

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.