

FSOC Paper for Discussion 2.2

From	Katy Simpson, Manager – Capital and Solvency
Approved by	Jess Rowe, Director of Prudential Policy
Date	4 June 2025
Subject	Review of key capital settings – Testing the direction of travel
For	Discussion
Value(s)	Integrity/Tauria Innovation/Wānanga
Strategic Theme(s)	Strengthening efficiency and competition, Promoting understanding and trust

1. Purpose

To support a discussion on the direction of travel of the review of key capital settings. The purpose of this discussion is to test your comfort with, and seek your views on, our emerging thinking and our options framework.

2. Key Points

1. The capital review work is progressing, and we have developed some initial policy positions (slides 11; 13-14 of Annex 1) and a framework to think about high-level options (slide 18 of Annex 1).
2. We are proposing:
 - a. to remove Additional Tier 1 capital from our capital stack (Annex 2), and
 - b. to move to more granular risk weights (Annex 3).
3. There are a range of emerging options about the form, amount and proportionality and distribution of capital (Annex 4):
 - a. A key consideration for the *form* of capital is whether we see a role for additional Loss Absorbing Capacity (LAC).
 - b. We are continuing to work on the key evidence to support the calibration of these options in terms of the *amount* and *distribution* of capital.

3. Background

On 27 March 2025, the Board approved the Reserve Bank undertaking a reassessment of regulatory capital settings for deposit takers. The Reserve Bank announced the review at a hearing of the Finance and Expenditure Committee's (FEC's) inquiry into banking competition on 31 March 2025.

On 14 April 2025, FSOC (under the Board's delegation) approved the Terms of Reference that set out scope, methodology, timing, and the use of external international experts. The Terms of Reference were published on 7 May 2025.

4. Material to support discussion at FSOC

We intend to use the slides in **Annex 1** to guide the discussion at FSOC. They set out emerging policy positions and some key questions for feedback. Annexes 2-5 provide further optional background reading on the key areas covered in the slides. Annex 6 is a glossary of key terms.

5. Project update

International experts

We have secured two of the top banking and competition experts in the world to review our analysis, options and recommendations and to support decision-makers: Sir John Vickers¹ and Thorsten Beck². We are in the process of finalising their procurement.

We are also in discussions with a third international expert – Elena Carletti³ – who also has bank/commercial experience.

International comparisons

We are also in the process of procuring an independent report comparing capital requirements in New Zealand with overseas jurisdictions. This is a complex technical exercise, and it has been challenging to source firms that have the capability and capacity to deliver this report in the timeframes required. However, we now have proposals from two firms with the skills and experience to perform this work and hope to begin work shortly.

Stakeholder engagement

We provided the Minister of Finance with an update on 29 May 2025 (which FSOC had the opportunity to review in advance). We will meet with the Minister on 5 June 2025. We have been keeping the Treasury updated on our progress.

We have had initial discussions with APRA, particularly around crisis management.

We intend to engage with deposit takers (banks and non-bank deposit takers) in June to outline the review's analytical approach and timeline.

6. Next Steps

Following your feedback on the direction of travel, we intend to seek approval at the July Board meeting to proposals that will be included in a consultation paper. We also intend to arrange for FSOC to meet with the international experts to discuss the proposals shortly before the July Board meeting.

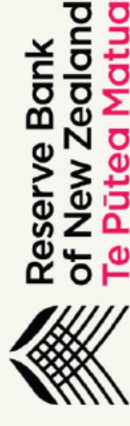
We intend to run a 6-week public consultation on key proposals from August to September 2025. Responses to the consultation, alongside cost and benefit analysis and engagement with independent international experts, will support the Board in reaching final decisions on policy positions by the end of 2025.

¹ Professor of Economics at Oxford University. Sir John is a former Chief Economist at the Bank of England and was Chair of 2010-11 UK Independent Commission on Banking. He is an expert in competition and regulation.

² Director, European University Institute and is co-chair of the Advisory Scientific Committee of the European Systemic Risk Board. He is an expert in the relationship between finance and economic development.

³ Professor of Finance at Bocconi University. She is a member of the Board of Directors of a European bank (Unicredit) and of the Expert Panel on banking supervision for the European Parliament. She is an expert in financial regulation and banking.

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Review of key capital settings

FSOC discussion - Testing direction of travel

10 June 2025

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Introduction

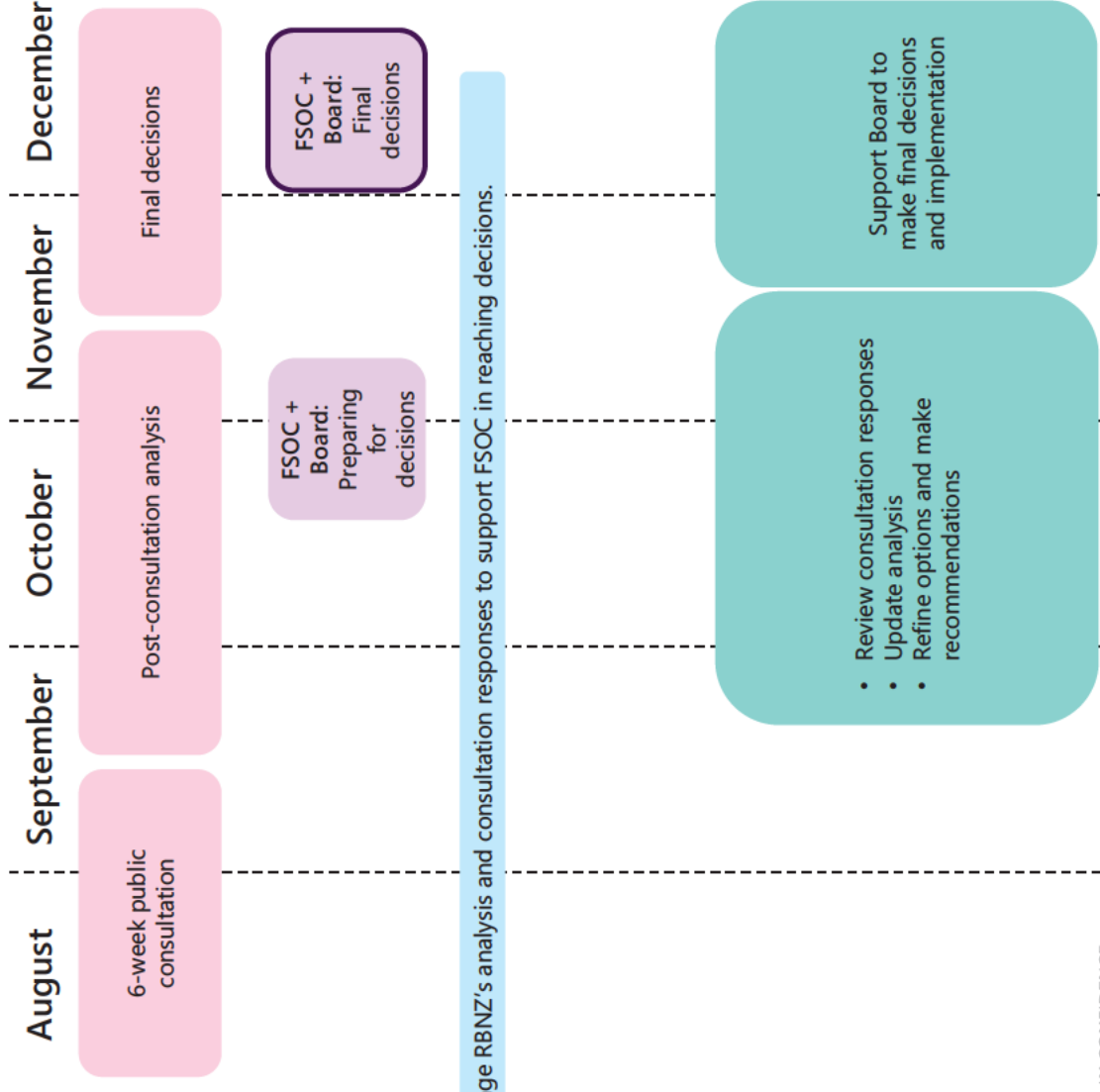
Purpose

- This session is to discuss out direction of travel of the Review of key capital settings
- We want to test your comfort with our emerging thinking and our framework for thinking about options
- Key questions for FSOC feedback are noted throughout

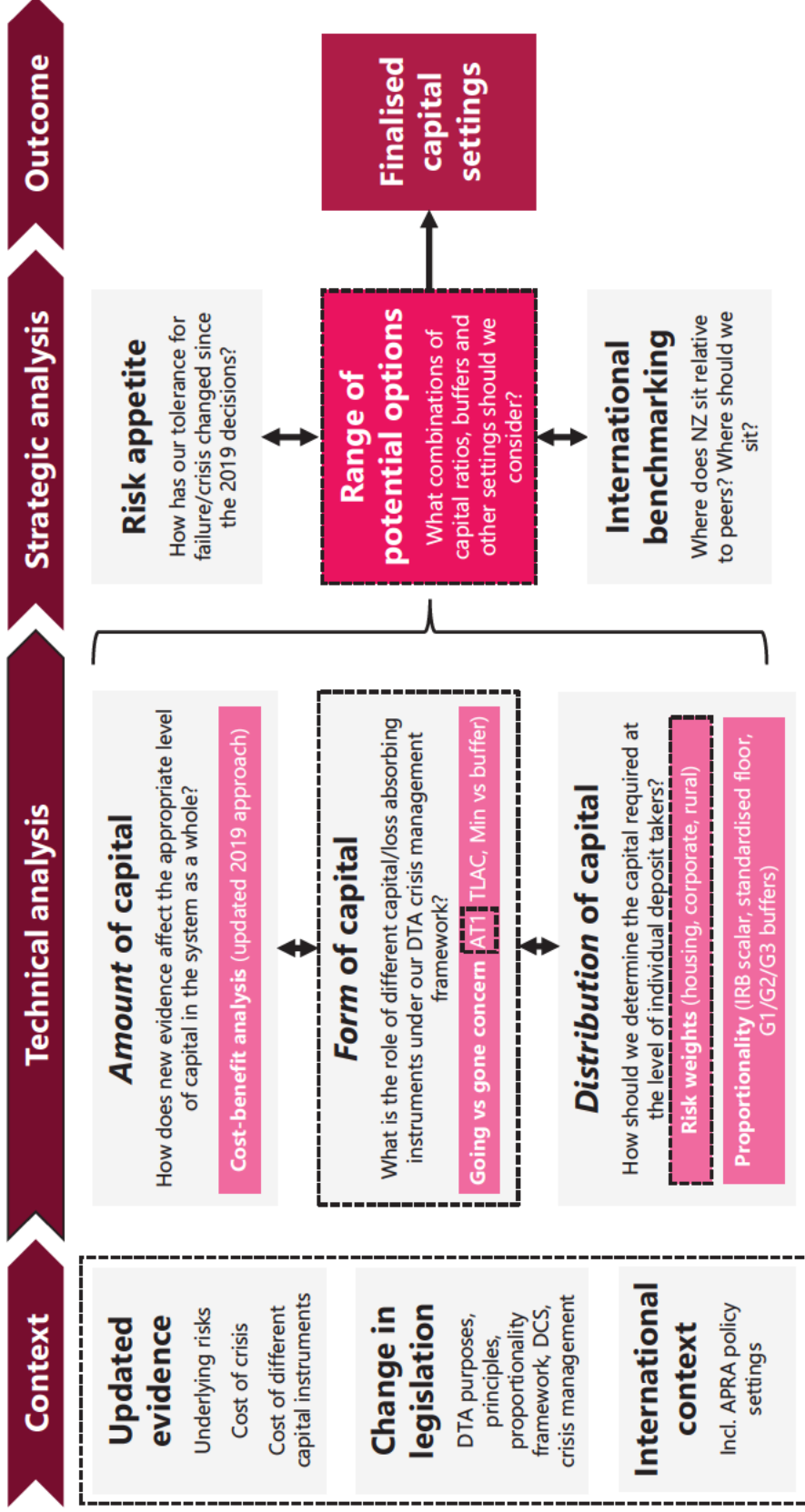
Agenda

1. Where we are in the process
2. Evidence to support reaching a decision
3. In principle agreement for some policy questions (AT1 and risk weights)
4. Emerging options





Where are we in the process?



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Evidence to support reaching a decision

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Evidence we're using in the review

Evidence	Status
<p>Included in consultation paper</p>	<p>See Annex 5 for initial findings</p>
<p>What has changed since 2019 and what that means for our risk profile and tolerance</p>	<p>Expected: Late June</p>
<p>Reviewing commentary in ComCom's market study and submissions to FEC's banking inquiry</p>	<p>Expected: Late June</p>
<p>International comparison of capital requirements</p>	<p>Initial views to support FSOC: July Final report: December</p>
<p>Updating the cost-benefit analysis where possible</p>	<p>Consultation planned for August – September</p>
<p>To inform final policy decisions</p>	
<p>International experts' views on the above elements</p>	
<p>Responses to consultation paper</p>	



Initial view on what's changed

Change since 2019	Examples	How has this impacted the underlying risks?	How does this suggest we adjust the level of capital?
Enhanced crisis mgmt. framework	DTA, DCS	↓	↓
Other prudential policy changes	DTA, DTIs, enhanced supervision	↓	↓
Changed macro environment	Climate, geopolitics, fiscal headroom	↑	↑
Observable impact of 2019 decisions	Cost pass-through, issuance costs	-	TBC
International developments	Basel III consensus, adoption of LAC	-	TBC

Key: ↑ Slight net increase ↑↑ Moderate net increase ↑↑↑ Significant net increase
 ↓ Slight net decrease ↓↓ Moderate net decrease ↓↓↓ Significant net decrease



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In-principle agreement for discrete policy questions

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Reminder

Minimum capital

Condition of registration for banks to meet at all times

- 9% for all deposit takers

Prudential capital buffer

Supervisory response if banks dip into the buffer

- 9% for Group 1 (big 4)
- 7% for Group 2 (mid-sized banks)
- 4% for Group 3 (mostly non-bank deposit takers).

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Tier 1

Common Equity Tier 1 (CET1) – ordinary share capital and retained earnings

- 13.5% for Group 1
- 11.5% for Group 2
- 8.5 for Group 3

Tier 1

Additional Tier 1 (AT1)

- redeemable perpetual preference shares
- up to 2.5%

Tier 2

Long term subordinated debt

- up to 2%

9

$$\text{Capital Ratio} = \frac{\text{Capital}}{\text{Risk Weighted Assets}}$$

Credit risk

~85% of RWAs

Calculated via either:

- **IRB approach** (big 4): more accurate, but costly. Subject to a floor to limit the benefit.
- **Standardised approach**: simpler but less granular.

Operational and Market Risk

~10% operational risk
~5% market risk
Calculated consistently across deposit takers

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Te Pūtea Matua

SHOULD WE REMOVE AT1 CAPITAL?

Rec 1: Remove AT1

- We recommend removing AT1 from the capital framework.
- We have some reservations about the effectiveness of AT1 to absorb losses on a timely basis and to support financial stability.
- Banks have also provided feedback that there is limited domestic market appetite for AT1.
- If removed, it will reduce loss absorbency to some extent. What to replace AT1 replacement is considered as part of the overall capital requirements at the *Emerging options* slide.

Q1 Do you agree with removing AT1?





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SHOULD WE HAVE MORE GRANULAR RISK WEIGHTS?

Overview of current proposals

Type of lending	Current standardised risk weight (%)	Proposed standardised risk weight (%)
Residential Mortgage		
Owner-occupier with LVR ≤50 <small>NEW</small>	35	25
Owner-occupier with LVR 50.01 – 60 <small>NEW</small>	35	30
Owner-occupier with LVR 60.01 – 80	35	35
Investor with LVR ≤50 <small>NEW</small>	40	30
Investor with LVR 50.01 – 60 <small>NEW</small>	40	35
Investor with LVR 60.01 – 80	40	40
Corporate		
SME retail <small>NEW</small>	100	75
SME corporate <small>NEW</small>	100	85
Agricultural		
LVR ≤30 <small>NEW</small>	100	50
LVR >30 to 50 <small>NEW</small>	100	75
LVR >50 <small>NEW</small>	100	100

Note: We are continuing to refine and conduct analysis on these options. We are also considering risk weight changes for commercial property; personal lending; lending for housing for Community Housing Providers, co-operative housing and whenua Māori.



Rec 2: More granular risk weights

- There is room in our current standardised approach to improve risk weight granularity & better reflect the underlying risk of different types of lending
- This is supported by evidence (e.g. from previous stress test results)
- However, this will reduce capital across the system as a whole, including Group 1 (~5% under the new option), meaning we accept a higher risk of deposit taker failure
- If necessary, it is possible to address/offset some or all of the reduction in capital through other parts of the capital review
- These changes need to be considered along with the impact of any other potential changes to capital as part of this review

Q2 Do you agree with the direction of travel that the standardised risk weights review is taking?



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Emerging options

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Overview

- Our initial focus is on **form** of capital for Group 1 deposit takers.
- We have some initial thoughts on the **amount** of capital but will need to flex depending on:
 - Cost benefit analysis
 - International comparison and experts' views
 - Board risk appetite.
- We also have some initial views on **proportionality**, but more work is needed
- We have assumed that:
 - There is not appetite to explore options that increase costs and therefore lending rates.
 - We adopt recommendations above to remove AT1 and adopt more granular risk weights.

Technical analysis

Amount of capital

How does new evidence affect the appropriate level of capital in the system as a whole?

Cost-benefit analysis (updated 2019 approach)



Form of capital

What is the role of different capital/loss absorbing instruments under our DTA crisis management framework?

Going vs gone concern (AT1, TLAC, Min vs buffer)



Distribution of capital

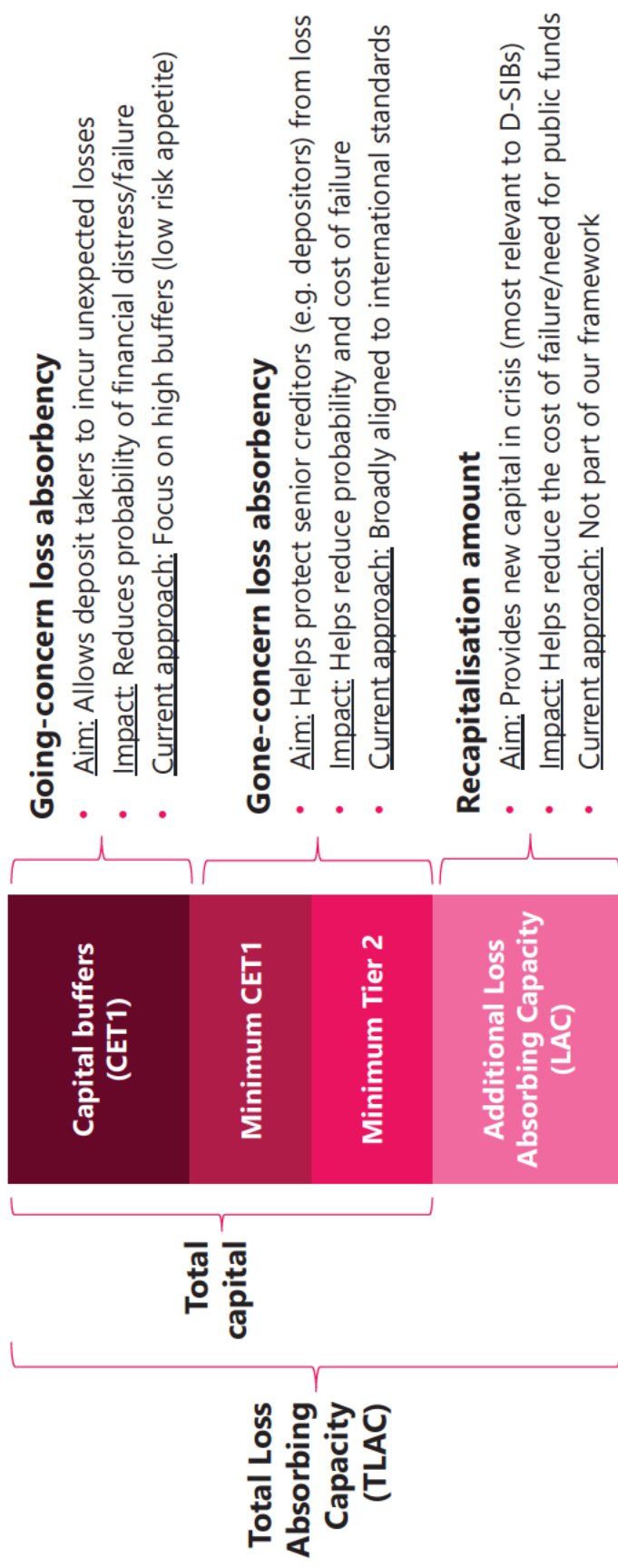
How should we determine the capital required at the level of individual deposit takers?

Risk weights (housing, corporate, rural)

Proportionality (IRB scalar, standardised floor, G1/G2/G3 buffers)



Different forms of capital

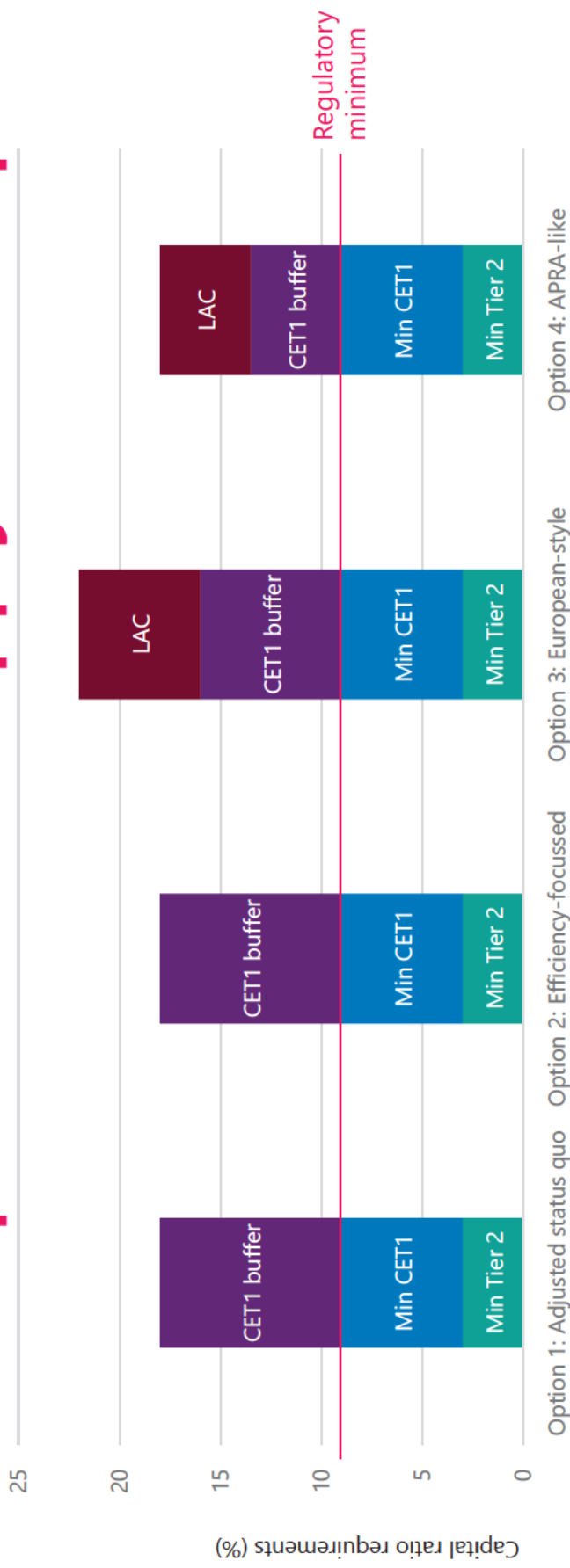


Options framework

		Amount of capital	
Form of capital	No additional LAC Retain focus on addressing probability of failure	Similar risk appetite About the same level of stability as now Potentially a small reduction in lending rates	Increased risk appetite Significantly less stability Material reduction in lending rates
	Additional LAC Pivot focus to addressing the impact of failure	Option 1: Adjusted status quo <ul style="list-style-type: none"> Offset impact of more granular risk weights on total capital for G1 Retain existing CET1 requirements 	Option 2: Efficiency-focused <ul style="list-style-type: none"> <u>Do not</u> offset impact of more granular risk weights for G1 (reducing the total nominal amount of capital by about 5%) <u>Reduce</u> capital ratios for G2 and G3 (for more proportionality) and potentially G1 (for more efficiency)
		Option 3: European-style <ul style="list-style-type: none"> Offset impact of more granular risk weights on total capital for G1 <u>Reduce</u> CET1 requirements for all deposit takers <u>Add</u> a significant amount of LAC for G1 (so TLAC ratios will be higher than current capital ratios) 	Option 4: APRA-like <ul style="list-style-type: none"> <u>Do not</u> offset impact of more granular risk weights for G1 (reducing the total nominal amount of capital by about 5%) <u>Reduce</u> CET1 requirements for all deposit takers <u>Add</u> some LAC for G1 to keep overall capital ratios about the same



How the options could apply to Group 1



Total amount of capital	No change	Reduced by at least 5%	Higher amount of total loss absorbing capacity but less CET1	Same amount of loss absorbing capacity but less CET1
Estimated change in interest rate impacts	No significant change	Reduced interest rate impact	No significant change	Significantly reduced interest rate impact

Note: Percentages are illustrative at this stage. Option 2 could be scaled to include a lower overall capital ratio and a bigger reduction in capital.



Discussion

- Q3** Are these the right options?
- Q4** Which option is most appealing, and why?
- Q4** Any options you would rule out?
- Q5** Other things we need to think about?



Annex 2: Additional Tier 1 (AT1) capital (slide 11 of Annex 1)

Background

Additional Tier 1 (AT1) is one of the forms of regulatory capital that banks can currently use to meet their Tier 1 requirements. It is cheaper than CET1 capital and is made of up of redeemable perpetual preference shares.

This form of capital was significantly revised as part of the 2017-2019 Capital Review to address some of the concerns we had around its effectiveness. The new requirements have been in place since 2021.

To date, AT1 has been successfully issued at a lower price than we expected.⁴ However, so far only about \$4.3b has been issued,⁵ with potential for a further \$5.5b still to be issued under current settings.⁶

Banks have been raising concerns with us which covers two main points:

- There is inadequate depth in the domestic market to absorb the amount of AT1 banks would need to issue to fulfil AT1 allowances.
- However, the equity nature of AT1 makes it difficult to sell offshore or to anyone without NZ tax liabilities.

Internationally, there seems to be some appetite to review the effectiveness of AT1 as a form of loss-absorbing capital.⁷ The Australian Prudential Regulation Authority (**APRA**) is the first global regulator to update its prudential framework to phase out AT1 entirely from the capital stack by 2032.⁸ However, Australian AT1 includes convertibility and write off features. In addition, there is the potential for complexity due to high levels of retail participation in the Australian AT1 investor base. Some of these features are not present in NZ and so not all the same arguments apply.

When we initially considered feedback on the DTA capital standard, we proposed continuing to monitor the barriers to issuing AT1 but not making any specific changes. However, now that we've reopened our capital settings and are considering these alongside crisis management tools, there are arguments for reassessing this decision.

In-principal proposal 1: Remove AT1 capital

We now propose we remove AT1 capital from our capital stack.

Beyond the issues mentioned above that have been raised by deposit takers, there are some issues with AT1 from a regulatory perspective:

⁴ As part of the cost benefit analysis of the Capital Review, we estimated that investors would require a margin or approximately 4% above current swap rates to purchase new-style AT1 instruments. We committed to monitoring the outcome of the Capital Review and published the first biennial assessment of the implementation and impact of the changes to the end of 2023.4 One of the trends we identified in the first review was that average AT1 margins were 2.93% which was lower than the 4% we had originally estimated. We have also observed AT1 issuances since that publication which have been priced with a margin below 4.00%.

⁵ This is from 4 banks – 2 D-SIBs and 2 non-D-SIBs.

⁶ This includes \$1.5b of transitional – ie. pre-2019 Capital Review AT1 still needing to be replaced.

⁷ The Dutch government published a [report](#) looking at particular policy options for AT1 capital including abolition or simplification, but noting that it could not implement changes by itself as it would require international and EU co-ordination. Government of the Netherlands. (2024, 19 March). *Policy directions for a resilient banking sector*.

⁸ [government.nl/documents/reports/2024/03/19/policy-directions-for-a-resilient-banking-sector](#). BIS published a [report](#) on the 2023 banking turmoil noting there is potential for further international consideration and indicating that a key measure is to look at AT1 and to strengthen risk bearing functions. Bank for International Settlements. The Swiss regulator's [report](#) into Credit Suisse's failure noted that regulatory requirements for AT1 capital urgently needed to be reviewed at an international level.

⁹ On 9 December 2024, APRA confirmed it would proceed with its proposal to replace AT1 capital with a mix of additional CET1 and Tier 2 capital. (See [Improving the effectiveness of Additional Tier 1 capital instruments | APRA](#))

- **Signalling risk** – if a bank were to stop paying dividends on AT1 (which is one of the ways it can support capital adequacy), this may have signalling effects on the market which are more detrimental for capital adequacy. This may mean the financial stability benefits of AT1 over Tier 2 (long-term subordinated debt) may not be worth the additional cost. This has not been tested in NZ, but there is international evidence to suggest there is validity to this concern.
- **Proportionality** – large banks can utilise their parents or other complex structures to issue AT1 in ways other banks cannot
- **Impact on competition** - banks that cannot issue AT1, perhaps due to their small size making it unattractive to do so, have to meet Tier 1 requirements with more expensive CET1 which may impact ability to grow
- **Relationship between capital and crisis management** – Removing AT1 may simplify some issues in relation to crisis management. For example, it would remove the need to consider what write down or conversion means in practice for our current AT1 instruments (which are preference shares rather than debt).

The question of what should replace AT1 in the capital stack will be considered in the round as part of the options assessment – as that has implications for the overall level of stability provided by capital, as well as its cost and the relationship with crisis management settings.

Annex 3: Standardised risk weights (slides 13 and 14 of Annex 1)

Background

Capital requirements express the amount of capital a deposit taker must have as a percentage of its risk-weighted assets (RWAs). Deposit takers are required to have more capital (such as equity) for riskier loans to provide a larger buffer to absorb potential losses. Risk weights help determine the amount of capital the deposit taker is required to have by reflecting the risks of underlying lending.

Our framework for calculating risk weights is based on the internationally developed Basel framework. Under this framework, there are two approaches used to calculate risk weights:

- The **standardised approach**, where risk weights are set based on the broad characteristics of loans, such as the loan-to-value ratio (LVR) for Residential Mortgage Loans.
- The **internal ratings-based (IRB)** approach, where banks accredited by the Reserve Bank calculate risk weights using their own internal risk models, enabling them to get a more precise measure of the riskiness of lending. Currently only Group 1 deposit takers have been approved to use this approach, but others can apply.

In both feedback on the DTA capital standard consultation and submissions to the FEC's inquiry into banking competition, Group 1 and 2 deposit takers have highlighted that the Reserve Bank's standardised risk weights have not been reviewed for at least 10 years. They argue for more granular, lower risk weights in several areas. Similar points were raised in the Commerce Commission's recommendations in their market study into personal banking services, and in the Minister of Finance's 2024 Letter of Expectations. In addition, the Primary Production Select Committee has been particularly focused on the impacts of risk weights on lending to the rural sector.

We agree that risk weights should reflect the actual risk faced by deposit takers in the New Zealand context. Therefore, in October last year, we issued an information request to the deposit takers to provide us more detailed information about exposures to help inform our analysis of the impacts of changing standardised risk weights. We received their responses in December 2024.

In-principal proposal 2: more granular risk weights

We propose five key changes to standardised risk weights which will increase granularity. The evidence we have reviewed supports this change as it would mean the standardised risk weights would be more closely aligned to actual risk. We are continuing to refine and conduct analysis on the specifics of these options.

1. New categories for residential mortgage lending at lower LVRs

- Currently, standardised banks must use the same risk weight for all mortgage lending of the same category⁹ that has an LVR of 80 or below – which is the vast majority.
- We propose introducing two new, lower risk weights for lending with an LVR equal to or below 50, and for lending with an LVR between 50.01 and 60.
- This is supported by evidence from our stress testing that shows losses can more than double at LVRs greater than 80, compared to lending with LVRs lower than 60.

⁹ There are different categories for property investment and other mortgage lending, as well as distinctions for lending with and without Lender's Mortgage Insurance.

2. More granularity for SME corporate lending

- Currently, standardised banks must use the same risk weight for all unrated corporate lending that does not have a credit rating. This is likely to capture all SME retail and corporate lending as it is generally not worth SMEs getting credit ratings.
- We propose two new corporate lending categories which would align SME retail and SME corporate lending risk weights with APRA's.
- Previous stress tests have shown that loss rates for SMEs are likely to be smaller than for large corporates, even if SMEs are more likely to default, due to the relative size of these exposures.

3. New risks weights specifically for agricultural lending

- Currently agricultural lending is captured under unrated corporate lending, meaning that such lending receives the same risk weight, regardless of how risky the lending is.
- We propose introducing three new categories of agricultural lending, based on LVR. We have calibrated the proposed risk weights by considering what risk weights IRB banks currently apply to agricultural lending with different LVRs.
- Previous stress test results have indicated that loss rates for agricultural lending are likely to be lower than loss rates for other types of corporate lending.
- APRA does not have different risk weight categories for agricultural lending, but we think it make sense in the NZ context.

4. Considering adding more granular risk weights for higher risk lending, such as commercial property and unsecured personal lending.

- There are some types of lending where the risks may be elevated. Previous stress tests have shown that commercial property and unsecured personal lending can result in loss rates that are considerably higher than most, if not all, other types of lending.
- We are considering whether we should consult on additional categories to be added to the framework to capture the risk characteristics of these types of lending. For example, APRA has a range of risk weights for commercial property lending. Further, the existing requirements for non-bank deposit takers provide higher risk weights for high-risk personal lending where there is no security.
- However, we have limited information about exposures in these categories, meaning it is difficult to assess the likely impacts at this time. We will provide more detail on this at the July Board meeting.

5. Other changes

- There are some additional technical changes to risk weights that have been raised by stakeholders. These will not have significant impacts on overall capital levels.
- We propose consulting on options to align risk weights for lending to Community Housing Providers to the actual risk, as the current risk weights used are likely to be too conservative in some cases. We also propose we consult on clarifying the treatment of

lending to housing co-operatives and are seeking feedback on any remaining issues with lending on Whenua Māori.

- Our assessment of these issues is well advanced, and we are working closely with the Ministry of Housing and Urban Development and the Treasury. We will bring detailed proposals to the July Board meeting.

Impacts of more granular standardised risk weights on capital levels

While Group 1 deposit takers do not use the standardised approach to calculate risk weights, the changes proposed above would also influence risk weight outcomes for deposit takers using the IRB approach. This is because we restrict the risk weights calculation outcome in the IRB approach to be no lower than 85% of the outcome for the same exposures in the standardised approach (this is known as the output floor).

Since the proposals will reduce average standardised risk weights, the outcome for IRB banks will also reduce, as 85% of the standardised outcome will be a lower number. Therefore, these changes would significantly reduce capital in the system as Group 1 deposit takers would have lower risk weights and consequently would need to have less capital to meet the prescribed capital ratios.

The maximum impact from the changes to standardised risk weights described above is estimated to be around a 5% fall in the overall amount of capital in the system, although the estimated size of this impact may change as we finalise the options.

As with the question of what to replace AT1 with, the question of whether this reduction in capital is desirable – or should be offset elsewhere - will be considered in the round as part of the options assessment.

Annex 4: Emerging options

The 'emerging options' section of the slides (slides 16-20 of Annex 1) sets out a range of high-level options to test your comfort in our direction of travel and to get initial feedback. This annex covers the three main components of this: **form, level and proportionality and distribution of capital.**

i) **Form of capital: do we want additional LAC or not? (slide 17 of Annex 1)**

At this stage, we want to focus on your views on options around the *form* of capital for Group 1 deposit takers. Currently, we rely on high capital buffers to *prevent a failure* (going concern capital), with little use of loss absorbing instruments that can be called on to *reduce the impact of failure should that occur* (gone concern capital).

Additional LAC instruments are debt instruments that make up part of a deposit taker's funding and are pre-positioned for bail-in. An additional LAC requirement would be in addition to total capital requirements (by total capital we mean the regulatory minima of capital and the capital buffers). LAC instruments are generally cheaper than CET1 capital and have to be convertible and/or be able to be written down to enable a deposit taker to be recapitalised.

LAC can either be issued internally to entities within a banking group to support a single point of entry (SPE) model (where the group is kept together) or externally to support a multiple point of entry (MPE) model (where a New Zealand deposit taker may be separated from the international banking group of which it is a part, and resolved on a standalone basis).

Given that our preferred crisis management approach for Group 1 deposit takers is an SPE model, we have been focusing on the potential role of an internal LAC requirement. Internal LAC instruments would be senior to CET1, AT1, and Tier 2 instruments but subordinated to senior/external debt.¹⁰

Table 1 below presents the mains pros and cons of adding internal LAC requirement for Group 1 deposit takers.

Pros	Cons
<p>Supports an SPE model and avoids the need to break up the group (and the additional complexity and potential loss of value associated with this).</p> <p>s9(6)(a)</p>	<p>By committing us more strongly to an SPE model, this may reduce optionality in a crisis situation (historically we have focused on the importance of being able to resolve New Zealand subsidiaries on a standalone basis). A stronger commitment to an SPE model may also make it harder to require industry to invest in MPE solutions.</p>
<p>Provides us with a tool to wholly or partly recapitalise a Group 1 deposit taker (assuming the quantum of LAC is sufficient).</p>	<p>If the quantum of LAC is not sufficient, the objective of recapitalising a New Zealand subsidiary to an appropriate level will be difficult to achieve.</p>

¹⁰ LAC and Tier 2 are likely to be broadly similar instruments with similar fundamental economic and legal characteristics. However, Tier 2 is recognised as capital, while LAC would not. Additionally, LAC would likely be subordinated below Tier 2 in the creditor hierarchy.

Pros	Cons
<p>s9(6)(a) with APRA in an SPE scenario by having pre-positioned instruments that we can trigger independently.</p>	<p>If the addition of a LAC requirement comes at the expense of a reduction in capital buffers, the likelihood of a deposit taker reaching the point of non-viability is increased (although it also strengthens the tools available to intervene should the point of non-viability be reached).</p>
<p>Aligns with international practice, where LAC requirements are common and host authority's favoured approach and often result in Total Loss Absorbing Capacity (TLAC) of well over 20% (TLAC refers to the combined total of LAC and capital).</p>	<p>We have previously removed conversion and write-off from our capital framework due to concerns about the effectiveness of such approaches. We would need to be confident that these concerns were no longer relevant.</p>

To support decision-making, the key things we are looking at before finalising potential options for consultation are:

- Cost of LAC vs CET1 capital
- Financial stability benefits provided by LAC vs CET1 capital
- Minimum LAC needed to provide viable response
- Potential trigger points for internal LAC instruments
- How to address previous concerns about the use of conversion and/or write-off
- The appropriateness of different bail-in models in an MPE context (noting that our approach to SPE may influence this assessment, and the potential need for a statutory bail-in power is more likely to arise in an MPE context).

Please advise if there is anything else that may be beneficial to support the Board's decision making in July.

ii) Amount of capital (slides 18 and 19 of Annex 1)

All the options around the *form* of capital can be scaled to provide different levels of stability and different impacts on lending rates.

For now, we are focusing on broad options that keep the level of stability in the system about the same, or those that reduce stability and costs. We will provide more specific options once we have more evidence to support these decisions (see Annex 5). We have not provided options that increase costs and lending rates.

iii) Proportionality and the distribution of capital

As with the *level* of capital, options can be scaled to provide different levels of proportionality – or the *distribution* of capital.

Slide 19 of Annex 1 illustrates our thinking for how the options would apply to Group 1, but we are still considering the distribution of capital for Groups 2 and 3.

Our emerging thinking is there could be scope, from a financial stability perspective, to reduce Group 2 requirements relative to Group 1 – given the risk to overall system stability are lower for this group. However, this would mean some increased risks to the soundness of those deposit takers.

In addition, crisis management issues relating to Group 2 and 3 deposit takers will likely be simpler to address than for Group 1. More specifically, we are considering whether there is any potential role for LAC in relation to larger or overseas owned Group 2 deposit takers.

We do not think that a LAC requirement will be relevant for other Group 2 deposit takers or for Group 3 deposit takers given the nature of their business. It would be difficult for smaller deposit takers to market such instruments, and there are other recovery and resolution tools available for these deposit takers.

Our analysis will focus on ensuring there are sufficient capital buffers for Group 2 and 3 deposit takers. These will provide space for effective recovery actions before these deposit takers reach the point of non-viability.

Annex 5: Evidence to support decision-making

We plan to produce key pieces of analytical work to support decision-making between the options presented in Annex 4. We are at different stages with each of these elements. An update on each is provided below.

Our analytical work will be supported by engagement with the international experts. Our recommendations regarding final decisions will also be supported by feedback we receive from the consultation.

What has changed since the 2019 Capital Review, and what does that mean for our risk profile and tolerance?

We have established the main factors that may have changed since the 2019 and carried out an initial assessment of their likely impacts. We are continuing to refine our views and expect to engage with the international experts on this topic.

Change since 2019	Does this change impact the risk environment? If so, how?	Does this change suggest we need more or less capital relative to 2019 Capital Review settings?
<p>Considerations</p>	<ul style="list-style-type: none"> Impact on financial stability 	<ul style="list-style-type: none"> Appropriateness of capital to address this change Impact on probability of a crisis Impact on cost of a crisis
<p>Enhanced crisis management framework, including:</p> <ul style="list-style-type: none"> DTA changes (powers to use more resolution tools) DCS 	<p>Yes. Our ability to resolve or otherwise deal with distressed entities has increased since 2019 and decreased the impact of failure.</p> <p>The introduction of the DCS makes protected deposits more stable and the banking system less impacted by a 'bank run'. The enhanced crisis management framework provides more tools to resolve distressed deposit takers.</p>	<p>When we did the 2019 Capital Review, our view was that, while deposit insurance may alleviate the impacts of a bank's failure on that bank's insured depositors, it would not reduce the probability of that bank failing in the first place and therefore would not reduce the amount of capital needed. Historical experience shows that crises are very costly even in jurisdictions where deposit insurance exists. Further, they can increase moral hazard risk.</p> <p>However, we will reassess the arguments here before coming to an updated view – particularly given we now have the DCS in place.</p>
<p>Ways we have reduced risk in the system outside of capital since 2019, including:</p> <ul style="list-style-type: none"> Debt-to-income (DTI) restrictions 	<p>Yes. These are ways that we have reduced risk in the system (alongside CCCFA from MBIE).</p> <p>The changes lower risk in the system in different ways – for example, DTI restrictions and CCCFA reform do this by reducing the riskiest lending</p>	<p>These changes suggest that less capital is needed relative to the 2019 settings for the same risk appetite. They should lower the probability of a crisis by lowering system wide Probability of Default and by increasing the likelihood that we can</p>

Change since 2019	Does this change impact the risk environment? If so, how?	Does this change suggest we need more or less capital relative to 2019 Capital Review settings?
<ul style="list-style-type: none"> Enhanced supervision and approach to enforcement and recovery DTA changes Enhanced stress testing CCCFA reforms 	<p>during an upswing in house prices and potentially reducing the magnitude of future house price cycles. Enhanced supervision, enforcement, and stress testing should enable us to see emerging problems sooner and move to counter these problems. Each item lowers the overall risk of the system.</p> <p>The impact of the changes is individually marginal but collectively lower the risk environment.</p>	<p>identify and react to emerging issues before they become a crisis.</p> <p>For example, DTIs should marginally lower the probability of a crisis by removing the highest risk lending but would have less impact on the cost of a crisis.</p> <p>In 2019 submitters raised stress testing and supervision as reasons we did not need to raise capital to these levels. We noted that we did not think that stress testing and supervision are substitutes for capital. Since 2019 our supervision capacity has lifted significantly. While this may give some comfort that lower amounts of capital are now required, it is difficult to quantify to what extent.</p>
<p>Changed macro environment, including:</p> <ul style="list-style-type: none"> Increased knowledge of climate risk Geopolitical risk Trade risk Concentration risk Fiscal headroom Covid-19 / black swan events 	<p>The overall macro environment is constantly evolving, and systemic risk in the short-term has increased (for example, through increased trade policy uncertainty).</p> <p>The main macro trend not accounted for in 2019 is the increased knowledge of climate risk.</p> <p>The other change is the government has lower fiscal headroom post Covid, which lowers the ability of future governments to provide countercyclical fiscal policy to offset economic shocks.</p> <p>Other macro trends are smaller – for example, geopolitical risk may be rising but has always been here.</p>	<p>Most of the changes in the macro environment are likely to have a marginal impact on the appropriate level of capital either way. The main area where higher capital would help lean against the risk would be for increased knowledge of climate risks.</p>

Overall, the factors considered so far suggest risk is at least slightly lower than when we did the 2017-19 review. This may support consideration of which options are most appropriate or affect assessments of overall risk appetite. However, many of these factors will be difficult to quantify or may have a limited impact on our cost benefit analysis.

We have also collated a range of factors where we think the evidence base may have changed since 2019. We are still considering the evidence here. The following areas that are our focus:

- Did the pass through of lending rates due to higher capital happen as we forecast?
- Our views on the ability of AT1 to absorb losses have changed, including noting that APRA has decided to remove AT1 capital from its capital stack.
- There is an international move towards LAC.
- There are new international failure examples. Is the view of capital failure point the same?
- Decreasing international consensus on Basel III capital requirements.

International comparison – how do New Zealand’s capital requirements compare with other countries?

We are close to commissioning a vendor to conduct an independent report comparing New Zealand’s capital requirements with other countries. We expect the report to feed into the July Board meeting.

Reviewing commentary from the Commerce Commission and FEC Inquiry

We have reviewed the submissions to the FEC Inquiry and main findings of the Commerce Commission market study.

The main themes from submissions to the FEC Inquiry related to capital requirements are set out below. All the main points raised are being covered by elements of the review.

- The RBNZ is best placed to set capital requirements given it has a system-wide view.
- Risk appetite of setting capital requirements to withstand a 1-in-200 year crisis is too conservative.
- The risk weights for corporate, agricultural and low-LVR residential mortgage exposures under the standardised approach are not sufficiently granular and otherwise too high.
- The different outcomes produced by the IRB and standardised approaches provides IRB banks with a competitive advantage.
- The existence of Additional Tier 1 instruments should be revisited, as has been done in Australia, particularly given how thin this market is in New Zealand.
- Lending rates are impacted by several factors, with capital requirements being only one.

In their evidence to the Inquiry, deposit takers argued that the RBNZ’s estimated lending rate impacts of the Capital Review are lower than what has been experienced to date, and what they are expected to be upon full implementation in 2028.

We intend to seek more details from deposit takers on how they calculated their estimates via the consultation, as the information provide to FEC was generally quite high level. We will also conduct sensitivity analysis to understand the impact if lending rates are closer to deposit takers’ estimates than our own.

The Commerce Commission report mostly focused on the competitive differences between Group 1 and Group 2 resulting from the differences between the IRB approach and standardised approach to risk weights. The report did not contain any findings that would suggest that the estimated variables used in our analytical framework need to be revisited.

The Commerce Commission report recommendation to implement more granular standardised risk weights for home loans and to consider the merits of introducing standardised risk weights for lending for Māori freehold land are covered by the review.

Annex 6: Glossary

Additional Tier 1 (AT1) capital is the second highest quality of capital behind CET1. Under RBNZ policies AT1 capital is made up of perpetual preference shares that offer fixed dividends, no redemption date and which limit other rights of the holder. Preference shares rank ahead of ordinary shares in a liquidation.

Bail-in is a crisis management mechanism where a failing bank's shareholders and creditors absorb losses by having their claims written down or converted to equity, thus recapitalising the deposit taker without the need for public funds. There are different ways bail-in can be effected using different legal mechanisms (not discussed in this paper).

Capital buffer (also known as a 'Prudential Capital Buffer' or 'CET1 buffer') absorbs losses during stress and protects deposit takers from failure. The capital buffer is placed on top of the regulatory minimum requirements and must be made up of entirely CET1. The capital buffer is made up of three components: a Conservation Buffer, D-SIB Buffer and Counter-cyclical Capital Buffer.

Capital ratio: A deposit taker's capital divided by its risk weighted assets (RWA). A capital ratio is a key indicator of the financial strength of a deposit taker, measuring the losses it can withstand relative to the risk of the deposit taker's business.

Capital Review decisions in 2019 introduced higher capital requirements which are split into two broad categories: minimum requirements and prudential capital buffer (PCB) requirements. The combined impact of these is in the process of gradually shifting up to 18% of risk weighted assets (RWA) for the four largest banks. An outcome of the review was also to no longer recognise convertible debt securities for capital purposes.

Common Equity Tier 1 (CET1) capital is the highest quality of capital as it is permanently available to absorb a deposit taker's financial losses. CET1 includes shareholders' investment (ordinary shares) and the deposit taker's retained earnings.

Going concern capital can absorb losses while a bank remains viable and able to meet its financial obligations.

Gone concern capital can absorb losses when a deposit taker has reached the point of non-viability (e.g. where a bank has failed, or is likely to fail, and has been placed in a resolution or insolvency process).

Internal ratings-based (IRB) approach allows accredited banks to use the internal models-based approach to calculate their capital requirements; otherwise they must use the standardised approach. Accredited banks are sometimes called 'IRB banks'.

Loss Absorbing Capacity (LAC) instruments are debt instruments that make up part of a deposit taker's funding and are pre-positined to allow for bail-in. An additional LAC requirement would be in addition to total capital requirements (the total capital consists of the regulatory minima of capital and the capital buffers). Total Loss Absorbing Capacity (TLAC) consists of the total capital and the additional LAC.

Minimum capital (ratio) requirements: The minimum capital ratio must be met in order to be licenced and operate as a deposit taker. If a deposit taker has a capital ratio below the minimum

requirement, it is likely to be in financial distress from a prudential perspective and leading the Reserve Bank to take regulatory actions.

Multiple point of entry (MPE) model where resolution tools are applied to different companies within a group that the deposit taker is part of. This may apply across different jurisdictions involving two or more resolution authorities acting in coordination. Relevant host authorities will initiate and implement resolution actions in relation to the legal entity within their jurisdiction. In the MPE resolution, a New Zealand deposit taker may be separated from the international banking group of which it is a part and resolved on a standalone basis.

Output floor is a limit on the IRB approach for the deposit takers that calculate the RWA using the IRB approach. When determining its capital ratio, the RWA cannot go below 85% of the RWA that the deposit taker would calculate under the Standardised approach.

Recapitalise is the process of reestablishing a sustainable capital structure for a deposit taker by generating new capital from external sources or bail-in.

Risk weighted assets (RWA) is an adjusted picture of a deposit taker's financial position (e.g. its loan portfolios and other investments, and its operational and market trading activities) that takes into account the risk profile of that financial position.

Standardised approach to credit risk: One of the two methodologies available to calculate RWA for banks' credit risks, the Standardised approach requires deposit takers to use Reserve Bank specified rules to determine the risk weights to apply to different types of loans and other assets.

Single point of entry (SPE) model where resolution tools are applied to the ultimate company of a group that a deposit taker is part of. It will be initiated a home resolution authority (e.g., APRA) and host authorities (e.g., RBNZ) may need to take supporting action in their jurisdictions to give full effect to the resolution measures of the home authority. In the SPE resolution, the group is kept together.

Tier 1 capital consists of CET1 capital and AT1 capital.

Tier 2 capital can generally absorb losses once a deposit taker has begun to experience financial difficulty. It includes some subordinated debt and is considered of lower quality than Tier 1.

Total Loss Absorbing Capacity (TLAC): An international regulatory standard requiring global systemically important banks to hold sufficient equity and bail-in debt that can absorb losses and recapitalise the deposit taker during crisis, minimising the application of government funds.