

## Memo for the Board – Review of key capital settings: updated options for consultation

<b>From</b>	Capital Review team – Katy Simpson
<b>Approved by</b>	Angus McGregor, Acting Assistant Governor Financial Stability
<b>Date</b>	25 July 2025
<b>Subject</b>	Review of key capital settings: updated options for consultation
<b>For</b>	Information and feedback
<b>Value(s)</b>	Integrity/Tauira   Innovation/Wānanga
<b>Strategic Theme(s)</b>	Strengthening efficiency and competition

### Purpose

At the Board meeting on 24 July you requested:

- A set of options to consult on that are more closely anchored to the *amount* of capital in option A (based on current levels of capital in the system) with a range (albeit narrow) of settings for the other options to reflect variation in the *form* (LAC) and *distribution* (proportionality) of capital. You requested options that would be considered credible by industry players.
- More information on:
  - the current overall dollar amount of capital;
  - the overall projected dollar amount of capital in 2028 if no changes were made (including no changes to risk weights/AT1);
  - the overall dollar amount of capital under the three options below; and
  - the estimated cost of each tranche of capital.

### 1. Background

We understand that you are comfortable with the level of overall capital currently in the system based on the Board’s 2025 Risk Appetite Statement and taking into account the Financial Policy Remit (which is the legal mechanism through which democratic guidance is provided to the Board in its decision making).

While we recommend moving away from a public articulation of risk appetite that anchors to a “1-in-X year” likelihood of crisis, for the Board’s information the current level of capital in the system (i.e. Option A) represents a **1 in 90-100 year** risk appetite, as opposed to a **1 in 200 year** risk appetite.

We have assumed that this is a deliberate decision by the Board to adopt a significantly less conservative risk appetite than in 2019 (e.g. representing a greater tolerance for financial instability and situations where we need to use resolution measure). If this is not the case, please let us know. This will be important for us in drafting the consultation paper and articulating the Board’s rationale for the options.

## 2. Options

This section sets out the revised options based on your feedback at the Board meeting on 24 July. Option A has no changes as you were supportive of this option at the meeting. Options B and C have been adjusted in response to your feedback. We have marked in red any changes to the charts in the slide pack that was discussed at the Board meeting on 24 July. Please cross-refer to those slides if helpful.

### Option A: Pause and Refine

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

Key features:

- Capital levels do not increase above currently held levels (at March 2025).
- Some of AT1 is replaced with cheaper Tier 2 capital, some is removed and not replaced.
- Similar average funding costs to now, and around 9 basis points (bps) lower than 2028.

Some industry players have explicitly called for an option along these lines, so are likely to welcome this option. We have not heard industry calling for us to go further e.g. have capital drop from where it is now.

### Option B: More proportionality

	Group 1	Group 2	Group 3
Minimum CET1/Tier 1	6	6	6
Prudential capital buffer	8	5	4
<b>Total CET1/Tier 1</b>	<b>14</b>	<b>11</b>	<b>10</b>
Tier 2	3	3	3
<b>Total capital</b>	<b>17</b>	<b>14</b>	<b>13</b>
Additional LAC	-		
<b>Total LAC (TLAC)</b>	<b>17</b>		

Key features:

- For Group 1, 2 percentage points (ppts) of AT1 is replaced with cheaper T2 and 0.5 ppts replaced with CET1. Combined with the significant reduction in capital due to lower risk weights (despite no change in the underlying risk of the deposit taker's assets), this is effectively a reduction in CET1 compared to the 2028 status quo for Group 1 – as well as a lower total capital ratio.

- For Group 2, 2 ppts of AT1 is removed and not replaced and 0.5 ppts is replaced with T2. A further 0.5 ppts of CET1 is replaced by T2.
- This provides more proportionality – with a 3ppt difference between G1 and G2, compared to 2 ppts in option A and the 2028 status quo.

We think this is an option that industry would consider credible, and some deposit takers may support over Option A, while also providing more support to financial stability than Option A by requiring somewhat higher capital for the largest deposit takers

We do not think there are any feasible options to consult on that provide both more proportionality than option A and lower total capital than this revised option B. This is because:

- We think the proposals for Group 3 in Option A are as low as they can go and still meet our obligations around the safety and soundness of individual deposit takers – anything smaller than a 4% buffer does not provide sufficient runway if a deposit taker began to get into difficulties.
- Given that, we think the proposals for Group 2 in Option A are as low as they can go too – as they just have a 1 ppt larger buffer than Group 3.
- Having 6% Tier 1 in the minimum is a Basel requirement – so while it is not essential to meet, it is highly desirable.

Further, we continue to believe there is merit in consulting on a broader range for Option B (for example, including the Option B we presented in the slides at the 24 July Board meeting). This would preserve more optionality for the Board following the consultation and help gather evidence on the cost of options with a wider range of risk tolerances. It is also supported by our technical analysis and the initial views of the international experts. However, unless you instruct us otherwise, we will proceed with the Option B as articulated in this paper.

### Option C: LAC

	Group 1	Group 2	Group 3
Minimum CET1/Tier 1	6	6	6
Prudential capital buffer	6	5	4
<b>Total CET1/Tier 1</b>	<b>12</b>	<b>11</b>	<b>10</b>
Tier 2	3	3	3
<b>Total capital</b>	<b>15</b>	<b>14</b>	<b>13</b>
Additional LAC (internal)	6-7		
<b>Total LAC (TLAC)</b>	<b>21-22</b>		

Key features:

- No increase in average funding costs from 2025/Option A.
- Reduced level of CET1 than what banks currently have. Lower prudential capital buffer compared to other options, offset with additional LAC to manage crisis with a reasonable manner.
- Broadly consistent with international practice in having a LAC requirement.
- Reduced proportionality on CET1, though partly offset because LAC applies only to G1.

We are confident that this is an option that industry will consider credible for consultation. The LAC levels required in this option are similar to the total capital ratios actually held by Australian parent banks. Group 1 deposit takers would likely support this option as internal LAC is generally less expensive than CET1, so the lower end of the range has a lower WACC than Option A, despite having a higher overall ratio. Group 2 deposit takers would likely oppose this option, as proportionality on CET1 is reduced: Group 1 deposit takers would likely require less CET1 (on a dollar-for-dollar basis) than Group 2 banks for equivalent lending, because the 1 percent difference in CET1 required is more than offset by the RWA reduction that Group 1 deposit takers receive from using the IRB approach.

### 3. Impacts

This section outlines the answers to your questions about:

- (a) The \$ levels of capital in the system, as we understand you are interested in the economic impacts of capital being repatriated to Australia rather than held in New Zealand to support lending and economic activity.
- (b) The % and \$ cost of funds for each tranche of capital under the proposal to discern the true economic cost of the proposal below the headline numbers, which can sometimes be misleading.

#### *Cost of each type of capital in each option*

	Actual capital at March 2025	2028 status quo	A: Pause and Refine	B: More Proportionality	C: Higher LAC	C: Lower LAC
CET1: Regulatory requirement/buffer		53.2	48.1	51.3	45.7	45.7
CET1: Assumed management buffer		4.0	3.7	3.7	3.7	3.7
<b>CET1 - Subtotal</b>	<b>52.7</b>	<b>57.2</b>	<b>51.9</b>	<b>55.1</b>	<b>49.4</b>	<b>49.4</b>
AT1	5.8	9.3	-	-	-	-
Tier 2 / LAC	7.0	8.1	10.7	10.7	33.4	29.6
<b>Total</b>	<b>65.6</b>	<b>74.5</b>	<b>62.6</b>	<b>65.8</b>	<b>81.8</b>	<b>79.1</b>
Weighted-average funding cost	5.11%	5.17%	5.08%	5.11%	5.06%	5.06%

*Cost of each type of capital assumed in each option*

	Actual capital at March 2025	2028 status quo	A: Pause and Refine	B: More Proportionality	C: Higher LAC	C: Lower LAC
Cost of equity (pre-tax)	13.36%	13.29%	13.38%	13.33%	13.42%	13.42%
AT1 (pre-tax)	8.65%	8.65%	N/A	N/A	N/A	N/A
Tier 2	5.13%	4.95%	5.28%	5.21%	5.34%	5.34%
LAC	5.13%	4.95%	5.28%	5.21%	5.34%	5.34%
Marginal debt	4.44%	4.42%	4.45%	4.44%	4.42%	4.42%
Other debt	2.21%	2.21%	2.21%	2.21%	2.21%	2.21%

**Note:** The table above shows that the costs of different sorts of funding are assumed to change based on their safety in each option. For example, when there is less equity, equity is slightly more expensive. The cost of equity is applied to an estimated market value of equity for New Zealand banks, not their book (accounting) value of equity, which is lower. The table also shows these effects are assumed to be quite small.

#### 4. Next Steps

Please let us know by COP Monday 28 July if you have any concerns with the above. If not, we can then incorporate this into the draft version of the consultation paper that you will receive in early August.

We note that any delay in confirming the options will impact the delivery of the consultation paper, which is already on a tight timeframe with us targeting release on 25 August. We also need to build in time to provide a draft to the Minister ahead of publication.