Key Questions and Answers: 2025 Review of key capital settings

What is deposit taker capital?

The money that banks – or deposit takers as we refer to them - get from their owners is known as 'capital'. It is the part of a deposit taker's funding that first absorbs losses if it becomes distressed. The more capital a deposit taker has, the lower the chances are that losses will be borne by depositors (people and businesses who have money in their bank accounts)[1].

Currently, there are three 'tiers' of recognised capital in New Zealand:

- **Common Equity Tier 1 (CET1)** capital is the highest quality of capital as it is permanently available to absorb a deposit taker's financial losses. CET1 includes shareholders' investment (ordinary shares) and the deposit taker's retained earnings.
- **Additional Tier 1 (AT1)** capital, which includes perpetual preference shares, is the second highest quality of capital behind CET1.
- **Tier 2 capital**, which includes some subordinated debt, is capital that can generally only absorb losses once a bank has failed. It is therefore considered of lower quality than Tier 1 capital (CET1 or AT1 capital).

What are capital requirements?

Capital requirements set out the minimum investment that owners of a deposit takers must make in their business. Capital requirements that are set too low risk a deposit taker failing when it faces a shock. On the other hand, capital levels that are too high can increase costs unnecessarily.

Capital ratio requirements set out the amount of capital a deposit taker needs to use to fund the loans it makes and is expressed as a percentage of a deposit taker's '**risk-weighted assets**'[2]. Deposit takers are required to have more capital for riskier loans, as these are more likely to generate losses.

Why are you doing this Review?

In 2019, our previous review of New Zealand's capital framework resulted in the decision to increase the quantity and quality of capital that banks were required to operate with by 2028. We focused on simple, but conservative, capital requirements. However, concerns have been raised that the 2019 capital settings may be undermining competition and efficiency and that the 2019 review underestimated the impact on the New Zealand economy.

Therefore, earlier this year we announced a targeted review to test whether we have got our capital settings right.[3] We want capital settings that support a stable financial system which enables a productive and sustainable economy and ultimately promote the prosperity and well-being of all New Zealanders.

[1] The Depositor Compensation Scheme covers each depositor for up to $100,000 if their money is held in a DCS-protected account.
[2] Risk-weighted assets are used to determine the minimum amount of capital held by banks and financial institutions to reduce the risk of insolvency.
[3] See the Terms of Reference at 2025-review-of-key-capital-settings-terms-of-reference.pdf

What are your proposals?

In the Consultation Paper, *2025 Review of key capital settings: Policy proposals for feedback*, we propose two specific changes to our capital framework which should improve efficiency:

We propose simplifying the requirements by removing AT1 capital

We have heard from stakeholders that there are certain features which are making it difficult for deposit takers to issue it efficiently. There is also growing international evidence that AT1 may not have the stabilising effect it was initially designed to achieve.

We propose introducing more granular risk weights

Our proposals aim to better align requirements with actual risk. We propose changes in risk weights for:

- residential mortgage lending;
- corporate lending;
- agriculture lending; and
- lending to community housing providers/housing co-operatives.

The changes to risk weights reduce the amount of capital that deposit takers are required to hold by around 5% across the system.

We also set out two options for capital ratio requirements for feedback. These options are likely to reduce overall funding costs for banks compared to the decisions made in 2019. We are open to other options or variations to the options presented.

Option 1

Proposes a similar approach to current settings but does not require an increase in capital from current levels, whereas additional step ups would be required to 2028 under the existing rules.

Option 2

Proposes a shift in approach – with lower capital ratios than those proposed in 2019 or under Option 1 but introducing Loss-Absorbing Capacity (**LAC**) requirements for the largest banks. LAC includes debt instruments that are able to absorb losses and be turned into capital if an entity is in distress and is usually cheaper for deposit takers to issue than CET1.

The proposals could introduce more proportionality into capital requirements relative to current settings by reducing requirements for smaller deposit takers by more than larger deposit takers.

The previous review in 2019 anchored to a risk appetite that ensured there was sufficient capital in the system to avoid capital being fully depleted in a shock once every 200 years. This review has moved away from using this metric, so how should we think about the Reserve Bank's risk appetite now?

While it is common in insurance regulation to refer to a 1 in x-year event, it is not commonly used internationally as a measure for banking capital requirements. Under our new legislation, we have moved to a qualitative approach where we aim to set capital requirements that are:

- simple, strong, and proportionate, and
- calibrated by reference to international peers, considering New Zealand's country specific risks and market dynamics.

What did the independent report by Oliver Wyman conclude about New Zealand's capital levels?

To inform this review, we commissioned international management consultancy, Oliver Wyman, to benchmark the capital requirements for New Zealand's largest banks against international peers. Their report found our current Tier 1 capital requirements are relatively high by international standards, but our requirements are lower than average on some other measures.

What is the role of the international experts and when will their reports be available?

Following consultation, three independent international experts – Thorsten Beck, Elena Carletti and Sir John Vickers – will review and challenge our analysis. They will write independent reports that will be published at the completion of the review.

What are the next steps?

Responses to this consultation, alongside a cost and benefit analysis, will inform our finalised capital settings. We intend to make final decisions by the end of the year.

From there, we will look to implement any changes under existing legislation – the Banking (Prudential Supervision) Act 1989 and the Non-Bank Deposit Takers Act 2013. At the same time, we will work to incorporate the changes into new prudential standards being developed under the Deposit Takers Act 2023, which are due to come into force in late 2028.

You can find a copy of the Consultation paper and submit your feedback on our proposals at https://consultations.rbnz.govt.nz/prudential-policy/review-of-key-capital-settings