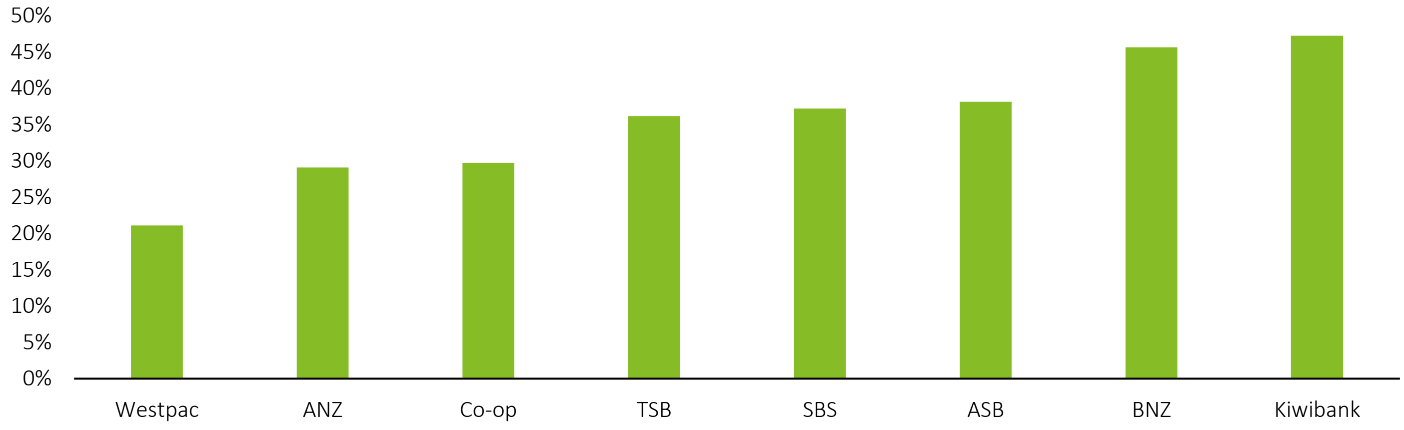
[78] American Bankers Association "The enduring importance of brand, reputation and trust in banking" (March 2022) available at https://bankingjournal.aba.com/2022/03/the-enduring-importance-of-brand-reputation-and-trust-in-banking/

[79] ACCC "Reasons for Determination – Application for merger authorisation lodged by Australia and New Zealand Banking Group Limited in respect of its proposed acquisition of Suncorp Bank" (4 August 2023) at [6.313].

[80] Boston Consulting Group "Retail Banking in New Zealand: Customer Satisfaction, Use and Perception Compared With the Rest of the World" (2022) at [Exhibit 3] available at nz-retail-banking-report-nov-2022.pdf (bcg.com)

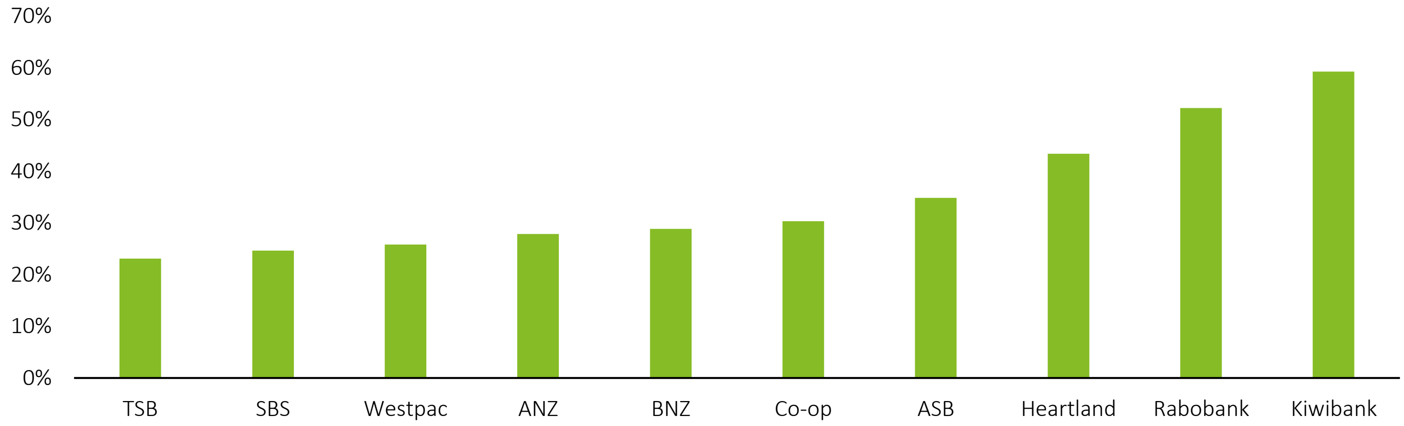
107. While branding and reputation appear to be important considerations for consumers when choosing personal banking services, **evidence suggests this is not an insurmountable condition of entry and exit**. For example, there is evidence that smaller banks (in terms of balance sheet size), have grown over the past five years for both deposits and mortgage lending, as demonstrated by the figures below.

Figure 25: Percentage change in value of residential mortgages (June 2023 versus June 2018)



Source: Deloitte Access Economics based on RBNZ data. Note, Heartland is not presented in the figure. This is because Heartland is understood to have only substantively re-entered the provision of conventional home loans in 2020.

Figure 26: Percentage change in value of deposits (June 2023 versus June 2018)



Source: Deloitte Access Economics based on RBNZ data

108. Establishing a trusted brand and reputation is also likely to evolve with the increasing digitisation of personal banking services. As the research by the Boston Consulting Group described above demonstrates, the speed and ease of opening an account and digital capabilities are also important reasons New Zealanders would recommend a bank. This may mean that digitally focused brands, initially established for related financial services such as wealth management, are able to effectively enter and expand for personal banking services. As we discuss in more detail below, there is evidence of this occurring, with platforms such as Revolut and Sharesies recently introducing personal banking products.

Regulation matters for financial stability, but can have implications for competition

Overview

109. Of the current and proposed regulations governing the provision of financial services highlighted in the PIP, 13 of the 16 identified have an objective that includes financial stability and/or consumer protection. If the recently revised outsourcing policy required by the RBNZ (BS11) and the existing Fair Trading Act are included, this increases to 15 of 18 areas of legislation and compliance. Of the total, six include a purpose of encouraging innovation and competition.

110. A focus on financial stability is paramount given the systemic importance of the banking sector in any economy. A large bank or system failure would have material consequences to the New Zealand economy compared to a failure of a provider of other services. It is unsurprising that the regulatory system is designed primarily to ensure financial stability objectives are met.

111. A consequence of imposing regulatory objectives is higher conditions for entry and expansion across the personal banking sector as compliance costs, obligation standards, and penalties for non-compliance are significant, which may also delay or inhibit innovation. This is evidenced with some new entrants publicly voicing their concerns over the regulatory environment significantly impacting their business models.[81]

112. Regulation not only impacts conditions of entry, but regulation can also serve the purpose of improving (directly or indirectly) consumer outcomes. For example, the introduction of the responsible lending rules under CCCFA which, although only aimed at lending products, has in recent years, along with competition dynamics, played a role in the reduction or removal of banking fees for regulated products.

113. In addition to New Zealand regulations, Australian subsidiary banks are subject to further regulations set by the Australian Prudential Regulation Authority (**APRA**) via their parent banks such as Prudential Practice Guide APG 223 Residential Mortgage Lending (APG 223),[82] which places requirements in relation to residential mortgage lending including the need to address credit risk within risk management frameworks, sound loan origination criteria, and having a robust stress testing framework in place. Further examples include Prudential Standard APS 210 Liquidity (APS 210)[83] which aims to regulate the management and measurement of liquidity risk by placing obligations on organisations such as the need to require a 31-day notice period for a customer to break a term deposit. As part of its oversight, APRA would expect both the Australian parent company and New Zealand subsidiary to be compliant with these regulations, which has implications for the design and flexibility of personal banking services for New Zealand subsidiary banks.[84]

114. Given there are some areas where New Zealand regulation imposes a higher standard than international markets (for example BPR100: Capital Adequacy, as discussed below), applying learnings from offshore experience and identifying whether similar conditions exist in the New Zealand context may be a worthwhile focus of the Commission to ensure policy objectives are met while ensuring competition and innovation is promoting outcomes to the benefit of New Zealand consumers.

---

[81] Gareth Vaughn "Harmony's Neil Roberts says the P2P lender, which launched in September 2014, has been 'slowly operating a pivot and moving to lending our own money' since 2015" (26th September 2019), available at https://www.interest.co.nz/personal-finance/101804/harmoneys-neil-roberts-says-p2p-lender-which-launched-september-2014-has

[82] APRA "Prudential practice guide – APG 223 residential mortgage lending" (December 2022), available at https://www.apra.gov.au/sites/default/files/2022-12/Prudential%20Practice%20Guide%20-%20APG%20223%20Residential%20Mortgage%20Lending.pdf

[83] APRA "Prudential standard APS 210 – Liquidity" (January 2018), available at https://www.apra.gov.au/sites/default/files/APS%2520210%2520FINAL.pdf

[84] For example, the AFR reported in October 2019 that APRA was concerned "major banks will shift capital to New Zealand to meet higher capital requirements there, reducing the amount of capital in Australia". See Australian Financial Review "APRA urges more capital be held against NZ banks" (October 2019), available at https://www.afr.com/companies/financial-services/apra-urges-more-capital-be-held-against-nz-banks-20191015-p530py and APRA "APRA proposes new measures to strengthen capital protection for bank depositors" (October 2019), available at https://www.apra.gov.au/news-and-publications/apra-proposes-new-measures-to-strengthen-capital-protection-for-bank

Regulatory burdens differ across firms

115. Personal banking services are provided by a diverse range of firms, but they are not all regulated equally. From a regulatory perspective, firms can be divided into three main categories:

115.1. Registered banks are regulated by the RBNZ under the Banking (Prudential Supervision) Act 1989.[85] This includes restricting the use of the word "bank" to entities regulated and licenced by the RBNZ. There are two subsets of registered banks, Domestic Systemically Important Banks (**D-SIB**) and other registered banks.

115.2. Non-bank deposit takers (**NBDT**) are regulated by the RBNZ under the Non-Bank Deposit Takers Act 2013.[86]These entities, like registered banks, are regulated by the RBNZ, but have a different set of regulatory requirements to registered banks.

115.3. Other providers of products which fall under personal banking for the purposes of the Commission's market study (such as Buy Now Pay Later providers) are regulated by various other legislation and regulatory bodies.[87]

116. Regulations, especially on registered banks and NBDTs, imposes a direct condition for entry for new firms seeking to provide traditional personal banking products. As noted by the ACCC, such restrictions can discourage new firms from entering the market and create a perception from consumers that there are differing levels of regulatory and prudential protection (which, as we note above, is true in some cases).[88]

117. It is important to consider the different regulatory burdens on firms providing personal banking services in New Zealand and how this impacts conditions of entry, expansion and exit. For example, D-SIBs may face a higher overall regulatory burden, which may act against benefits from economies of scale and / or scope.

Capital adequacy requirements demonstrate the impact of regulation on entry and expansion

118. The Commission has noted its intention to focus on "those aspects of the regulatory environment that are most likely to affect competition in personal banking services".[89] We want to emphasise an important aspect of regulation to consider is capital adequacy requirements.

119. Capital adequacy requirements are an important part of the RBNZ's prudential regulatory framework and help ensure New Zealand's banks and the wider financial sector is well positioned to withstand financial shocks. From 1 July 2022 new capital requirements are being phased in, which require D-SIBs to meet a minimum capital ratio of 18% and other registered banks to meet 16%. This is increased from 8% for both types of registered banks.[90]

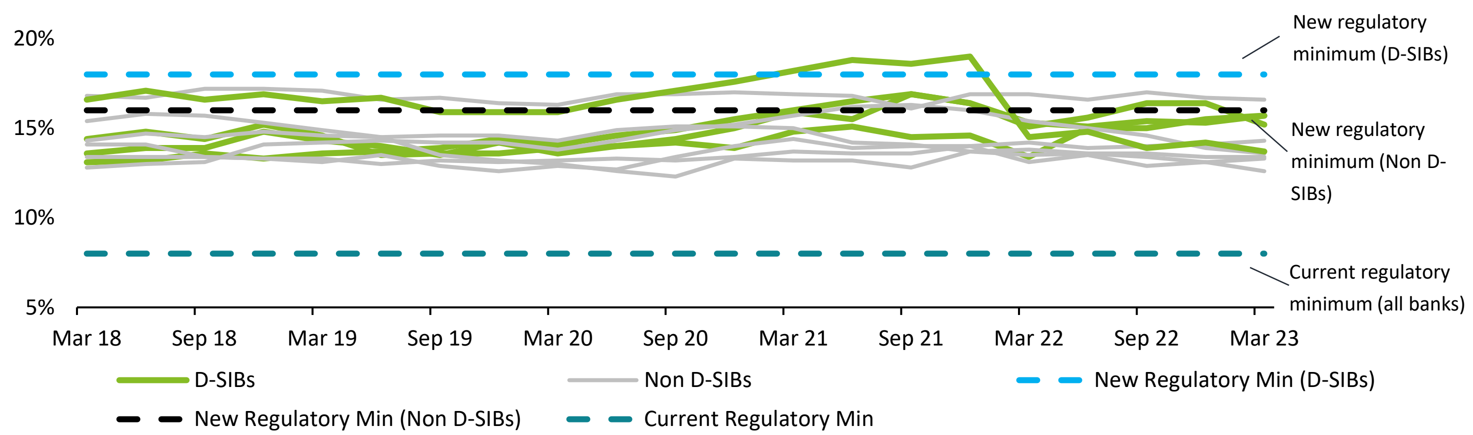
---

[85] Parliamentary Counsel Office "Banking (Prudential Supervision) Act 1989" (1 July 2022), available at https://www.legislation.govt.nz/act/public/1989/0157/latest/whole.html
[86] Parliamentary Counsel Office "Non-bank Deposit Takers Act 2013" (1 July 2022), available at https://www.legislation.govt.nz/act/public/2013/0104/latest/DLM3918915.html
[87] See, for example, Parliamentary Counsel Office "Financial Service Providers (Registration and Dispute Resolution) Act 2008" (1 September 2022), available at https://www.legislation.govt.nz/act/public/2008/0097/latest/DLM1109427.html
[88] ACCC "Productivity Commission Inquiry into Competition in the Australian Financial System – Australian Competition and Consumer Commission submission" (September 2017) at 17, available at https://www.accc.gov.au/system/files/ACCC%20submission%20to%20Productivity%20Commission%20Inquiry%20into%20Competition%20in%20the%20Australian%20Financial%20System.pdf
[89] Commerce Commission "Market study into personal banking services – Preliminary Issues paper" (10 August 2023) at [50].
[90] Reserve Bank of New Zealand "Capital requirements for banks in New Zealand" (1 July 2022), available at https://www.rbnz.govt.nz/regulation-and-supervision/oversight-of-banks/standards-and-requirements-for-banks/capital-requirements-for-banks-in-new-zealand

120. According to S&P, these would be among the world's most restrictive capital requirements.[91] We do, however, note that comparing capital adequacy requirements and levels between jurisdictions is not straight forward. As noted by the World Bank, it is subject to accounting, taxation and supervisory differences.[92] Different capital adequacy regimes can apply differently to different sizes and types of banks within a country, and often set out specific requirements for the types of capital which are required to make up the regulatory minimum.[93]

121. Figure 27 shows historical capital ratios for registered New Zealand banks compared to the current 8% minimum and the new 16% and 18% minimums which take full effect from 2027 (but are already being phased in). All D-SIBs currently sit below the new minimum capital requirements, while most non-D-SIBs also sit below their new requirement (noting that Bank of India and Bank of Baroda were excluded as they have capital ratios above 50%).

Figure 27: Capital ratios for New Zealand banks



Source: Deloitte Access Economics analysis based on RBNZ data (banks shown are ANZ, ASB, BNZ, Co-op, Heartland, Kiwibank, Rabobank, SBS, TSB and Westpac). Note that the vertical axis starts at 5% to improve the presentation of the data.

122. Higher capital adequacy requirements provide greater stability to the financial sector and can improve how investors and credit rating agencies view the riskiness of banks in New Zealand, but they also increase the funding required by banks to carry out operations. In an environment where access to domestic funding can be limited[94], this is an important condition to entry and expansion to consider as part of this Market Study.

Differing wholesale costs matter for firms looking to enter and expand

123. A key consideration for assessing entry, expansion and exit in the market for the provision of personal banking products is access to funding.

124. New Zealand has a relatively low savings rate compared to other OECD nations[95], meaning access to new deposits from customers can be limited, especially for firms looking to enter a new product or expand existing offerings. This leaves wholesale funding as an important source of funding for firms looking to expand.

---

[91] Standard and Poors "World's toughest capital requirements in New Zealand may squeeze credit" (8 August 2021), available at https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/world-s-toughest-capital-requirements-in-new-zealand-may-squeeze-credit-65720981

[92] World Bank "Global financial development database" (September 2021), available at https://www.worldbank.org/en/publication/gfdr/data/global-financial-development-database

[93] See, for example, recent changes in Australia introduced by APRA. Moody's Analytics "APRA finalizes capital adequacy standards for banks" (November 2021), available at https://www.moodysanalytics.com/regulatory-news/nov-29-21-apra-finalizes-capital-adequacy-standards-for-banks

[94] RBNZ "The banking sector" (18 May 2022) at "Our debts from overseas borrowing", available at https://www.rbnz.govt.nz/financial-stability/about-the-new-zealand-financial-system/the-banking-sector

[95] OECD "Saving rate" (accessed 16 August 2023), available at https://data.oecd.org/natincome/saving-rate.htm

125. Due to the small size of New Zealand's capital markets, New Zealand banks and financial institutions must obtain wholesale funding from large overseas markets. Key factors determining the cost of funding in these markets include credit ratings, swap rates and currency sentiment.

126. We note that New Zealand banks and NBDTs[96] have a variety of credit ratings (ranging from AA to CCC+) reflecting their relative financial strength and rating agency assessment. These ratings are likely to impact the ability of various institutions to compete for overseas funding and determine the relative prices they pay.

Table 3: Credit ratings of New Zealand registered banks (as at March 2023)

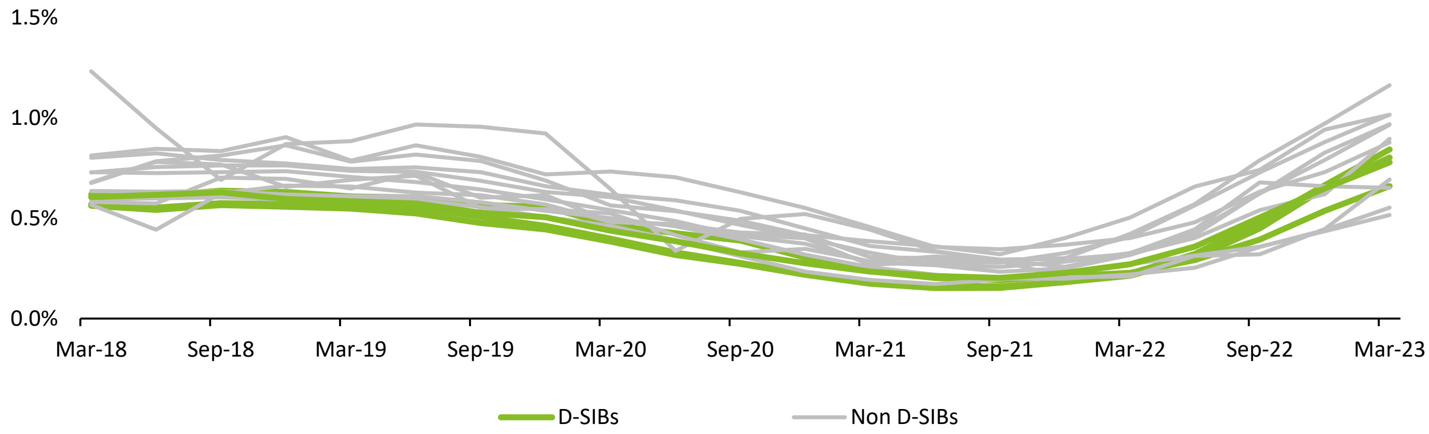
Bank	S&P Global	Fitch	Moody's
ANZ	AA-	A+	A1
ASB	AA-	A+	A1
BNZ	AA-	A+	A1
BOB		BBB-	
BOC	A		A1
BOI		BBB-	
CCB		A	A1
Co-op		BBB	
Heartland		BBB	
ICBC	A		A1
Kiwibank		AA	A1
Rabobank	A		
SBS		BBB	
TSB		A-	
Westpac	AA-	A+	A1

Source: RBNZ

127. The ACCC recently noted that in Australia "on balance the major banks experience lower funding costs than smaller ADIs".[97] An analysis of New Zealand banks' interest expenditure as a percentage of total liabilities suggests a similar trend holds in New Zealand as well, with this metric for D-SIBs typically sitting at the lower end of the spectrum.

[96] See, for example, RBNZ "Register of non-bank deposit takers in New Zealand", available at https://www.rbnz.govt.nz/regulation-and-supervision/cross-sector-oversight/registers-of-entities-we-regulate/register-of-non-bank-deposit-takers-in-new-zealand
[97] Australian Competition and Consumer Commission "Reasons for determination – Application for merger authority lodged by Australia and New Zealand Banking Group Limited" (4 August 2023), at [4.96].

Figure 28: Interest expenditure as a percentage of total liabilities



Source: Deloitte Access Economics analysis based on RBNZ data

128. Access to, and the price of, wholesale funding is an important consideration for the Commission. It serves to highlight the complexity of how banks fund themselves in the context of various operating models and prudential regulatory requirements. Wholesale funding is also an important source of funding for banks looking to expand their balance sheet, whether that is to meet new regulatory requirements or to enter or expand into personal banking services.

The relevance of conditions of entry and expansion to competitive outcomes

129. Despite the presence of the conditions of entry and expansion discussed in this report, in-scope personal banking services may be workably competitive. [98]

130. The shift towards digital channels has lessened the commercial requirements for entry and expansion for personal banking services. The need for a strong physical presence is diminishing, and recent entry into personal banking services has highlighted how certain business models have been able to take advantage of falling commercial requirements.

131. We would also note that entry and expansion may occur in particular personal banking services or products. This means that the extent of the conditions of entry and expansion may differ, depending on the service or product where the entry and expansion is occurring. An example is the recent entrance of technology firms and start-ups in savings and payments. Although these do not replace a bank's core role in the provision of payment facilities, deposit accounts or credit, they do change how and who the consumer interacts with:

131.1. Wellington-based online share trading platform Sharesies recently launched a savings account product. Sharesies is not a bank, or a registered deposit taker, instead the money customers deposit through the Sharesies savings account is held by an "AA- rated registered NZ-based bank… on your behalf".[99]

---

[98] As the Commission notes in the PIP, the existence of barriers to entry, expansion and exit does not itself necessarily give rise to a competition problem - Commerce Commission "Market study into personal banking services – Preliminary Issues paper" (10 August 2023) at [195].

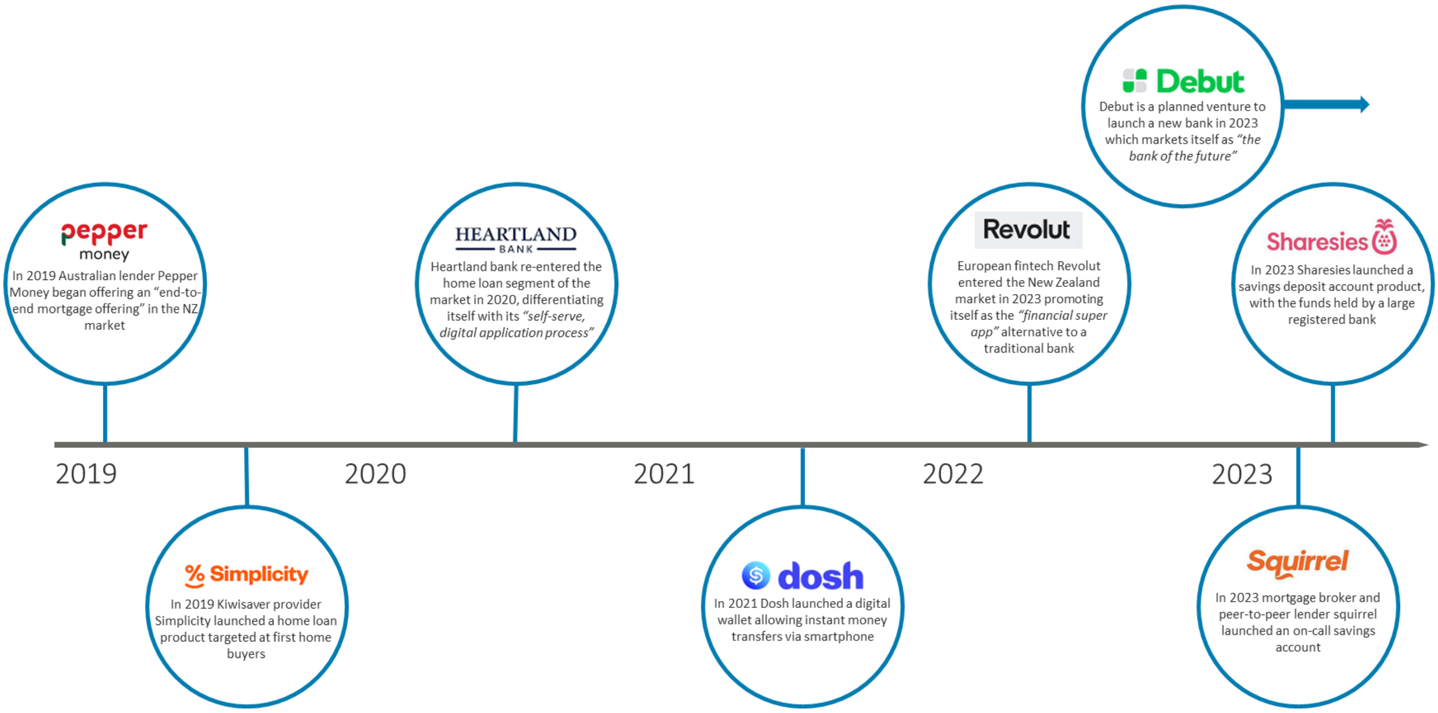
[99] Sharesies "Sharesies save account", available at https://www.sharesies.nz/save

131.2. The recent entrance of large technology firms into payments, highlights how digital preferences have reduced the commercial impediments to entry. In the payments space, this has allowed Apple[100] and Google[101] to enter with mobile payment products (despite not managing the payment infrastructure themselves). [102] This allows them to act as an interface between customers and their payment provider (such as traditional banks). In the US market Apple has gone a step further and launched a credit card product (noting the card itself is issued not by Apple but by Goldman Sachs with payment processing handled by Mastercard). [103]

131.3. More established players such as Windcave, Stripe, Paypal, AfterPay and Xero continue to actively look for opportunities to leverage their existing consumer bases into adjacent personal banking services.

132. We note that in the last few years there has also been entry and expansion into in-scope personal banking products. These are largely in the form of overseas platforms (such as Revolut) or existing players in out-of-scope segments expanding into new products (such as Kiwisaver provider Simplicity offering home loans to first-home buyers).

Figure 29: Timeline of recent entry and expansion into in-scope personal banking segments



Source: Deloitte Access Economics

[100] Apple 'Apple Pay', available at https://www.apple.com/nz/apple-pay/
[101] Google "Google Pay', available at https://pay.google.com/intl/en_nz/about/
[102] Apple "Apple Pay security and privacy overview", available at https://support.apple.com/en-us/HT203027
[103] Apple "Apple Card", available at https://www.apple.com/apple-card/

Profitability and comparative indicators of bank performance

Key points

- **While profitability analysis** may potentially provide insight into whether a market is **workably competitive**, care needs to be taken when interpreting the presence of profitability in a market. It is important that profitability should be considered in the context of the overall assessment of competition, **not in isolation**, and that **wider reasons** need to be explored to explain the relative performance of the New Zealand banking sector and the differences in profitability levels between banks in New Zealand.
- **Cross-country** comparisons of profitability may provide insights into whether the New Zealand banking sector is workably competitive ***only if*** **other cross-country differences are adequately controlled for**. Differences in the size, composition and makeup of economies and banking sectors, sectoral coverage and intensity of banking services, regulatory regimes and requirements, savings attitudes and preferences of consumers, risk and different operating models and focus can all impact profitability levels.
- The Commission's initial analysis neglects controlling for cross-country comparisons. Analysis in this report shows, for example, New Zealand's banking sector does not derive much income from trading, derivatives, securities and commissions and has a relatively low overheads to assets ratio relative to the countries in the set of countries the Commission addressed in its cross-country profitability analysis. **Several other factors would need to be controlled for** to provide accurate and reliable insights into whether New Zealand's banking sector is workably competitive.
- **Cross-country** comparisons also **lack a competitive benchmark**, due to the differences in the level of competition in the various markets that need to be factored into any analysis.
- **Cross-firm** (within New Zealand) profitability analysis may provide **better insight into the workably competitive nature of the market**. However, once again, **other factors would need to be considered that may explain differences**, including differences in **intangible assets** and the interaction between **macroeconomic conditions**, including the **changes in supply and demand for money**, and **differing funding composition of financial institutions**.
- We would note that even if certain firms do in fact have perceived elevated profitability levels, this does not necessarily indicate that a market is not workably competitive. Economic profitability should be focussed on the "marginal producer". Other providers may have **cost efficiencies** driven from advantages associated with economies of scale and scope, ownership structure and wholesale funding.
- A key issue in the assessment of profitability for purposes of competition policy is the appropriate period of time over which such an assessment should be conducted. Further consideration should be given to the assessment of cross-firm profitability over **a longer time period** as the current assessment across firms only extends over a 5-year period.
- Assessing the level of profitability of banks at a **"whole of bank level",** rather than looking at the product lines that are in-scope, may **not provide the full picture and skew results for in-scope products**. In particular, the costs to serve may vary between banks and products and this needs to be adequately allowed for.
- We note that the **allocation of common costs is not trivial**. Consideration of profitability at a product level was eventually abandoned by the CMA, likely because of the complexities involved and numerous assumptions required to arrive at a figure for economic profitability and a competitive benchmark for profitability.

Purpose

133. The purpose of this chapter is to highlight additional considerations the Commission may want to consider as part of the analysis on profitability and bank performance measures in this market study.

134. Profitability can provide insights into the nature of competition. However, care needs to be taken when interpreting the presence of profitability in a market, as it does not provide conclusive evidence that a market is not vigorously competitive or that there are high impediments to entry, expansion and exit.

135. In this Market Study, it is therefore important that profitability should be considered in the context of the overall assessment of competition and not in isolation. Wider reasons need to be explored to explain the relative performance of the New Zealand banking sector and the differences in profitability levels between banks in New Zealand.

The Commission's proposed approach and initial findings

136. The Commission proposes to focus on three measures of banking profitability. The three measures are:[104]

136.1. Net Interest Margin (**NIM**)

136.2. Return on Equity (**ROE**)

136.3. Return on Assets (**ROA**)

137. The Commission intends to consider indicators of financial performance at a "whole of bank level" to understand profitability in the wider banking sector and to potentially build on this by investigating more granular measures.[105]

138. The Commission found that larger banks in New Zealand tended to outperform their local peers (but with some notable exceptions such as Heartland Bank when considering ROA and NIM), while the New Zealand banking sector as a whole sits in the upper quartile when compared against international banking sectors tracked by the World Bank.[106]

139. The Commission does not propose to conduct its own internal calculations of firms' opportunity cost of capital or profitability.[107] We understand this to mean that the Commission will use cross-firm and cross-country comparisons for its profitability analysis, focussing on NIM, ROE and ROA measures at a "whole of bank level" and to potentially build on this by investigating more granular measures.

140. Cross-firm and cross-country profitability assessments can provide a view on the nature of competition for personal banking services in New Zealand. As noted by the RBNZ when conducting a similar analysis, their view was a lack of competition can potentially explain differences in profitability when comparing firms within New Zealand as well as those overseas.[108]

141. However, there are other reasons for the levels of profitability of the New Zealand banking sector and the larger banks within New Zealand. The Commission has noted risk compensation, efficiencies from ownership structures, tax treatment of returns to shareholders and differences in New Zealand's regulatory environment and operational structure as areas of further investigation.[109]

---

[104] Commerce Commission "Market study into personal banking services – Preliminary Issues paper" (10 August 2023) at [C4].
[105] Commerce Commission "Market study into personal banking services – Preliminary Issues paper" (10 August 2023) at [114] to [120].
[106] Commerce Commission "Market study into personal banking services – Preliminary Issues paper" (10 August 2023) at [C24] to [C61].
[107] Commerce Commission "Market study into personal banking services – Preliminary Issues paper" (10 August 2023) at [117].
[108] RBNZ "Trends in Bank Profitability" (3 May 2023), available at https://www.rbnz.govt.nz/hub/publications/financial-stability-report/2023/may-2023/fsr-may-23-specialtopic-3
[109] Commerce Commission "Market study into personal banking services – Preliminary Issues paper" (10 August 2023) at [C79].

Cross-country profitability analysis

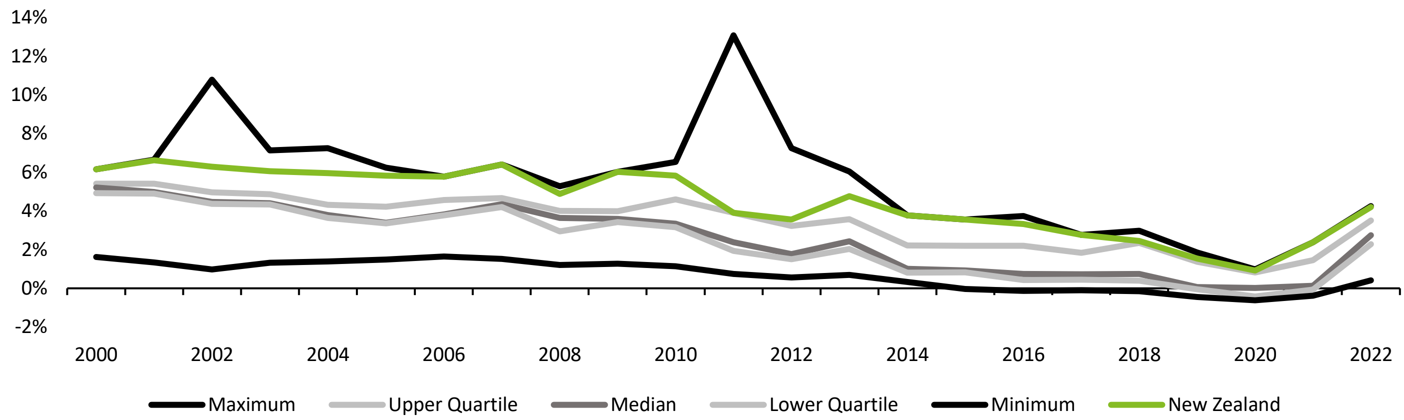
Differences, other than the level of competition, could be relevant

142. Cross-country comparisons of profitability may provide insights into whether the New Zealand banking sector is workably competitive *only if other cross-country differences are adequately controlled for.*

143. This is not a trivial task. There are several factors, other than the level of competition, that drive differences in the profitability levels. Factors that could drive differences include the relative size and makeup of economies and their banking sectors, sectoral coverage and intensity of banking services, regulatory regimes and requirements, savings attitudes and preferences of consumers, risk and different operating models and focus (e.g., the focus on investment banking and fund management services). These factors may also interact with each other and with the level of competition in different countries to drive differences in the profitability levels observed.

144. For example, the risk-free rate of return is unlikely to be constant amongst comparison countries. Conceptually, the return on equity demanded by investors can be broken down to the 'risk-free' component, which is required by investors regardless of risk, and the 'risk premia', which is required by investors to compensate the perceived riskiness of an investment. Differences in the risk-free component of ROE required by investors would drive a degree of differences in ROE and ROA metrics across countries alone. All else equal, a higher risk-free rate would be expected to translate to a higher ROE, and a higher risk-free rate would also lead to a higher ROA.

Figure 30: 10-year government bond yields



Source: Deloitte Access Economics analysis on OECD data (bond yields are as at December of each year, Hong Kong and Singapore were excluded as they are not part of the OECD dataset)

145. A comparison of 10-year government bond yields (a commonly used benchmark for the risk-free rate) suggests that the risk-free rate in New Zealand has tended to sit at the high end for the range of economies used by the Commission for cross-country comparisons.

146. Another consideration in using ROE as a measure of profitability is the proportionate level of debt held by comparator firms across countries. Differences in ROE may be driven by the relative level of gearing of different banks. High gearing can not only increase ROE as a higher proportion of funding comes from the liabilities section of the balance sheet (meaning less equity), but also because it can increase the perceived riskiness of a firm by investors.

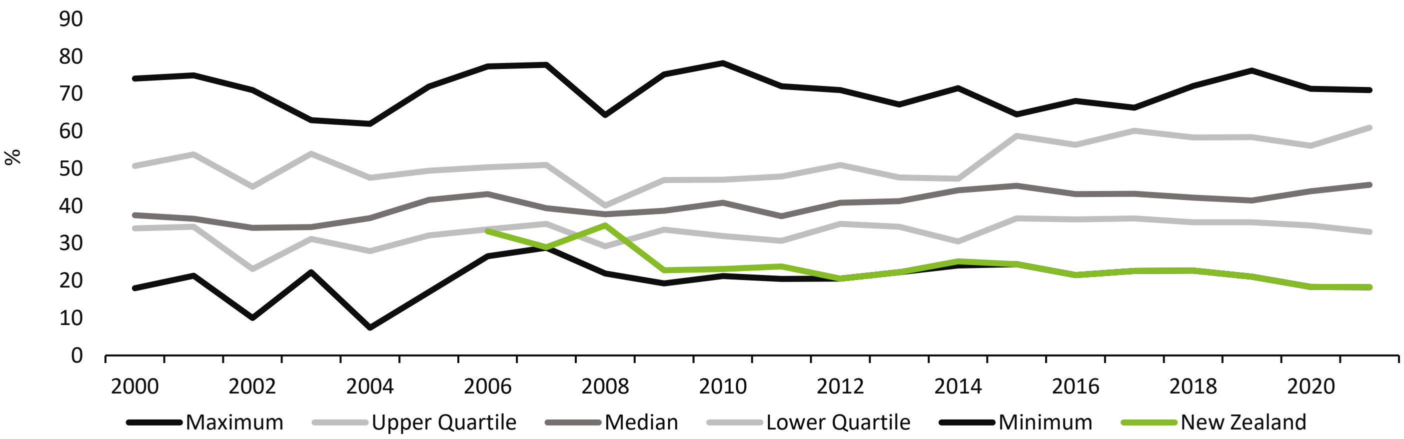
147. To provide a sense of the potential differences between countries other than the level of competition, we use the World Bank Database the Commission relied on as part of its profitability assessment, using the same set of countries the Commission included in its analysis in the PIP. The figures below provide a view on the differences between banking sectors across countries, focusing on:[110]

147.1. The percentage of banks' income generated by non-interest related activities as a percentage of total income (net-interest income plus non-interest income). Non-interest related income includes net gains on trading and derivatives, net gains on other securities, net fees and commissions and other operating income.

147.2. Operating expenses of a bank as a share of the value of all assets held.

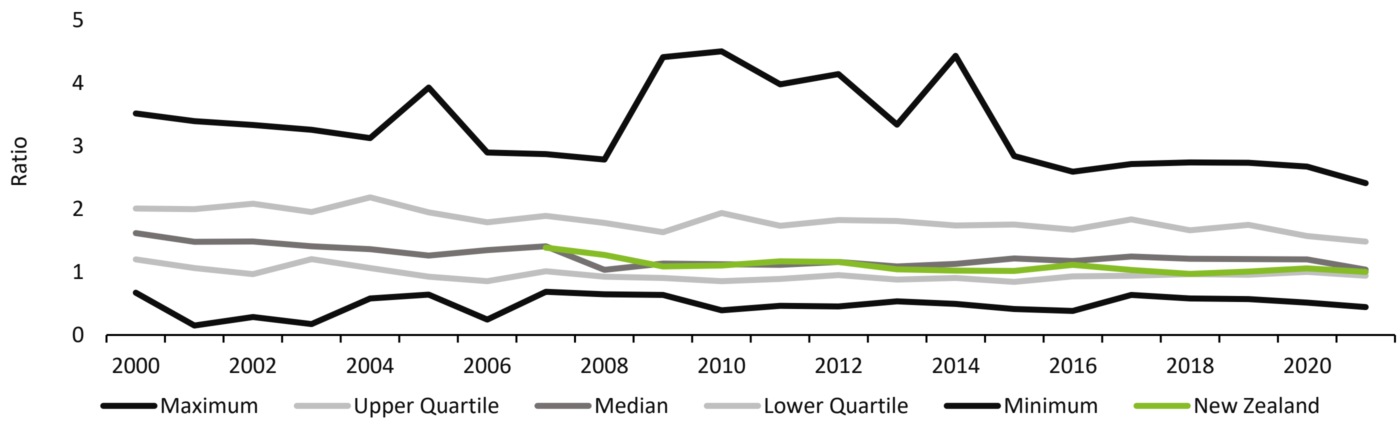
147.3. Bank credit to private sector as a percentage of total deposits.

Figure 31: Bank non-interest income to total income



Source: Deloitte Access Economics analysis based on World Bank Data. Data for New Zealand is only available from 2006 onwards.

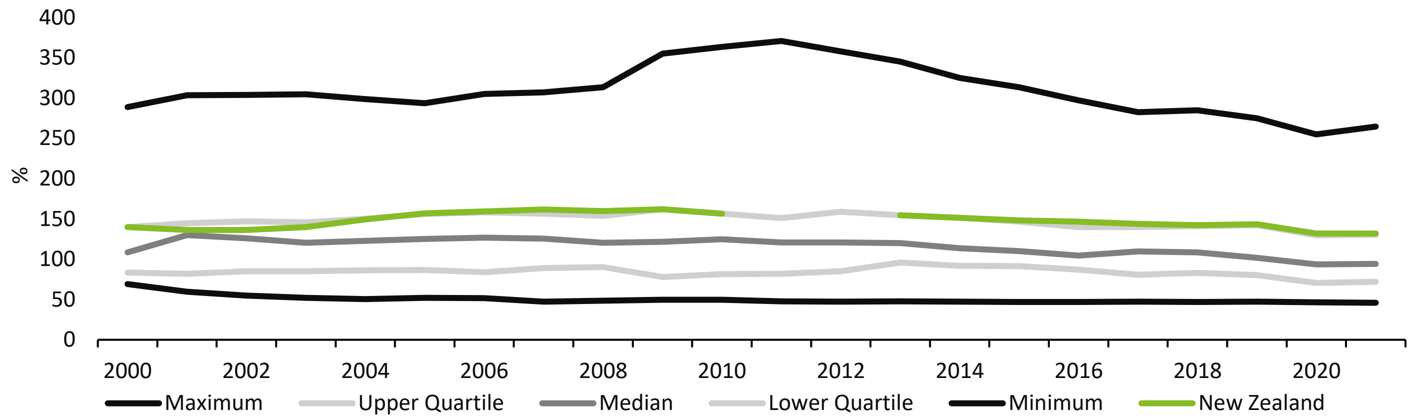
Figure 32: Overheads to asset ratio



Source: Deloitte Access Economics analysis based on World Bank Data. Data for New Zealand is only available from 2007 onwards.

[110] World Bank "Global Financial Development Database" Series: GFDD.EI.03, GFDD.EI.04 and GFDD.SI.01, September 2022 Version, available for download at https://www.worldbank.org/en/publication/gfdr/data/global-financialdevelopment-database.

Figure 33: Bank credit to private sector



Source: Deloitte Access Economics analysis based on World Bank Data. Data for New Zealand was not available for 2011 and 2012.

148. The above figures suggest that New Zealand's banking sector does not derive much income from trading, derivatives, securities and commissions, has a relatively low overheads to assets ratio and has a reasonably high proportion of credit supplied to the private sector, relative to the countries in the set of countries the Commission undertook in its cross-country profitability analysis.

149. These factors may have some bearing on the perceived levels of profitability of the New Zealand banking sector observed by the Commission in its initial analysis. For example, the lack of focus on non-interest earning activities and its associated costs and relatively lower overheads may act to increase profitability levels, relative to other countries.

150. We have not come to a view on how these factors drive the levels of profitability observed across ROE, ROA or NIM, given the inherent complexities of controlling for cross-country differences other than the level of competition between countries. However, they serve to emphasise other factors may potentially be acting to drive the relative levels of profitability seen in the Commission's cross-country analysis.

151. For example, New Zealand has relatively strong capital adequacy requirements relative to comparable jurisdictions. While the impacts of capital adequacy requirements and level of capital holding on bank profitability and performance is unclear, with a number of conflicting hypothesises,[111] there is some empirical evidence from New Zealand studies to suggest the relationship may be positive.[112]

The lack of a competitive benchmark

152. In addition to the potential for other factors that may be driving the observed profitability of the New Zealand banking sector, we would note that cross-country comparisons suffer from a lack of benchmark against which to draw inferences on whether observed outcomes reflect a workably competitive market or not.

[111] Nikita Sinhal, Shikha Goyal, Divya Sharma, Sapna Kumari and Shweta Nagar "Capitalization and profitability: applicability of capital theories in BRICS banking sector" (2022) 8(30) Future Business Journal, available at https://fbj.springeropen.com/articles/10.1186/s43093-022-00140-w

[112] Vijay Kumar, Sanjeev Acharya and Ly T. H. Ho "Does monetary policy influence the profitability of banks in New Zealand?" (2020) 8(2) International Journal of Financial Studies 35, available at https://www.mdpi.com/2227-7072/8/2/35

153. The Commission has recognised this in previous work. In its market study into the retail grocery sector, the Commission compared the average return on average capital employed (**ROACE**) for the three major grocery retailers with the average ROACE observed for a sample of overseas retailers. The average ROACE for the three major grocery retailers was slightly higher than, but similar to, the average ROACE for the overseas comparator companies.[113]

154. The Commission noted that it was difficult to draw firm conclusions regarding whether the major grocery retailers' ROACE was consistent with workable competition by comparing it with overseas grocery retailers. Doing so would require a close examination of the overseas grocery retailers' businesses and the competitive context in which each of them operates, such as the extent to which the overseas grocery retailers were operating in workably competitive markets.[114]

155. The same applies to personal banking services. A close examination of the degree of competition is required for each of the overseas comparisons included to make the cross-country comparison valid.

Cross-firm profitability analysis

156. We consider that cross-firm comparisons of ROE, ROA and NIMs may offer a better insight into whether the markets for personal banking services are workably competitive. Cross-firm comparisons within New Zealand have the benefit of controlling factors such the size of New Zealand's economy and banking sector, the make-up of its economy, risk and its regulatory regime.

157. However, there may be other factors that may explain differences in the profitability levels of firms within the New Zealand banking sector, other than the level and extent of competition. We discuss some of these factors below.

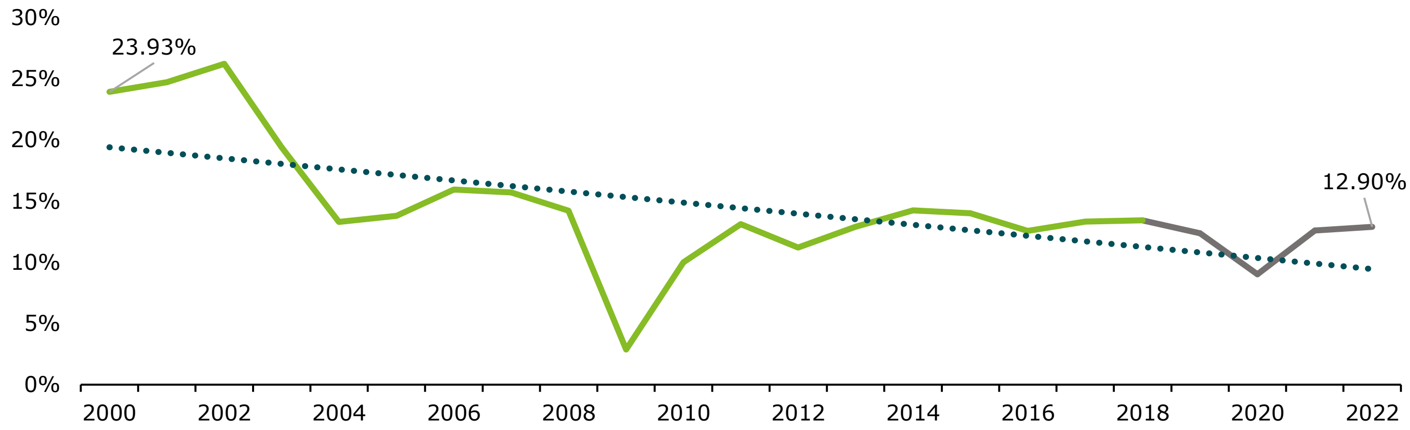
158. Also noting, a key issue in the assessment of profitability for purposes of competition policy is the appropriate period of time over which such an assessment should be conducted. We note the Commission's analysis for cross-firm profitability analysis is only for five years, which does not necessarily constitute a full business cycle. The period considered by the Commission includes the Covid-19 pandemic and the rapid inflection from a highly stimulatory economic environment to a contractionary one. The time period considered in the PIP could be driven by the fact that the RBNZ dashboard is only available from 2018, but further consideration should be given to the assessment of profitability over a longer time period in the assessment of profitability for purposes of this Market Study.

159. As demonstrated by Figure 34 below, the trend for profitability for the New Zealand banking sector, as measured by ROE, has generally been on a downward trend when examined beyond the time period considered by the Commission in the PIP. This downward trend is consistent with the tendency towards reducing profitability levels that would be expected in workably competitive markets.

[113] Commerce Commission "Market study into the retail grocery sector – Final report" (8 March 2022) at [3.57], available at https://comcom.govt.nz/__data/assets/pdf_file/0024/278403/Market-Study-into-the-retail-grocery-sector-Final-report-8-March-2022.pdf

[114] Commerce Commission "Market study into the retail grocery sector – Final report" (8 March 2022) at [3.58] and [3.59], available at https://comcom.govt.nz/__data/assets/pdf_file/0024/278403/Market-Study-into-the-retail-grocery-sector-Final-report-8-March-2022.pdf

Figure 34: Return on equity (annual average)



Source: Deloitte Access Economics analysis based on RBNZ data (the grey part of the line indicates the profitability levels during the period considered by the Commission in the PIP. Annual ROE levels shown are an average of quarterly ROE. Trendline is linear.)

Factors that may impact profitability

160. The following paragraphs outline various factors which may impact the profitability levels of firms within a market.

Differences in intangible assets

161. As noted in our discussion of conditions of entry, expansion and exit, expenditure on branding and reputation are typically hallmarks of the competitive process and a means of differentiating products from competitors. More generally, from an economic perspective, expenditure on intangible assets are productive assets that firms invest in to generate returns.

162. As previously acknowledged by the Commission[115], investments in intangible assets should be factored in when considering profitability measures. The exclusion of intangible assets from profitability analysis (noting these are often understated or excluded from audited financial statements in accordance with accounting standards[116]) can lead to overstated profitability estimates,[117] especially when expressing returns as a ratio.

163. The Commission has previously included the value of branding and intangibles. For example, in its market study into the retail fuel sector, the Commission used the Tobin's q methodology to estimate the ratio of fuel firm market values to the replacement cost of their assets. The Commission included as an intangible asset not only the value of purchased brands (which are usually included in financial statements) but also "internally-generated" brands.[118] Similarly, in its market study into the retail grocery sector, the Commission included the value of brands owned by Woolworths NZ as intangible assets in calculating ROACE.[119]

[115] Commerce Commission "Market study into the retail grocery sector – Final report" (8 March 2022) at [B91] to [B94], available at https://comcom.govt.nz/__data/assets/pdf_file/0024/278403/Market-Study-into-the-retail-grocery-sector-Final-report-8-March-2022.pdf
[116] External Reporting Board "New Zealand equivalent to International Accounting Standard 38 – Intangible assets (NZ IAS 38), available at https://www.xrb.govt.nz/dmsdocument/4342
[117] OXERA for the Office of Fair Trading "Assessing profitability in competition policy analysis – Economic discussion paper 6" (July 2003) at [5.19] to [5.22], available at https://www.oxera.com/wp-content/uploads/2018/03/OFT-Assessing-profitability-1.pdf
[118] Commerce Commission "Market study into the retail fuel sector- Final report" (5 December 2019) at [C104] to [C106], available at https://comcom.govt.nz/__data/assets/pdf_file/0028/193915/Retail-fuel-market-study-Final-report-5-December-2019.PDF
[119] Commerce Commission "Market study into the retail grocery sector – Final report" (8 March 2022) at [B91] to [B94], available at https://comcom.govt.nz/__data/assets/pdf_file/0024/278403/Market-Study-into-the-retail-grocery-sector-Final-report-8-March-2022.pdf

164. Spending on intangible assets is expenditure incurred by banks with the intention of yielding future returns but often not capitalised on balance sheets.[120] The denominator for the ROE and ROA measures may therefore not take into account investments in intangible assets. However, returns from such investments may be captured under 'net income'[121] resulting in higher ROE and ROA figures.

165. We acknowledge that the cross-firm ROE and ROA comparisons within New Zealand in the Commission's initial analysis in the PIP may not take into account intangible investments across all firms.

166. However, differences in the intensity and frequency of intangible asset investments, and so the underlying value of intangible assets, between banks may explain the differences in overall returns (e.g., higher brand expenditure may drive higher overall income, all else held equal). We consider accounting for differences in intangibles investment could be worth exploring as a potential explanation for differences in profitability levels observed to date. We acknowledge accounting for differences in intangibles investment could involve capitalising past investments in brand (such as recruitment, training and skills of the workforce and marketing and sales activities)[122] and that care would be needed to exclude any elements of economic rents, if there are any, in brand valuations.[123]

Macroeconomic conditions

167. ROE, ROA and NIMs may also be driven by factors outside of the level of competition. As recently noted by the ACCC, domestic macroeconomic and interest rate conditions are other important factors in considering bank profitability.[124]

There has been a shift away from short-term funding

168. The global economy, New Zealand included, has until very recently been in a very low interest rate environment since the Global Financial Crisis (**GFC**). Between 2010 and 2020 the Official Cash Rate (**OCR**) in New Zealand peaked at 3.5%, compared to 8.25% in 2008.[125] There have also been changes in how banks fund themselves in recent times. This has implications for the price of wholesale funding and for profitability outcomes more generally.

169. At a sector-wide level, there has been a move towards the use of retail deposits and long-term debt to fund lending operations.[126] This shift away from shorter-term funding has been driven in part by responses to the GFC which saw short-term debt markets seize, as well as mounting pressure from stakeholders such as regulators, investors and credit rating agencies.

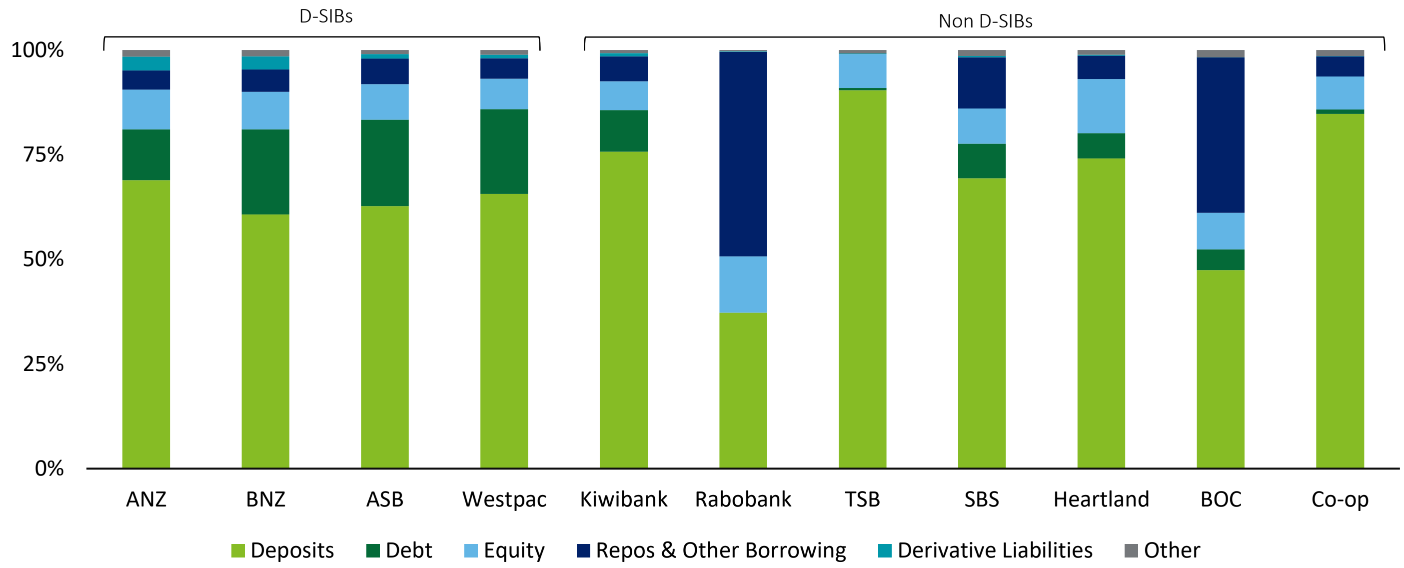
170. An analysis of RBNZ data on balance sheet compositions for D-SIBs and non-D-SIBs highlights the differences in funding sources and mechanisms in use by deposit takers.

170.1. Deposits, debt and equity account for 91.3% of balance sheet funding for D-SIBs as of March 2023. Repos and other borrowing, which is typically of a shorter-term nature, accounted for 5.1%.

[120] With the exception of goodwill recorded for acquired brands. See, for example, goodwill relating to ANZ's purchase of National Bank of New Zealand (ANZ "ANZ Bank New Zealand Limited – Registered bank disclosure statement for the year ended 30 September 2022" (November 2022) at Note 19, available at https://www.anz.com/content/dam/anzcom/shareholder/ANZ-Bank-NZ-Ltd-DS-30.9.22.pdf)
[121] In particular, due to timing differences between when intangible expenditure is incurred and when returns from such expenditure are generated.
[122] OXERA for the Office of Fair Trading "Assessing profitability in competition policy analysis – Economic discussion paper 6" (July 2003) at Box 5.3, available at https://www.oxera.com/wp-content/uploads/2018/03/OFT-Assessing-profitability-1.pdf
[123] Commerce Commission "Market study into the retail grocery sector – Final report" (8 March 2022) at [B93], available at https://comcom.govt.nz/__data/assets/pdf_file/0024/278403/Market-Study-into-the-retail-grocery-sector-Final-report-8-March-2022.pdf
[124] ACCC "Reasons for determination – Application for merger authorization lodged by Australia and New Zealand Banking Group Limited" (4 August 2023) at [4.57], available at https://www.accc.gov.au/system/files/public-registers/documents/Reasons%20for%20determination%20-%2007.08.23%20-%20PR%20-%20MA1000023%20ANZ%20Suncorp.pdf
[125] RBNZ "Monetary policy decision" (Retrieved 15 August 2023), available at https://www.rbnz.govt.nz/monetary-policy/monetary-policy-decisions
[126] Jason Wong (RBNZ) "Bank funding – the change in composition and pricing" (June 2012) at 17.

170.2. For non-D-SIBs deposits, debt and equity accounted for 82.4% of balance sheet funding as of March 2023. Repos and other borrowing, which is typically of a shorter-term nature, accounted for 16.3%.

Figure 35: Balance sheet funding composition (selected banks as at March 2023)



Source: Deloitte Access Economics analysis based on RBNZ data

171. Funding composition is an important consideration when analysing how firms operate in the personal banking sector. Funding composition will have an impact on a firm's pricing strategy, cost to serve, ability to meet demand for products and perceived 'riskiness' of the entity.

172. The nature of risk involved in different banking products offered by a firm will also determine the makeup of funding and cost it pays for this as well as the return required by investors. This has implications for ROA, ROE and NIMs.

173. Stable and longer-term funding sources can also help protect the financial system from external shocks and cushion consumers from the direct impacts of these.

There has been large monetary and fiscal stimulus in recent times

174. The sudden and significant change in monetary policy became common place in developed economies in response to the outbreak of Covid-19. In New Zealand this took the form of the RBNZ's 'Large Scale Asset Purchase Programme' (**LSAP**). The programme operated by injecting capital directly into the financial system as a means of keeping short-term interest rates low. By the programme's end in July 2021 nearly $53b had been injected.[127]

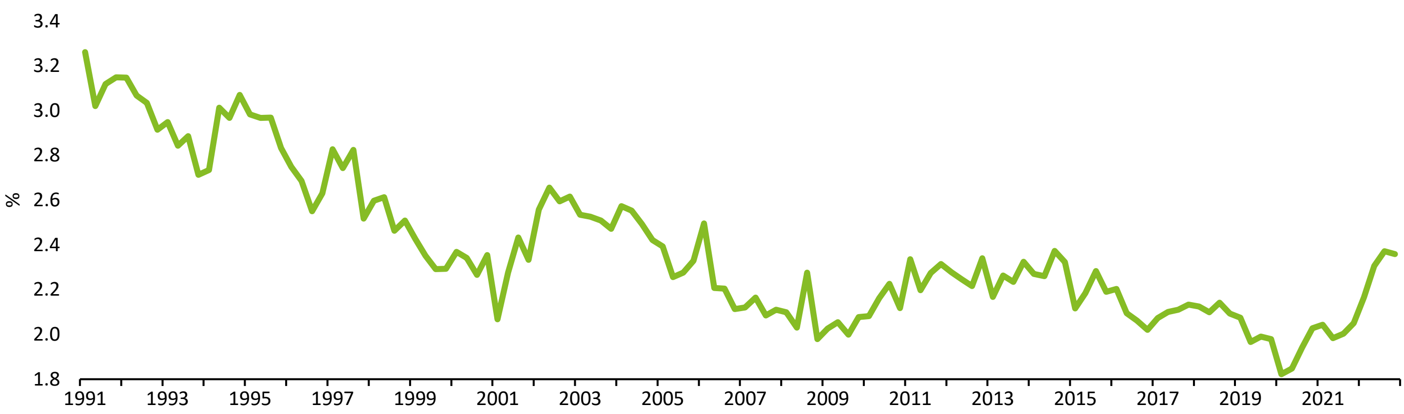
[127] RBNZ "Large scale asset purchase programme" (Retrieved 15 August), available at https://www.rbnz.govt.nz/monetary-policy/monetary-policy-tools/large-scale-asset-purchase-programme

175. Although there is research suggesting that low interest rate environments are typically less profitable for banks[128], this does not take into account the impact of recent unconventional approaches to monetary policy. As programmes such as New Zealand's LSAP are intended to support financial institutions in accessing funds at a low rate to ensure access to credit for businesses and households, and often saw the RBNZ purchasing bonds directly from banks[129], it could be expected this would support higher-than-otherwise levels of profitability.

Changes in the supply and demand for money can impact outcomes

176. The RBNZ has noted the impact of recent monetary and fiscal stimulus on NIMs. It notes that deposit growth has been strong, supported by the large monetary and fiscal stimulus introduced at the start of the pandemic. In the meantime, lending growth has been subdued. These conditions, combined with temporarily subdued funding costs as a result of the lagged transmission mechanisms of monetary policy, has meant "NIMs are temporarily higher than otherwise". These conditions are expected to pass as the economy completes its transition to higher interest rates.[130]

Figure 36: Net interest margin (quarterly, annualised)



Source: RBNZ. Note that the vertical scale starts at 1.8% to better demonstrate trends.

177. The impact of broader macroeconomic changes, such as changes in money supply and demand, as well as significant financial shocks, on personal banking products can be seen when considering a longer period.

178. Figure 37 shows that prior to the GFC, wholesale rates tracked deposit rates closely. At this stage New Zealand banks were heavily reliant on shorter-term wholesale debt which funded approximately half of their balance sheets.[131]

179. However, the GFC saw global capital markets seize up virtually overnight, highlighting the level of liquidity risk banks were bearing on their balance sheets. The aftermath of the GFC saw pressure from investors and regulators alike for banks to shift their sources of funding to favour longer-term, more stable sources, such as retail deposits.

[128] See, for example, Hong Kong Monetary Authority "The profitability of the banking sector in Hong Kong" (September 2003), available at https://www.hkma.gov.hk/media/eng/publication-and-research/quarterly-bulletin/qb200309/fa1.pdf

[129] New Zealand Parliament "Library research brief – Large scale asset purchase (LSAP) programme" (October 2023), available at https://www.parliament.nz/mi/pb/library-research-papers/research-papers/library-research-brief-large-scale-asset-purchase-lsap-programme/#PDF

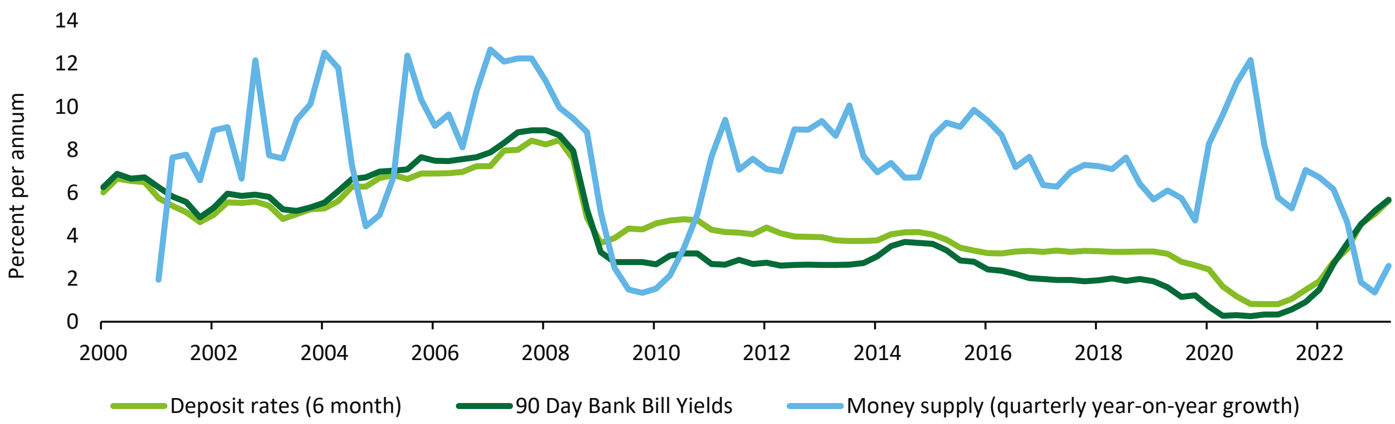
[130] RBNZ "Trends in Bank Profitability" (3 May 2023), available at https://www.rbnz.govt.nz/hub/publications/financial-stability-report/2023/may-2023/fsr-may-23-specialtopic-3

[131] Jason Wong (RBNZ) "Bank funding – the change in composition and pricing" (June 2012) at 16.

180. In the 'market' for deposits, banks would act as purchasers and so act on the demand side. Prior to the GFC, banks were likely more indifferent between wholesale funding and retail deposits, and so it would be expected the 'price' for both would track closely. However, post-GFC, the perceptions of banks changed, with deposits being preferred to short-term wholesale funding. This would likely mean that banks were willing to pay a premium for deposits over the cost of short-term wholesale funding, which is what appears to have happened. Deposit rates have been sitting above wholesale rates over the decade since the GFC.

181. This trend has reversed since late-2021 with deposit rates and wholesale rates converging once again. This is explained by a change in the money supply because of the RBNZ's LSAP initiative during Covid-19. As discussed above, the RBNZ has noted that the impact of recent monetary and fiscal stimulus has been to reduce the need for banks to use more expensive wholesale funding and to compete for further deposit funding.

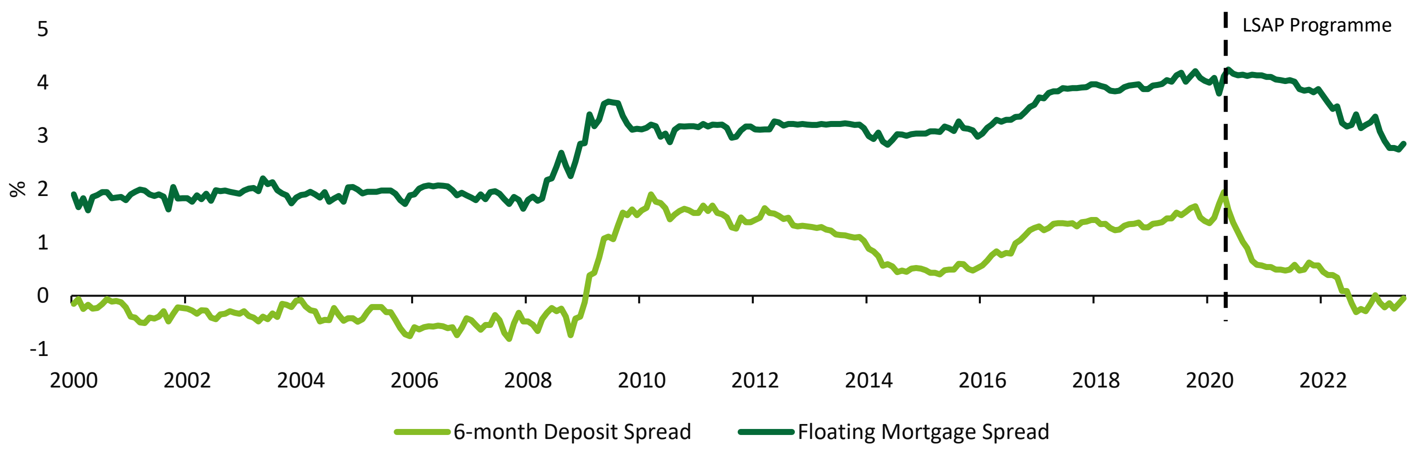
Figure 37: Deposit rates, wholesale rates and money supply (quarterly, annualised)



Source: Deloitte Access Economics analysis based on RBNZ data

182. The impact of the RBNZ's LSAP initiative becomes clearer when considering interest rate spreads on deposit and mortgage products relative to wholesale interest rates. Figure 38 shows that following the RBNZ launching the LSAP programme in March 2020, spreads on both mortgage and deposit products declined significantly, with deposits falling below wholesale rates.

Figure 38: Spreads on mortgage and deposit products relative to wholesale rates



Source: Deloitte Access Economics analysis based on RBNZ data (figure shows the spread between product interest rates and 90-day bank bill yields)

183. The impact of changes in money supply and demand highlights how outcomes for personal banking services, such as deposit rates and profitability, can be determined by factors outside of the level of competition.

Efficiencies

Economic profitability and the 'marginal' producer

184. We would note that even if certain firms do in fact have elevated profitability levels, this does not necessarily indicate that a market is not workably competitive.

185. Economic profitability assessments should be focused on the 'marginal' producer in a market and whether such firms are earning above normal returns. In a market with firms with differing costs and capacity constraints, the supply curve can be 'upward sloping'. In such a situation, the market price in equilibrium will be set by the highest cost or 'marginal' producer who will only make a 'normal' return at market prices. Lower cost producers or firms will make a margin above costs in such a situation.[132] Above normal returns, reflecting greater efficiency does not necessarily indicate a competition problem.[133]

186. The Commission has previously recognised that if high profitability is persistent in a competitive market, it will generally be confined to a subset of firms that have some form of enduring competitive advantage, such as relatively lower costs.[134]

187. Our discussion of the conditions of entry, exit and expansion points to potential cost advantages for certain firms. This is driven from advantages associated with economies of scale and scope and wholesale funding advantages, which in turn is driven by more favourable credit ratings.

188. Care should be taken in attributing excess profitability of a subset of firms as an indication that the market for personal banking services is not workably competitive.

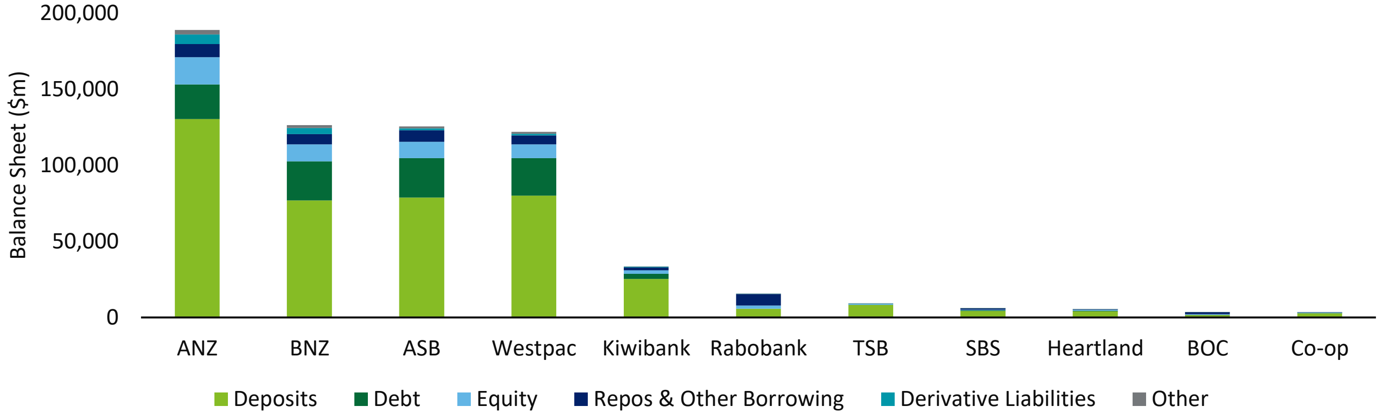
Economies of scale and scope

189. As discussed earlier in our discussion of the conditions of entry, expansion and exit, a key element of the competitive dynamics in the market for personal banking products is likely to be economies of scale and scope. In a small market like New Zealand, economies of scale and scope can be difficult for all firms to achieve. This may mean that certain firms may naturally derive larger economies of scale and scope, and so cost efficiencies, compared to others.

190. Figure 39 demonstrates the different sizes of registered banks[135] in New Zealand based on their balance sheet composition. With balance sheets ranging in size from $132m to nearly $190b[136] it should be expected that firms experience varying levels of economies of scale and so efficiencies.

[132] Gunnar Niels, Helen Jenkins and James Kavanagh *Economics for Competition Lawyers* (2nd Ed, Oxford University Press, Oxford, 2016) at [1.32].
[133] OXERA for the Office of Fair Trading "Assessing profitability in competition policy analysis – Economic discussion paper 6" (July 2003) at [8.16], available at https://www.oxera.com/wp-content/uploads/2018/03/OFT-Assessing-profitability-1.pdf
[134] Commerce Commission "Market study into the retail grocery sector – Final report" (8 March 2022) at [3.16].
[135] RBNZ "Bank Financial Strength Dashboard" (Retrieved 14 August 2023)
[136] RBNZ "Bank Financial Strength Dashboard"

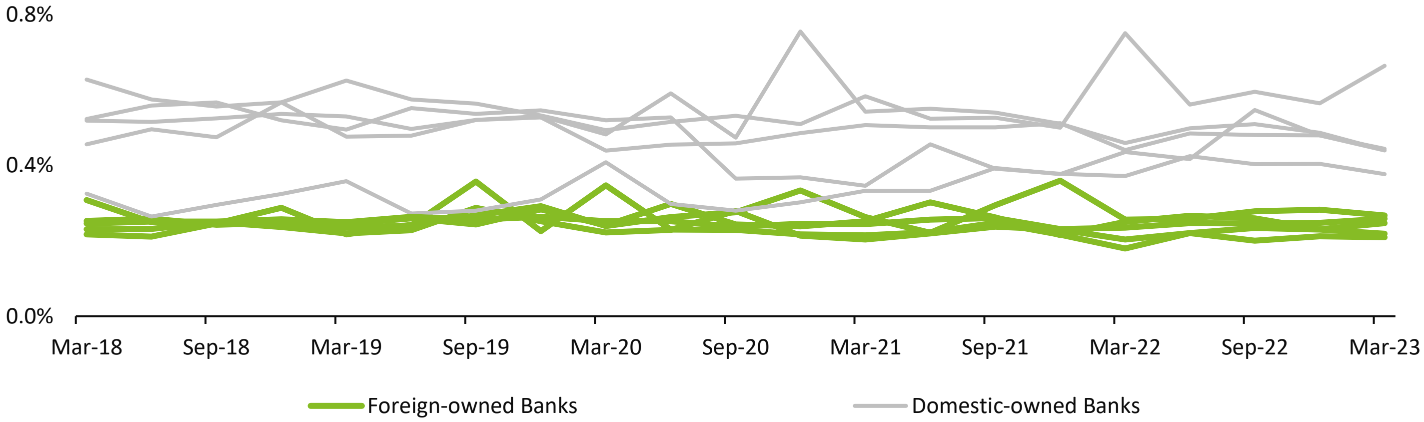
Figure 39: Balance sheet size of selected registered banks



Source: Deloitte Access Economics analysis based on RBNZ data

191. Similar observations have been made by RBNZ in its May 2023 Financial Stability Report. It noted that the revenues of New Zealand banks relative to the size of their balance sheets are similar to the peer country average. However, the large New Zealand banks operate lower cost structures than both the small New Zealand banks and large banks in peer countries. According to the RBNZ, the superior cost efficiency relative to smaller banks is likely to be driven by greater economies of scale within large banks' operations. In addition, the RBNZ noted that New Zealand was the only country in the comparator group where the largest banks are owned by larger overseas parents and that this ownership structure is likely to provide further efficiencies and support to the large New Zealand banks.[137]

Figure 40: Operating expenditure as a percentage of total assets



Source: Deloitte Access Economics analysis based on RBNZ data. Foreign-owned banks displayed are ANZ, ASB, BNZ, Rabobank and Westpac. Domestic-owned banks displayed are Co-op, Heartland, Kiwibank, SBS and TSB.

192. Figure 40 highlights the potential cost-efficiencies that banks with larger overseas parents are able to potentially achieve relative to banks with onshore ownership structures. These are separate to any cost of funding advantages these banks may be able to achieve, looking only at relative levels of operational expenditure.

---

[137] RBNZ "Trends in Bank Profitability" (3 May 2023), available at https://www.rbnz.govt.nz/hub/publications/financial-stability-report/2023/may-2023/fsr-may-23-specialtopic-3

193. The ability of these banks to have policy, operational, technical and administrative services provided by a larger overseas parent company likely reduces the operating cost of their New Zealand business. In addition, they may experience benefits from parent-branding and reputation. These factors can all help foreign-owned banks deliver superior cost efficiencies to domestic-owned banks.

194. We note that Rabobank, despite its relatively small balance sheet in New Zealand, is able to experience similar cost efficiencies to that of banks with much larger New Zealand balance sheets. This suggests it may be the benefits of a large parent, rather than the size of New Zealand operations, which is driving these.

Wholesale funding advantages

195. Another potential driver of relative profitability levels is the price of wholesale funding. Wholesale funding is an important source of funding for banks, but the price paid for it depends on several systemic and individual factors.

196. Conceptually, the cost of funding can be divided into two main components, the risk-free return and the risk premia required by investors as compensation for their perceived 'riskiness' of the investment. This risk premia are dependent on systemic risk factors, such as the macroeconomic environment and prudential requirements, but also firm-specific factors such as the strength of its balance sheet and perceived risk of default.[138]

197. This means different firms have different costs of accessing funding. New Zealand banks and NBDTs have a range of credit ratings[139], suggesting various risks of default and therefore costs of accessing wholesale funding.

198. As we described earlier, larger New Zealand banks, especially those with large overseas parents, tend to have a stronger credit rating.[140] This is likely due to increased diversification benefits as well as access to funding via parent organisations.

Issues with firm-wide profitability assessments

199. The Commission's proposed approach carries with it the risk that factors that drive differing profitability levels for personal and out-of-scope products are not adequately controlled for. While we recognise that disaggregating costs, funding and returns between personal and out-of-scope products is not trivial, we consider it is important to recognise that there will be differing costs across personal and out-of-scope banking products. Costs to serve will vary between banks and products.

200. Firms providing personal banking products encounter 'costs to serve'. These are the costs of connecting to and interacting with customers. This includes costs associated with branches, technological infrastructure and regulatory compliance. Individual banks' cost to serve will also vary under differing models.

201. The provision of personal banking services will often draw upon shared funding mechanisms, internal infrastructure and distribution channels. The unified nature of business models for the provision of personal and out-of-scope banking products has implications for the Commission's analysis, especially as it relates to any profitability analysis.

---

[138] Bank of England "Quarterly Bulletin – Bank funding costs: what they are, what determines them and why do they matter?" (October 2014), available at https://www.bankofengland.co.uk/-/media/boe/files/quarterly-bulletin/2014/bank-funding-costs-what-are-they-what-determines-them-and-why-do-they-matter.pdf

[139] See RBNZ "Registered bank in New Zealand", available at https://www.rbnz.govt.nz/regulation-and-supervision/cross-sector-oversight/registers-of-entities-we-regulate/registered-banks-in-new-zealand and RBNZ "Register of non-bank deposit takers in New Zealand", available at https://www.rbnz.govt.nz/regulation-and-supervision/cross-sector-oversight/registers-of-entities-we-regulate/register-of-non-bank-deposit-takers-in-new-zealand

[140] RBNZ "Registered banks in New Zealand", available at https://www.rbnz.govt.nz/regulation-and-supervision/cross-sector-oversight/registers-of-entities-we-regulate/registered-banks-in-new-zealand

202. On the other hand, there may be some costs associated primarily with providing personal banking services. This includes costs associated with retail branches that are primarily aimed at catering to personal banking products, call centres for personal banking customers and regulatory costs associated with being a deposit taker and complying with the CCCFA.

Allocation of common cost is not trivial

203. The proposed focus on a narrow subset of in-scope products further emphasises the importance of caution when making inferences from sector-wide profitability measures to ensure consistency with other aspects of the study.

204. The measurement of profitability of a specific activity is typically subject to problems related to the allocation of costs that are common to other activities. Shared and common costs may include a range of costs, such as shared branch networks, frontline staff, payment systems, IT systems and firm wide regulatory compliance costs. Theoretically, the lower bound of these costs could be the incremental costs of providing the in-scope personal banking services. The upper bound could be equivalent to the efficient stand-alone cost of providing in-scope personal banking services.

205. Disaggregating costs and funding from in-scope and out of scope products are not trivial. The ACCC also recently noted, the sensitivity of product-specific profitability measures to underlying assumptions and methodology means an analysis of these are "unlikely to provide a meaningful picture of the strength of competition".[141]

206. This was the intended approach of the CMA for their retail banking market investigation. The CMA proposed the following steps to construct profitability measures:[142]

206.1. The use of funds transfer pricing (**FTP**) techniques to attribute funding costs and product income to individual products which allow for a view of the income and costs associated with particular product areas (UK banks are required by regulators to use FTP).

206.2. Adjustments were then to be made to income and costs to reconcile 'accounting profit' to 'economic profit'. This was to be largely done on a case-by-case basis.

206.3. Derive an *"economically meaningful"* value of equity capital. Banks were asked to estimate a value for equity relating to in-scope products. This was to be adjusted to align with the economic concept of equity (e.g., the inclusion of intangible assets and considering alternative valuation methods for assets).

206.4. The Capital Asset Pricing Model (**CAPM**) was then to be used to estimate a benchmark cost of equity for comparisons.

[141] ACCC "Reasons for determination – Application for merger authorization lodged by Australia and New Zealand Banking Group" (4 August 2023) at [6.143], available at https://www.accc.gov.au/system/files/public-registers/documents/Reasons%20for%20determination%20-%2007.08.23%20-%20PR%20-%20MA1000023%20ANZ%20Suncorp.pdf
[142] CMA "Retail banking market investigation – Approach to market-wide financial and profitability analysis" (27 March 2015), available at https://assets.publishing.service.gov.uk/media/5515794640f0b6140400005e/Approach_to_market_wide_financial_and_profitability_analysis.pdf

207. However, this approach was eventually abandoned by the CMA[143], likely because of the complexities involved and numerous assumptions required to arrive at a figure for economic profitability and a competitive benchmark for profitability. In particular, in the CMA's final report, the CMA decided not to use traditional profitability analysis: [144]

> "We considered possible methods that might enable us to form a view as to whether banks were achieving levels of profitability that were in excess of what we might expect in a competitive market. We concluded that there were inherent difficulties with such an exercise which would mean that such an analysis would not be sufficiently reliable to inform our assessment of competition."

208. The CMA found it was not possible to:

208.1. Isolate the profitability of the relevant retail markets as they would not sensibly allocate costs, revenue or capital

208.2. The ROE concept is difficult in banking, as it is not clear what should be considered as debt

208.3. Trends over time were difficult to interpret.

[143] We note the absence of the intended profitability analysis outlined in the CMA's working paper (CMA "Retail banking market investigation: Approach to market-wide financial and profitability analysis, available at https://assets.digital.cabinet-office.gov.uk/media/55cdf857ed915d534600002d/Financial_performance_working_paper.pdf) from their final report (CMA "Retail banking market investigation – final report" (9 August 2016) at [7.71] and [32], available at https://assets.publishing.service.gov.uk/media/57ac9667e5274a0f6c00007a/retail-banking-market-investigation-full-final-report.pdf)

[144] We note the absence of the intended profitability analysis outlined in the CMA's working paper (CMA "Retail banking market investigation: Approach to market-wide financial and profitability analysis, available at https://assets.digital.cabinet-office.gov.uk/media/55cdf857ed915d534600002d/Financial_performance_working_paper.pdf) from their final report (CMA "Retail banking market investigation – final report" (9 August 2016) at [7.71] and [32], available at https://assets.publishing.service.gov.uk/media/57ac9667e5274a0f6c00007a/retail-banking-market-investigation-full-final-report.pdf)