

Comments on the RBNZ Consultation Paper on key capital settings

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I offer some brief thoughts on the proposals set out by the RBNZ for a loosening of the capital requirements on banks. I was asked by the RBNZ at the time of the 2019 re-set of bank capital requirements to provide an assessment of that set of proposals. In my report to the central bank in 2019 my assessment then was that the substantially higher capital requirements that were being proposed were supported by the thorough analysis that was then done by the RBNZ and which I considered to provide a firm foundation for the decision taken.

I am much less persuaded of the evidence for the proposed relaxation of the rules now.

The scale of the reduction in capital requirements on either of the proposals which the RBNZ now sets out is substantial. As the consultation documents say:

“Combining the changes to both capital ratios and risk weights, Option 1 reduces total required capital by 12% relative to the fully phased-in 2019 Capital Review outcomes. While Option 2 increases the amount of TLAC, the amount of CET1 required is around 10% lower than in Option 1.”

A series of arguments is presented to justify this change. The one which is given most emphasis is that the current rules require of banks in New Zealand a level of capital higher than in most other countries. At several points in the documentation for the current proposals it is noted that they would bring the RBNZ capital requirements down to levels much closer to those set by banking regulators in most other countries.

But it was very clear at the time the capital rules were set in 2019 that they would be substantially higher than those set by nearly all other regulators. So it has not been a new development that the RBNZ capital requirements are higher. I said in my assessment for the RBNZ of the proposed capital rules that were set in 2019:

“That the RBNZ proposals would make banks in NZ better capitalised than in almost any other developed economy – and are in that sense “out of line” – is in itself not a powerful argument that the proposals go too far. They should be judged in terms of their effects on banks and on the wider economy in NZ – which is what the RBNZ analysis sets out to do. If the answer from a careful analysis is that capital will be different from that in most other countries then so be it; other countries might usefully ask whether the divergences are a reflection of economic differences between NZ and their own country or whether they have not done enough of the sort of analysis done by RBNZ.”

The fact that both options now being considered would bring greater alignment with international approaches is presented as an advantage. But there remain powerful arguments that those international levels are well below optimal levels. The analysis of John Cochrane, Anat Admati, Martin Hellwig, and many other finance economists, who advocate much higher levels of bank capital are of great force. At the heart of the case that current rules globally are too lax are two things.

The first is the incontrovertible logic of the Modigliani Miller theorem which substantially undermines the case most frequently made by those who advocate allowing lower levels of capital required of banks that equity is very much more expensive for banks than is debt.

The second is the empirical evidence that bank failures can be very costly. In 2019 the evidence of the enormous scale of costs of the global banking sector crises that began in 2008 was more salient than it is now, some six years further away from the financial turmoil. But that evidence, and the scale of damage from earlier banking crises, remains central to an assessment of optimal capital requirements and still seems to me to justify the rules introduced by the RBNZ in 2019.

One argument presented for a relaxation of the rules now is that the degree of risk aversion used in 2019 was inappropriate. It is noted that the RBNZ in its description of the 2019 rules made reference to an appetite for risk that would be consistent with accepting the chances of major banking failures making them once every 200 year events.

The RBNZ now says:

“We have moved away from a “1-in-X year event” basis for our risk appetite and instead have focused on benchmarking against a range of comparator countries.”

This makes it clear that being in line with other countries rules is given great weight. But it also rather overplays the role of the “1-in-200 year event” goal in the 2019 decisions. I noted this in my evidence to the RBNZ in 2019. I said then:

“The approach taken by the RBNZ appears to be to set an acceptable limit on the risk of widespread bank failure and then to assess what level of capital is consistent with that. The wider implications of that level of capital – for example on aggregate incomes – appear to be secondary. This approach seems to be lexicographic: decide on an acceptable amount of banking sector risk to take and then assess whether going beyond that (in terms of capital required of banks) is justifiable because it might generate higher average output. In fact the idea underlying the analysis that underpins the proposals is much more nuanced than this and does not start from a (somewhat arbitrary) decision that once in 200 years is the right average frequency to accept the arrival of banking crises. Instead there is more of an iterative process: start with a lower

acceptable level of safety (so that crises happen once in 100 years) and then assess whether one could do better in terms of average economic output with higher capital. That is found to be the case (conditional on the calibration of banking risks and of their economic implications). Only at an acceptable risk of banking crises that makes it a 1 in 200 year event is there no clear scope for raising average GDP by going for higher bank capital. So in fact the 1 in 200 year outcome is not a pre-set target; it is more a consequence of the iterative procedure which takes into account the wider economic implications of setting bank capital.”

The criticism that the RBNZ in 2019 started with an arbitrary and excessively risk intolerant assumption about acceptable chances of banking sector crises – the 1 in 200 year rule - does not take account of the crucial role played by the estimated impact of bank capital upon average aggregate incomes (i.e. GDP) in New Zealand. The conclusion reached by the RBNZ in 2019 on acceptable levels of banking sector risk was in fact a result of considering potential trade-offs between greater security and lower average levels of aggregate incomes in New Zealand. That was a form of cost benefit analysis which used average GDP as a measure of the relevant wider economic outcomes - a measure which implicitly assumed risk neutrality.

I concluded my 2019 assessment of the proposed capital rules then put forward by the RBNZ – and which would be materially relaxed under the current proposals – with an observation I still believe to be relevant. It is this:

“One final point leads me to the conclusion that the RBNZ has probably not over-estimated the appropriate level of bank capital. This concerns supervisory philosophy; perhaps strategy is a less pompous term. The RBNZ has adopted a principle of being conservative as regards bank capital to offset possible risks from its light-handed approach to supervision. That is a choice and one partly based on the view that having very large resources devoted to intrusive oversight of banks is not the most efficient road to go down. That is a conclusion that engineers and safety experts often apply when dealing with the design of structures. There is a choice between building bridges many times stronger than you expect them to need to be or you having large teams of inspectors who pay frequent visits to examine all bridges and monitor flows of traffic over them. It is clear that nearly all countries follow the first strategy. That may be a useful guide for bank supervision. “

I believe that this point remains just as true today as it was in 2019.

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