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Key Capital Settings Review Team
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Key Capital Settings – Policy proposals

Thank you for the opportunity to provide feedback on the policy proposals for the Key Capital Settings. This submission is supplementary to the collective banking industry submission prepared by the New Zealand Banking Association - Te Rangapū Pēke (NZBA). As a member of NZBA we endorse the feedback made in that industry submission. In addition, SBS Bank endorse the collective submission made by The Co-operative Bank Limited, Heartland Bank Limited, Kiwibank Limited, SBS Bank and TSB Bank Limited.

We have provided our responses to the specific questions in the consultation document however please note that we have not addressed all questions or topics within this submission, only those that we have a specific view on, or where these have not been explicitly addressed in the NZBA submission. We also make the following overarching comments.

As a registered bank operating under a mutual building society structure, SBS Bank holds a rare position in the New Zealand banking industry, in that the bank's owners are also our customers (referred to as members). This mutual ownership structure mandates that we operate in a way that ensures long-term sustainability and financial stability, whilst returning value to our members and their communities. Further, this operating model creates diversity, competition, and adds to the domestic capability within the banking and wider financial services sector including a strong regional focus.

SBS Bank are broadly supportive of the proposed changes to the capital settings which serve to improve proportionality and competition across the industry, however we do note the following exceptions.

First, the proposed increase to unsecured lending risk weights from 100% to 150% would widen the gap between standardised risk weights and IRB, APRA and Basel risk weights worsening proportionality and competition across the industry. Credit card lending is risk weighted 45% to 75% by Basel and 75% by APRA which suggests the risk weights on credit cards should be decreasing rather than increasing from the current 100%. Similarly, motor vehicle lending is risk weighted 75% by Basel lower than the 100% standardised risk weight currently applied.

Second, for Group 2 banks the 2.5% component of Additional Tier 1 (AT1) capital has been removed from the capital stack but the Tier 2 (T2) capital component of the capital stack has only increased by 1%. A better approach from a proportionality and competition point of view would be to allocate the full 2.5% of AT1 to the T2 capital component whilst maintaining an overall capital requirement at 14%.

Responses to questions within consultation paper:

Introduction

Q1: Do you have any comments on the proposed assessment criteria?

SBS Bank are comfortable with the proposed assessment criteria:

1. Going Concern Loss Absorbency
2. Crisis Management
3. Proportionality
4. Competition
5. Funding costs
6. Simplicity / Achievability
7. International alignment

As a smaller bank using standardised methodology for calculating capital, we are particularly conscious of maintaining proportionality across the industry, supported by appropriate levels of simplicity / achievability, which should ultimately improve competition in the banking industry.

Q2: Do you have any comments on the appropriate risk appetite for New Zealand's capital settings?

SBS Bank agrees it is appropriate to compare New Zealand's capital settings to similar jurisdictions globally in determining risk appetite. This ensures the cost of debt in the New Zealand remains competitive internationally allowing exporters and producers to compete on a more level international playing field. Furthermore, SBS consider it is appropriate to have a higher risk appetite for the non D-SIB's as they add competition without the adding systemic risk of failure. This higher risk appetite should emerge as lower capital requirements.

Capital Stack Options

Q9: Do you have any feedback on the proposal for Group 2?

SBS is supportive of the proposed reduction in the Prudential Capital Buffer for Group 2 banks from 7% in the status quo of the 2019 Capital Review decisions to 5% and the removal of AT1 capital from the stack providing more scope to use T2 capital. SBS believes this will provide better proportionality across Group 1 and Group 2 banks improving the opportunity for competition in the banking industry.

Additional Tier 1

Q25: Do you agree with the proposal to remove Additional Tier 1 capital as a form of regulatory capital?

SBS support the removal of AT1 from the capital stack noting the complexity of the product, challenges in issuing the product, and market appetite.

Q26: Are there any other factors that you think we should take into account in making this decision?

SBS note that under the proposal AT1 which currently comprises 2.5% of the capital stack has been removed, however the amount of Tier 2 (T2) capital that can be issued only increases from 2% to 3%. A better approach to improve proportionality and competition between Group 1 and Group 2 banks, would be to make the entire 2.5% decrease in AT1 capital available in T2 capital. This could be achieved by increasing the T2 component up to 4.5% and reducing tier 1 capital by 1.5% which would still result in a total capital requirement of 14%.

Standardised Risk Weights

Q29: Do you agree that the Reserve Bank should introduce more granular standardised risk weights for mortgage, corporate and agricultural lending?

SBS support the intention to increase the granularity and reduce the standardised risk weights as indicated the RBNZ proposal. This improves the alignment with Basel, APRA and IRB risk weights which also serves to improve competition for these loan types.

Q30: Do you have any comments on the proposed changes to standardised risk weights for mortgage, corporate and agricultural lending?

SBS note the proposed risk weights still remain higher than the IRB risk weights giving IRB banks a competitive advantage thus limiting the impact the smaller challenger banks have on market competition. Whilst supportive of the direction of this change, SBS also would encourage the RBNZ to look at the alignment of standardised risk weights for other lending products such as credit cards and motor vehicles.

Q31: For deposit takers: Can you quantify the overall and sectoral impact that the proposed changes to standardised risk weights for residential mortgage, corporate, and agricultural lending would have on your institution?

Yes. This will be provided separately.

Q32: Would you expect more granular residential mortgage lending risk weights to lead to more differentiation in loan pricing to borrowers?

In the same way residential mortgage pricing is currently differentiated for below 80% and above 80% LVR's, SBS can see more granular risk weightings would provide the opportunity for banks to price more granularly based on risk weightings.

Q33: For deposit takers: Can you provide a lending breakdown for your institution by the following corporate sectors: rating, small and medium-sized enterprise retail, small and medium-sized enterprise corporate, and other unrated corporate?

Yes. This will be provided separately.

Q36: Do you have any comments on increasing risk weights for personal lending?

SBS strongly disagree with the proposal to increase risk weights on unsecured personal lending from 100% to 150%. This would reduce the alignment with Basel, APRA and IRB risk weights which would also deteriorate competition between Group 1 and Group 2 banks for these loan types. SBS do not see any New Zealand specific dynamics that would warrant divergence from Basel/APRA for these lending categories.

Basel risk weights for credit cards are 45% when they are fully repaid and 75% for all other credit cards. In addition, Motor Vehicle lending is risk weighted 75% under standardised risk weights.

| | Basel CRE20 Standardised Risk Weights (CRE20.63 to 20.68) | APRA APS112 Standardised Risk Weights (Attachment B Table 13 and 14) | RBNZ Current Standardised Risk Weights | RBNZ Proposed Standardised Risk Weights |
|--|---|---|--|--|
| Credit Cards (fully repaid monthly last 12 months) | 45% | 75% | 100% | 150% |
| Credit Cards (not fully repaid monthly last 12 months) | 75% | 75% | 100% | 150% |
| Motor Vehicle | 75% | 100% | 100% | 100% |
| Other Secured Retail | 100% | 100% | 100% | 100% |
| Other Unsecured Retail | 100% | 100% | 100% | 150% |

SBS recommend rather than increasing the risk weight on credit cards to 150% that the risk weights should be decreased to align better with Basel risk weights and improve competition. In relation to motor vehicle lending, SBS recommends decreasing risk weights to 75% to align better with Basel risk weights and improve competition. For all other unsecured lending SBS recommend leaving the risk weight at 100% which is consistent with Basel and APRA. Even at the suggested Basel risk weights, the overall risk weights for standardised banks would be higher than the average IRB risk weight of 57% for other retail lending as published in their most recent disclosure statements.

Finally, if a standardised risk weight above 100% was adopted, the cost of this would likely need to be passed onto customers through higher interest rates. This adverse customer impact could also potentially raise competition concerns if larger banks were more readily able to absorb the costs without raising interest rates and smaller banks were unable to do so. In addition, a higher risk weighting and resultant higher interest rate could also mean that some vulnerable customers

may fail a loan affordability assessment and not be offered lending by a bank. This could drive such customers to lower tier lenders who are less regulated and are likely to charge higher interest rates, which would be detrimental for such customers.

Q37: For deposit takers: Can you quantify the impact that a 100% risk weight on secured personal lending and a 150% risk weight on unsecured personal lending would have on your institution?

Yes. This will be provided separately.

Q38: For deposit takers: Can you provide a lending breakdown for your institution for the following sectors: commercial property (investment, development, and a loan-to-value ratio breakdown within these categories), and personal lending (secured, unsecured, credit card and other)?

Yes. This will be provided separately.

Q39: Do you think the proposed standardised risk weights more closely align with the actual risk of the underlying lending? If not, where do you think the biggest discrepancies are?

As reflected in question 36, the proposed risk weights on credit cards would be creating a significant discrepancy between actual risk and standardised risk weightings.

Q40: For deposit takers: Is there a desired lead-in time to adopt the proposed standardised risk weight categories and updated minimum capital ratio? What are the expected costs (and their magnitude) to systems and processes of the proposed standardised risk weight categories?

The proposed changes would require changes in classifications of lending, but should be relatively straight forward. Three months should be sufficient for SBS to implement.

We appreciate the opportunity to provide this feedback on your proposals and would be happy to discuss any of the items raised in this submission further.

Yours sincerely

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