

# Comments on RBNZ's 2025 review of key capital settings

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As a general rule, requiring banks to be well-capitalised is a good thing as it reduces the risk of bank failure and the social costs arising from failures (of large banks in particular). In general, more capital is better than less capital, although there is an effective upper limit in that, if capital levels increase too much, the returns earned on capital will not be sufficient for banks to be able to persuade providers of capital to supply it to them (this is broadly consistent with the model based on optimising capital by maximising the market value of equity put forward by Berger, Herring & Szegő, 1995, but reframed to reflect New Zealand banks not generally being listed in their own right). I note that many of the smaller banks in New Zealand are already in the position where returns on equity are insufficient to make them attractive outlets for investors of capital.

It should also be noted that banks will want to hold capital in excess of the regulatory minimum, so that they are able to absorb shocks without making themselves subject to regulatory intervention. This is particularly important for smaller and stand-alone institutions, for which obtaining additional capital in response to shocks would be likely to be problematic, and many of these already hold higher capital levels to protect their continuing operations.

My specific comments are in relation to Question 2 only. In this I am concerned at the measure of risk tolerance for systemic crisis, even though I note that you are proposing to discontinue that approach.

Any attempt to measure risk appetite for financial stability as a 1 in X years approach implies that there is a known and parameterised probability distribution, which allows this 1 in X years effect to be measured. This is inherently problematic, as a systemic event is going to lie in the tail of a distribution, which is much more difficult to quantify, particularly when it is doubtful that we know the parameters of the relevant probability distribution. Even if we did know the parameters, these should not be expected to remain constant over any reasonable period of time, because they would be impacted by changes in banks' business mix over time, changing bank practices and technological interfaces, and regulatory change. Note of these have been fixed for the last 100 years, let alone the last 200 years, which means that we have no basis for assessing either a 1 in 100 years or 1 in 200 years event. See Guttentag & Herring (1995) and Berger & Udell (2004).

### References:

- Berger, A. N., Herring, R. J., & Szegö, G. P. (1995, June). The role of capital in financial institutions. *Journal of Banking and Finance*, 19, 393-430.
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- Guttentag, J. M. and Herring, R. J. (1986). Disaster myopia in international banking. *Essays in International Finance*. Number 164. Princeton University. 1-36.