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Personal banking services

Final competition report – Executive summary

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Executive summary

This report sets out our findings on factors affecting competition for personal banking services in New Zealand and our recommendations to improve competition.

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

The major banks do not face strong competition

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

The major banks and Kiwibank are the main providers of personal banking services, particularly for the products that we have focused on in the study (home loans and deposit accounts).

There is a stable oligopoly with no maverick provider

There is a two-tier market, with the major banks in a stable oligopoly in the first tier, smaller providers in the second tier, and Kiwibank currently sitting between the two tiers. The major banks in the first tier have high and largely stable market shares, holding 85-90% of the assets of all registered banks in New Zealand.

No new entrants have been able to meaningfully increase the competition faced by the major banks since the establishment of Kiwibank in 2001. Kiwibank imposes some constraint on the major banks but lacks the scale and capital backing to consistently drive stronger competition. None of the smaller providers, including smaller banks, non-bank deposit takers and financial technology companies (fintechs), are exerting strong competitive pressure on the major banks.

Smaller providers lack the scale to compete with the major banks and tend to focus their effort on specific regions, products or consumer groups. The major banks typically only closely monitor the other majors and Kiwibank, indicating that smaller providers are not regarded as a significant competitive threat.

There is currently no maverick – a particularly aggressive or innovative provider – disrupting the major banks. Kiwibank does not have sufficient capital or differentiation from the majors to be considered a maverick. Fintechs have the potential to be a disruptive competitive force, but their impact in the New Zealand market has been modest to date due to challenges they face in entering and expanding.

We do not observe consistently strong rivalry between the major banks

The intensity of competition between the major banks appears to be sporadic for home loans and deposit accounts. There have been times of relatively intense competition and other times where some or all of the major banks pull back, choosing to put more focus on maintaining profit margins than competing harder to gain market share.

We have not observed an ongoing struggle – with competitors constantly trying to "injure" each other by taking sales away from their rivals – as we would expect in *strongly* competitive markets. Nor do we consider there is an observable tendency towards strong competition. Instead, we see little strategic differentiation between the major banks and growth targets which balance market share aspirations with protecting margins and avoiding significant competitive responses.

Price matching is a prevalent strategy of the major banks. The major banks are aware of, and respond rapidly to, each other's changes in interest rates and other credit settings – both for headline rates and discretionary rates (case-by-case reductions below headline rates). They generally ensure their advertised rates are in line with each other. They are also prepared to match competing offers, for example through discretionary discounts for home loans.

Over time, the prevalence of price matching is likely to have reduced the incentives to compete hard on interest rates. Providers know that if they introduce a new promotion or better interest rate, this will likely be quickly matched by competitors – limiting the gains from the offer.

For home loans, discretionary discounting and price matching enable banks to selectively compete to win or retain price-sensitive (engaged) customers, while offering higher interest rates for less price-sensitive customers. This means that the benefits of competition mostly accrue to those customers who are willing and able to shop around for the best deals – but many customers do not.

It appears to require external factors to destabilise the prevailing competitive dynamic between the major banks and bring out more intense price competition. For example, there was more intense competition for home lending from early 2022 to early 2023, coinciding with a rapidly rising interest rate environment.

Limited investment in innovation by the banks

We have been surprised by the limited investment by the major banks and Kiwibank in upgrading to modern core banking systems and the low prioritisation given to this. Legacy systems constrain the ability of banks to innovate and compete. They also constrain and delay fintechs' ability to introduce innovative services – due to the need to interface with banks' legacy systems.

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

The major banks and Kiwibank are planning or progressing transformation programmes. However, they have yet to complete core systems upgrades, despite the resources available to them.

The major banks have told us that their limited investment in core systems has been largely due to the need to keep pace with changing regulatory requirements. We do not accept that this is a satisfactory or complete explanation – particularly given the ability of the Australian parent banks to balance similar investment demands. We see fully depreciated core systems as an indicator of sustained under-investment reflecting a lack of competitive pressure over an extended period.

The NZ banking sector has sustained high levels of profitability

The New Zealand banking sector has demonstrated sustained high levels of profitability relative to international peers. Between 2010 and 2021, New Zealand's banking sector has, on average, performed in the upper quartile relative to peer nations on three important measures: return on equity, return on assets, and net interest margin. Cross-checks we have undertaken since our draft report was issued produce consistent results and provide us with greater confidence in our findings.

We consider that at least part of the profitability we see is explained by the market power of the major banks. We considered non-competition explanations that have been put forward, but they do not explain the profitability we observe.

New Zealand's banking sector is relatively low risk because it is more heavily weighted towards traditional (vanilla) banking activities (like home lending) than many peer nations. Because these activities are lower risk, if competition was working well, we would expect the New Zealand banking sector to derive lower returns relative to riskier banking sectors overseas.

The major banks have experienced high average returns on equity relative to smaller New Zealand banks since 2018. This is consistent with the two-tier market we have observed in personal banking, where smaller providers struggle to exert significant competitive pressure on the major banks.

Some groups are not well served by competition alone

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

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

Five main factors are limiting competition

We have identified five main factors limiting competition for personal banking services in New Zealand. These factors overlap and can be mutually reinforcing.

Structural advantages of the major banks

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

Retail deposits (funds held in deposit accounts) are crucial to bank funding and are typically the lowest cost source of funding available to banks. Because the major banks hold a higher proportion of deposits in transaction accounts (which generally do not pay interest), they have a significant funding cost advantage over smaller banks. This reflects advantages the major banks have in winning and maintaining main bank relationships with customers.[1]

Regulatory barriers to entry and expansion

Regulation shapes competition in personal banking. It has been a universal theme of our engagements with stakeholders that regulation is the single most important factor constraining new entry and the ability of existing providers to expand and compete.

While the regulatory burden affects all providers, it affects the smaller providers disproportionately more due to their lack of scale. Consequently, proportionality in regulatory policy settings is critical to increasing competition.

Prudential capital requirements in particular have affected competition. Prior to the Reserve Bank’s 2019 Capital Review, these requirements gave the major banks a material competitive advantage over Kiwibank and smaller providers. While the Capital Review largely addressed the difference in capital requirements, we think the Reserve Bank can do more within its current legislative framework to further level the playing field when implementing prudential capital requirements and other policies within its remit.

The Government may need to amend legislative settings if it prefers a different balance between competition and financial stability.

Barriers to consumer switching and engagement

There is significant customer inertia for personal banking services. Consumers tend to be sticky – they often remain inactive or disengaged, rarely switching between banks.[2] This favours the major banks who hold most of the main bank relationships with customers.

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

[2] Our consumer survey found that 54% of customers have never switched their main bank.

When consumers do engage, it can be hard for them to find the best deal. Comparing offers from different banks is challenging for consumers due to the various strategies employed by banks in marketing their interest rates, fees and cash back incentives, and in promoting the quality of their mobile apps and online banking services. For example, discretionary discounts off headline rates for home loans – combined with the need to go through the loan application process to get an offer – means that it is not possible for consumers to determine the best price in market without significant effort or assistance.

There are both real and perceived logistical difficulties with switching providers which reduce the competitive pressure on the major banks. The industry-led account switching service run by Payments NZ has not been effective. Some consumers are also deterred by the compliance requirements driven by the Anti-Money Laundering and Countering Financing of Terrorism Act (AML/CFT Act) and/or the Credit Contracts and Consumer Finance Act (CCCF Act). These include customer identification processes to open a new account and the processes and evidence required to demonstrate loan affordability.

Impediments to innovation by fintechs

Fintechs are a potential source of disruptive innovation and competition. They leverage modern core banking systems and alternative business models to deliver low-cost digital-only services.

However, fintechs face several impediments to entry and expansion such as: opening and maintaining a business bank account, meeting the costs and complexity of regulatory requirements, obtaining sufficient capital, gaining access to the consumer data they need to provide their services, and restrictions on use of the terms 'bank' and 'banking services'.

Open banking has enabled fintechs to compete in the UK and Australia. Open banking lets consumers authorise third party businesses such as fintechs or other banks to receive their banking data (such as transaction history) or make payments on their behalf.

Progress towards open banking in New Zealand has been too slow because the major banks have been left to set the nature and the pace of change. As a result, New Zealand consumers are missing out on the competition and innovation open banking can provide.

Industry is progressing open banking through Payments NZ and the API Centre, while the Government is progressing the Customer and Product Data (CPD) Bill which will introduce a regulatory framework for open banking. There is a risk of current industry work stalling while CPD processes are worked through, and an opportunity now to accelerate and better co-ordinate progress.

Mortgage advisers and banks are not driving price competition for home loans

Mortgage advisers are increasingly being used by consumers to navigate the complexity of home loans. They can help with the process of obtaining a home loan, and finding lenders who are willing to fund less straightforward purchases.

Mortgage advisers should be champions of price competition, while continuing to provide holistic financial advice.

- Banks' systems need to improve to make it easier for mortgage advisers to focus on getting the best deals for their clients. Manual application processes and a lack of standardisation between banks make it needlessly time-consuming for consumers and advisers to shop around for offers of finance. Lender practices also discourage advisers from lodging multiple loan applications per client.
- Mortgage advisers should also put more emphasis on price when recommending a provider. This includes being more transparent about gaps in their lender coverage and highlighting any superior headline rates offered by providers outside of their panel of lenders.

Multi-faceted solutions are needed to improve competition

Improving competition requires multi-faceted solutions. Overseas experience suggests that the scale and brand advantages of large banks and consumer inertia are difficult to overcome, even where open banking is well-established.

Our recommendations are designed to work together to support new entry and expansion, reduce the regulatory barriers to competition and empower consumers to get better prices and services.

Capitalise Kiwibank

1. **The Government, as Kiwibank's owner, should consider what is necessary to make Kiwibank a disruptive competitor, including how to provide it with access to more capital.** In the shorter term, capitalising Kiwibank appears to have the greatest potential to constrain the major banks and disrupt a market that is otherwise stable due to lack of competition.

Accelerate and co-ordinate progress on open banking

2. **Industry and the Government should commit to ensuring open banking is fully operational by June 2026.** In the medium to long-term, open banking has the greatest potential to promote ongoing disruptive competition for personal banking services. Commitment to ambitious milestones and coordinated work between industry and Government, particularly over the next 12 months, will bring early gains to consumers.

3. **The Government should support open banking by being an early adopter**, and taking an all-of-government approach to adopting payments enabled by open banking functionality. For example, by supporting new payment methods for taxes, welfare and Government services such as vehicle licensing. This will help build confidence in open banking and assist in developing a market for open banking-enabled products and services. Early adoption by Government will accelerate progress on open banking.

Ensure the regulatory environment better supports competition

4. **The Reserve Bank should broaden the way it undertakes competition assessments under the Deposit Takers Act and place more focus on reducing barriers to entry and expansion in the banking sector.** There is scope for the Reserve Bank to do this within its statutory framework while striking an appropriate balance between financial stability and competition.

5. **The Reserve Bank should place greater emphasis on competition in specific upcoming decisions.** Competition would be improved if the Reserve Bank took upcoming opportunities to support competition in personal banking within its new regulatory framework by:

   - implementing more granular standardised risk weightings for home loans, and considering the merits of standardised risk weights specifically for lending for housing on Māori freehold land;
   - setting minimum capital standards that encourage new competitors;
   - permitting more entities to be a ‘bank’ and provide ‘banking services’;
   - widening access to the Exchange Settlement Account System; and
   - reducing the risk rating of lending to housing co-operatives and community housing providers to lower, and more accurate, levels.

   We also recommend the Government introduce an initial flat-rate rate levy for the Depositor Compensation Scheme.

6. **The Government should ensure that existing legislation and future decisions do not unintentionally favour banks, particularly larger banks, over other providers.** The Government should review existing legislation that favours some providers (for example, registered banks) over others, particularly when prescribing where deposits must be held. The Government should also ensure future decisions are competitively neutral, even when made under urgency such as during a national emergency.

7. **The Government should lessen barriers to switching home loan providers as part of CCCF Act reforms.** The Responsible Lending Code should set out guidance making it easier for consumers to switch to lenders who offer better terms, including in a rising interest rate environment.

8. **The Government should prioritise competition concerns when reforming the AML/CFT regime.** Reforms to the AML/CFT regime should identify and prioritise opportunities to promote competition and access to personal banking services.

Empower consumers

9. **Industry should invest in making improvements to its switching service.** The bank-owned Payments NZ service needs improvement, starting with greater promotion of the service and monitoring and reporting on service standards.

10. **Home loan providers should present offers in a readily comparable manner, accounting specifically for the effective value of cash contributions.** Industry should create a standard means of comparing home loan offers across all providers such as through a single effective interest rate that incorporates the effect of cash contributions over the clawback period to help consumers compare the cost of different loan offers.

11. **Home loan providers should pro-rate all clawbacks for mortgage adviser commissions and bank cash contributions.** Some clawback practices impose unjustifiable costs on consumers looking to switch lender. Competition would be promoted if consumers faced lower and more certain costs when switching home loan providers.

12. **Mortgage advisers and banks should make changes to promote price competition and choice for home loans.**

    - Banks' processes need to improve to make it easier for mortgage advisers to submit multiple applications on behalf of their clients and more efficient for lenders to quickly process loan applications.
    - Banks should ensure that "conversion rate" targets for mortgage advisers (whereby a specific percentage of applications must be accepted) are not discouraging mortgage advisers from submitting qualifying home loan applications to multiple lenders as this reduces competition.
    - Advisers should highlight gaps in their panel to clients and identify any superior headline rates offered by providers outside of their panel.
    - Where possible, advisers should present at least three actual offers to their clients to ensure consumers are making informed choices.

    As the financial advice regulatory regime develops, the Financial Markets Authority should take steps to ensure that the mortgage adviser channel fulfils its potential to provide suitable advice that promotes price competition and consumer choice.

13. **Industry and the Government should prioritise reducing barriers to lending for housing on Māori freehold land.** Lenders should support existing successful models for lending for housing on Māori freehold land, including by explicitly considering joining the Kāinga Whenua Loan Scheme. The Government should address the unjustified level of scrutiny on Māori land trusts as part of its AML/CFT reforms.

14. **Industry should co-operate to make basic bank accounts widely available**, including minimum standards, promotion among relevant population groups and ensuring frontline staff are appropriately trained and supported.