Reserve Bank of New Zealand
Te Pūtea Matua

# Review of key capital settings

## Board discussion

24 July 2025

# Summary

## The Board's risk appetite informs our range of options…

RBNZ has "a low appetite for any action or inaction that materially reduces financial system stability."

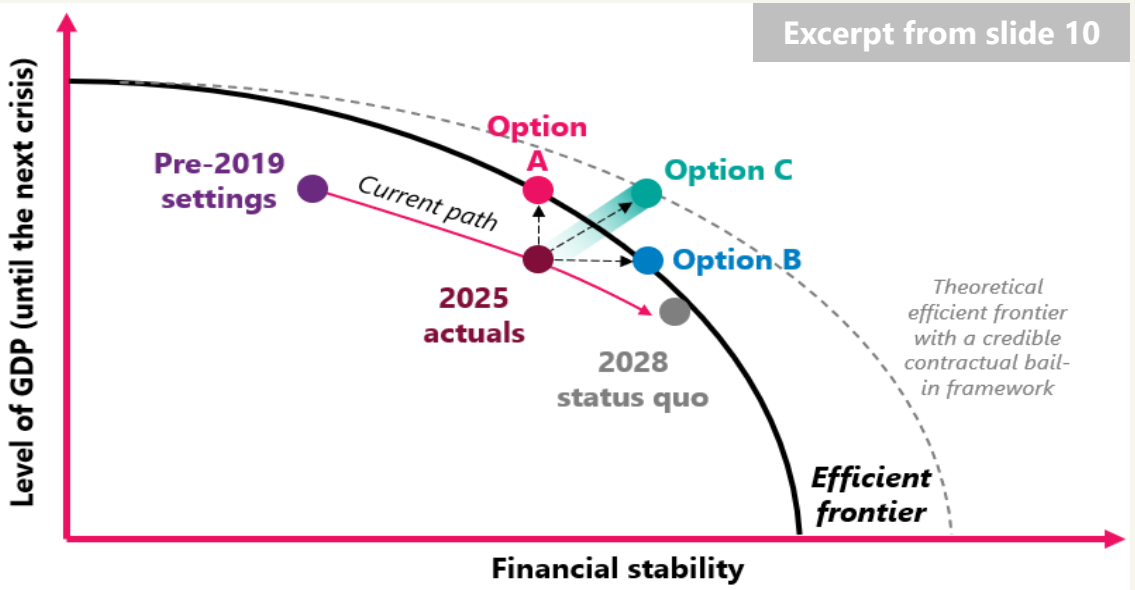
*RAS, RBNZ Board, February 2025*

"However, we do not run a zero-failure regime (i.e., we allow regulated entities to fail where the risks to the financial system are understood and can be managed) – 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. …this provides the incentives for self– and market–discipline to operate effectively. When firms do fail, we will use our regulatory tools towards ensuring this occurs in a controlled and managed fashion and to avoid significant damage to the financial system that could flow from that failure."

*Statement of Prudential Policy, 2022*

## But judgement is required on where we land…

**Excerpt from slide 10**




### Option A: Pause and Refine

**G1:** 16%, **G2:** 14%, **G3:** 13%

- Total capital levels do not increase above current levels
- Some of AT1 is replaced with cheaper T2 capital, some is removed and not replaced
- Average funding costs around 3bps lower than now, and around 9bps lower than 2028

### Option B: Build System Resilience

**G1:** 18%, **G2:** 15%, **G3:** 13%

- Headline capital increase from 2025 position, however new risk weights provide an effective 5% capital reduction against 2028 for G1 and a larger drop for G2 – improve proportionality
- AT1 is replaced with some cheaper T2 capital and some more expensive CET1
- Average funding costs estimated to increase around 2bps compared to now, but 3bps lower than 2028 estimates

### Option C: Pivot to Crisis Management

**G1:** 16% + LAC, **G2:** 14%, **G3:** 13%

- Headline capital levels do not increase above current levels, but additional (internal) LAC is required for Group 1
- Some of AT1 is replaced with cheaper T2 capital, some is removed and not replaced
- Additional internal LAC requirement of 6-9%
- Average funding costs around 2bps lower than now, and around 8bps lower than 2028

# Purpose

## We are seeking Board approval of:

1. Two discrete policy positions for consultation:
   - Introduce more granular risk weights
   - Remove Additional Tier 1 (AT1) capital and replace it with a mixture of Common Equity Tier 1 (CET1) and Tier 2 capital.
2. ***Three options for the amount and form of capital for consultation***
3. Proposed key messages and draft structure of the consultation paper

**This slide pack covers…**

- Three options for consultation
- Key characteristic feature of the options
- What we are trading off among the options
- Supporting evidence
  - Cost of funding and GDP impacts
  - Cost of crisis
- Experts' initial feedback
- Proposed structure of the consultation paper

FSOC to comment on draft consultation paper 8-11 August.

# Context

## Capital requirements play a key role in protecting the financial system's stability….

- Banking is a **very large and highly leveraged sector** that households and businesses must be confident in to spend and invest.
- An **efficient financial system supports higher levels of economic prosperity and wellbeing**. To maximise these benefits, our prudential requirements should not pose unwarranted costs.
- However, **in periods of financial instability, these benefits can rapidly unwind**. E.g. The GFC caused major scarring to the economy through the impacts of heightened uncertainty, reduced access to credit, and the cost of restoring stability.
- Capital requirements that are **too weak will ultimately reduce** the long-run prosperity and wellbeing of New Zealanders.

## Initial views from international experts are broadly supportive of our existing approach…

### Sir John Vickers & Thorsten Beck

- The 2019 decisions were **sound and still hold** today.
- There is a **strong case for robust regulation** for financial stability and a long-term, 'technocratic' lens should be taken.
- Our risk environment has, if anything, only become **more challenging and volatile** – domestic changes that we have made (introduction of the DTA + ongoing capability uplift) are not enough to counteract global volatility.

### Elena Carletti

- Current proposals (especially LAC) **may add unnecessary complexity** compared to 2019 decisions.
- Changing capital requirements **may not improve competition and competitiveness**.

# Proposed options for consultation

## Revised options following FSOC's feedback

**No LAC**

**Option A: Pause and Refine** (**G1:** 16%, **G2:** 14%, **G3:** 13%)

- Capital levels do not increase above current levels
- Some of AT1 is replaced with cheaper T2 capital, some is removed and not replaced
- Similar average funding costs to now, and around 9bps lower than 2028

**Option B: Build System resilience** (**G1:** 18%, **G2:** 15%, **G3:** 13%)

- Headline capital increase from 2025 position, however new risk weights provide an effective 5% reduction against 2028 for G1 and a larger drop for G2 – improving proportionality
- AT1 is replaced with some cheaper T2 capital and some more expensive CET1
- Average funding costs estimated to increase 3bps from 2025 levels, but 3bps lower than 2028 estimates

**LAC**

**Option C: Pivot to Crisis Management** (**G1:** 16% + LAC, **G2:** 14%, **G3:** 13%)

- Headline capital levels do not increase above current levels, but additional (internal) LAC required (between 6-9%)
- Some of AT1 is replaced with cheaper T2 capital, some is removed and not replaced
- Additional internal LAC requirement of 6-9%
- Similar average funding costs to now, and around 8bps lower than 2028

**Assumptions across all options**

More granular risk weights

AT1 has been removed

Group 3 is set at the minimum safest level – any lower would detrimentally impact financial stability

# Assessment of options

- **Option A** puts a higher weight on financial system dynamism and less on financial stability than the 2019 review settings - but financial stability would be similar to now.
- **Option B** puts a lower weight on financial system dynamism, but more on proportionality, competition and financial stability (because Group 1 bears more of the costs).
- **Option C** theoretically improves both stability and financial system dynamism, but less certain that theory will play out in practice (given crisis are inherently difficult to manage, crisis framework still at an early stage of development and the uncertainty about the reliability of LAC instruments).

# Option A: Pause and Refine

## *Option overview*

| | Group 1 | Group 2 | Group 3 |
|---|---|---|---|
| Minimum CET1/Tier 1 | 6 | 6 | 6 |
| Prudential capital buffer | 7 | 5 | 4 |
| **Total CET1/Tier 1** | **13** | **11** | **10** |
| Tier 2 | 3 | 3 | 3 |
| **Total capital** | **16** | **14** | **13** |
| Additional LAC | - | | |
| **Total LAC (TLAC)** | **16** | | |

- New option embedding the capital amount on deposit takers' current balance sheets, new risk weights and removing AT1.
- More "dovish" than options in the Board paper.
- Lower buffer for Groups 1 and 2 and no LAC.
- Group 2 has 2% lower buffer than Group 1, reflecting their impact on the system, the same as in existing policy settings.

## *Industry reaction*

- Likely to be well received by **Group 1 deposit takers** due to positive impact on rates of returns
- Less **proportionality** relative to 2028 status quo
- **Competition** impact not expected to be material

## *Economic impacts*

- No further increase in **average funding costs** – and 9 bps lower than the 2028 status quo
- Level of stability likely to be below what is **socially optimal**
- Cost of future crises expected to reduce **long-term incomes** compared with 2019 decisions

## *International comparison*

- **Broadly comparable** with international standards
- No LAC means we are more **dovish** overall in terms of **TLAC**

## *Risk stance*

- We set capital requirements to achieve a **baseline** level of resilience
- Increased risk will need to be managed with strong incentives on deposit taker shareholders to manage and respond to risk, supported by robust supervisory responses

# Option B: Build System Resilience

## *Option overview*

| | Group 1 | Group 2 | Group 3 |
|---|---|---|---|
| Minimum CET1/Tier 1 | 6 | 6 | 6 |
| Prudential capital buffer | 9 | 6 | 4 |
| **Total CET1/Tier 1** | **15** | **12** | **10** |
| Tier 2 | 3 | 3 | 3 |
| **Total capital** | **18** | **15** | **13** |
| Additional LAC | - | | |
| **Total LAC (TLAC)** | **18** | | |

- New risk weights are applied to all Groups – so a reduction in capital for Group 1 deposit takers relative to the status quo of around 5%.
- Group 1 Minimum and buffers retained at 2028 ratios.
- Reflects greater proportionality – larger (3%) difference between Group 1 and 2 buffers than status quo.

## *Industry reaction*

- Likely to be well received by **Group 2 deposit takers** due to enhanced **proportionality**
- Some **competition** benefits, but also risks given Group 2 deposit takers are more susceptible to failure

## *Economic impacts*

- **Some further increases in average funding costs**, but around 3 bps lower than 2019 review settings in 2028
- Level of stability likely in **socially optimal** range

## *International comparison*

- **Relatively strict CET1** requirements for our largest deposit takers given the specific risks we face as a small open economy
- No LAC means we are more **dovish** overall in terms of **TLAC**

## *Risk stance*

- We set robust capital requirements to assure NZers and global markets that our **financial system as a whole** is stable
- We tolerate a higher incidence of failure for smaller entities reflecting the different levels of systemic risk

# Option C: Pivot to Crisis Management

## *Option overview*

| | Group 1 | Group 2 | Group 3 |
|---|---|---|---|
| Minimum CET1/Tier 1 | 6 | 6 | 6 |
| Prudential capital buffer | 7 | 6 | 4 |
| **Total CET1/Tier 1** | **13** | **12** | **10** |
| Tier 2 | 3 | 3 | 3 |
| **Total capital** | **16** | **15** | **13** |
| Additional LAC (internal) | 6-9 | | |
| **Total LAC (TLAC)** | **22-25** | | |

- Increased focus on crisis management relative to crisis prevention.
- Additional (internal) LAC is introduced for Group 1 to reflect their impact to the system and to support home/ host co-ordination in crisis management.
- For Group 1, part of PCB is replaced with additional (Internal) LAC.
- For Groups 2 and 3, same as Option B.

## *Industry reaction*

- **Group 1 deposit takers** may support as internal LAC is generally less expensive
- Less proportionality on CET1, but LAC applies only to G1. Roughly neutral **impact on competition**

## *Economic impacts*

- No increase in average **funding costs** (and around 8bps lower than 2019 review settings in 2028)
- Level of stability will depend on RBNZ and industry's **crisis management capability** (which will take years to fully develop)

## *International comparison*

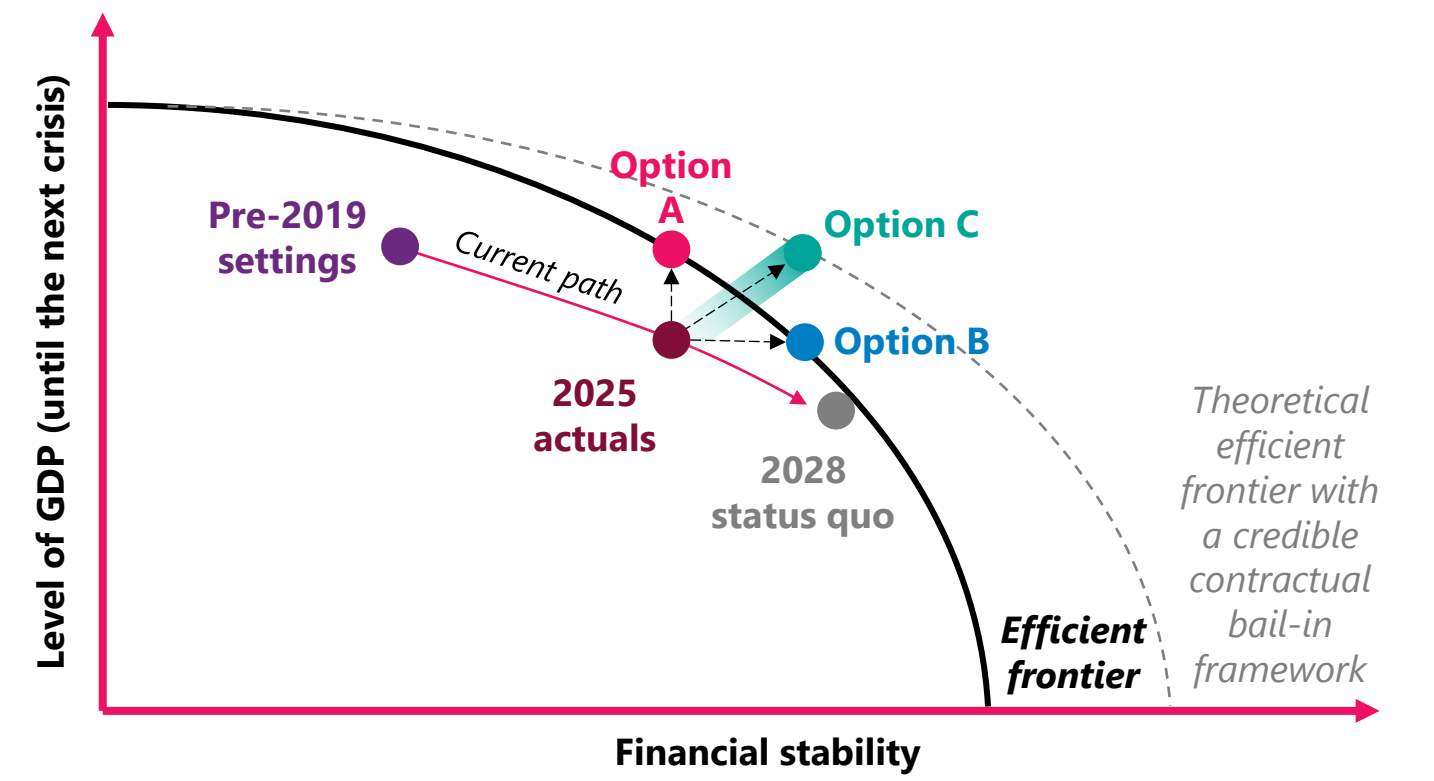
- **Broadly aligned** with international best practice in having some form of LAC requirement
- LAC size will be set by reference to approach in other jurisdictions, and objective of supporting **home/host coordination**

## *Risk stance*

- We accommodate a **reasonable level of risk taking**
- We accept a risk around our ability to **manage a crisis** (given crisis framework still at early stage, questions about reliability of LAC instruments, etc)

# Financial stability trade-offs

## Illustrative location of options vs the "efficient frontier"

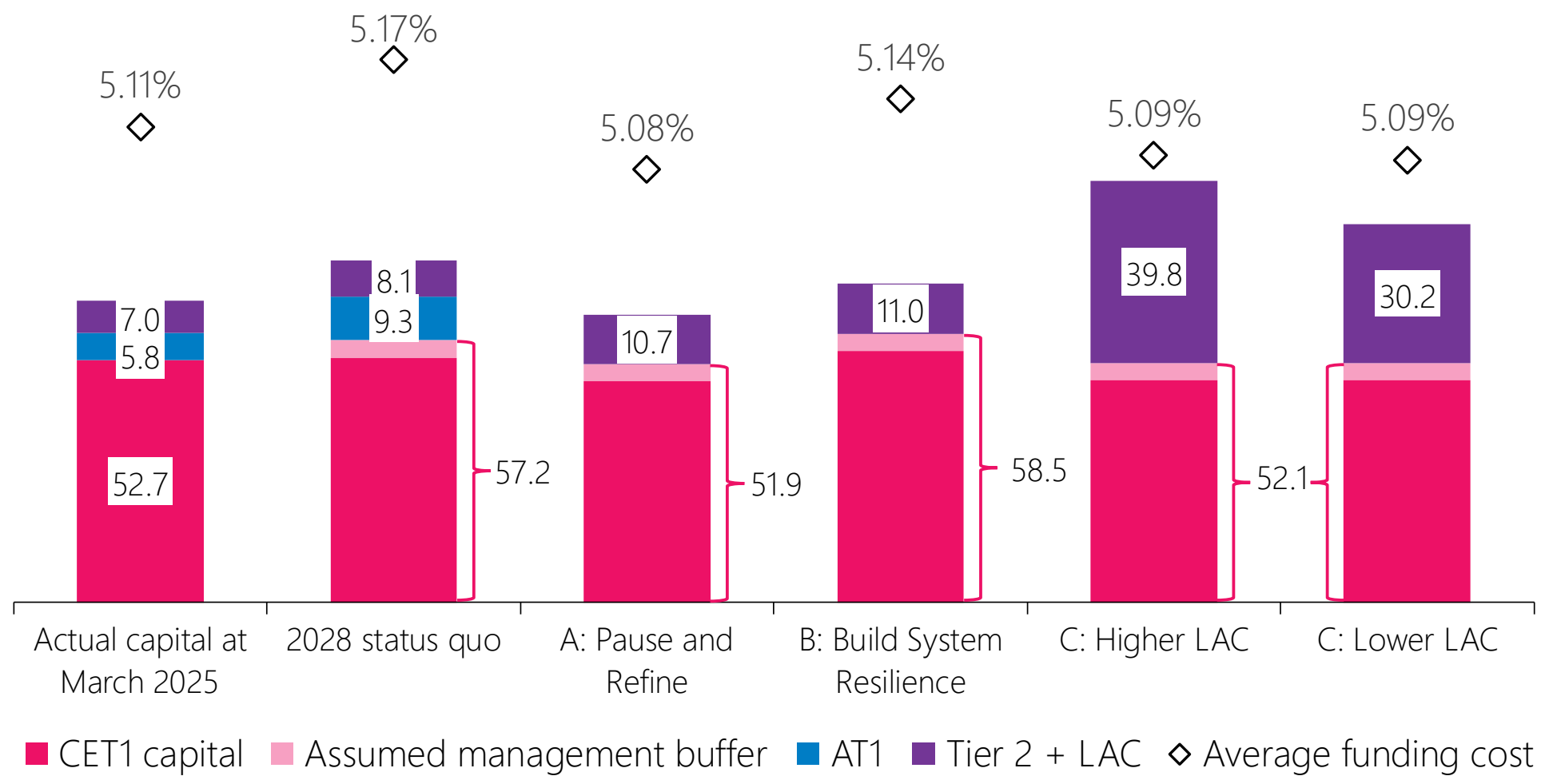



### Notes

- NOT TO SCALE.
- Compared to the current path, all options deliver marginal efficiency gains from changes to AT1 and risk weights.
- Option C may enable us to "push out" the frontier, but it is uncertain if LAC will work as intended.
- Net benefits are not constant along the frontier.

# Supporting evidence: Cost of capital

## Estimated total capital stack ($bn) and impact on funding costs (WACC)



# Supporting evidence: Cost of depletion

## What is 'depletion'?

A depletion event refers to the severe economic costs when all Tier 1 Capital (equity) in the banking system is depleted. The economic consequences from the GFC in the United States (2007-2009) is a comparable event.

## Initial estimates of annualised cost of depletion (% of GDP)

| | Cost of depletion (impact on GDP) | | |
|---|---|---|---|
| | Lower boundary | Mid point | Upper boundary |
| **Status quo / 2028** | 0.29% | **0.32%** | 0.35% |
| **Option A: Pause and Refine** | 0.57% | ↑↑ **0.63%** | 0.70% |
| **Option B: Build System Resilience** | 0.42% | ↑ **0.47%** | 0.52% |
| **Option C: High LAC** | 0.21% | ↔ **0.31%** | 0.43% |
| **Option C: Low LAC** | 0.28% | ↑ **0.38%** | 0.49% |

The 2028 Capital settings are used as the status quo. The "no change" option

The no-LAC options that lower capital could increase the cost of crisis by ~0.15-0.30% of GDP

The impact on the cost of crisis for the LAC options is more uncertain, but could have a similar cost to the status quo

# Supporting evidence: Net benefit

## Provisional estimates of net economic benefit (% of GDP)

| | Lending benefits | Financial stability impacts | Net benefit* |
|---|---|---|---|
| **Status quo / 2028** | 0.00% | 0.00% | 0.00% |
| **Option A: Pause and Refine** | 0.12% | -0.31% | -0.19% |
| **Option B: Build System Resilience** | 0.04% | -0.15% | -0.11% |
| **Option C: High LAC** | 0.10% | 0.01% | 0.11% |
| **Option C: Low LAC** | 0.11% | -0.06% | 0.05% |

**Non-LAC options** are likely to have a small negative net benefit

**LAC options** are likely to have a small (but less certain) positive net benefit

***** Similar to the 2019 analysis, the CBA will include a *'Transfer of Wealth'* impact, which measures the impact of bank profit being paid to foreign bank owners, and the tax impact of that profit.

**Note:** There is a relatively small difference between each option and the results are dependant on assumptions which have a high degree of uncertainty. Modelling assumptions have previously been a significant source of debate for stakeholders and are all subject to consultation and further refinement. If the impacts of capital on lending rates are higher than assumed, the net benefits of all options would be less negative/more positive. However, the relativities between options should hold.

# Structure of the consultation paper

## How we have addressed FSOC's feedback

**Proposed in Board paper**

1. Introduction
2. Context
3. AT1
4. Risk weights
5. Capital stack options
6. Conclusion & next steps

**Proposed post-FSOC**

1. Introduction
2. Context
3. **High-level options**
4. Conclusion & next steps
5. **Chapters:**
   - AT1
   - Risk weights
   - Draft CBA

FSOC to comment on draft consultation paper 8-11 August

**Points to emphasise:**

- ✓ The consequences of bank failure
- ✓ Impact of each option on GDP and competition
- ✓ Our high level "stance" on risk under each option

Reordered to keep the focus high-level