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Reserve Bank of New Zealand – Te Pūtea Matua

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2025 Review of Key Capital Settings

Thank you for the opportunity to submit on the Reserve Bank of New Zealand's (**Reserve Bank**) 2025 Review of Key Capital Settings Consultation Paper (**Consultation Paper**). We, The Co-operative Bank Limited, Heartland Bank Limited, Kiwibank Limited, SBS Bank and TSB Bank Limited, welcome the review and are pleased to see that the Reserve Bank is taking into account the concerns we have consistently raised on the adverse impact the current capital settings have on banking competition.

The review comes at a critical time where there is a greater focus on competition. We urge the Reserve Bank to take this opportunity to address the significant competitive disadvantage that currently exists for smaller competitors. Appropriate changes to capital settings would considerably strengthen our ability to compete with the larger banks.

We support the direction the Reserve Bank is taking to adopt a higher risk appetite, to bring New Zealand's standardised risk weights more in line with Basel III, and to consider regulatory capital requirements in the context of the relative system risks. Lower capital requirements for Group 2 deposit takers and the removal of Additional Tier 1 (AT1) capital instruments are welcome changes.

However, we believe the Reserve Bank has not applied enough consideration to the impact this has on competition. The material capital advantage the four large banks (**IRB Banks**) have relative to smaller competitors will still exist after the changes proposed in the Consultation Paper are made. IRB Banks would still be able to hold less capital than smaller competitors for the same risk.

Changes to make now

There are two changes the Reserve Bank can make now that would reduce the significant competitive disadvantage that currently exists, without impacting the resilience of the banking system. We advocate for the Reserve Bank to make these changes as soon as possible.

1. Adopting the Basel III standardised approach to credit risk weights, to align requirements with actual risk

The fairest position would be that all market participants use the same credit risk weights. However, if different methodologies to quantify credit risk are retained, these methodologies must be aligned to deliver fair outcomes. This can be achieved by making the standardised risk weights as granular as possible, ensuring that their requirements are not materially divergent from what conservative internal models would provide (including capturing segment and size risk reductions already captured in the Reserve Bank's internal model formulas), and ensuring New Zealand does not adopt standardised risk weights that are

conservative in comparison to Basel III unless this can be justified by objective, quantitative analysis.

We submit that any benefits of a simplified framework have disappeared due to the increasing complexity of required data from the Reserve Bank. For example, all banks in New Zealand will soon provide highly granular loan-level data with up to 144 unique characteristics. As this data is already required, it should be utilised to improve classification of standardised risk weightings.

We have also observed that some of the standardised recommendations appear to be driven by intuition rather than grounded in robust, objective quantitative analysis. We also note that these areas diverge materially from what IRB Banks are offered. Examples include the proposal to group all commercial property in the same bucket without consideration of use type and leverage (on which we comment further below) and the lack of consideration of the impact of correlation on Retail (personal lending), but including it as a category in internal models.

Our individual submissions provide more detail on this point, however, a few examples of standardised risk weights that detrimentally impact smaller competitors that should be changed are:

- Owner-Occupier Residential Mortgage Lending: The proposed standardised risk weights are higher than the Basel III risk weights and, for all lending with an LVR of 70 or below, higher than the average IRB risk weights. This gives the IRB Banks a significant competitive advantage for low LVR lending, which makes up a substantial portion of lending in the banking system. For example, a 50-60% LVR loan at an IRB Bank would attract a 15% risk weight. Under the proposals, if the same loan were to transfer to a standardised bank its risk weighting would double to 30%.
- Personal Lending: The proposed standardised risk weights of 100% and 150%, for secured and unsecured personal lending respectively, are significantly higher than the average IRB risk weight of 57% for other retail lending. This gives the IRB Banks a significant competitive advantage for personal lending. It would also put New Zealand out of step with international peer jurisdictions, where risk weightings for comparable exposures are as low as 45%. Further, higher standardised risk weights for personal lending could lead to higher pricing and reduced credit availability. They could also have a negative impact on competition, because larger banks are more readily able to absorb additional costs. The standardised proposals are also inconsistent with established modelling practices, academic literature, and statistical evidence, all of which consistently indicate that personal lending is more idiosyncratic than cyclical.
- Unrated Corporate Commercial Property Lending: While we consider it appropriate to distinguish unrated corporate commercial property lending from other SME exposures, our preference is that the Reserve Bank apply further granularity to this category. To better align with the Basel III and APRA risk weights, we recommend separating this category in two - introducing distinct commercial property investment lending and development lending categories, with differentiated risk weights applying based on key credit variables such as LVR buckets and dependency on property related cash flows. This would ensure that capital outcomes are better aligned to the underlying credit risk of each loan type and incentivise the right lending behaviours.

- **SME Retail and SME Corporate Definitions:** The current threshold for a SME to be considered corporate rather than retail is NZ\$1m. The threshold is low compared to the Basel III threshold, which is €1m (approximately NZ\$2m) and the APRA threshold, which is A\$1.5m (approximately NZ\$1.7m). This is a good opportunity to update New Zealand's threshold, which has not been changed in nearly a decade, to better reflect risk and align with international practice.

2. Increasing the output floor to 100%

We acknowledge the attempts to address the inequity in regulatory capital settings through the introduction of the 1.2 scalar, the 85% output floor and the D-SIB buffer. We also acknowledge that more granular risk weights will help to reduce the gap between modelled risk weights and standardised risk weights. However, as long as the output floor is lower than 100%, the IRB Banks will be able to adopt lower risk weights than non-IRB banks.

Allowing IRB Banks to use lower risk weights gives them a significant competitive advantage. Accordingly, we would expect any decision to allow IRB Banks to use lower risk weights to be justified by significant financial stability benefits. We have not seen any evidence that IRB capital modelling results in better credit risk management outcomes. The IRB Banks persistently report higher troubled loan balances as a percentage of their portfolios.

This significant competitive advantage could be addressed by increasing the output floor to 100%. If a more granular standardised risk weighting is used, this will more closely align the risk weights with the actual risk of lending, which would reduce (but not eliminate) the competitive benefits enjoyed by the IRB Banks under the IRB approach.

Other domestic bank specific comments

Capital stack options: We note that Option 2 presents challenges for domestic banks because it is underpinned by an assumption that all Group 1 deposit takers will have offshore parent companies. Additionally, the Consultation Paper notes that the Reserve Bank may reconsider LAC requirements for Group 2 deposit takers as part of the implementation of the crisis management framework. It would not be appropriate to reconsider the LAC requirements in isolation from the other elements of the capital stack – this could lead to an increase in overall capital requirements for Group 2 deposit takers without any corresponding increase in the requirements for Group 1 deposit takers, which would create a further competitive disadvantage for Group 2 deposit takers. Also, LAC for Group 2 deposit takers would need detailed and differentiated consideration given Group 2 deposit takers' idiosyncratic ownership structures. Some domestic banks are unable to issue subordinated debt or LAC internally.

DCS levy: The Reserve Bank will need to adjust the capital adequacy factor for the DCS levy risk score calculation to reflect any adjustments to the capital requirements. If left unchanged, the lower capital requirements could lead to DCS risk score outcomes that would preclude any Group 2 bank from being in Risk Category 1, further embedding the competitive advantage for the IRB Banks.

Cost of capital: There are some assumptions in the Consultation Paper regarding the cost of capital which do not hold true for domestic banks.

The assumption that different capital requirements do not affect the amount that needs to be charged to recover operating costs is incorrect. Capital is a finite resource (particularly for smaller banks) and there are limits to how much it can be increased. Capital requirements determine the total amount a bank is able to lend, which in turn defines the denominator over which fixed operating costs must be spread. For example, a 50% risk weighted asset allows a bank to lend twice as much as a 100% risk weighted asset. As a result, the cost that needs to be recovered per dollar lent is halved under the lower risk weighting. This leverage dynamic is not captured in the analysis undertaken by the Reserve Bank, which should be reconsidered accordingly.

There are weaknesses in the cost-benefit analysis used by the Reserve Bank, including the lack of differentiation between IRB Banks and domestic banks. Recent empirical studies indicate that the cost of capital does not decrease proportionally with increased capital requirements for small institutions (that is, there is little Modigliani-Miller offset for small banks). When applying small bank capital data to the Reserve Bank's methodology, this supports that the cost of capital for smaller banks is significantly higher, and accordingly the expected impact to lending rates is expected to be higher, with the alternatives being lost market share to the IRB Banks, or to non-bank lenders. The Reserve Bank should revisit its cost-benefit analysis.

Conclusion

The Reserve Bank should implement these changes as soon as possible to deliver immediate certainty and drive a more competitive environment from the outset. These changes will help strengthen the position of smaller competitors and enhance competition in the New Zealand banking market – ultimately driving better long-term outcomes and greater choice for customers.

We are happy to discuss this further.