APRA's capital rules unquestionably good for key stakeholders

The tough new capital rules for the big four banks are unquestionably good for investors, depositors and taxpayers. David Rowe

by Tony Boyd

The tough new capital rules for the big four banks are unquestionably good for investors, depositors and taxpayers.
Investors are better off because the $8 billion in additional capital required by the major banks to reach the new minimum 10.5 per cent core equity capital ratio can be achieved without large-scale new equity share issues.

Another significant aspect of the announcement by the Australian Prudential Regulation Authority is that, after almost a decade of uncertainty, the bank capital regime in Australia is set in stone.
There are more changes in capital requirements coming down the pipeline but APRA has made it clear that these can be covered by the 10.5 per cent minimum capital ratio.
The last big capital change is the upward movement in the risk weighting of mortgage loans. There was uncertainty about whether this would result in even higher capital charges.

That was a source of concern among analysts and investors who have said this would add another $10 billion in capital. But those concerns can now be dismissed as APRA has made it clear the risk weighting issue is captured by the 10.5 per cent minimum requirement.

The uncertainty in the market on Wednesday about the impact of the changes to the risk weighting for mortgages was fuelled by initial reports from several leading analysts claiming the banks would need about $10 billion in capital on top of the $8 billion identified by APRA.

Chanticleer understands APRA rang around the analysts to clarify the position.

Existing investors in the big four banks can now stop worrying about their returns being diluted by new share issues.

Strengthens the buffer

Investors contemplating buying into one or more of the big four banks should consider the relative capital strength of each bank. But that should not distract them from more fundamental valuation issues. For example, ANZ Banking Group has made clear it will reach the 10.5 per cent common equity tier one ratio this year thanks to asset sales. But that is not necessarily a reason to buy the stock.
ANZ is far less efficient than other banks according to analysis by Macquarie Securities. The broker said that if it can lift its productivity to the average level of the big four, it would add about $1.6 billion a year in revenue.

If ANZ CEO Shayne Elliott can lift the productivity of the bank it would be a reason to buy his stock, whereas there is no certainty about what he would do with excess capital.

APRA's new capital rules are good for depositors with money in the vaults of the major banks because it strengthens the buffer against a crisis.

However, there may be an impact on deposit rates from the banks putting more money aside from retained earnings to boost capital.

Lower deposit rates and higher loan rates are tools that can be used by the banks to lift their profitability. That would enable them to have more profit to put into capital reserves.

APRA's new rules are good for taxpayers because they will lower the probability of the government having to step in and save a bank that is too big to fail.

Stress tests

Each of the big four banks is too big to fail. But history has shown that in Australia a troubled bank has always been taken over by another bank.

This happened with the Bank of Adelaide, which was taken over by the ANZ, State Bank of South Australia, which was taken over by Westpac, the State Bank of Victoria, which was taken over by the Commonwealth Bank of Australia and with Bankwest, which was taken over by CBA.

Westpac also took over St George Bank, which would have struggled had it remained an independent entity.

The possibility of one of the big four needing to be rescued is slim. They have repeatedly been put through stress tests by APRA and come out the other side with sufficient capital to survive in a profitable form.

The stress tests assume an 11 per cent unemployment rate, a recession for two years and a 40 per cent fall in property prices.

The big four have, over the past decade since the financial crisis, shown the benefits of being highly profitable.

It is easy to forget that when the global financial crisis hit the minimum level of core equity capital that had to be held by the big four was 6 per cent.

When the crisis struck the banks had common equity tier one capital of between 6 and 7 per cent. It is currently about 10 per cent on average.

There is a rough rule of thumb that every 50 basis points of common equity capital is about $8 billion.

From January 1, 2020, it will be 10.5 per cent. In other words, the banks have about two and a half years to add $8 billion.

This is relatively straightforward when you think they earn about $30 billion a year and pay out about $22 billion a year in dividends.

That leaves about $8 billion a year in retained earnings. But at least half of that has to go to backing new loans.

Interests of all stakeholders

The bottom line is that the banks can use dividend reinvestment plans to reach the new capital requirements.

Westpac chief financial officer Peter King told Chanticleer that it was welcome to have clarity about the capital rules."It's been a long journey on capital that started almost a decade ago," he said.

"There was an immense amount of uncertainty and it's now great to have a definite benchmark to achieve unquestionably."

King is in a good position because at March 31 Westpac had a common equity tier one ratio of 10 per cent. Since then it has sold its stake in BTIM for $645 million. That deal added 10 basis points to Westpac's core capital.

Shareholders in the major banks can be thankful that APRA's strengthening of core capital under chairman Wayne Byres is being done with an eye to the role banks play in the financial system.

APRA did not want to impose rules which affected the ability of the banks to lend money to business and households. Credit is growing at about four to five per cent. The banks can fund this level of credit growth within the bounds of the new capital rules.

The new rules are a tribute to the willingness of APRA to consult widely and take into account the interests of all stakeholders.

That is in stark contrast to the approach of the federal government and the South Australia government when they imposed new taxes on the banks.

APRA's work on the new capital rules took into account the impact of the federal bank tax, which will pull about $6 billion out of the banks over the next four years.

Treasurer Scott Morrison on Wednesday welcomed the capital changes and said they "should not significantly impact loan pricing or consumers' ability to access finance".

At the end of APRA's capital-strengthening process Australia's big four will be among the top quartile of most strongly capitalised banks in the world.

In fact, when you harmonise the tier one capital ratio in Australia with those in Europe to take account of differences the common equity tier one capital of the big four will be in excess of 15 per cent.

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