REFERENCE: #6331

DATE: 6 November 2025

TO: Hon Nicola Willis, Minister of Finance

FROM: Jess Rowe – Director, Prudential Policy
Jess.Rowe@rbnz.govt.nz 9(2)(a)

MAIN CONTACT: Jess Rowe – Director, Prudential Policy
Jess.Rowe@rbnz.govt.nz 9(2)(a)

Aide Memoire: Meeting with independent experts to the Review of Key Capital Settings 12 November 2025

Purpose

To provide you with information to support your meeting with the international experts on 12 November 2025 at 8pm on the Review of Key Capital Settings (**the Review**). As the experts are all based overseas, they will be attending this meeting virtually.

Background

As part of the Review, the Reserve Bank commissioned three independent international experts to review the Reserve Bank's analysis, options and recommendations and to support the Reserve Bank's Financial Stability Oversight Committee (**FSOC**) and Board in reaching decisions.

The experts are Sir John Vickers, Thorsten Beck and Elena Careletti. They have been provided with all the consultation paper submissions and have met with some stakeholders (ANZ, ASB, BNZ, Westpac, Kiwibank, Heartland, Rabobank and the Non-Bank Deposit Taker Association) to further understand their submissions (RBNZ #6328 refers).

Having considered the submissions, the experts have prepared summaries of their initial views of the proposals in the consultation paper. These are included in Annexes 1 to 3. The experts will be ready to talk you through their initial views and answer any questions you have.

The international experts' initial views show some scepticism about the benefits of the options over the 2019 Capital Review decisions. Their analysis and perspective provide a counterbalance to the submissions received arguing for more significant reductions in Common Equity Tier 1 capital, as they consider our capital settings in 2025 with an international perspective. As set out in their initial views documents, key areas of focus for the international experts are:

- Support for removing AT1 capital but prefer for it to be replaced with CET1 capital.
- Do not think that the environment has changed since 2019 sufficiently to justify a relaxation of capital requirements relative to 2019 analysis.
- A general preference for Option 1 over Option 2 of our consultation proposals.
- Concern for how an option with internal Loss-Absorbing Capacity (**LAC**) will work.
- Concern that proportionality is not reflected in the proposals (particularly in Option 2).

- Cautious support of changing risk weights to reflect credit risk.

As part of this Review, we will analyse the following sources of information to support the Board's decision-making process:

- Submissions from stakeholders on our Consultation Paper where we sought feedback on proposed settings (RBNZ #6238 refers).
- Independent reports from the three international experts to the Review.
- Updated analysis including criteria analysis and cost benefit analysis, having considered feedback from stakeholders.

We discussed our current thinking with you at our meeting on 4 November 2025 (RBNZ #6238 sets out this thinking and the Treasury's perspective is outlined in T2025/2719). We will continue to have conversations with the experts as we refine our analysis and advice to the Board.

Next steps for the experts

The experts are meeting with FSOC on 7 November to discuss their initial views on the consultation proposals. Following this meeting, the experts will continue engaging with Reserve Bank staff as they draft their full reports and we finalise our advice to the Board.

FSOC and the Board will be provided with the experts' near-final reports to support them to reach final decisions on capital settings in December. The experts' final reports will published as part of a package of documents that explain the Board's decision-making process in December.

Information about the independent international experts

Thorsten Beck (Annex 1)
Thorsten Beck is Director of the Florence School of Banking and Finance and Professor of Financial Stability at the European University Institute. He is also the co-chair of the Advisory Scientific Committee of the European Systemic Risk Board. He is an expert in the relationship between finance and economic development.

Elena Carletti (Annex 2)

Elena Carletti is a Professor of Finance at Bocconi University. She is also the Vice-Chair of the Board of Directors of UniCredit, a former member of the Advisory Scientific Committee of the European Systemic Risk Board and past-President of the European Finance Association. She is an expert in banking, finance and regulation.

Sir John Vickers (Annex 3)

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

9(2)(a)

Jess Rowe
Director, Prudential Policy
Reserve Bank of New Zealand

Jess.Rowe@rbnz.govt.nz 9(2)(a)

Annex 1 - Summary report - Thorsten Beck

Annex 2 - Summary report – Elena Carletti

Annex 3 - Summary report – Sir John Vickers

Annex 1 – Summary report from Thorsten Beck

First draft of observations on RBNZ capital review

Thorsten Beck

31 October 2025

This is a collection of first thoughts about the ongoing review process for capital requirements in New Zealand. They will be complemented in due course with a more detailed report.

First, the 2019 review and subsequent decision on capital requirement went beyond Basel III and many other advanced countries in terms of imposing high capital requirements on banks in New Zealand. This can be justified with a higher reliance of the New Zealand economy on its banks, limited diversification benefits by banks within New Zealand and, more generally, the risks that come with a small open economy. The current review, including the public consultation, argue that risks have declined because New Zealand has introduced several reforms to its financial safety net, including a strengthened bank resolution regime and deposit insurance. It also refers to a higher risk appetite, although one wonders whether this is a politically driven cyclical element.

It is here that my first disagreement arises: the global macrofinancial landscape is worse than in 2019. Risks arising from changes in the geopolitical and -economic landscape can have severe impact on the New Zealand economy and thus its banking system (to name a few: tariffs with their impact on trade including diversion in trade; geopolitical tension in Taiwan Strait, and, more generally, rivalry between US and China). While I concur that some of the recent reforms in the financial safety net might have reduced the risk environment and strengthened the resilience of banks in New Zealand, this seems more than off-set with the higher risk arising from the global environment

Herewith some more specific comments on the proposed changes:

What to like

Getting rid of AT1 and thus simplification of capital stack. There are increasing doubts globally on the usefulness of AT1 capital, for either going- or gone-concern, so I do not think that eliminating this as part of the capital stack has much downside. I concur with the idea to replace AT1 Capital with CET1 capital, although I would prefer to replace all of it rather than reducing total Tier 1 capital and partly replacing AT1 with Tier 2 capital.

Adjustments of risk weights: in general, I agree with the approach to align risk weights to historical loss data for New Zealand, with one important caveat. While loss data for individual loans across different categories might be useful for risk weights, they do not necessarily take into account cyclical risks, which might have to be captured with a countercyclical capital buffer. In addition, the (mostly downward) adjustment of risk weights reduces overall capital level even more than envisioned in the review, under either option, which is of concern. One important challenge to keep in mind, however, is regulatory arbitrage, i.e., banks shifting loans (or assets more generally) across different categories to minimise risk weights. However, this can be addressed through supervisory actions.

Proportionality: I concur that it is adequate to set different levels of capital requirements to the different groups within the banking system. It seems that one very specific concern is the possible transition of a domestic Group 2 institution to Group 1, as – unlike the four current members of Group 1, all subsidiaries of Australian banks – such a bank could not rely on internal LAC from the parent bank but only external LAC, i.e., debt issued on markets.

What to be critical of

The **Oliver Wyman study** shows that banks in New Zealand have somewhat higher capital ratios than banks in other jurisdictions. However, and as also pointed out by Martien Lubberink in a recent blog entry, the choice of countries is rather eclectic and does not take into account the nature of New Zealand as small open economy, the heavy reliance on foreign-owned banks, the smaller size of the banks and the potentially higher sectoral concentration of the New Zealand economy.

The current framework does not include a **leverage ratio**, which is in contrast with the Basel III framework. While rather stringent capital requirement as foreseen in the 2019 review might suggest that such a counterweight to reducing the ratio of risk-weighted to total assets too much might not be necessary, the reduced risk weights and overall lower capital requirement should definitely trigger revisiting this point.

Option 1 vs. Option 2 for Group 1 banks – maybe not surprising, Group 1 banks mostly favour option 2 with internal LAC provided by their parent banks. However, it is important to assess this option in combination with a realistic ('hard-nosed') assessment of resolvability of Group 1 institutions. Also, there is a strong argument (also made by some Group 2 institutions) that shifting away from Tier 2 capital instruments towards internal LAC instruments would reduce the depth and liquidity of markets for banks' Tier 2 capital instruments.

Finally, and as I have argued earlier, it would be important to focus more on the usability of the **countercyclical capital buffer**, with a positive neutral CCyB of at least 1% (maybe better 2%) as part of the prudential buffer.

DRAFT

Annex 2 – Summary report from Elena Carletti

Preliminary and Partial Comments on the Proposed Review of Capital Settings (October 2025)

Elena Carletti and Brunella Bruno

Below we present our preliminary and partial comments on the proposed review of capital settings. We begin with a brief overview of the main proposed changes and consultation outcomes. We then provide concise comments on the rationale for the review (why the settings are being revisited), the approach to risk appetite, and, finally, specific aspects of the proposal.

A. Motivation and Structure of the Proposal

- The main motivation for the review appears to be the desire to increase competition, support growth, enhance proportionality and simplicity, and improve alignment with international standards.
- The RBNZ's proposal includes two key elements:
  - i. **Capital requirements:** Two options are presented:
    - a. **Option 1:** Maintains the current overall capital level, replacing AT1 instruments with CET1 and Tier 2 capital.
    - b. **Option 2:** Reduces CET1 requirements (net of AT1 substitution) but introduces a Loss Absorbing Capacity (LAC) requirement that partly replaces prudential capital buffers (PCBs)
  - ii. **Risk weights:** The proposal introduces a more granular approach to risk weighting, with lower risk weights for residential mortgages, SMEs, and agricultural exposures.

B. Consultation Outcomes

- All banks support the removal of AT1 instruments, but their preferences differ by size group:
  - i. **Large banks (Group 1)**: Generally, support Option 2, with some proposing even lower capital ratios.
  - ii. **Mid-sized banks (Group 2)**: Tend to prefer Option 1, citing concerns that the LAC buffer may disproportionately benefit larger banks able to access a broader (mostly non- domestic) investor base for TLAC instruments.
  - iii. **Smaller banks (Group 3)**: Express concern that neither option sufficiently enhances proportionality.
- Responses by other contributors are more diverse, with some advocating the need to maintain capital levels as in the 2019 review, and others suggesting instead to go further with the proposed changes.
- Several respondents also advocate for closer alignment with Australian regulation, particularly regarding the definition and composition of capital instruments.

C. Our Comments

1) Rationale for the Review

Regarding the motivations behind the review, we suggest that the following aspects be considered with greater attention:

- There have been no major changes in economic fundamentals, and New Zealand-specific risk factors remain broadly stable. If anything, the macroeconomic environment has deteriorated in recent years due to global geopolitical tensions.
- More generally, there is no clear empirical evidence that higher capital ratios reduce economic growth or competition. On the contrary, while higher capital requirements may entail short-term transition costs, extensive evidence shows that better-capitalised banks lend more, particularly during downturns.[1]
- Legislative changes occurred in recent years in New Zealand appear to have unclear or minimal effects on capital requirements, as noted in Section 2.1 of the 2025 Review of Key Capital Settings.
- In addition, the impact of ongoing reforms in crisis management and supervision cannot yet be assessed, as these processes are still underway.
- International comparisons should be interpreted with caution. While New Zealand may appear to have relatively stricter requirements, meaningful comparison requires analysing the composition of capital regulation (capital components, risk-weighted assets, supervisory and resolution frameworks) and the structural characteristics of each banking system (bank size and prevalent business models, home/host-country status).[2]

2) Risk Appetite

- The 2019 decision was based on a clearly articulated risk appetite — targeting no more than one crisis every 200 years.
- The current review does not define its risk appetite as clearly. It appears partly based on benchmarking exercises and the objective of enhancing competition, even if this implies a higher probability of individual bank failures.
- A less conservative risk appetite increases the likelihood of both individual and systemic crises. The RBNZ and the New Zealand government should recognise the higher probability of intervention in the financial system and the associated potential fiscal costs.
- The potential unfolding of a crisis management is particularly relevant in a country like New Zealand, which is heavily dependent on foreign-owned banks and would therefore require substantial international coordination in the event of a crisis.

---

[1] See, e.g., Gambacorta & Shin, 2018 (https://doi.org/10.1016/j.jfi.2016.09.005). Recent evidence also suggests that better-capitalised banks are more resilient to geopolitical shocks. See Beck, Bruno, Carletti, 2025 and literature review therein. European Parliament In-Depth Analysis, forthcoming.

[2] Comparable size is important: in the euro area, for example, smaller less-significant institutions (LSIs, with total assets below €30 billion) are better capitalised than significant institutions (SIs) in terms of CET1 and Tier 1 ratios SIs appear better capitalised only when total capital ratios (including Tier 2) are considered. (www.bankingsupervision.europa.eu/framework/statistics/html/index.en.html).

3) Comments on Specific Aspects of the Proposal

- The review focuses on capital regulation, while other key frameworks — deposit insurance, supervision, and crisis management — are also under review. It is difficult to assess the capital proposals in isolation. This uncertainty would call for a more conservative approach at this stage.
- Consultation responses reveal divergent perspectives between Groups 1 and 2. While these may partly reflect self-interest, it is clear that mid-sized and smaller banks face greater difficulty attracting investors for subordinated instruments. This could justify either a differentiated approach (e.g., Option 2 for large banks and Option 1 for smaller ones) or a simpler uniform framework based on Option 1 for all, which would preserve the simplicity of the 2019 framework while supporting proportionality.
- In terms of alignment with Australia, LAC instruments should be consistent with those accepted by APRA. However, higher capital ratios in New Zealand may still be appropriate, given differences in underlying risks, supervisory structures, and the dominance of foreign- owned subsidiaries (≈ 85% of total banking assets), which adds complexity to crisis management.
- As the eligible instruments for the LAC requirement have not yet been defined, it is premature to assess the merits of Option 2. While it lowers CET1 requirements, the total requirement (including LAC) may ultimately be higher. Replacing capital with LAC is not neutral in terms of overall loss-absorption capacity, and the final evaluation should await clarification on eligible instruments.
- Although the removal of AT1 instruments could simplify the framework, it is important to acknowledge that different capital components absorb losses at different stages — some in a going-concern context, others only once the institution has failed. These differences should be carefully considered when determining replacement levels.
- Should Option 2 prevail, the differing ability of domestic banks to issue TLAC instruments should be taken into account, as this could undermine the principle of proportionality — one of the main motivations behind the reform.

DRAFT

Annex 3 – Summary report from Sir John Vickers

Summary of provisional views on the RBNZ 2025 Review of key capital settings

John Vickers, 29 October 2025

The Review document issued on 25 August 'seeks feedback on options calibrated to a higher risk appetite' than in the 2019 review of capital settings for NZ banks. The two options that are presented both involve a substantial reduction in CET1 capital relative to current policy (meaning once fully implemented in 2028). Option 2 has a greater reduction in CET1 capital than Option 1 but has significant LAC for Group 1 institutions.

This note summarizes my current and provisional views on the pros and cons of each option, including relative to current policy. Various other issues in the Review will be discussed in my final report.

Current policy

Following the 2019 review, the RBNZ adopted a policy on bank capital that differs from the international norm, particularly in respect of its focus on CET1 (rather than less surely loss-absorbing capital) and its discipline on risk weights. Capital levels were calibrated with the aid of a framework for cost-benefit analysis (CBA), and it is important to ask (i) whether that framework was flawed (e.g. too risk-averse) to begin with, and/or (ii) whether events since 2019 justify a significant recalibration.

On (i), the 2019 review has been criticized for the crisis-once-in-200-years characterization of optimal capital. My understanding however is that this was a way of describing the outcome of the CBA, not its desired result. The CBA itself does not appear to be risk-averse; indeed it is based on a risk-*neutral* view of gains and losses of NZ output. Against this background it is unclear what a greater risk appetite would involve.

A puzzle about the 2019 analysis is its treatment of gains/losses flowing from NZ to Australia. Counterintuitively, higher equity capital *increases* transfers to Australia in the CBA. Relatedly, the analysis assumes that all cost changes are passed through to borrowers, but with imperfect competition one would expect imperfect passthrough.

On (ii), although there have been legislative changes since 2019, macroeconomic and fiscal risks have risen, as the Review document notes, and there are lessons from the banking failures of 2023. Overall I would not say that the 2019 framework overstates risks as they appear today.

Option 1

Option 1 reduces capital by about 12% relative to current policy, and Tier 1 capital by 17% as AT1 is removed. This lowers estimated bank funding costs (given the partial Modigliani-Miller offset) but raises the expected output loss from bank failures. In the central estimate in Table 25, the net effect on GDP relative to current policy is *negative*: a drop of 0.16% of GDP. The estimated wealth transfer to foreign owners, about which I have the doubts above, reduces the loss to 0.09% of GDP. Table 26 shows sensitivity analysis for four adjustments. The net benefit of Option 1 relative to current policy is negative in all of them.

Economic models are important guides, but no more than guides, to policy makers. It is however a challenge for Option 1 that it is estimated to be worse than current policy. (This is not surprising if the 2019 analysis remains broadly correct, because that analysis estimated optimal capital at the time, and risks appear not to have diminished since.) If Option 1 is nonetheless a better policy for NZ, then the CBA is missing something important, but I do not at present see what.

Option 2

Option 2 has CET1 capital 10% lower than Option 1 but adds substantial LAC – debt intended to allow bail-in if the bank ceases to be economically viable. Thus Option 2 places much more reliance on gone-concern capital than current policy or Option 1. A major question for the loss-absorbency of LAC is whether the regulator would find it acceptable for the bank to become a gone concern. If not, then public bail-out will happen instead of private sector bail-in. A prerequisite for the credibility of bail-in is investment in regulatory and supervision capacity. Even when that capacity is in place there can be no certainty that bail-in will work. It might, especially if a single institution is in trouble, or it might not, especially if a crisis is systemic. The events of 2023, both in the US and Switzerland, are not altogether encouraging about resolution – even AT1 – working as planned.

The central estimate of the CBA, however, is positive about Option 2. The LAC is assumed to work sufficiently well that, relative to current policy, the output loss from bank failures is quite small. The gain from lower lending rates is larger than in Option 1, as is the wealth transfer from Australia to NZ (which is most of the estimated gain). I have two concerns about this analysis, in addition to the points above about wealth transfer and passthrough.

First, it is important to consider *why* LAC is lower-cost funding for banks. Tax is one factor, but another is the chance in an adverse situation that public bail-out will save debtholders from being bailed in. This highlights that there is some tension between LAC being both inexpensive and loss-absorbing with high probability. Second, I do not have confidence that LAC would absorb loss with high probability, even when internal to the banking group. As the Review document rightly says (Box B): 'However, the existence of internal LAC instruments does not guarantee a successful recovery or resolution. The process is a complex one'.

Provisional conclusion

Of the two proposals, Option 2 involves a major shift towards reliance on gone-concern loss-absorbency in the event of a crisis. That appears to be quite a high-risk strategy, and I would not recommend it over Option 1. That said, it is not at all clear that Option 1 is better for NZ than current policy.

DRAFT