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First draft of observations on RBNZ capital review

Thorsten Beck

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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.