

# 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.<sup>1</sup>
- 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).<sup>2</sup>

## **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.

---

<sup>1</sup> 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.

<sup>2</sup> 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](https://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 ( $\approx 85\%$  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.