Reserve Bank of New Zealand Te Pūtea Matua

Financial Stability Oversight Committee Paper for Decision: Review of key capital settings: policy positions for consultation

From	Review of key capital settings team (Katy Simpson - Manager, Prudential Policy)
Approved by	Angus McGregor, Acting Assistant Governor Financial Stability
Date	16 July 2025
Subject	Review of key capital settings: policy positions for consultation
For	Decision
Value(s)	Integrity/Tauira | Innovation/Wānanga
Strategic Theme(s)	Strengthening efficiency and competition; Promoting understanding and trust

1. Purpose

The purpose of this memo is to seek your endorsement of our proposed policy positions for consultation ahead of the Board meeting on 24 July 2025.

2. Recommendations

That subject to discussion, FSOC recommends that the Board accept the following recommendations at the meeting on 24 July 2025:

1. Note that our assessment does not suggest a significant overall change in the risk environment surrounding New Zealand's financial system since 2019 and therefore only minor changes in the overall calibration of regulatory capital settings may be required.
2. Note that, after adjusting for our relatively strict risk-weighting, preliminary work by RBNZ and Oliver Wyman suggests New Zealand banks currently have relatively high levels of 'going concern' loss absorbency but relatively low levels of additional 'gone concern' loss absorbency aimed at supporting orderly crisis management.
3. Note that a key trade-off for the Board to consider is around the relative costs and benefits of these two types of loss absorbency.
4. Approve the following policy positions for public consultation:
    a. Introduce more granular risk weights as set out in Appendix 3.
    b. Remove Additional Tier 1 (AT1) capital and replace it with a mixture of Common Equity Tier 1 (CET1) and Tier 2 capital.
5. Approve for consultation the three options for the amount and form of capital set out in Section 4.3.5 and Appendix 5 of this paper, indicating a preferred option if appropriate.
6. Approve the draft structure and key messages of the consultation paper set out in Appendix 9, leaving finalisation of the document to management.

7. Note the near final consultation paper will be circulated to FSOC members for comments on 7 August.

3. Background

On 27 March 2025, the Board approved the RBNZ undertaking a reassessment of regulatory capital settings for deposit takers. 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.[1]

On 10 June and 12 June, FSOC and the Board respectively considered a paper on the direction of travel of the review. They supported the proposals to remove AT1 capital from the capital stack (replacing it with a mix of CET1 and Tier 2 capital) and to have more granular risk weights.

A draft of this paper was discussed at the Financial Stability Committee (FSC) on 2 July. The FSC focussed their discussion on the proposed criteria and options (as set out in section 5 and Appendix 5) and endorsed three options as preferred options to the Board. This paper has been amended to address FSC's feedback.

On 9 July FSOC met with our international experts Sir John Vickers and Thorsten Beck to discuss their initial views on the review. We have not had time to make substantive changes in response to the issues raised in that discussion but will give further thought to this as we draft the consultation paper. We note that both experts expressed the view that the 2019 Capital Review was a very high-quality piece of work and the policy decisions were sound.

4. Discussion

4.1 Context

Deposit takers' capital is a fundamental component of their safety and soundness. Higher levels of capital reduce the likelihood of an entity failing, reduce the impact of failure on creditors (e.g. depositors), and, at a system-wide level, protect the economy from costs that can arise when entities fail. However, higher levels of capital also increase the costs of intermediation in the economy. A glossary of key concepts is at Appendix 9.

Following a review of our regulatory settings over 2017-2019 (the '2019 Capital Review'), since 2022 deposit takers have been transitioning to new regulatory capital requirements that will take full effect in 2028. In 2019 we assessed that these settings would result in an expected likelihood of systemic crisis of 1 in 200 years. The cost-benefit analysis found that the new settings would result in a net benefit of +0.43% of expected GDP, relative to the then-status quo. The settings feature an increased role for capital buffers to manage entities as they encounter stress.

There are a range of capital settings that can meet our legislative mandate for financial stability, which underpins our organisational risk appetite. Those settings sit on the spectrum of different regulatory emphases – i.e. the relative weighting on financial stability vs impact on economic activity, and the extent to which financial stability is better achieved by preventing crises vs

[1] 2025 Review of key capital settings: Terms of Reference https://www.rbnz.govt.nz/regulation-and-supervision/oversight-of-banks/how-we-regulate-and-supervise-banks/our-policy-work-for-bank-oversight/2025-review-of-key-capital-settings

managing crises. While there is uncertainty when measuring the benefits and costs of different capital settings, we are confident that we can formulate different combinations of capital settings along this spectrum that would produce net benefits.

Therefore, the right settings for New Zealand depend on how a range of criteria is weighted. Our new legislation (the Deposit Takers Act 2023 (DTA)) and the Financial Policy Remit provide clear guidance for how to consider issues such as competition alongside financial stability for this review (though it should be noted that the implications for competition were also assessed in the 2019 Capital Review).

How these criteria are balanced depends on risk appetite, i.e. the willingness to accept risk to a defined extent. The RBNZ Risk Appetite Statement states: "We have a low appetite for any action or inaction that materially reduces financial system stability." Our published Statement of Prudential Policy builds on this by noting that we do not operate a zero failure regime "we are prepared to tolerate risks that may lead to the failure of regulated entities where the impact on the financial system is understood and manageable, or may be characterised as medium risk".[2]

We recommend not trying to anchor the risk appetite that we are seeking to achieve to a particular metric e.g. a 1-in-200 year financial crisis. We have found that this has not been a useful anchor point since the 2019 Capital Review, and we recommend moving away from this articulation to something that is more qualitative and aligned with the Board's own Risk Appetite Statement. This qualitative approach would be more aligned with the "unquestionably strong" articulation used by the Australian Prudential Regulation Authority (APRA).

We have formulated options below which meet the Board's stated risk appetite. However, there are still judgements the Board will need to make – particularly around 1) how its risk appetite for deposit taker failure varies across different groups of deposit takers; and 2) how it may have a higher risk appetite for the incidence of financial crises if it is confident that there are better measures in place to manage these crises. It will be important that the consultation paper clearly articulates how the options fit within and connect to this.

4.1.1 The risk environment surrounding the financial system – what's changed and what hasn't

In the 2019 Capital Review, we explicitly set out to be more conservative than other countries because of our assessment at the time of key risk factors facing New Zealand.[3] These include the dominance of banks in New Zealand's financial intermediation, the concentration of the system into a small number of large entities, and the concentration of credit risk in banks' lending portfolios.

As part of our current review, we have reconsidered those factors and considered any new factors – such as newly introduced polices or new evidence. Appendix 1 summarises our analysis.

Broadly, our assessment is:

[2] Statement of Prudential Policy – 2022
[3] Capital Review Decisions 2019
https://www.rbnz.govt.nz/-/media/project/sites/rbnz/files/consultations/banks/review-capital-adequacy-framework-for-registered-banks/decisions/capital-review-decisions.pdf
Regulatory Impact
Assessment and Cost Benefit Analysis 2019
https://www.rbnz.govt.nz/-/media/project/sites/rbnz/files/consultations/banks/review-capital-adequacy-framework-for-registered-banks/decisions/capital-review-cost-benefit-analysis.pdf

- While some factors suggesting we should be more conservative than other countries have increased or decreased, most of these are unchanged.
- Changes in prudential policies, our supervisory approach, and our crisis management framework taken together, reduce risk to the financial system. Not all are good substitutes for capital though – with some focusing on risks other than solvency. Overall, they should provide some comfort for lower capital, but it is hard to quantify this and it will also depend on the Board's appetite to allow entities to fail in a (hopefully) managed way in future. Policies such as new standards under the DTA and more intensive supervision may reduce risk more for Group 2 deposit takers than Group 1 – so could support an increase in proportionality. On the other hand, the Depositor Compensation Scheme (DCS) increases the risk potential for Group 3 entities due to moral hazard.
- Recent Financial Stability Reports highlight that the macro risk environment is overall less benign than in the period of the 2019 Capital Review. Domestic (housing and agricultural sector) risks are currently low on a cyclical basis, however, there has been a steady increase in other risks, such as geopolitical and cyber. This suggests some caution, particularly if we expect these to continue over the medium-term.

Taken together, while some individual components might support variation in capital requirements, our assessment does not suggest a large net change in the risk environment.

Nevertheless, there is room for a different judgement on the degree of conservatism needed compared to that made in 2019 – especially if a high weight is placed on the supervisory and crisis management uplift since 2019.

4.1.2 International benchmarking

A key piece of evidence to inform the Board's decisions on appropriate capital settings for New Zealand will be how we compare with other countries.

Oliver Wyman is progressing a detailed analysis of this for RBNZ. So far results look roughly as we expected and broadly similar to work PWC did for the New Zealand Banking Association (NZBA) back in 2019. Overall, NZ's unadjusted CET1 ratios (as at March 2025, average across major banks) are at the low end compared to peer countries, but after adjusting for our relatively strict risk-weighting NZ (and Australia) are near the high end. NZ (adjusted) would likely be at or near the top in terms of tier 1, once the full 2028 requirements are in force. A full report, including a view on where 2028 settings would place us, will be available to release alongside our consultation paper.

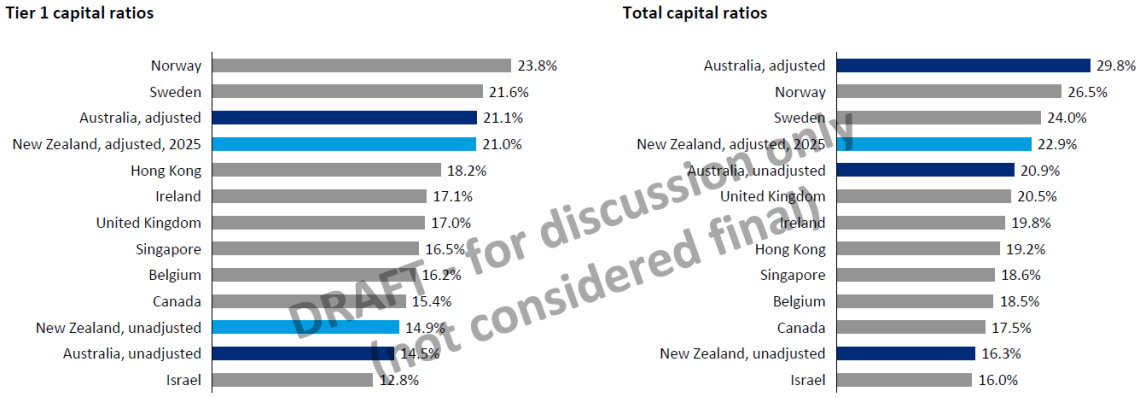
We have also internally produced 'capital coverage' figures for New Zealand. These show how much capital (or total loss absorbency) banks have relative to a (non-risk adjusted) dollar of mortgage or corporate lending. They can be compared across countries as a way of looking through differences in regulators' approaches to risk weights.

This work is discussed in more detail in Appendix 2. New Zealand banks have relatively high amounts of CET1 capital for their mortgage and corporate exposures. However, looking at all forms of loss absorbency, including total loss absorbing capacity (TLAC)[4], gives a different result:

[4] Total Loss Absorbing Capacity (TLAC) is a concept used in an international regulatory standard. It requires 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. See the Glossary in Appendix 9.

total TLAC coverage of credit risk in New Zealand is fairly typical of the international sample we consider. Appendix 2 sets out more detail.

Figure 1: Preliminary Oliver Wyman adjustments to NZ and Australian Capital ratios



Oliver Wyman are also preparing a table comparing TLAC ratios for applicable countries. New Zealand does not currently have TLAC requirements, and so this will only be for relevant peer countries

Capital coverage calculations assume that a mortgage (for example) in each country is equally risky, but other international analysis tries to take cross-country risk into account. For example, S&P consider New Zealand to have slightly higher industry risk than countries like the UK, slightly higher economic risk than countries like Ireland – and higher risk against both categories than countries like Australia, Canada and Singapore. A key driver of S&P's assessment is New Zealand's persistent external deficit, which makes the financial system more vulnerable to global shocks than peers. S&P's analysis suggests they expect more capital coverage in New Zealand than those other countries to achieve the same credit rating.

Overall, to date this work supports our earlier view that we are relatively strict in terms of CET1 requirements after adjusting for our conservative definitions, but much more typical once broader measures of TLAC are considered.

4.2 Discrete policy positions

There are some discrete policy recommendations we propose implementing, regardless of broader questions about the form, level and distribution of capital (discussed in the next section).

4.2.1 More granular risk weights

We presented a proposal to introduce more granular risk weights at the June FSOC and Board meeting. You confirmed you were happy with the direction of travel. Appendix 3 describes the detail underlying the proposals and summarises some of the key underlying evidence that supports the recommendations.

Overall, this change would significantly reduce risk weights and the capital in the system – we estimate this to result in CET1 capital that is around 5.7% lower than if existing risk weights were retained.

We have also proposed some changes to risk weighting of lending to Community Housing Providers and Housing Cooperatives – areas of focus of the Commerce Commission market study. Appendix 4 explains the detail and the underlying evidence.

4.2.2 Removing and replacing AT1 capital instruments

As set out in the June FSOC and Board paper, we propose we remove AT1 capital from the capital stack and replace it with a mix of CET1 and Tier 2 capital. You confirmed you were happy with the direction of travel. The options presented in section 5 of this paper present alternatives to AT1.

4.2.3 Output floor/IRB scalar

We have considered options where the output floor and scalar that limit the gap between standardised and IRB banks is changed, for example to reduce the reduction in total capital from the proposed changes to risk weights. However, we see benefits in maintaining the incentive for IRB banks to manage and model their risk, so do not propose changing the output floor and scalar in any of the options presented in this paper.

4.3 Policy options

We have considered the *amount*, *form* and *distribution* of capital and identified a range of options for change. Appendix 5 contains the full details and calibrations of each option.

4.3.1 We propose the following criteria are used for comparing options

The Board will need to be satisfied that all options advance the purposes of the DTA, while having regard to the DTA principles, and the Financial Policy Remit (December 2024). The Board's risk appetite (as expressed in the Risk Appetite Statement) will also be a key guide for deciding among options.

To assist the Board, we have developed the following assessment criteria. They are based on our statutory parameters including the DTA purposes and principles that we consider most relevant for this review.

Financial stability criteria

1. Business-as-Usual (BAU) loss absorbency: Maintaining a sufficient prudential capital buffer above the regulatory minimum to absorb losses and promote the stability of the financial system and the safety and soundness of each deposit taker (links to s3(1) and (2)(a) purposes).

2. Crisis management: enable a distressed deposit taker to be dealt with in an orderly manner, recognising the need for a credible resolution strategy for deposit takers to promote financial stability and avoid the use of public money (links to s259 purposes).

Other criteria

3. Proportionality: Taking a proportionate approach to regulation and supervision (links to s4(a)(i) principle).

4. Competition: Maintaining competition within the deposit-taking sector, recognising the desirability of a diverse deposit-taking sector that provides financial products and services to a diverse range of New Zealanders (links to s3(2)(c) purpose, and s4(a) and s4(b) principles).

5. Funding costs: Consider the impact on banks' weighted average funding costs, which in turn affect lending rates, recognising the importance for supporting the prosperity and well-being of New Zealanders (links to s3(1) purpose and s3(2)(d) principle).

6. Simplicity/achievability: Be practical to administer, easy to implement and avoid unnecessary compliance costs (links to s4(c) principle).

7. International alignment: Aligning with international standards where appropriate (links to s4(d) principle).

4.3.2 A potential change towards more gone-concern forms of capital

In the 2019 Capital Review we prioritised having large buffers of CET1 capital. This lowers the likelihood of an entity failing in the face of a given shock, and provides us with increased headroom to intervene and manage a distressed entity (through the subsequently developed Capital Buffer Response Framework) while it remains a going concern.

In the current review we are examining two sets of options, all of which reflect a low risk appetite for financial instability while seeking to enhance proportionality and competition (to varying degrees):

- Non-LAC options maintain our 2019 regulatory emphasis whereby deposit takers have high BAU levels of equity, lowering the likelihood they would get into distress in the first place, but potentially at a higher ongoing cost to the economy through increased costs of bank intermediation. These options look at different ways to reduce these ongoing costs through accepting less financial stability.
- LAC options would introduce a role for increased loss absorbing capacity (LAC) for the Group 1 deposit takers. These options look to change the form of capital to reduce ongoing costs, while seeking to mitigate any loss of financial stability (albeit with greater uncertainty around the net stability impact).

LAC refers to debt instruments containing terms agreed by the issuer and holder allowing for the write down or conversion of the principal of the instrument in circumstances triggered by the Reserve Bank. We are considering requiring Group 1 deposit takers to issue LAC to their holding entity (Internal LAC). LAC is a common feature in other jurisdictions including Australia. For further details, see the LAC option section in Appendix 5.

Table 1 summarises how this change in approach could look for the different groups of banks.

Table 1: Regulatory emphasis for capital under different options

	Group 1	Group 2/3
2019 Capital Review	Banks maintain high capital buffers in BAU, providing flexibility to manage a failing institution through the Capital Buffer Response Framework. Calibrated with less headroom for smaller entities, reflecting a higher tolerance for failure. Limited role for gone concern capital due to scepticism about effectiveness. Part of buffer varies countercyclically as a macroeconomic stabilisation tool.	

	Group 1	Group 2/3
2025: Options without LAC	Fundamentally similar to 2019, but with a wider gap between groups (more proportionality). Under some variants, buffers are lower overall (higher risk appetite).	
2025: Options with LAC	Smaller buffers in BAU = less front-loading of capital. Introduce a new layer of loss absorbing instruments to pre-position for a recapitalisation of a failing entity.	Buffers play a similar role as in other options. Smaller gap in going concern capital compared to Group 1, but wider gap in TLAC (mixed effect on proportionality).

At the FSOC meeting on Wednesday, 9 July, our international experts cautioned against excessive focus on 'proportionality' and 'efficiency' to name options that would ease capital requirements, as it is important not to conflate these concepts per se with reduced capital requirements (as in some cases this could reduce economic efficiency). We will ensure the language in the consultation paper is clear on the definition of these concepts.

4.3.3 Non-LAC options initially considered

	1: Adjusted status quo			2: More proportionality			3: More proportionality and efficiency		
	G1	G2	G3	G1	G2	G3	G1	G2	G3
CET1	15	13	10	15	12	10	14	11	9
Total capital	18	16	13	18	15	13	18	15	13
Prudential capital buffer	9	7	4	9	6	4	9	6	4

Option 1: Adjusted status quo

This option would remove 2.5% of AT1 and replace it with a mix of CET1 (1.5%) and Tier 2 capital (1%). The increase in CET1 would broadly offset the reduction in capital from the risk weights changes. This option would likely be preferable to the status quo for many stakeholders. Total capital levels ($ amount) would be lower than the status quo – but more of it would be the highest-quality form of capital (CET1). It will likely leave funding costs similar to where they are now and will not materially change proportionality in the system.

Option 2: More proportionality

This option is the same as option 1 but also reduces the buffer for Group 2 by 1% – increasing proportionality and potentially increasing opportunities for Group 2 deposit takers to compete with the larger players. This option would increase the probability of a Group 2 failure compared to our current settings, but because Group 2 deposit takers make up a relatively small share of the system, this would not have a large impact on total capital in the system.

Option 3: More proportionality and efficiency

This option replaces the 2.5% of AT1 with mostly Tier 2 (2%) and reduces the buffer for Group 2 by 1% – increasing proportionality. Alongside changes to risk weights, this leads to materially lower CET1 in the system – providing less stability – but with funding costs lower than the status quo.

LAC options: Background and context

In considering the potential design of LAC options we have assumed that:

- Minimum capital requirements for a Group 1 deposit taker following the proposed removal of AT1 are set at 9% (comprised of 6% CET1 and 3% Tier 2).
- LAC requirements only apply to Group 1 deposit takers
- Both LAC and Tier 2 instruments include write down and/or conversion terms, and are internally issued (as the purpose of the LAC options is to support a single point of entry (SPE) recovery approach at the group level for Group 1 deposit takers)
- The level at which the buffer is set is a question of what level of resilience we want to build in BAU, and the level at which LAC is set is a question of what level of recapitalisation capacity is necessary to stabilise a deposit taker at the point of non-viability (PONV) (taking into account the appropriate trigger point for writing down or converting LAC)
- The appropriate trigger point for write down or conversion is when the buffer is, or is near to being, exhausted in a strict capital ratio sense (i.e. when the deposit taker is at PONV). That is, the minimum capital requirement (of 9%) has been, or will soon be, breached.

The broader role of LAC in the context of crisis management (including its potential role in buttressing a SPE model for resolving a major trans-Tasman banking group) is discussed further in Appendix 7.

4.3.4 LAC options initially considered

	4: Higher TLAC			5: Medium TLAC			6: APRA-like lower TLAC		
	G1	G2	G3	G1	G2	G3	G1	G2	G3
CET1	13	12	10	12	11	10	10.5	10.5	10
Total capital	16	15	13	15	14	13	13.5	13.5	13
TLAC	25	15	13	21	14	13	18	13.5	13
Prudential capital buffer	7	6	4	6	5	4	4.5	4.5	4

Option 4: Higher TLAC (25% TLAC)

For Group 1, this option has a buffer of 7% and additional internal LAC of 9%, leading to a TLAC requirement of 25%. This level of LAC could credibly replenish capital levels to above the minimum capital requirement. Group 2 and 3 would not have additional LAC requirements and would have lower capital buffers of 6% and 4% respectively.

Option 5: Medium TLAC (21% TLAC)

We consider that the minimum amount of additional LAC needed to credibly recapitalise a Group 1 deposit taker would be around 6% of RWAs. Under this option, Group 1 would have a buffer of 6% and additional internal LAC of 6%. Group 2 and 3 would not have additional LAC requirements, and would have lower capital buffers of 5% of RWAs and 4% of RWAs respectively. The countercyclical capital buffer (CCyB) would decrease from 1.5% to 1% to ensure Group 2 buffers did not fall below Group 3 buffers.

Option 6: Lower TLAC (18% TLAC)

This option is akin to APRA's capital/TLAC stack for its largest banks. This option would increase financial stability risks relative to the 2028 status quo, which is difficult to justify from a cost-benefit

perspective. In particular, it would lower the buffer and increase the likelihood that intervention was required while only providing 4.5% of RWAs in LAC, which is below our expected recapitalisation needs for the NZ subsidiary in a group-level resolution.[5]

In addition, it leaves limited scope for proportionality across Group 1, 2, and 3 deposit takers, given that proportionality would be largely just reflected in the lack of a LAC requirement for Group 2 and 3 deposit takers, and unlike under the higher and medium LAC options could only be reflected in the size of buffers to a very limited extent (more specifically, it is difficult to argue that the buffer for Group 2 and 3 deposit takers should be larger than the 4.5% buffer for Group 1 deposit takers under this option, and equally difficult to argue that the buffer for Group 2 and 3 deposit takers could be under 3.5%-4% given the heightened risk of failure below that level).

Feasible ranges for the buffer and LAC

Feasible ranges for the buffer

With the introduction of LAC, a feasible range for the buffer could be 6%-7%. The 7% upper bound is determined by the adjusted status quo (as the baseline, but reduced to 7% to acknowledge the cost/benefit trade-off between LAC and buffer as outlined in Appendix 5). The setting of the 6% lower bound includes an inherent risk appetite question. However, we believe that 6% is a reasonable point to mark the lower bound of the possible range for the buffer. In particular:

- 6% provides enough scope to allow for early intervention under the Capital Buffer Response Framework.
- A buffer set at a level any lower than 6% would pose issues for proportionality for Groups 2 and 3.

Feasible ranges for LAC

Based on the feasible range for buffers, international practice suggests that a reasonable range for additional LAC could be between 6% - 9%. This is based on consideration of the Financial Stability Board's (FSB's) TLAC settings and guidance on internal TLAC.

Another way to think about the size of LAC is the need to recapitalise a bank to a Tier 1 ratio that is sufficiently above minimum capital requirements as part of a credible recovery / resolution strategy. Sufficiently above minimum capital requirements in this context ideally means re-building at least part of a deposit takers' capital buffer. At least in the lower-middle end of the 6%-9% buffer/LAC range, this can lead to setting additional LAC at least the same size as a deposit taker's buffer.

[5] We also note that even if LAC is similar to Tier 2 capital, and both LAC and Tier 2 are convertible, LAC formally sits outside the minimum capital requirement and buffer, and as such can be used to generate "new" capital (whereas Tier 2 forms part of the minimum capital requirement, so when converted does not change the quantum of capital - only the form).

4.3.5 Preferred options for consultation

Non-LAC options for consultation

Our preferred approach is to consult on a two non-LAC options: Options 2 and 3. We will use the adjusted status quo (Option 1) as a baseline for comparing options, but will not set this out as one of the options we intend to choose between.

LAC option for consultation

Our preferred option is to consult on a single LAC option for Group 1 deposit takers with:

- Minimum regulatory capital of 9% (6% CET1 and 3% Tier 2);
- A range of possible buffers between 6%-7%, the buffers under options 4 and 5;
- A range of possible LAC between 6%-9%, the LAC requirements under options 4 and 5).

At present are inclined towards an 'upper bound' buffer of 7% and LAC of 9% and could also note this in the description of this option. However, we see benefits in including the ranges in this option as it clearly signals the limits of what we think is feasible, while at the same leaving scope for calibration of the exact numbers based upon feedback from submitters and further analysis.

With a 7% buffer for Group 1 under this option, we would also propose buffers of 6% for Group 2 and 4% for Group 3 (with a 6% buffer for Group 1 we would propose a 5% buffer for Group 2 and 4% buffer for Group 3.

Proportionality under this option would be reflected in the absence of a LAC requirement for Group 2 and 3 deposit takers, and in the proposed size of the buffers.

Table 2: Comparison of options against criteria

Key

All options are broadly feasible. However, each option performs better on certain criteria than others.

⬆⬆ Strongly meets the criteria. ⬆ Meets the criteria

↔ Impact is neutral

⬇⬇ Strongly does not meet the criteria. ⬇ Does not meet the criteria.

		Financial stability criteria			Other criteria			Lending rate impact (bps)
		BAU loss absorbency	Crisis management	Proportionality	Competition	Simplicity and achievability	International alignment	
	Status Quo (2028)	⬆⬆	↔	↔	↔	⬆⬆	↔	Baseline
No LAC	1. Adjusted status quo: More granular Standardised risk weights Replace AT1 with mixture of CET1 & Tier 2	⬆⬆	↔	↔	↔	⬆⬆	↔	-4.0
	2. More proportionality: As above, but lower buffer for Group 2	⬆	↔	⬆	↔	⬆⬆	↔	-4.6
	3. More proportionality and efficiency: As above, but replacing AT1 with Tier 2 only	⬇	↔	⬆	⬆	⬆⬆	⬇	-9.6
LAC	4. European style/High LAC: 9% LAC for Group 1 No LAC and reduced buffers for Group 2&3	↔	⬆	↔	↔	⬇	⬆	-11.3
	5. Medium LAC: 6% LAC for Group 1 No LAC and further reduced buffers for Group 2&3	⬇	⬆	↔	↔	⬇	↔	-17.1
	6. APRA style/Low LAC: 4.5% LAC for Group 1 No LAC and further reduced buffers for Group 2&3	⬇	⬇	⬇	↔	⬇	↔	-19.6

4.4 Risk and Opportunities

This review provides an opportunity to enhance our capital framework and reinforce our credibility as prudential regulator. However, it is being undertaken at a much quicker pace than is typical for a review of this significance, complexity, and scale. While we are working on a best-efforts basis to ensure the analysis is as robust as possible, there is a risk that we will not be able to complete the analysis to a sufficient level of rigour to enable final policy decisions by the end of 2025.

4.5 SOI and SPE

We confirm that our recommendations are in alignment with the approved strategy and plan.

5. Next Steps

The team will finalise the consultation paper. We intend to share the consultation paper with FSOC on 7 August and with the Minister of Finance on 14 August, ahead of publication on 25 August. We will engage with APRA and Treasury before the publication and other key stakeholders during the consultation.

Following the consultation, we will review the feedback provided and update our analysis and advice. The international experts will consider the consultation material and feedback received. They will provide written reports to support FSOC and the Board in reaching final decisions, with decisions to be made by the end of 2025 under current plans.

Appendix 1 – The New Zealand risk environment: 2019 and now

New Zealand risk factors – how have they changed?

In the 2019 Capital Review, we explicitly set out to be more conservative than other countries because of our assessment at the time of some of the key risk factors facing New Zealand.

We have considered whether those factors remain or if they have changed (see Table 3).

Most factors have not seen a material change. There has been a reduction in New Zealand's banks reliance on wholesale debt markets since the last review, which may suggest less need for conservatism. On the other hand, the fiscal position in New Zealand has deteriorated over this period.

Table 3: Analysis of recent trends in risk factors for New Zealand deposit takers

Factor	Recent trends or analysis
NZ's reliance on bank-intermediated funding	No change. We remain broadly as reliant on bank-intermediated funding as in 2019. There has been broadly no change in terms of bank credit to GDP, and few alternatives to banks have developed.
Bank's reliance on wholesale debt markets	Reduction in risk. There has been a decline in the proportion of bank funding coming from overseas (or other wholesale debt holders). See FSR special topic 2.1 here for more details.
Concentration of banking sector into a few key firms	No change. The industry is still heavily concentrated in Group 1 deposit takers. See dashboard here.
Fiscal headroom	Increase in risk. While it remains low by international standards, net debt has gone from near zero in 2018/19 to a forecast of 26% of GDP in 2028/29. Moreover, future superannuation challenges are now arriving sooner than previously forecast (see IMF Article IV). This limits the ability of future Governments to intervene during a financial crisis.
Concentration of banks' portfolios	No change. The main change since 2019 is a slight increase in household lending relative to other types of lending. But the large increase in the share of housing lending was pre-2019.

FEC Feedback

We also reviewed submissions to the Finance and Expenditure Committee's (FEC's) inquiry into banking competition and the Commerce Commission's market study into personal banking services. Most of the discussion about capital requirements did not focus on evidence-based arguments that impact our cost-benefit analysis. The exception is the potential impact of the 2019 Capital Review decisions on lending rates.

Group 1 deposit takers submitted to FEC that lending rates could be around 40-60 basis points higher than otherwise once the 2019 Capital Review decisions are fully implemented in 2028. This is higher than our estimates from the 2019 Regulatory Impact Assessment of a 21 basis points increase in lending rates.

We intend to engage with Group 1 deposit takers on these estimated lending rate impacts and test whether their assumptions change our cost-benefit analysis. Higher-than-expected pass-through of capital requirements to lending rates is important for us to consider, but we cannot take these estimates as given without understanding how they were derived.

Other deposit takers supported lower and more granular risk weights for corporate and agricultural lending, and reconsidering the existence of AT1 capital instruments. The Commerce Commission report included a recommendation to implement more granular standardised risk weights for residential mortgage lending and to consider standardised risk weights for lending for Māori freehold land. We are considering these issues in the current review.

What is the implication for policies introduced since 2019 for capital requirements?

As well as considering how the risk factors have changed, we've also considered the policy changes since 2019 and - crucially – what they may imply for capital settings. These policy changes deliver many benefits for the New Zealand's financial system including harmonised regulations across deposit taking institutions, strengthened crisis management and enhanced macroprudential oversight.

Many of these benefits are complimentary to capital, rather than directly substitutable. For example, they may help tackle non-financial risk in the system.

Cumulatively these changes may add together and give comfort to the Board in having lower capital settings. However, individually their impacts are relatively small and hard to quantify.

Policies such as new standards under the DTA and more intensive supervision may reduce risk more for group 2 deposit takers than group 1 – in part due to the role of APRA.

Table 4: Implication for capital from policies introduced since 2019

Policy changes	Impact on risk	Impact on capital requirements
Depositor Compensation Scheme (DCS)	During the 2019 Capital Review, we had concluded the introduction of a deposit insurance scheme would not have an impact on the calibration of minimum capital requirements.	No change. Consistent with the 2019 view, the DCS is unlikely to have a notable impact on how capital requirements are calibrated at a system level. However, the presence of moral hazard risk for

Policy changes	Impact on risk	Impact on capital requirements
	The settings for New Zealand's deposit insurance scheme have now been finalised, with the DCS going live on 1 July 2025 and covering depositors up to $100,000 if their deposit taker fails, when their money is held in DCS-protected accounts. DCS levies are to some degree risk-based but do not reflect the true risk of higher-risk deposit takers (specifically Group 3 deposit takers).[6] It is expected the DCS could impact capital requirements through two channels: • improves financial stability through timely access to funds and reduced likelihood of bank runs; and • increased moral hazard risk.[7] These channels have the opposite effect on capital requirements. Improvements in financial stability help lower the cost and probability of deposit taker failures lowering the capital requirements. While increased moral hazard risk could increase the need for capital requirements. However, in response to the lower likelihood of bank runs we have reduced the liquidity requirements for insured deposits. Decreasing capital on top of this would be double counting the decrease in risk.	Group 3 deposit takers may require higher capital requirements for Group 3 than otherwise. *At a system level* International evidence suggests the impact from moral hazard from deposit insurance schemes could be the dominant impact on capital requirements. This would suggest higher capital requirements. However, at a system level, we do not expect significant moral hazard risk to materialise due to the nature of the banking sector in New Zealand (its relatively uncompetitive and conservative nature) and current policy settings (risk-based capital requirements). *Individual deposit-taker level* The relatively risk-insensitive levies, in addition to the incentive for depositors to seek out high-yielding deposit takers, does increase the risk potential for individual deposit takers. At this early stage of the DCS, it is difficult to ascertain the materiality of these impacts, and whether current prudential settings (i.e. risk-based capital requirements) would limit the ability for deposit takers to take on higher risk. Nevertheless, the DCS could increase the need for stricter capital requirements for higher risk deposit takers in order to promote the safety and soundness of individual deposit takers (currently, the highest risk deposit takers are in Group 3).
Activation of Debt-to-income (DTI) restriction	DTI restrictions remove some of the riskiest residential mortgage lending that has a higher probability of default. This decreases the risk banks can take on during a housing market upswing. The lower risk of the flow of new lending will overtime decrease the probability of default of the stock of residential lending. DTI restrictions also help lower the macroeconomic risk from housing bubbles by decreasing the amount of high DTI	Could support slightly lower capital requirements – but it is hard to quantify. DTI restrictions will lower risk, but it is important not to overstate the impact of this. For Group 1 deposit takers, the reduction in DTIs will flow through into lower risk in their IRB modelling and will decrease the amount of capital they hold, partly offsetting the risk reduction from DTIs for the Group 1 deposit takers. Given the market share of Group 1 this means lower capital partially offsets the benefits of DTIs at a system level. We

[6] That is, lower risk deposit takers to some degree cross-subsidise higher risk deposit takers. For the most part, Group 1 deposit takers are lower risk while many Group 2 and 3 deposit takers are considered higher risk.
[7] Moral hazard risk exists due to reduced market discipline from insured depositors, who no longer have incentives to monitor their bank's behaviour. Or otherwise, depositors actively seek higher yield through riskier deposit takers given the reduced downside risk.

Policy changes	Impact on risk	Impact on capital requirements
	borrowing that deposit takers can do thus lowering the amplitude of the cycle peak.	therefore need to be careful not to double count the impacts Macroprudential tools, like the DTI, are for addressing specific risks or finetuning the risk reduction done by capital requirements – not replacing it. For example, DTIs only impact the flow of new lending during a period of low interest rates and high house prices. The impact on the overall stock of lending, which is where the main risk is due to the size of the stock of lending relative to the flow, is limited. But capital requirements provide the financial system protection for both the flow and stock of lending.
More intensive supervision	Prior to 2019, RBNZ had relatively low levels of supervision. Since 2019, RBNZ has adopted a more intensive supervisory framework. Which includes elements like increased on-site inspections and engagement. More intensive supervision lowers the risk of individual deposit takers failure by promoting compliance with regulation and assessing if they are operating prudently. By lowering the probability of an individual deposit taker's failure, it also helps lower the risk to the overall system – if each individual deposit taker is more secure and resilient then there should be lower chance of a deposit taker failing and damaging the rest of the system.	Could support slightly lower capital requirements – but it is complex to quantify. The uplift in the intensity of supervision is larger for the smaller deposit takers (as the larger deposit takers already had more developed internal risk management, higher supervision requirements from us and from APRA via their parent banks). Therefore, we don't expect a large impact at the system level given the relative market share of Group 1 deposit takers. More intensive supervision doesn't automatically suggest that capital requirements should be less stringent. Capital and supervision are partly complementary rather than directly substitutable. This is because, supervision promotes deposit takers' compliance with regulation and assesses if they are operating prudently. Whereas capital requirements ensure the system is safer by providing higher protection against losses. This is partly about known versus unknown risks. More intensive supervision will help identify risks sooner and resolve them with lower chance of individual deposit taker failure. Capital buffers can also help to mitigate these known risks but can also be used to absorb losses from unexpected events and help protect the financial system. For example, if the dairy industry suffered an outbreak of bovine spongiform encephalopathy (AKA mad cow disease) and must cull their herds. Then capital provides deposit takers loss absorbing capacity for potential losses in the agricultural lending portfolios.

Policy changes	Impact on risk	Impact on capital requirements
Deposit Takers Act (DTA) changes	As part of the DTA processes we are updating parts of our prudential and crisis management frameworks to help address inadequacies or outdated parts of the current regulations. These changes help lift our risk management in other areas to be more in line with our capital risk tolerance. For example, a new set of prudential standards to uplift each entity's risk management capability helps improve each entity's resilience to both financial and operational risks. Cumulatively these changes should lower the risk of individual deposit takers and the overall system. If each individual deposit taker is more secure and resilient then there should be lower chance of a deposit taker failing and damaging the rest of the system.	Likely supports slightly lower capital requirements. However, we have not yet completed the DTA Regulatory Impact Assessment. Therefore, we cannot yet fully or quantitatively assess the cumulative impact of these changes. Or what these changes will mean for the capital required The DTA changes do not automatically suggest that we should have less stringent capital requirements. Capital helps ensure that deposit takers remain solvent. However, there are other risks than becoming insolvent that the DTA changes are looking to address. For example, capital provides buffers to prevent failure, and this is accompanied by other prudential standards for entities to manage the risks of failure financially and operationally.
Enhanced stress testing	Since 2019 we have introduced a more intensive stress testing regime. Stress tests assess deposit takers against defined stress scenarios and help us identify both system risks and risk in individual deposit takers.	No change There is no automatic link between stress tests and capital. Stress test results are limited to the specific scenario being tested. They are also sensitive to underlying assumptions and it is difficult to capture the real-world complexities of a financial crisis. Therefore, a given stress scenario will not capture all possible risks facing the banking system.
Strengthening of the Credit Contracts and Consumer Finance Act (CCCFA), overseen by MBIE	An updated and strengthened version of the CCCFA was released in 2021 with stricter rules for lenders before issuing credit. However, many of the stricter rules have since been wound back. The current rules are stricter than in 2019, but the stricter sections are mainly focused on high-interest lending, which does not make up a large share of the overall financial system.	No change If the stricter rules from 2021 remained in place there may have been an argument that we could reduce capital. But more work would be needed to assess this. However, many parts of the 2021 CCCFA updates have since been rolled back. For the largest product lines (residential lending, etc) these are similar to where they were in 2019. So, the CCCFA changes should not impact our capital settings.

How has the macro environment changed since 2019?

Financial stability risks stemming from the macroeconomic environment have generally increased since 2019, based on a review of recent key themes from Financial Stability Reports (FSRs). Key

global trends such as rising geopolitical tension and protectionist sentiments have contributed to more frequent shocks, including armed conflicts and tariffs. Increased fiscal sustainability risks in the major economies and other structural changes have made financial markets more volatile. The domestic macroeconomic risk environment has been more stable, but salient risks remain.

Table 5: Assessment of how the macro environment has changed since 2019

Variable/Risk	Assessment
Geopolitics/conflict	Geopolitical risks have increased from 2019, reflecting an intensifying pattern of conflicts including in Ukraine and the Middle East, tensions between the major powers, and the erosion of international rules and norms (see November 2024 FSR). This is reflected in surveys, such as the Bank of England's Systemic Risk Survey. These risk drivers appear likely to remain for some time. Geopolitical risks also contribute to cyber risks, including for banks' customers and counterparties. We are highly exposed to geopolitical risks as a small open economy highly reliant on maritime trade, overseas funding, and migration.
Trade policy	Risks from trade tensions have risen, driven by geopolitics and protectionist sentiment in some economies. International trade frameworks have been undermined over time, as countries pursue narrow national interests at the expense of cooperation. This has resulted in sweeping US tariff announcements in early 2025, and retaliatory measures by China and other countries (see May 2025 FSR). New Zealand is exposed to trade conflicts as we depend on external demand from all major trading economies.
Covid-19 / black swan events	We have increased our understanding of tail risks through regulatory stress tests, including global pandemic risks. In hindsight, the underlying tail risk distribution appears more negative than we had considered in 2019. However, should another pandemic occur, we should be better prepared owing to the recent experience. We are now more cognisant of how these risks may interact with other variables such as social cohesion and geopolitics (see our 2020 COVID-19 Stress Test).
Climate risk	Climate risks have continued to increase since 2019. Rising physical risk is evidenced by the escalating cost of natural disasters, record global emissions, and deterioration to natural assets vital for tourism in New Zealand. Transition risks remain high, with some states and corporations retreating from climate-related commitments. Increases in insurance and reinsurance costs also pose greater credit risk. However, we have increased our understanding of climate risks, including through a climate stress test for banks (see our 2023 Climate Stress Test and Box C in November 2022 FSR).

Financial asset valuations	Concerns persist about financial asset valuations. Previous low interest rates, upbeat economic performance and increased private credit in the US has led to strong growth in equity prices. However, structural concerns around global growth have raised questions around the extent of asset overvaluation, relative to fundamentals. Moreover, fiscal sustainability risks in the major economies have the potential to trigger market turbulence, undermine investor confidence and raise risk premiums. These fiscal concerns appear more pressing relative to 2019.
Domestic macro risk environment	Housing market risks appear to have eased on a through-the-cycle basis. Cyclically, housing demand remains subdued following a period of high interest rates and low migration, restraining housing credit growth at present. However, there are also structural factors limiting the risks of a house price correction. Government policy changes since 2019 have aimed to increase residential land supply, allow for greater densification, and improve infrastructure provision. If successful, greater supply responsiveness to price changes would moderate the extremes in future house price cycles. Agriculture sector risks have edged upwards on a structural basis. In the short-term, agriculture sector conditions have improved owing to high dairy and beef prices and declining interest rates. However, through-the-cycle risks have increased owing to heightened geopolitical tension, trade policy uncertainty and geoeconomic fragmentation. Trade concentration risks remain, around the reliance on China as our largest export market. These reflect the sensitivity of the agriculture sector to external demand.

Are there any implications from 2023 banking turmoil?

Table 6: Implications from the 2023 banking turmoil

International event	What happened	Lessons for New Zealand
2023 Credit Suisse crisis[8]	Credit Suisse experienced an acute crisis of confidence. It caused high level of withdrawals of client funds and heightened the risk of immediate insolvency in mid-March 2023. The Swiss Financial Regulator (FINMA) instructed Credit Suisse to completely write down its AT1 based on extraordinary government support	Our current AT1 and Tier 2 does not have a convertibility feature. This limits our options in responding to a crisis. If a convertible and write-down features are added into Tier 2 or additional LAC, careful consideration

[8] For further details, please see these webpages.
https://www.efd.admin.ch/en/credit-suisse-en#Fact-sheets
https://www.finma.ch/en/news/2023/03/20230323-mm-at1-kapitalinstrumente/
https://www.finma.ch/en/news/2023/12/20231219-mm-cs-bericht/

International event	What happened	Lessons for New Zealand
	being granted, as specified in the AT1 contractual terms. Given the treatment of CET1 equity, it was seen reversing the normal claims order. While Credit Suisse had a resolution strategy based on bail-in, the Swiss authorities ultimately chose to facilitate a commercial merger of Credit Suisse and UBS rather than a formal resolution.	should be given to the contractual terms The departure from the planned resolution strategy highlights the importance of flexibility in crisis management frameworks, as well as the highly complex – and untested – nature of a full bail-in strategy. This suggests that we should not solely rely on LAC for crisis management and should not be trading off too much CET1 buffer in order to introduce LAC.
2023 US bank failures	A key factor was unrealised losses in the banking book. For Silicon Valley Bank this was mainly in bonds that had lost value due to interest rate increases. For First Republic Bank it was a combination of securities and loans that had lost value.	New Zealand already has a Pillar 1 capital requirement for interest rate risk in the banking book. So unlike US banks, all New Zealand deposit takers hold capital against this risk. The failure of First Republic also highlights the importance of adequate capitalisation in maintaining depositor confidence. This suggests that, if we introduce LAC, requirements should be set such that there is sufficient LAC to adequately recapitalise a deposit taker.

Appendix 2 – International benchmarking

Internal analysis on how our capital requirements compare

Alongside the work by Oliver Wyman (which is not quite complete, but discussed in the main text), we have used data from bank Disclosure Statements and Pillar 3 Disclosures to compare capital ratios, risk weights, and 'capital coverage' ratios for Group 1 deposit takers against a selection of large banks from Australia, Canada, Europe, and Singapore.

New Zealand banks have fairly typical CET1 ratios, but amongst the lowest reported total capital and TLAC ratios in our sample. Total capital and TLAC ratios are generally highest in Europe. But these ratios partly reflect our relatively strict approach to things like risk weights.

To measure this, we calculate capital coverage ratios by multiplying capital ratios by the average risk weight that banks apply to mortgage and corporate lending. We do this calculation using the reported CET1, total capital, and TLAC ratio for each bank. The coverage ratio shows how much of each type of capital and loss absorbing instruments that banks have against their mortgage and corporate exposures.

The benefit of this approach is that we can compare capital levels between countries with tougher risk weights but relatively low capital requirements, and countries with lower risk weights that are offset by higher requirements and/or additional buffers. However, a limitation of this analysis is that it doesn't distinguish whether higher capital coverage reflects higher underlying risks or a lower regulatory risk appetite.

New Zealand banks currently have relatively high amounts of CET1 and total capital for their mortgage and corporate exposures. Although current capital and TLAC ratios are comparably low in New Zealand, risk weights for residential mortgage and corporate lending are high.

The table below summarises how New Zealand banks compare to the rest of the sample. Note that this is based on banks' current capital ratios and requirements, not the requirements once the 2019 Capital Review decisions are fully implemented in 2028.

Table 7: Internal analysis on how New Zealand banks compare internationally

	New Zealand median	Australian median	Sample median
Headline ratios			
CET1	13.3%	12.1%	14.9%
Total capital	16.6%	20.9%	19.8%
TLAC	16.6%	20.9%	28.6%
Average risk weights			
Mortgage exposures	33.3%	24.2%	17.7%
Corporate exposures	71.4%	52.2%	53.3%

	New Zealand median	Australian median	Sample median
Mortgage coverage ratios			
CET1	4.38%	2.92%	3.02%
Total capital	5.44%	5.04%	4.04%
TLAC	5.44%	5.04%	4.87%
Corporate coverage ratios			
CET1	9.63%	6.32%	7.68%
Total capital	11.9%	10.9%	10.4%
TLAC	11.9%	10.9%	12.7%

As an example, NZ's 4.38% CET1 mortgage coverage ratio means NZ banks hold 4.38 cents of capital for each dollar of mortgage lending. New Zealand banks have among the highest amount of CET1 capital for their mortgage exposures. Figure 2 shows that the CET1 mortgage coverage ratio is above the sample median for all New Zealand banks. Other countries with high CET1 capital for mortgage exposures include Ireland, Austria, and Norway, where risk weights for mortgage lending are also relatively high.

Banks that have less CET1 capital against their mortgage exposures – including those in other European countries and Singapore – tend to offset higher overall CET1 ratios with much lower mortgage risk weights. Australian banks have significantly less CET1 capital for their mortgage exposures, more in line with the sample median.

CET1 capital for corporate exposures is also high in countries with higher corporate risk weights, including New Zealand, Ireland, Austria, and Singapore. Corporate CET1 coverage ratios for all New Zealand banks are above the sample median despite relatively low headline CET1 ratios. Banks in Sweden and Denmark with high CET1 ratios have the least amount of CET1 capital for corporate exposures due to particularly low corporate risk weights. Australian banks also have at- or- below-average corporate risk weights, which gives relatively low CET1 for corporate exposures when combined with low CET1 ratios.

Because we don't apply additional LAC requirements beyond capital at present, the TLAC required per $ of mortgage in NZ is much more internationally standard and well below that for some of the sample banks (Figure 3).

Figure 2: CET1 coverage for mortgage exposures

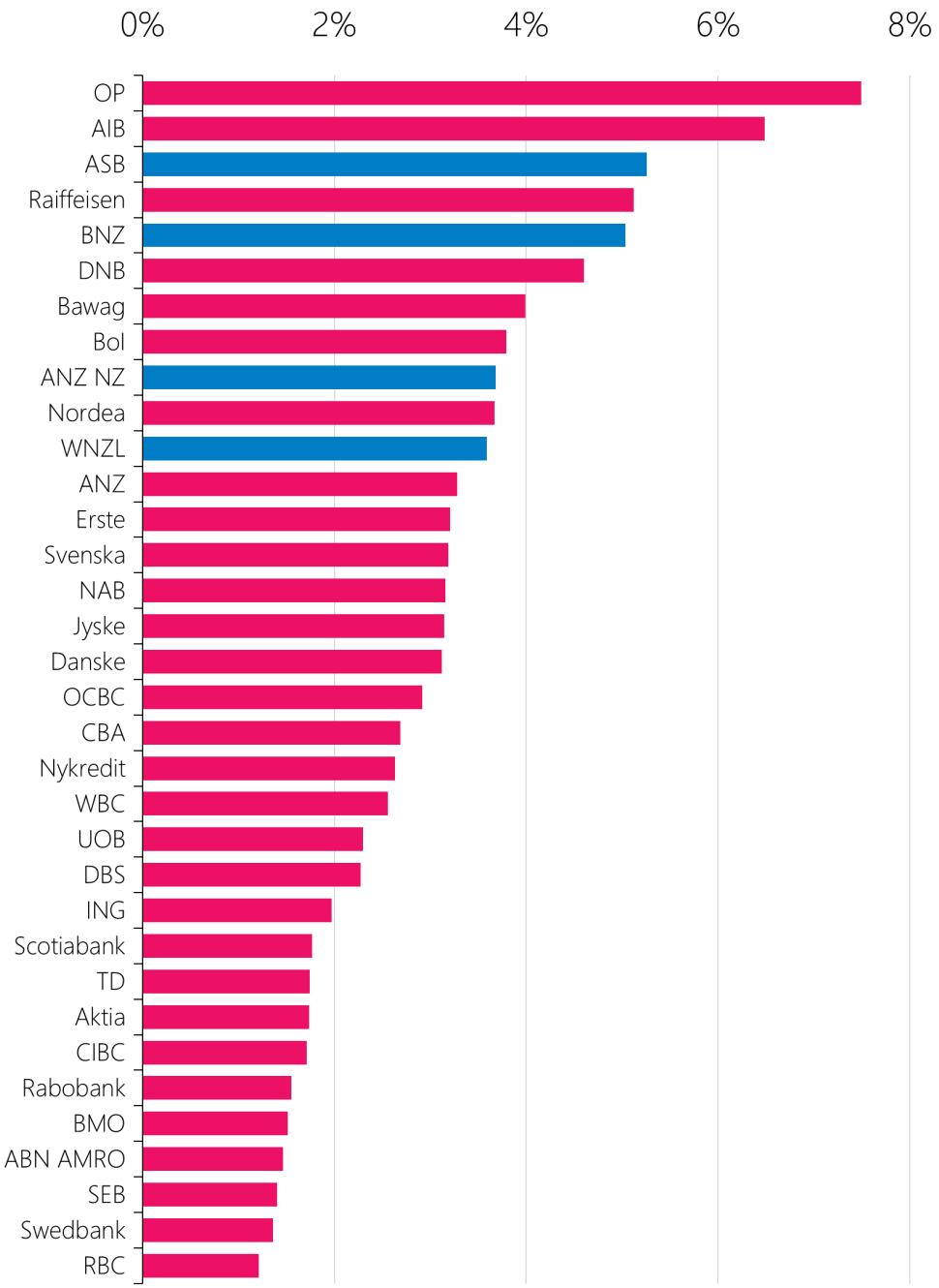
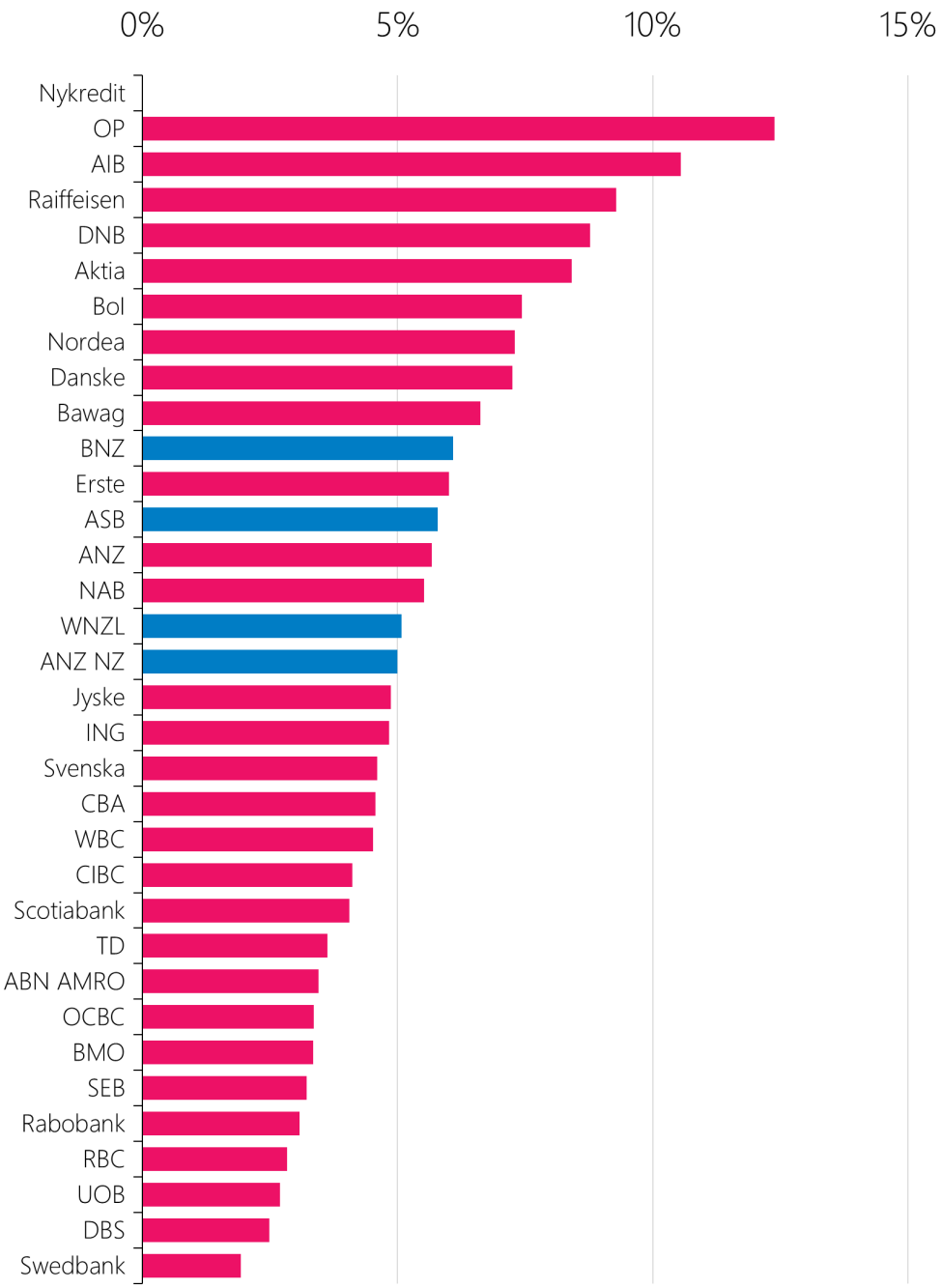


Figure 3: TLAC coverage for mortgage exposures

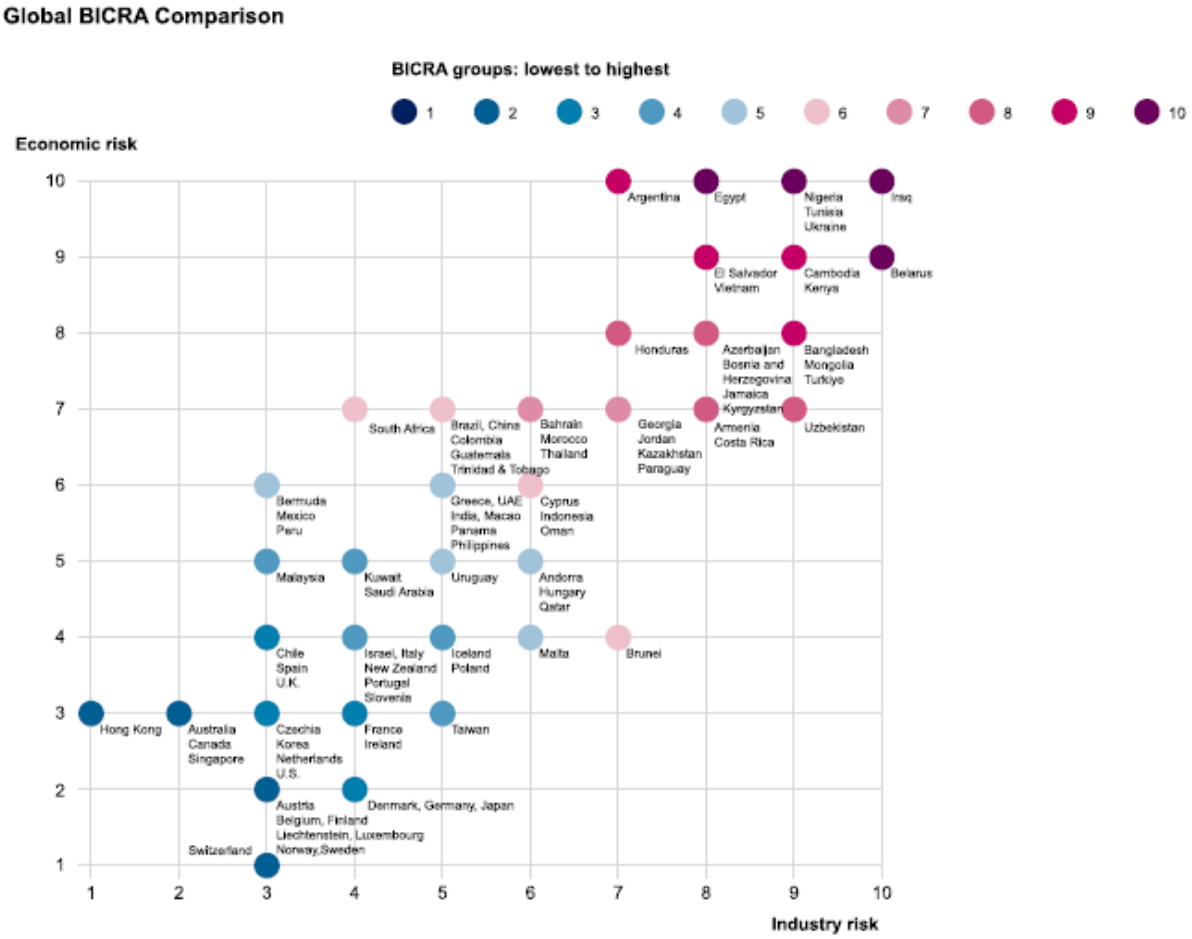


How should we compare

As well as considering how our capital settings compare, we must also consider how they should compare, given the risks we face. S&P Global Ratings produce an annual Banking Industry Country Risk Assessment. For New Zealand, it flags our strengths as a wealthy, open, resilient economy with a stable banking system with strong earnings. However, it flags our key risks as economic imbalances and a banking system materially reliant on external borrowing.

Figure 4 below shows that S&P consider New Zealand to have slightly higher industry risk than countries like the UK, slightly higher economic risk than countries like Ireland – and higher risk against both categories than countries like Australia, Canada and Singapore.

Figure 4: S&P Global Ratings Banking Industry Country Risk Assessment, 2025



Source:S&P Global Ratings.

Appendix 3 – More granular standardised risk weights

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 lending.
- The **internal ratings-based** (**IRB**) approach, where banks accredited by the RBNZ 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 the feedback on the DTA capital standard consultation and submissions to the FEC's inquiry into banking competition, Group 1 and 2 deposit takers highlighted that the RBNZ'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 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.

Proposed changes to standardised risk weights

We propose to consult on five key changes to standardised risk weights, which will increase granularity and aim to better align the risk weights with the actual risk of the lending. The changes proposed include residential mortgages, corporate, agriculture, and commercial property lending, as well as lending to Community Housing Providers/housing co-operatives and whenua Māori. Details such as definitions will be consulted on as part of the Capital Standard.

The evidence we have reviewed so far supports this, and we intend to seek further evidence through the consultation to fill in any existing gaps in our analysis that may be present due to data limitations.

Residential mortgages

Under the current standardised approach, all residential mortgage lending (**RML**) that falls within the same lending category[9] and has an LVR of 80 or under must use the same risk weight. We propose introducing two new categories for lower risk RML: one for RML with an LVR of 50 or under, and one for RML with an LVR of 50.01 – 60. Table 8 shows our proposed changes in risk weights for these categories.

Table 8: Current and proposed RML standardised risk weights by LVR

Type of lending	Current standardised risk weight (%)	Proposed standardised risk weight (%)
Owner-occupier with LVR ≤50 NEW	35	25
Owner-occupier with LVR 50.01 – 60 NEW	35	30
Owner-occupier with LVR 60.01 – 80	35	35
Owner-occupier with LVR 80.01 – 90 (no LMI)	50	50
Owner-occupier with LVR 90.01 – 100 (no LMI)	75	75
Owner-occupier with LVR > 100 (no LMI)	100	100
Investor with LVR ≤50 NEW	40	30
Investor with LVR 50.01 – 60 NEW	40	35
Investor with LVR 60.01 – 80	40	40
Investor with LVR 80.01 – 90 (no LMI)	70	70
Investor with LVR 90.01 – 100 (no LMI)	90	90
Investor with LVR > 100 (no LMI)	100	100

In addition, we propose aligning RBNZ past-due and impaired RML standardised risk weights more closely with APRA and Basel III's (generally) higher standardised risk weights for these categories. The main differences in these risk weights would be that:

[9] There are different categories for non-property investment and property investment loans, and distinctions for lending with and without Lender's Mortgage Insurance (**LMI**).

- Owner-occupied RML with LMI moves from its corresponding LVR-based risk weight in Table 8 (ranging from 35% - 100%) to 80%
- Investor RML with LMI moves from its corresponding LVR-based risk weight in Table 8 (ranging from 40% - 100%) to 95%
- Owner-occupied RML with LMI remains at 100%, but investor RML with LMI increases from 100% to 120%

In effect, this would make very little difference to the overall RWAs, and therefore capital levels, of deposit takers (around 0.2 percentage points) as the proportion of lending in these categories is very low. However, it would mean that these higher risk lending categories have a generally higher risk weight assigned to them which is more aligned with the actual risk of the lending. As with all our proposed changes to standardised risk weights, we intend to consult on this change with deposit takers.

Introducing more granular risk weights for both lower and higher risk RML is supported by evidence from previous RBNZ stress tests. The following figures show mortgage default rates and loss-given-defaults (LGDs) for each of the 2021 and 2022 RBNZ bank solvency stress tests[10].

[10] The 2022 bank solvency stress test is the most recent banking industry stress test that RBNZ has conducted which is useful for this type of analysis. We have included 2021 results as a check against idiosyncratic stress that may have been evident in certain sectors due to the type of scenario used. The 2023 solvency stress test was desk-based only and in 2024 we conducted a reverse stress test instead. We are awaiting the results of the 2025 bank solvency stress test, which will be received around the same time as the capital review consultation closes, at which time we can update this analysis with the most recent results.

Figure 5: 2021 Bank solvency stress test mortgage default rates by LVR

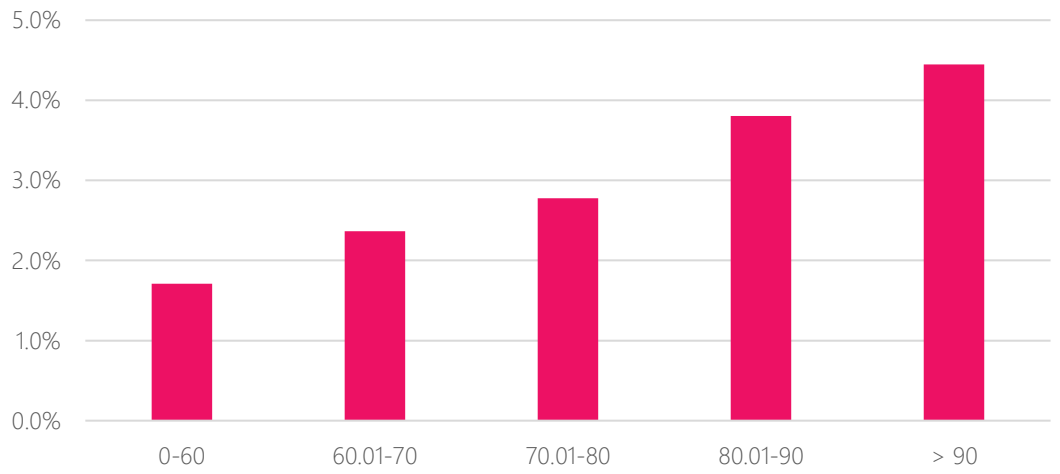


Figure 6: 2021 Bank solvency stress test mortgage loss-given-default by LVR

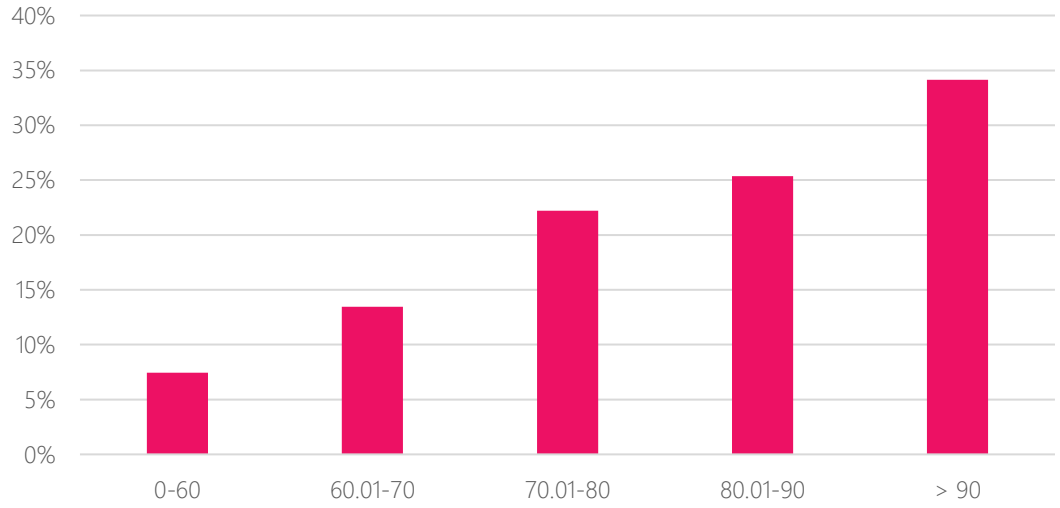


Figure 7: 2022 Bank solvency stress test mortgage default rates by LVR

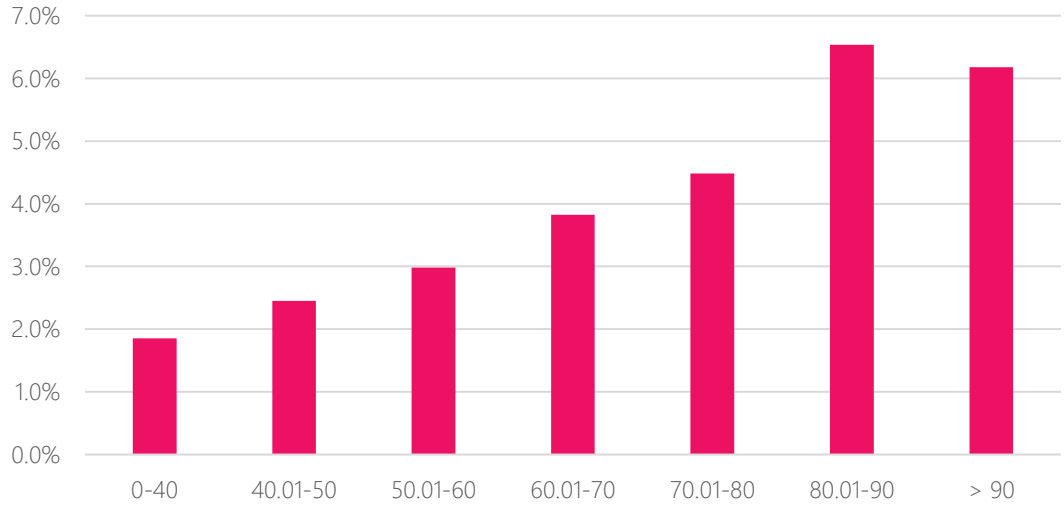
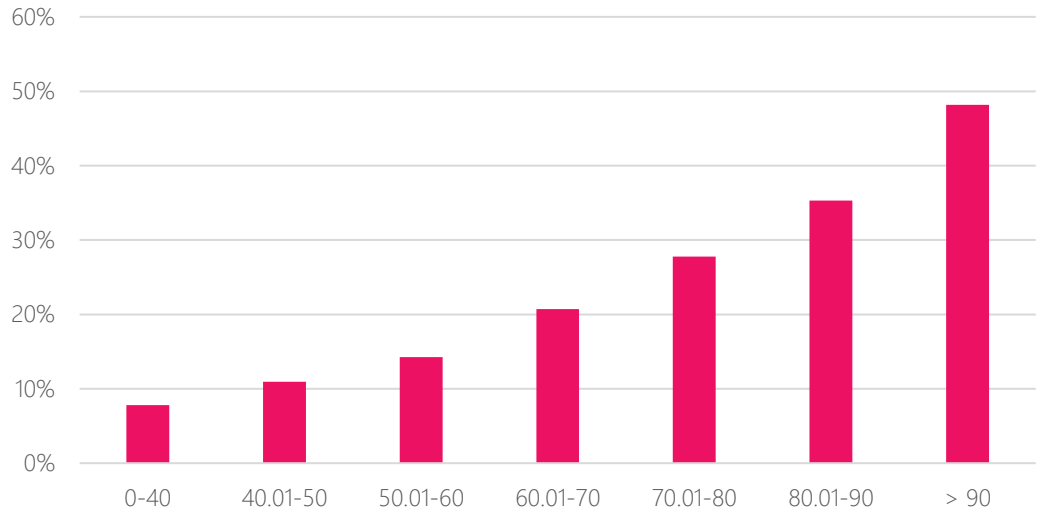


Figure 8: 2022 Bank solvency stress test mortgage loss-given-default by LVR



These results show that during periods of stress, default rates and loss-given-defaults on RML with an LVR of 80 or higher can more than double in comparison to RML with an LVR of 60 or under. Therefore, these results support splitting RML with LVRs of less than or equal to 80 into more granular risk weight categories to allow flexibility to more accurately reflect the relative risk of the lending, particularly for lending with an LVR of 60 of under. The results also support maintaining our current higher risk weights for riskier lending with an LVR of 80 or above, given the increased levels of defaults and LGDs shown for high-LVR RML.

The new categories outlined in Table 8 above would introduce additional granularity into our standardised risk weight approach and allow flexibility to assign risk weights which more accurately reflect the lower underlying risk of different types of lending (i.e., more flexibility in assigning lower risk weights to the lower risk ends of low-LVR lending) while maintaining our higher risk weights for riskier high-LVR lending and increasing risk weights for past-due/impaired lending, bringing us more in line with international (i.e., APRA and Basel III) approaches to standardised risk weights.

Corporate

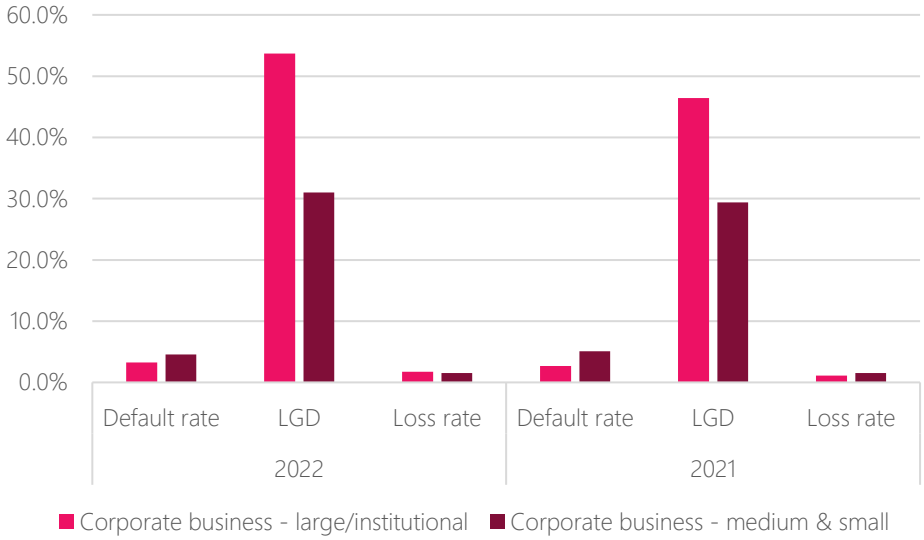
Under the current standardised approach, all corporate lending without a credit rating is assigned the same risk weight (100%). This is likely to capture all SME retail and corporate lending as it is generally not cost-effective or a net benefit for SMEs to seek and maintain a credit rating.

In order to introduce more granularity into corporate lending, we therefore propose introducing two new exposure categories to align the risk weights for SME lending in NZ with APRA's. The two new categories would be SME retail and SME corporate, with a risk weight of 75% and 85% respectively.

Previous stress tests have shown that the loss rates for SMEs are likely to be less volatile under stress than for large corporates; even if SMEs might be more likely to default, their losses are expected to be smaller than large corporates' given the relative size of each of these exposures and levels of security coverage.

The following figure shows the default rates, loss-given-defaults and loss rates for large corporates and SMEs in each of the 2021 and 2022 RBNZ bank solvency stress tests.

Figure 9: 2021 & 2022 Bank solvency stress test results for SME & large corporate lending



The results show that during periods of stress, while SMEs appear to have a slightly higher default rate than large corporate exposures, the LGD for large corporates tends to be significantly higher than for SMEs. This indicates that lenders expect to be unable to recover a much larger share of their large corporate lending, comparative to SME lending, should these exposures default. The loss rates – which show how much the lenders expect to lose across each lending portfolio during such stress events – remain consistent for SME lending across both stress tests (1.5%), while for large corporates they range between 1.1 – 1.8%. We believe these results support introducing granularity in corporate lending by creating separate risk weight categories for SMEs.

Agriculture

Currently, under the standardised approach, agricultural lending is likely captured under unrated corporate lending as, like SMEs, it is unlikely that they have pursued a credit rating due to the cost and barriers involved. This means that all agricultural lending likely receives the same risk weight (100%) regardless of how risky the underlying lending is.

We propose introducing three new exposure categories for agricultural lending, to enable lenders using the standardised approach to assign risk weights based on the LVR and therefore ensure the risk weights more accurately reflect the actual riskiness of this type of lending.

We have calibrated the proposed risk weights by considering the existing risk weights that the IRB banks apply to agricultural lending across the LVR buckets.[11] Table 9 shows the comparison between the average IRB risk weight assigned to each of the LVR buckets and our proposed standardised risk weights.

[11] Only three of the four IRB banks supplied the IRB risk weights that they apply to the different agricultural lending LVR buckets, so we have used the average IRB risk weights of these three only – the fourth IRB bank only provided the standardised risk weights they use for this lending.

Table 9: Simple & weighted-average IRB risk weights used by NZ IRB banks for agricultural lending & proposed standardised risk weights

LVR	Simple average	Weighted average	Proposed risk weight
LVR =<30	23.5%	21.7%	**50%**
LVR >30 to 50	42.2%	41.8%	**75%**
LVR > 50	92.5%	92.1%	**100%**

We have chosen to keep the proposed standardised risk weights above the average of the IRB risk weights for several reasons. The IRB banks vary widely in the risk weights they apply to each type of lending, ranging from 17% - 130% depending on the LVR, with the ranges spanning around 20 to 70 percentage points within each bucket. In addition, standardised risk weights are generally calibrated at a more conservative level than IRB as they tend to be less precise than IRB risk weights (which can be calibrated to a wider range of bank, borrower and portfolio risk characteristics).

Introducing more granularity into corporate lending via additional agricultural exposure categories is also supported by evidence from previous RBNZ bank solvency stress tests, which show that overall agricultural lending can be less risky than other types of corporate lending during periods of stress.

We would need to carefully define the 'value' for the LVR calculations to provide consistency with how value is currently calculated in IRB modelling of agricultural risk weights. For example, IRB banks must generally 'scale' down the value of security, to reflect uncertainty about what value is like to be recovered. We intend to apply similar considerations for the standardised proposals.

Figure 10: 2021/2022 Bank solvency stress test average loss rate by lending sector

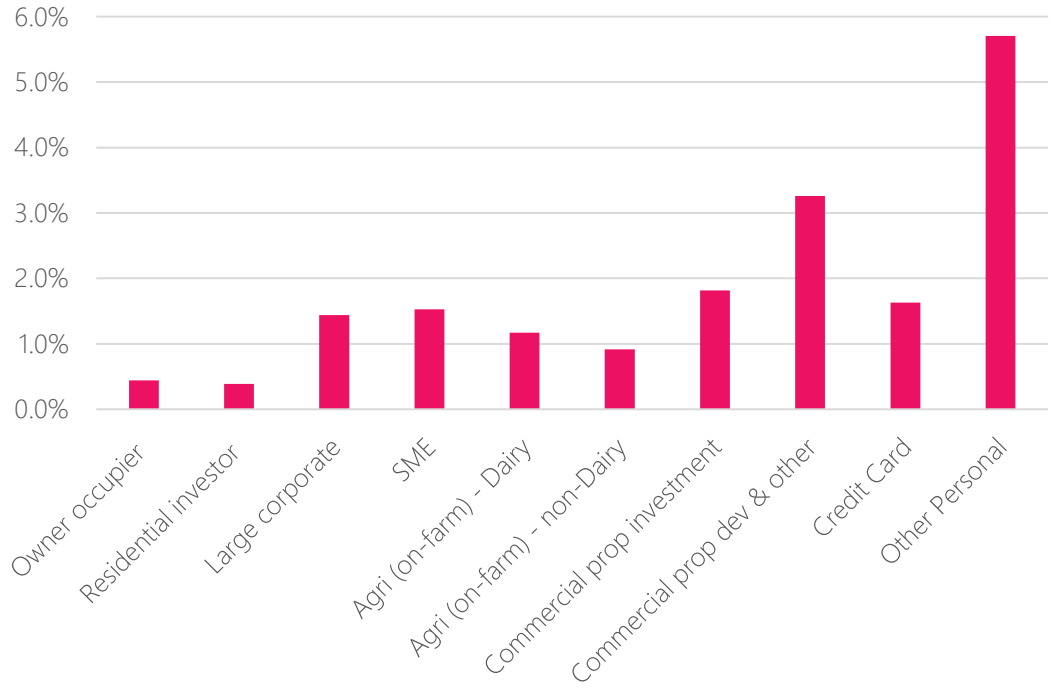
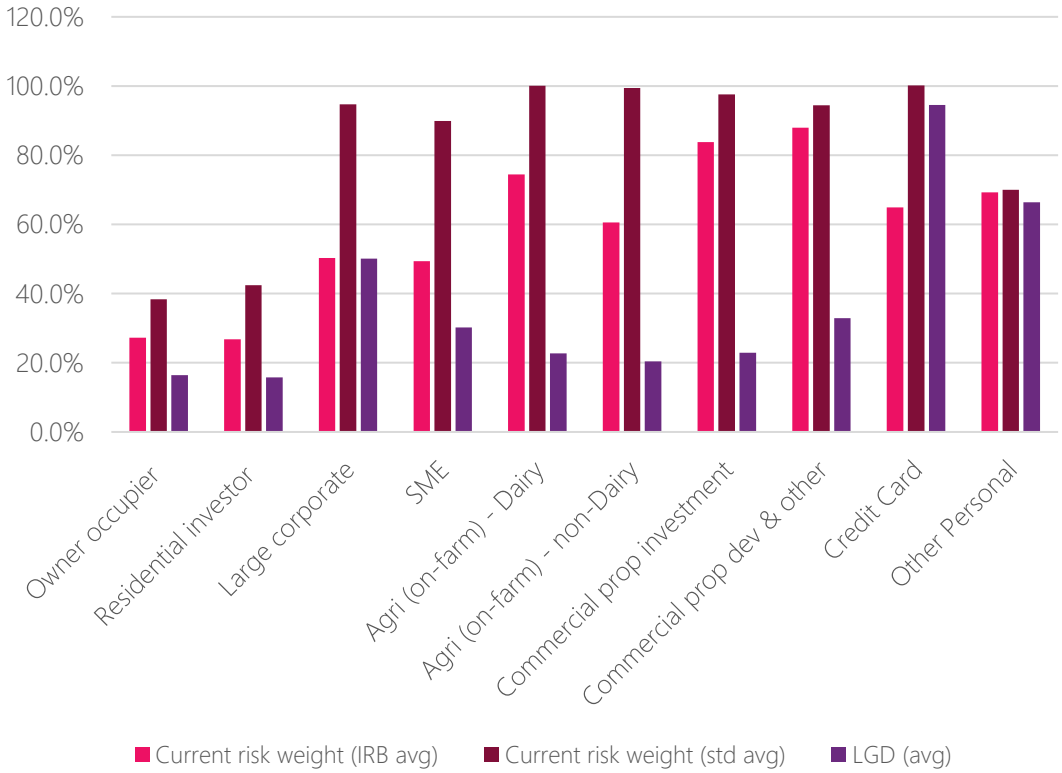


Figure 11: 2021/2022 Bank solvency stress test average LGD & current risk weights by lending sector



Figures 10 and 11 show that during the periods of stress the expected the average loss rate and LGD for agricultural lending was lower than that of other types of corporate lending in both the 2021 and 2022 bank solvency stress tests. Figure 11 also shows that the standardised risk weights

currently applied to agricultural lending may be disproportionately high, given the underlying risk implied by these results comparative to some of the other types of lending.

However, we do not have a breakdown of the stress test results for agricultural lending by LVR to be able to go into further detail or more accurately calibrate the risk weights to that more granular level.

Commercial property & personal lending

Figures 10 and 11 also show that there are types of lending that may have elevated risks compared to others. The stress test results show that lenders expect significantly higher losses for aspects of commercial property and unsecured personal lending than most other types of lending. Therefore, there is potentially scope to add more granular, higher risk weights for these types of lending in order to more accurately reflect their comparative inherent riskiness.

Currently, commercial property exposures are captured as part of corporate lending, which means risk weights are assigned according to whether they have a credit rating (and, if so, what that credit rating is). Therefore, it is likely that there are unrated SME providers of commercial property which could be captured in our proposed lower risk weights for SMEs - this would likely result in lenders underweighting the underlying risk of this type of lending. As a result, we would propose creating a new category (or categories) explicitly for commercial property exposures to allow lenders to more accurately risk weight the lending according to the comparatively higher risk it presents. We believe a starting point of a 100% risk weight could be appropriate to accurately reflect this risk, but we need more detailed data to be able to assess the appropriateness and potential impact of such a change.

Personal lending is captured under 'other' exposures and already has quite high risk weights assigned at both standardised banks and at Group 3 deposit takers. We believe there could be scope to move the banks' risk weights even higher to more closely align with those applied by Group 3 deposit takers. This would likely make very little difference to RWAs, and therefore capital levels, as banks tend to have minimal personal lending exposures. In addition, Group 3 lenders are considerably more exposed to this type of lending than Groups 1 and 2 so their higher comparative risk weights could be justified from this perspective.

We have very limited detailed data on commercial property and personal lending, meaning it is difficult to assess any potential impacts from changing their risk weights or introducing additional granularity via new exposure categories. As a result, we believe the best way to analyse any potential impacts of such changes would be to ask for more information from lenders about their exposures to these categories and the risk weights they apply via the consultation process.

Summary of potential impacts of changes to standardised risk weights on each deposit taker group

Overall impact on banking sector – Group 1 & 2 combined

Table 10 shows the total estimated impact of introducing the proposed standardised risk weights across New Zealand's Group 1 and 2 banks combined.

Table 10: Overall impact of introducing the proposed standardised risk weights on Group 1 & 2 banks

	June 2024 (actual)	Corporate risk weights	RML risk weights	Agri risk weights	RML + Corporate + Agri
Capital $m	60,205	60,205	60,205	60,205	60,205
RWA $m	377,677	373,817	366,392	371,344	356,198
% change in RWA		-1.0	-3.0	-1.7	-5.7
Total Capital Ratio %	15.9	16.1	16.4	16.2	16.9
Capital required at 18%	67,982	67,287	65,951	66,842	64,116
TCR required to keep overall capital unchanged %		18.2	18.6	18.3	19.1

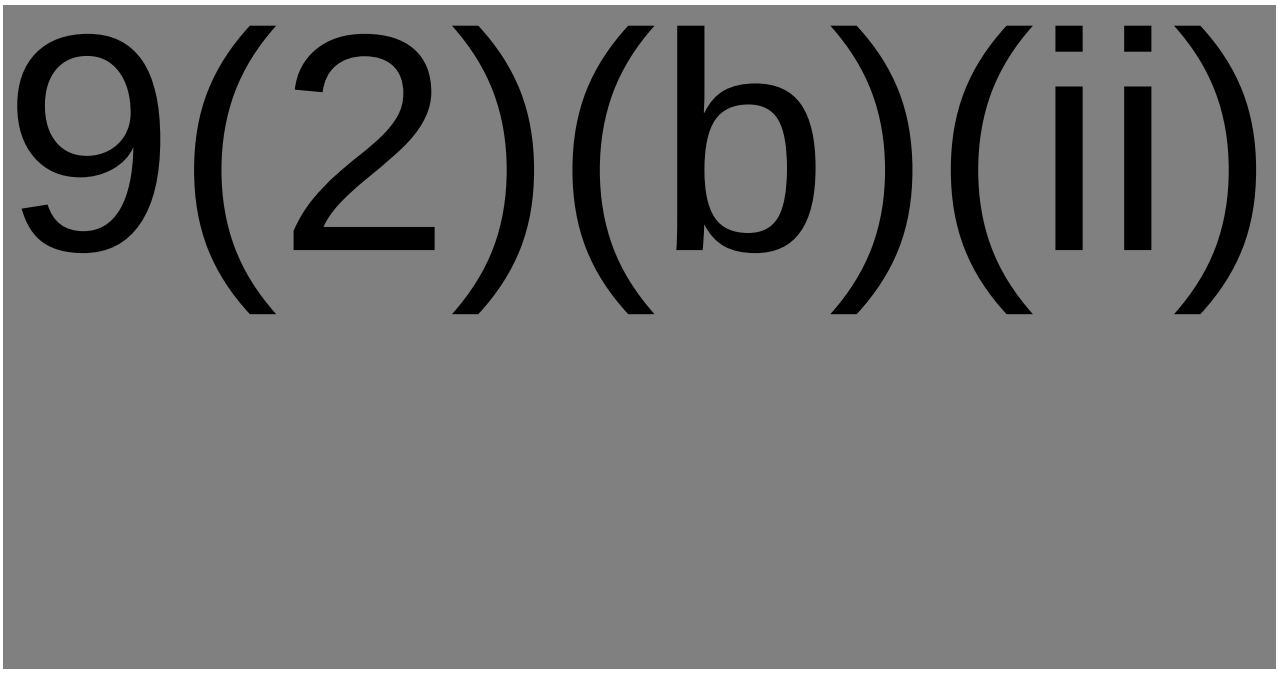
Figure 12 illustrates the impact on Group 1 and 2 banks' total capital ratios (TCRs) if we were to move from our current standardised risk weights to the risk weights proposed above. The total capital ratio refers to the amount of capital that a deposit taker must have in relation to its risk-weighted exposures and is calculated using a deposit taker's total capital divided by its RWAs. Current requirements mean the TCR must be at least 18% for Domestic Systemically Important Banks (the four Group 1 deposit takers) by 2028.

Capital ratios are 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. However, in this analysis, the relatively higher TCR associated with the proposed standardised risk weights does not indicate greater financial strength but is rather a result of the reduction in RWAs (the denominator) while holding current capital levels constant.

Figure 12: Banks' total capital ratios under current vs. proposed standardised risk weights

Table 10 and Figure 12 above show that changing from our current standardised risk weights for residential mortgage, corporate and agriculture lending to our proposed new risk weights could reduce banks' overall RWAs by around 5.7%. This means that banks would face a lower overall capital requirement compared to if the 2019 Capital Review were to be fully implemented in 2028, thereby allowing banks to reach the minimum TCR required much more quickly under the new risk weights than they would under the status quo.

This is further illustrated in Figure 13 below, which shows banks such as 9(2)(b)(ii) (which is the most extreme example), reaching the 18% TCR requirement more quickly under the proposed risk weights than the current status quo.



These results indicate that a trade-off exists between using lower, more granular risk weights – allowing us to be more responsive to the real risk posed by different types of lending – and overall

financial stability, as the RWAs, and therefore the overall capital, that banks would currently be required to have by 2028 would be lower using our proposed standardised risk weights compared to the current risk weights. Therefore, implementing the lower, more granular risk weights, in the absence of other changes, would mean accepting a comparatively higher likelihood of a financial crisis compared with the capital levels set in the 2019 Capital Review.

Group 1

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 proposal will reduce average standardised risk weights, the outcome for IRB banks will also reduce, as 85% of the standardised outcome will now be 85% of 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.

Table 11 summarises the estimated impact of introducing the proposed standardised risk weights on Group 1 banks.

Table 11: Impact of introducing the proposed standardised risk weights on Group 1 banks

	June 2024 (actual)	Corporate risk weights	RML risk weights	Agri risk weights	RML + Corporate + Agri
Capital $m	52,593	52,593	52,593	52,593	52,593
RWA $m	328,083	326,860	318,209	323,100	312,003
% change in RWA		-0.4	-3.0	-1.5	-4.9
Total Capital Ratio %	16.0	16.1	16.5	16.3	16.9
Capital required at 18%	59,055	58,835	57,278	58,158	56,161
TCR required to keep overall capital unchanged %		18.1	18.6	18.3	18.9

Table 11 shows that changing from our current standardised risk weights for residential mortgage, corporate and agriculture lending to our proposed new risk weights could reduce Group 1 banks' overall RWAs by around 4.9%. This means that Group 1 banks would face a lower overall capital requirement compared to if the 2019 Capital Review were to be fully implemented in 2028, thereby

allowing Group 1 banks to reach the TCR required much more quickly under the new risk weights than they would under the status quo.

Group 2

Table 12 summarises the estimated impact of introducing the proposed standardised risk weights on Group 2 banks.

Table 12: Impact of introducing the proposed standardised risk weights on Group 2 banks

	June 2024 (actual)	Corporate risk weights	RML risk weights	Agri risk weights	RML + Corporate + Agri
Capital $m	7,612	7,612	7,612	7,612	7,612
RWA $m	49,594	46,956	48,183	48,244	44,195
% change in RWA		-5.3	-2.8	-2.7	-10.9
Total Capital Ratio %	15.3	16.2	15.8	15.8	17.2
Capital required at 18%	8,927	8,452	8,673	8,684	7,955
TCR required to keep overall capital unchanged %		19.0	18.5	18.5	20.2

Table 12 shows that changing from our current standardised risk weights for residential mortgage, corporate and agriculture lending to our proposed new risk weights could reduce Group 2 banks' overall RWAs by around 10.9%. This means that Group 2 banks would face a lower overall capital requirement compared to if the 2019 Capital Review were to be fully implemented in 2028, thereby allowing Group 2 banks to reach the TCR required much more quickly under the new risk weights than they would under the status quo.

Group 3

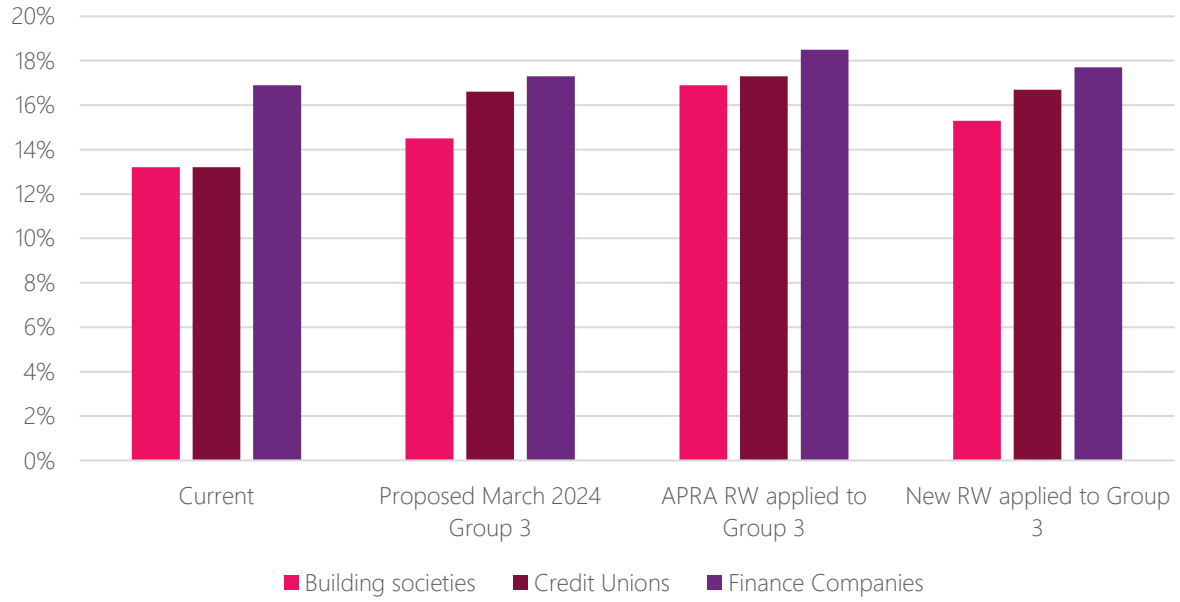
We have also considered the impacts of the lower, more granular standardised risk weights on Group 3 deposit takers.

The 2024 DTA Core Standards consultation proposed aligning Group 3 risk weights with the standardised risk weights that will apply to Group 2. We estimate that this will result in significant drops in RWAs for Group 3, as the existing non-bank deposit taker (**NBDT**) requirements are more conservative.

The more granular standardised risk weights under consideration now would magnify those risk weight reductions for Group 3, as shown below in Figure 14. We have also updated the shortfall analysis that was included in the DTA Capital Standard Response document considered by the Board

in February 2025. 9(2)(b)(ii)

Figure 14: Group 3 TCRs under the current, APRA, & new standardised risk weights



Note: 'Proposed Group 3' refers to the risk weights proposed in the DTA Capital Standard consultation and agreed to by the Board earlier this year.

Ultimately, a more granular approach to standardised risk weights would allow us to be more responsive to the real risk posed by certain types of lending (i.e., more flexibility in assigning lower risk weights to the lower ends of low-LVR lending and higher risk weights to riskier high-LVR lending).

However, it is also worth highlighting that any changes that reduce standardised risk weights, such as those we are proposing, could increase the risks to the soundness and safety of individual deposit takers. This would be contrary to one of the additional purposes of the DTA - 'to promote the safety and soundness of each deposit taker'.

The maximum impact from the changes to standardised risk weights described above is estimated to be around a 5.7% fall in the overall amount of capital in the system, although the estimated size of this impact may change as we receive additional information from the consultation. Throughout this analysis, we have come up against limitations in both the data provided through our information request to deposit takers last year (which was gathered on a best-endeavours basis) and in our own data repositories. These limitations mean that the 5.7% impact identified above is an estimate only and should not be considered to be the upper bound of the potential reduction in capital from the proposed changes to standardised risk weights. The data provided on corporate lending in particular was more difficult to reconcile (due to some omissions) and could understate the impact we would have otherwise expected from the proposed changes.

We intend to use the consultation to seek more detail from deposit takers on their lending breakdowns and the potential impacts from the proposed changes to standardised risk weights, to provide more accuracy to our existing analysis.

The question of whether this reduction in capital is desirable – or should be offset elsewhere – is to be considered as part of the options assessment we are undertaking as part of this capital review.

Changes to standardised risk weights are unlikely to materially shift the competitive landscape

Improving the granularity of the standardised approach will improve the sensitivity of deposit-takers' capital requirements to the actual risks they face, however we expect that the changes will have only limited impacts on the competitiveness of smaller entities in the short term.

As highlighted in our submissions to the Commerce Commission and FEC competition inquiries,[12] capital is only one part of the challenge smaller deposit takers face when competing with the major banks. Major banks benefit from significant economies of scale that enable them to deliver financial services at a lower unit cost than smaller competitors – for example, in their ability to spread the costs of investment into IT infrastructure (improved apps, cybersecurity, risk systems, etc.) across a larger pool of customers. Their size (on a standalone basis) and the fact they are part of a major Australian banking group also offers them more favourable access to wholesale funding markets and overall lower funding costs than smaller banks.

Lowering the average risk weight under the standardised approach will free up capital constraints that some Group 2 and 3 deposit takers currently face, enabling them to potentially grow their lending at a faster rate than otherwise in the short term. It is possible there could be a spurt of competition and changes in market shares because of the changes. However, since changes to the standardised approach would also benefit the Group 1 banks (assuming no change to the IRB output floor), this is likely to be relatively limited.

Over the longer term, the sustainable growth rate of a bank's balance sheet is primarily dependent on its profitability and ability to grow its capital base through retained earnings or investments from its shareholders. Entities with persistently higher cost structures will therefore tend to struggle to match either the growth rate or profitability/returns of those with lower cost profiles.

[12] See Commerce Commission submission (https://www.rbnz.govt.nz/-/media/project/sites/rbnz/files/publications/information-releases/2024/rbnz-submission-commerce-commission-personal-banking-services-market-study.pdf) and FEC submission (https://www.rbnz.govt.nz/-/media/project/sites/rbnz/files/publications/information-releases/2024/fec-submission---inquiry-into-banking-competition.pdf).

Appendix 4 – Community Housing Providers, Co-operatives and Whenua Māori (standardised and IRB)

Community Housing Providers and Co-operatives

In 2024 we committed to reviewing the approach to risk weights for Community Housing Providers (**CHPs**) and co-operative housing, and lending secured by whenua Māori.[13] This was in response to topics raised by respondents in the DTA Core Standards consultation feedback, and in the Commerce Commission's market study into personal banking services. It was also covered by the Minister of Finance in her December 2024 Letter of Expectations to the RBNZ.

This appendix covers our analysis of risk weights across these topics and identifies preferred options. We have also identified some gaps where we are looking for additional information before final decisions are made later in 2025.

Community Housing Providers are generally not-for-profit groups meeting housing needs through a range of affordable rental and home ownership options. CHPs provide around 16% of all New Zealand's social housing places, or around 13,000 houses. Existing lending to CHPs totals around $650 million, while property owned by CHPs is valued at around $2.5 billion.

Some CHPs are registered and regulated by the Community Housing Regulatory Authority (**CHRA**), an independent agency within HUD. Organisations which demonstrate the ability to meet the CHRA's Performance Standards become 'registered Community Housing Providers'.

Since 2014, registered CHPs have been able to provide homes to those on the Public Housing Register and apply to access the Income Related Rent Subsidy (**IRRS**). The subsidy covers the difference between the market rent and the tenant's income-related rent, set by the Ministry of Social Development. The average income-related rent paid by social housing tenants is $150 per week, so it makes up a small proportion of the market rent.

Housing co-operatives (also referred to as 'co-operative housing') is a concept which shares similar lending risks with CHPs. A typical housing co-operative is a legal entity with "members who gain a permanent right to occupy a dwelling, usually, but not always, in return for affordable rent".[14] Commonly, residents are also co-operative members and therefore are able to collectively make decisions about the co-operative and its governance.

Unlike CHPs, there is no regulation of housing co-operatives. As a result, they are not guaranteed payment of a market rent. Although the rent charged is commonly below market rent, rent is set at a rate that covers property expenses and maintenance. We understand that housing co-operatives typically have higher demand than traditional rental properties (with many co-operatives having wait lists to become residents).

Co-operatives are an emerging form of housing, with limited use so far in New Zealand. Northern European countries, particularly in Scandinavia, have a longer history and more experience with this approach.

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[13] Whenua Māori can take a number of different forms, including whenua owned by a Māori land trust, a Māori Incorporation, and directly by the owners themselves.

[14] 2023-Rental-cooperatives-Peterborough-street-FINAL1.pdf

Problem definition

The evidence we have considered indicates that the current risk weights generally faced by CHPs and co-operatives are high, relative to actual risk.

CHP lending will generally either be treated as a corporate exposure, with a 100% risk weight in the standardised approach, or as income producing real estate (**IPRE**) in the IRB approach, with a risk weight of at least 70%. Some CHP lending can be classified as a residential mortgage loan (**RML**) in the standardised approach, attracting a significantly lower risk weight in cases where there is a loan-to-value ratio (**LVR**) of less than 80%.

However, in the vast majority of cases, the lender has limited capacity to recognise the value of the property as security as the lending will not qualify as RML and will face the more stringent corporate and/or IPRE treatment. Lenders also cannot recognise the longer-term funding contracts that some CHPs have with the Crown. Our assessment is that this leads to risk weights that are higher than the actual risk of the lending.

We estimate that the 70% risk weight adds an extra 0.4 percentage points to the interest rate faced by a CHP interest rates compared with treating the borrowing as property investment RML. A 100% risk weight, as in the standardised approach, adds a further 0.4 percentage points, taking the total impact to an additional 0.8 percentage points to the interest rate.

Options

We propose that options treat this lending the same in both the standardised and IRB approaches. We have identified the following options.

Table 13: Options for approach to CHP and housing co-operative risk weights

Option	Approach
Option 1	Status quo.
Option 2	Treat all lending to CHPs and housing co-operatives as RML, excluding lending for property development.
Option 3 **(preferred)**	Create a new standardised category of risk weights for CHPs and housing co-operatives and require IRB banks to use the standardised risk weight. This would be separate from RML.

Option 2 is similar to the APRA treatment, which allows authorised deposit-taking institutions (**ADIs**) to treat CHP lending as RML under its standardised framework.[15] In Option 2 this treatment would be extended to housing co-operative lending.

Option 2 would allow banks to treat CHP lending in the same way as RML lending. While we have not worked out the exact detail of how this would work for the IRB approach, we expect that IRB banks would not be able to treat lending to CHPs and housing co-operatives as RML under the current specifications for IRB models. This option would therefore require some loosening of the current approach to retail RML. This would create a significant risk and could undermine the IRB

[15] Response to submissions - A more flexible and resilient capital framework for ADIs.

model approach, as it is likely that IRB banks will not have enough statistical data to manage these exposures on a pooled basis as part of their models.

Option 3 would create a completely new set of exposures in the standardised framework and would require IRB banks to also use this category of exposures. This set of exposures would apply to both CHP and housing co-operative lending. It is also possible that papakāinga developments may also qualify as a CHP or co-operative and could also benefit from the new category.[16]

The key issue for option 3 is to determine the appropriate risk weight. To make this assessment we have considered the features of this lending compared with other types of lending. Based on this assessment, we have concluded that the risk of the lending is similar to that for property investment RML.

There is not an exact match, and risk will vary across different forms of lending. For example, some CHPs with long-term Crown contracts may be lower risk than small housing co-operatives. However, designing multiple categories to cover this heterogeneity is unlikely to be useful given the small scale of lending.

Option 3 is the most highly ranked of the options and is our preferred approach for the following reasons:

- Alignment of risk weight with risk.
- Applies to similar types of lending with similar risk levels (CHPs and housing co-operatives).
- Transparency through having a separate category of exposures that deposit takers would report.
- Simple and does not require different approaches for standardised and IRB approaches.

As a result, the proposed risk weights for option 3 are the same as for property investment RML, including the wider changes for this category discussed elsewhere in this paper (see Appendix 3).

Impacts

Option 3 would result in a reduction in average risk weights, perhaps by as much as halving the risk-weighted assets for these exposures. The information we received from deposit takers in late 2024 suggests this could be a fall of up to $100m in RWAs.

We estimate lending rates for borrowers could fall by 0.4-0.8 percentage points.

Whenua Māori

Background

In 2024, the RBNZ published the Improving Māori Access to Capital issues paper. This concluded that the unique nature of some Māori economic activity put Māori at risk of missing the full benefits of the financial system and carrying unrewarded risk and cost. We have been assessing the impact of prudential regulation in contributing to these outcomes, with a focus on the treatment of whenua Māori.

[16] Papakāinga refers to housing developments on ancestral Māori land, often including communal living spaces, marae, and shared resources.

Whenua Māori makes up around 5% of land in Aotearoa (1.4 million hectares).

In 2024, the Māori Land Court bench released a practice note for lending money on whenua Māori. The aim of the practice note was to provide clarity for both whānau and lenders on Māori Land Court processes when accessing finance for development activity on whenua Māori.[17]

The practice note covers the following:

- How do owners of whenua Māori approve a mortgage?
- How is a mortgage registered against whenua Māori?
- Can a mortgage be registered against the leasehold estate of whenua Māori?
- How does a mortgagee exercise its power of mortgagee sale in relation to whenua Māori?
- What are the Court's powers under the Property Law Act 2007 in relation to whenua Māori?

Proposed approach

The practice note provides increased clarity to borrowers and lenders. However, the note was published in 2024, and it is unclear how much impact this has had on activity. We are interested in feedback from stakeholders about whether the practice note has changed their decisions regarding lending or borrowers secured by whenua Māori.

Our assessment is that RML secured by whenua Māori will benefit from the other changes proposed for RML risk weights outlined in Appendix 3. For example, lending at low LVRs will be eligible for the revised standardised risk weights discussed in Appendix 3.

Some lending may also qualify for the new CHP and co-operative exposure categories, providing additional scope for matching risk weights with risk.

We have not identified any features of lending secured by whenua Māori that would support lower risk weights, outside of the wider changes discussed above. However, we are open to considering additional evidence and propose that we ask stakeholders for further information, which can be considered before final decisions are made at the end of 2025. We propose asking the following questions:

- How has the Māori Land Court whenua Māori practice note altered borrowing and lending decisions?
- Does lending secured by whenua Māori have different risk characteristics than other lending, and if so, how should this be incorporated into prudential requirements? Is this relevant for RML, and/or other forms of lending?
- Will lending secured by whenua Māori benefit from the other changes proposed in this Capital Review?
- Are there other aspects of the prudential framework that could be addressed to more accurately match risk weights with actual risk for lending secured by whenua Māori?

[17] Banking-Practice-Note.pdf.

Appendix 5 – Option appraisal

Following the 2019 Capital Review, we announced that capital requirements would reach those set out in the table below in 2028 for Group 1 and 2 deposit takers. For Group 3, we have included the proposal we consulted on in the DTA Core Standards consultation.

Status quo

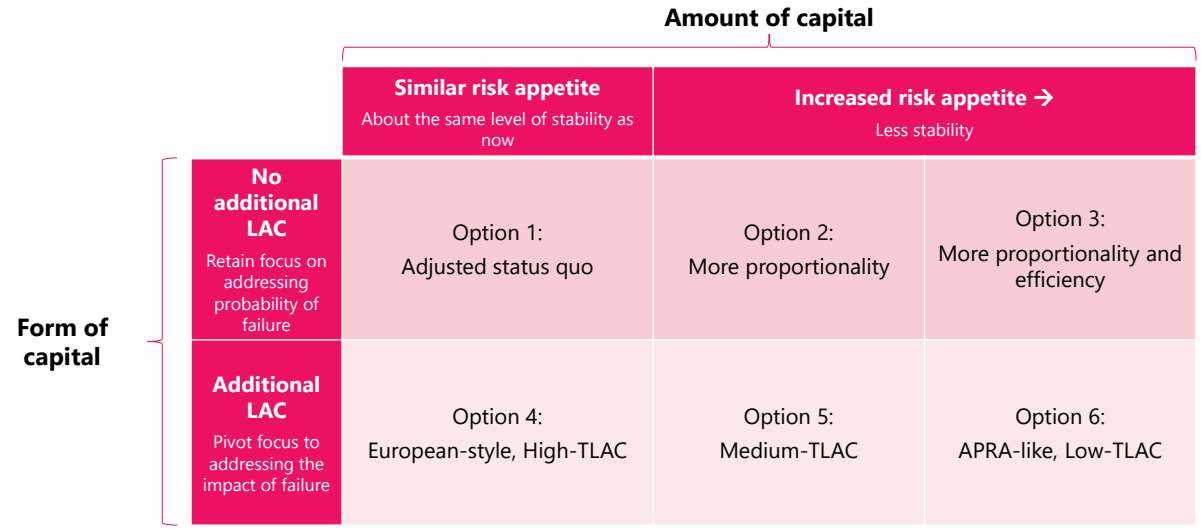
	G1	G2	G3
MIN CET1	4.5	4.5	4.5
PCB (CET1)	9	7	4
TOTAL CET1	*13.5*	*11.5*	*8.5*
AT1	2.5	2.5	2.5
TOTAL TIER 1	*16*	*14*	*11*
Tier 2	2	2	2
TOTAL CAPITAL	18	16	13

Options for change

We have developed a range of options based on the key variables – *amount*, *form* and *distribution* of capital.

Figure 15 illustrates how these options fit together.

Figure 15: Options for change



The following tables provide the precise calibrations used in each of these options. To note: there is large number of possible permutations of these options, so these can be refined with feedback.

Table 14: Options without LAC

1: Adjusted status quo

	G1	G2	G3
MIN CET1	6	6	6
PCB	9	7	4
TOTAL CET1	*15*	*13*	*10*
AT1	0	0	0
TOTAL TIER 1	*15*	*13*	*10*
Tier 2	3	3	3
TOTAL	*18*	*16*	*13*

2: More proportionality

	G1	G2	G3
MIN CET1	6	6	6
PCB	9	6	4
TOTAL CET1	*15*	*12*	*10*
AT1	0	0	0
TOTAL TIER 1	*15*	*12*	*10*
Tier 2	3	3	3
TOTAL	*18*	*15*	*13*

3: More proportionality and efficiency

	G1	G2	G3
MIN CET1	5	5	5
PCB	9	6	4
TOTAL CET1	*14*	*11*	*9*
AT1	0	0	0
TOTAL TIER 1	*14*	*11*	*9*
Tier 2	4	4	4
TOTAL	*18*	*15*	*13*

Table 15: Options with LAC

4: Higher TLAC

	G1	G2	G3
MIN CET1	6	6	6
PCB	7	6	4
TOTAL CET1	13	12	10
AT1	0	0	0
TOTAL TIER 1	*13*	*12*	*10*
Tier 2	3	3	3
LAC	9	0	0
TLAC	*25*	*15*	*13*

5: Medium TLAC

	G1	G2	G3
MIN CET1	6	6	6
PCB	6	5	4
TOTAL CET1	12	11	10
AT1	0	0	0
TOTAL TIER 1	*12*	*11*	*10*
Tier 2	3	3	3
LAC	6	0	0
TLAC	*21*	*14*	*13*

6: APRA-like lower TLAC

	G1	G2	G3
MIN CET1	6	6	6
PCB	4.5	4.5	4
TOTAL CET1	10.5	10.5	10
AT1	0	0	0
TOTAL TIER 1	*10.5*	*10.5*	*10*
Tier 2	3	3	3
LAC	4.5	0	0
TLAC	*18*	*13.5*	*13*

How options compare with the criteria

We have considered these options against the criteria set out in Section 4:

- BAU loss absorbency: Maintaining a sufficient prudential capital buffer above the regulatory minimum to absorb losses and promote the stability of the financial system and the safety and soundness of each deposit taker (links to s3(1) and s(2)(a) purposes).
- Crisis management: enable a distressed deposit taker to be dealt with in an orderly manner, recognising the need for a credible resolution strategy for deposit takers to promote financial stability and avoid the use of public money (links to s259 purposes).
- Proportionality: Taking a proportionate approach to regulation and supervision (links to s4(a)(i) principle).
- Competition: Maintaining competition within the deposit-taking sector, recognising the desirability of a diverse deposit-taking sector that provides financial products and services to a diverse range of New Zealanders (links to s3(2)(c) purpose, and s4(a) and s4(b) principles).
- Funding costs: Consider the impact on bank funding costs, which in turn affect lending rates, recognising the importance for supporting the prosperity and well-being of New Zealanders (links to s3(1) purpose and s3(2)(d) principle).
- Simplicity/achievability: Be practical to administer, easy to implement and avoid unnecessary compliance costs (links to s4(c) principle).

- International alignment: Aligning with international standards where appropriate (links to s4(d) principle).

All options come with a range of pros and cons, and how the Board chooses to weight these criteria will influence which is preferred. The analysis illustrates:

- Options without LAC provide more BAU loss absorbency (helping reduce the risk of a crisis) but would rely on existing approaches to resolution and recovery. Options with LAC either a medium or large amount of LAC are likely superior when it comes to crisis management, but provide less BAU loss absorbency.

- Both options with or without LAC can provide more competition and proportionality than the status quo.

- Removing AT1 will likely improve simplicity relative to the status quo. Introducing LAC will add some complexity at the margin.

- Options that could support lower funding costs are the ones that provide the least stability.

Further details on LAC

Additional LAC would apply to Group 1 and introduce a new layer of capital-like funding designed to recapitalise a deposit taker that has exhausted (or is close to exhausting) its capital buffer.[18]

Under these LAC options, deposit takers have less equity in BAU times but can draw on a pre-positioned pool of capital-like funding to recapitalise if the need arises. This potentially lowers ongoing costs to the economy, but requires high confidence in LAC working as intended, and an acceptance that the frequency of entities becoming distressed is higher.

Our starting assumption is that this LAC could take a form similar to Tier 2 capital, and be issued internally (to the Australian parent). We would potentially also require the Tier 2 within the existing capital stack to be issued internally under this model. However, we intend to consult on key features of this form of additional LAC (with potentially more detailed consultation on this as a later stage if a LAC option is adopted).

An internal LAC requirement would enhance our preferred single point of entry recovery strategy by providing a legal mechanism to ensure the down-streaming of new Tier 1 capital in a group-level recovery situation. This aligns with the approach taken for most major cross-border banking groups overseas. While it would likely require us to reintroduce selected contractual bail-in features, we are comfortable that the concerns we had with such features in the 2019 Capital Review either do not apply or could be suitably mitigated through the design of Tier 2 and the internal LAC instruments (see Appendix 7).[19]

[18] It is important to note that a stressed deposit taker's true capital position is likely to be worse than its reported capital numbers, and the bailing in of LAC must be sufficient to stabilise the deposit taker. As such LAC may need to be written down or converted before the buffer is fully exhausted.

[19] We note that international practice typically involves setting internal TLAC requirements between 75% and 90% of double a bank's minimum capital requirement, plus its capital buffers. Our proposals for TLAC focus on being at the more conservative focus of this range (i.e. at 90%) given the relatively low LAC requirements across individual trans-Tasman banking groups (Australia only has a 4.5% LAC requirement for the largest deposit takers), and the fact that resolvability requirements are still in the process of being implemented in Australia.

Table 16: Comparison of options against criteria

Key

All options are broadly feasible. However, each option performs better on certain criteria than others.

⬆⬆ Strongly meets the criteria. ⬆ Meets the criteria

↔ Impact is neutral

⬇⬇ Strongly does not meet the criteria. ⬇ Does not meet the criteria.

		Financial stability criteria			Other criteria			Lending rate impact (bps)
		BAU loss absorbency	Crisis management	Proportionality	Competition	Simplicity and achievability	International alignment	
	Status Quo (2028)	⬆⬆	↔	↔	↔	⬆⬆	↔	Baseline
No LAC	1. Adjusted status quo: More granular Standardised risk weights Replace AT1 with mixture of CET1 & Tier 2	⬆⬆	↔	↔	↔	⬆⬆	↔	-4.0
	2. More proportionality: As above, but lower buffer for Group 2	⬆	↔	⬆	↔	⬆⬆	↔	-4.6
	3. More proportionality and efficiency: As above, but replacing AT1 with Tier 2 only	⬇	↔	⬆	⬆	⬆⬆	⬇	-9.6
LAC	4. European style/High LAC: 9% LAC for Group 1 No LAC and reduced buffers for Group 2&3	↔	⬆	↔	↔	⬇	⬆	-11.3
	5. Medium LAC: 6% LAC for Group 1 No LAC and further reduced buffers for Group 2&3	⬇	⬆	↔	↔	⬇	↔	-17.1
	6. APRA style/Low LAC: 4.5% LAC for Group 1 No LAC and further reduced buffers for Group 2&3	⬇	⬇	⬇	↔	⬇	↔	-19.6

Appendix 6 – Initial thinking on cost-benefit analysis

We intend to use the same underlying approach to cost benefit analysis (CBA) as we did in the 2019 Capital Review. This approach aligns with overseas practice, and we deem it fit-for-purposes for our current review. As necessary we have updated options and assumptions and made some modifications to ensure that all of the options can be considered in the framework.

In this Appendix we summarise the analytical approach and some initial draft results, though we note that these are preliminary, to be refined and subject to further QA.

The approach is to use the estimates of costs and benefits below to generate a measure of 'Expected GDP', where the level of actual GDP is adjusted for

- The expected impact of a crisis – when the risk of a crisis increases there is a reduction in Expected GDP, since there is a bigger chance of a crisis in the future, which would reduce actual GDP at that time.
- The impact of any interest rate changes on output from the approach to modelling costs.

Expected GDP is then compared across different options, and against the 2028 status quo, where all 2019 decisions are implemented.

In the consultation paper, we intend to explain our proposed approach and calculations and seek feedback and information from stakeholders for further refinements.

All of the analysis is still at early stages and subject to change as we progress through the work and finalise consultation material. In particular:

- The approach to modelling costs is well advanced and we are satisfied that the approach is producing robust estimates, though these need further testing. As a result, this paper includes quantified impacts relating to funding costs and interest rates.
- The approach to modelling the benefits of capital is less well-advanced, including ensuring that we accurately capture the impacts of LAC. As a result, we do not have robust measures of the quantified impact of the benefits. We will continue to develop these estimates for future papers.

Approach to modelling costs

We intend to use the same bottom-up approach as the 2019 approach to calculate the total cost of funds. However, we will make some adjustments and improvements if possible.

In 2019, we calculated the cost of funds from perspective of bank treasurer – i.e., how does my overall funding cost change if I change the mixture of liabilities and equity, based on current market pricing. In practice, we:

- aggregated balance sheets into the banking system-wide balance sheet
- split balance sheet into different funding sources – Equity, AT1, Tier 2, marginal debt, other funding (e.g. transaction deposits)
- calculated a weighted-average funding cost based on actual observed data and estimates for each type of funding

- calculated pro forma balance sheet after full Capital Review implementation and the new weighted-average funding cost by adjusting funding costs using the Modigliani-Miller theorem
- compared the new weighted-average funding cost with the status quo.

Once we obtained an estimated lending rate impact, we translate this into an economy-wide cost of higher capital. Based on international literature, we assumed a 1-for-1 pass through, that is, for every 0.01% higher than average lending rates went, the steady-state level of GDP fell by 0.01%. Higher borrowing costs translate to an overall lower level of investment in the economy over time, lowering GDP.

In 2025, we intend to:

- model the changes in balance sheets under each option at a bank level, to take into account that some banks are more progressed than others in moving towards the previously agreed 2028 capital ratios
- aggregate the modelled balance sheets up to Groups 1, 2 and 3 deposit takers to enable us to assess the options against criteria relevant to proportionality and competition
- include additional LAC in funding sources to assess the different options' cost implication
- use the market-based data, instead of assumption-based estimate, if available. For example, we may calculate:
    - the cost of equity based on the parent's entity's market-based data for unlisted New Zealand deposit takers
    - the cost of internal LAC based on the cost of Tier 2 issued by the parent's entity.

Costs: Impact on funding costs and lending rates

For each option we have estimated the impact that the change in banks' capital structures would have on their weighted average funding costs, which in turn affect the interest rates on charged to borrowers. We compare the different options with a counterfactual, under which banks would continue to increase their capital levels in line with the original 2019 decisions, and with no changes to risk weights. As with the estimates of benefits, these lending rate impacts are preliminary and subject to further analysis and refinement.

Key areas we intend to refine our analysis include:

- Inclusion of Modigliani-Millar type effects, i.e. adjusting the returns required on different components of the capital stack to reflect differences in risk under different options. For example, investors' required return on Tier 2 instruments should be lower under options with more equity, since equity absorbs losses first.
- How banks optimise their capital stack under options that have significant reductions in Tier 1 capital (substituted for LAC): in practice, other factors such as target credit ratings may become the binding constraint on Tier 1 capital, ahead of regulatory minima, so therefore we should not assume that banks fully reduce their Tier 1 capital to a lower minimum regulatory requirement.

As shown in the table below, the impact of different capital stacks on lending rates is relatively modest. This is because under any of these options banks still rely on approximately 90% of their funding to come from debt, the price of which is relatively unresponsive to the marginal changes in banks' capital composition. Compared to our estimate of the weighted average funding cost

under the fully implemented 2019 decisions, the range of options being considered would see lending rates change within a range of -4 to -20bps. As noted above, these are preliminary estimates and subject to further refinement as the team works on the methodology and data inputs, particularly the adjustment of investors' required returns in options with less common equity.

Table 17: Estimated lending rate impacts under each option

	Current (March 2025)	Status quo / 2019 decisions	Adjusted status quo	Increased proportionality	Efficiency focussed	Higher LAC	Medium LAC	Lower LAC
Tier 1 capital ($bn)	59	67	59	59	55	52	49	49
Total loss absorbing capacity ($bn)	66	75	70	70	70	92	79	69
Weighted average funding cost (%)	5.11	5.19	5.16	5.16	5.11	5.10	5.05	5.03
Impact on lending rates (bps.)		Baseline	-4.0	-4.6	-9.6	-11.3	-17.1	-19.6

Consistent with our 2019 CBA, we use these lending rate estimates to assess the impact on GDP for the costs and benefits.

Approach to modelling benefits

The benefits of capital primarily arise from a reduction in the frequency (and impact) of financial crises. As in our 2019 CBA, in this context a crisis occurs once all capital in the system is depleted.

To quantify the benefits, we need to estimate both the probability and cost of stylised crisis for a given capital stack. This allows us to estimate how different options impact the annualised costs of crises as a % of GDP. We can then compare these impacts with those arising from changes in lending rates to estimate the option's net benefit relative to the status quo.

We model the probability of crisis using the same stylised view of potential credit losses that we used in the 2019 Capital Review. For simplicity, we also continue to assume that a "crisis" occurs when these losses wipe out total Tier 1 capital for Group 1 deposit takers. This does not mean that a crisis only occurs (or that we only intervene) when reported Tier 1 capital reaches 0%. In practice, we monitor deposit takers on a forward-looking basis, and would seek to initiate recovery and resolution measures well before this point.

For the cost of crisis, we continue to use the BCBS assumption that such a crisis would result in lost economic output equivalent to 63% of GDP.[20] For non-LAC options, we disregard the potential impacts of deposit insurance and Tier 2 capital on cost of crisis (as we did in 2019). These features were also present in many of the historical examples that the 63% of GDP estimate is based on.

For options with LAC, we need to adjust our 2019 approach. In line with analysis by the Hong Kong Monetary Authority (HMKA)[21] we assume that a 63% of GDP crisis only arises when TLAC reaches 0%. This reflects that, when (or before) Tier 1 capital reaches 0%, we would have the option to bail in Tier 2 capital and additional LAC to recapitalise a Group 1 deposit taker. However, unlike the HKMA, we assume that, even if bail-in averts a full-blown crisis, it still has economic spillovers. We estimate that these spillovers could result in lost economic output equivalent to something like 20% of GDP.[22] This reflects that Tier 2 capital and additional LAC do not absorb loss costlessly, and are therefore imperfect substitutes for Tier 1 capital.

We are using the framework described above to estimate some indicative impacts associated with each option:

- In general terms, any non-LAC option that includes a reduction in Tier 1 capital results in decrease in Expected GDP in the benefits part of the estimation. This is because the risk of a crisis goes up so expected GDP is scaled down.
- The impact in the LAC options is less clear, since the additional LAC works to offset some of the financial stability risks, by providing a future source of capital.
- Any impacts from lower stability are insensitive to the cost of a crisis, since the cost of crisis in status quo will be the same as in the options.
- The negative impact on expected GDP will be at least partially offset by reductions in funding costs in the options above where funding costs reduce. This is because the lower interest rates led to an increase in the level of GDP.

We have not presented any quantified impacts through the benefits channel in this paper. This is primarily because we are still testing the approach to ensure that it produces robust results. Once we are confident of those impacts, we can add the benefits and the costs together.

Wealth and tax impacts

As in the 2019 analysis, we will include further consideration of the wealth and tax impacts that arise from the fact that the majority of the banking system is foreign owned. To the extent that higher capital ratios increase lending rates, this can lead to a transfer of wealth from New Zealand-based borrowers to Australian-based shareholders, reducing New Zealand's national welfare. Offsetting this, higher capital ratios mean a larger bank equity base in New Zealand that increases taxable income.

[20] See https://www.bis.org/publ/bcbs173.pdf

[21] See https://www.hkma.gov.hk/media/eng/publication-and-research/research/research-memorandums/2018/RM05-2018.pdf

[22] This aligns to BCBS estimates of the costs of an orderly crisis which was used as a lower bound in the 2019 analysis. We reach a similar estimate when applying the Bank of England's assumption that orderly bail-in reduces cost of crisis by 60%, in addition to having other benefits (see https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-paper/2015/measuring-the-macroeconomic-costs-and-benefits-of)

Appendix 7 – 'Loss Absorbing Capacity' and the resolution process: additional background

One of the key choices in the paper is between a framework with or without 'LAC' for the Group 1 deposit takers.

How LAC would work in the New Zealand context

International capital frameworks increasingly include 'loss absorbing capacity' (LAC) that is set in addition to capital requirements. This 'capacity' consists of debt instruments that can be written-off or converted into equity when a bank is in distress, Conversion/write-off reduces the fixed liabilities on the bank's balance sheet, increasing equity. (We refer to this process as 'triggering' the LAC).

Figure 16: Stylised use of LAC instruments

LAC is significantly cheaper to issue than equivalent equity would be, since LAC instruments carry less risk-exposure than equity in a going-concern scenario (because they are fixed value, fixed interest instruments). If LAC is written off, the entity would eventually need to issue additional loss-absorbing capacity to return to its original resilient state.

In the case of home jurisdictions (i.e., the jurisdictions where a parent entity locates), LAC is issued externally to the market. When it is written-off, investors holding the instruments take the losses.

However, in the case of host jurisdictions (i.e., the jurisdictions where a subsidiary locates), LAC is typically issued internally to the subsidiary's parent entity.[23] In our context in New Zealand, all our Group 1 deposit takers are subsidiaries of an Australian banking group.

We are proposing that any LAC would only be issued to the Australian parent bank. Under this approach LAC works as a mechanism to down-stream capital from the Australian parent to the New Zealand subsidiary as part of a single point of entry recovery approach. If APRA also triggers LAC issued by the parent, this then down-streams capital from external LAC investors to the parent. In other words, recapitalisation primarily takes place at group level, but the Reserve Bank has the ability to allocate a set amount of the group's (new) capital to the New Zealand subsidiary.

The Australian parent would likely down-stream capital either by absorbing the reduction in its capital or by triggering its externally-issued loss-absorbing instruments. The former would become a reallocation of capital within the banking group (boosting subsidiary capital at the expense of the parent's stand-alone balance sheet) but wouldn't alter the financial position of the group as a whole.

Why don't we already have LAC?

The logic of our current framework is to rely on trans-Tasman banking groups' incentives to ensure that capital is down-streamed to a New Zealand subsidiary in the event of distress.

Generally, the Australian parent bank has strong incentives to recapitalise the New Zealand subsidiary as the New Zealand business is profitable and its failure would inflict reputational damage on the parent. Any capital 'down-streamed to New Zealand' continues to be fully owned by the Australian parent - it is not a 'gift' but rather a re-allocation of resources within the group.

This position would only become strained where resources were scarce so that the parent was unwilling or unable to raise enough capital itself to fund the recapitalisation of the New Zealand subsidiary. The parent would then need to raise additional capital, including potentially by triggering its own LAC instruments, which *are* issued externally. As noted above triggering external LAC instruments involves inflicting losses on market players, creating political and legal risk. It is also possible that LAC instruments are insufficient to meet the magnitude of the losses that have materialised.

In these circumstances, trans-Tasman negotiations might be difficult. However, there is still value in the New Zealand subsidiary and this continues to provide strong incentives to capitalise adequately. If insufficient capital is forthcoming, the RBNZ as regulator can determine that it is not acceptable for a deposit taker in that situation to continue doing business under that structure in New Zealand. We can then use our resolution powers to separate the New Zealand bank from its parent and recapitalise it independently (multiple point of entry resolution or MPE).

Our existing capital stack also includes AT1 and Tier 2 instruments which cannot be bailed in outside of formal resolution. This makes it hard for us to add LAC (which should be able to trigger

[23] The Financial Stability Board has published the Guiding Principles on Internal Total Loss-absorbing Capacity of G-SIBs ('Internal TLAC'). The BIS's summary of the Guiding Principles is available here. https://www.bis.org/fsi/fsisummaries/internal_tlac.htm

prior to formal resolution, to be compatible with Australia's Tier-2 based LAC framework). Removing AT1 and altering our Tier 2 framework will eliminate this issue.

What difference would 'internal LAC' make?

If we required Group 1 deposit takers to have a specific amount of internal LAC in place, the subsidiary would have a pre-positioned legal right to require capital to be reallocated within the group (once the conditions for triggering the LAC were met).

This would provide a very important starting point for trans-Tasman negotiations in a capital-constrained context. It would also provide a particularly transparent signal to APRA, during normal times, and encourage further co-ordination around resolution planning. Under APRA's existing capital rules, it would likely result in the Australian parent issuing more external LAC, increasing the total new capital available to the group in a resolution scenario.

However, it would not remove all the risk and difficulty potentially involved in a trans-Tasman crisis. For example, internal LAC usually needs to be deliberately triggered by a regulator. RBNZ would need to discuss that trigger decision with the Australian authorities. Pre-agreement is likely to make those discussions easier but may not remove all potential for conflict (the decision to 'trigger' would have flow on effects including, potentially, the need for Australian authorities to impose losses on investors).

There is also a risk that the level of pre-positioned internal LAC in our framework would turn out to be insufficient to recapitalise the New Zealand bank to acceptable levels, leaving us in the position of needing to negotiate additional capital down-streaming on top of LAC (or considering alternative options).

In both cases, it would be important that we had also maintained a credible fall-back option for separating and resolving the New Zealand deposit taker (other than liquidation or the injection of public funds). We note that a LAC requirement could also strengthen the fallback MPE resolution option because LAC could be triggered in conjunction with separation, reducing the liabilities on the subsidiary's balance sheet.

Overall, LAC has the potential to improve the prospects for orderly recovery/resolution but it is also important to understand its limitations. LAC eases the negotiating process around capital allocation within the Group.[2] Introducing too little LAC poses particular risks, in that it imposes costs on industry without significantly easing negotiations in a crisis context. Even with a LAC framework in place, it would continue to be important to maintain the frameworks required to enable a fall-back separation and recapitalisation option. And, even without a LAC framework, there is a mechanism through which resources can be obtained from the parent bank to recapitalise the subsidiary.

Trading LAC for capital?

The decision we're seeking is the extent to which the advantages of LAC justify the replacement of some capital in the stack with LAC, noting that LAC has lower funding costs than CET1.

There are constraints around the potential for this trade-off. We think it would be unwise to set a *minimum* total capital ratio (the amount of capital required to be held excluding the buffer) that was weaker than the Basel minimum of 8%. Additionally, we assume that LAC would only be

triggered once a bank had used up close to its full capital buffer (because triggering LAC is a costly measure that should only be undertaken once and decisively). LAC levels, then, should ideally be at least as large as the buffer so the buffer can be restored through LAC.

Considering the trade-off, then, only need be done within fairly narrow bounds. Hence we are recommending we consult on a small range of LAC options.

Table 18: Advantages and risks of more LAC

Advantages of more LAC	Risks of more LAC
Eases SPE negotiations, making down-streaming of capital more likely + Potentially increases resources for MPE resolution (depending on other settings)	For any level of TLAC, reduces the 'buffer' capital level, making it more likely that we need to go to resolution
Could be used in a way that increases proportionality	Creates transition costs as 'old' capital instruments are replaced
Likely results in the parent issuing more external LAC available to recapitalise the group as a whole	Complicates the framework
Is a more 'logical' fit with our preferred SPE solution than a *status quo* option that includes external T2 which we may be unlikely to use (except in MPE).	May make it harder to continue arguing for the importance of a credible fallback

Appendix 8 – Contractual Bail-in

We note that in the 2019 Capital Review, we decided to remove instruments with contractual bail-in (conversion/write off) features from our definition of capital in New Zealand. When considering the introduction of internal LAC instruments for Group 1 deposit takers, we will need to identify design approaches that ensure our previous concerns are no longer relevant, or are substantially mitigated through the design of a contractual bail-in framework. The key arguments against contractual bail-in that were raised in the 2019 Capital Review and our responses are summarised below:

Table 19: Summary of key concerns with contractual bail-in raised in the 2019 Capital Review

Key concern raised during the 2019 Capital Review	How the concern could be mitigated
The cost and difficulty of effectively administering contractual bail-in in the New Zealand context. This included arguments around the complexity of the contractual terms, opportunities for regulatory arbitrage, interactions with the tax framework, and relatedly the operational burden on the RBNZ to administer the regime – noting that several cases of non-compliance had occurred in the relatively short time that contractual bail-in had been in place.	These concerns could be mitigated through the design of any bail-in standard. We expect that the bail-in standard would set out clear requirements for the content of contractual clauses (which would be simpler than those used by banks prior to 2019). Limiting contractual bail-in to internally issued instruments by Group 1 deposit takers could also make the framework simpler to administer (e.g. we may only need to review one set of terms per Group 1 deposit taker). It is important to note, however, that this would still add some administrative burden relative to the current approach (given that capital instruments issued after the 2019 Capital Review do not include contractual bail-in features)
The potential ineffectiveness and unintended consequences of going concern triggers. This included arguments around the timeliness of recapitalisation, potential moral hazard issues, and concerns around the viability of writing down preference shares.	We would only consider contractual bail-in clauses that apply in a "gone concern" scenario (i.e., it applies only when a deposit taker has reached the point of non-viability). Concerns around the viability of writing down preference shares would not be relevant given AT1's proposed removal.

Appendix 9 – Consultation paper skeleton

The below sets out a high-level skeleton of the consultation paper and some indicative consultation questions. The exact structure of the consultation paper and wording of the consultation questions will continue to be refined as we draft the paper.

Executive summary

Chapter 1: Introduction

- Scope of the review and why we are doing the review.
- Outline DTA purposes/principles.
- Explain what capital is, why capital requirements are important, and the different components of the capital stack.
- Explain crisis management framework under DTA.
- Explain the structure of the document and assessment criteria.
    - *Consultation question: Do you have any comments on the proposed assessment criteria?*

Chapter 2: Context

- What's changed since 2019 Review:
    - *Consultation question on whether there is new or other evidence for what has changed that we have not covered.*
- International comparisons.
    - *Consultation question: Do you have any feedback on where we should sit relative to comparator jurisdictions and why?*
- Description of Board's risk appetite.

Chapter 3: AT1

- Background, options, cost-benefit analysis, and preferred option.
    - *Consultation questions: Do you agree with the proposed changes? Do you have any feedback on the cost-benefit analysis and/or additional evidence we should consider?*

Chapter 4: Risk weights

- Background, options, potential impacts, and preferred option.
    - *Consultation questions: Do you agree with the proposed changes? Do you have any feedback on the analysis and/or additional evidence we should consider?*

Chapter 5: Capital stack options

- Explain that this chapter is taking the preferred AT1 and risk weight options as given.

- Explanation of the key options, split by Group:
  - Group 1: LAC or no LAC options.
    - *Consultation question: Do you have any feedback on whether we should introduce LAC requirements for Group 1 deposit takers?*
  - Group 2: options with different balances between supporting competition and managing risks to financial system stability.
    - Explain why we are not considering LAC for Groups 2 and 3.
  - Group 3: we do not think there is scope to further weaken requirements while maintaining a minimum baseline level of resilience.
  - *Consultation question: Do you have any feedback on the options we have considered?*
- Cost benefit analysis of the options, including qualitative and quantitative assessments, against the assessment criteria.
  - *Consultation questions: Do you agree with our assessment of the costs and benefits of the proposed options? Do you have any additional evidence on the impacts of the policy proposal that would assist our cost-benefit analysis?*
- Preferred option (if applicable).

Chapter 6: Conclusion and next steps

Appendix 9 – 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-positioned 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.