Elstree

Rambo retreats
APRA going soft on capital

- Some more confusing tweaking by APRA; we'll try and explain.
- We think the 11year global trend to stricter and higher bank capital is over as the anti-growth effect of higher capital is felt.
- The read through for hybrids is that banks remain extremely default remote and dividend/distribution non-payments are highly unlikely; investors are getting paid a lot for taking relatively small risks.

Has APRA overdone it this decade?

There's been a massive increase of capital in Australian banking system since the GFC. Depending on how you measure it, the level of capital has increased by between 100% and 150%. The most common ratio used is the Basel 3 equity ratio which is Equity (adjusted for stuff APRA doesn't like)/Risk Weighted Assets or RWA (adjusted for stuff APRA doesn't like). However, part of the problem is that Basel 3 is a dog's breakfast and each regulator adjusts it in their own way. So, Australian Basel 3 equity levels are c10.5 - 11.0%, compared to the APRA minimum of 8%. Australian banks claim that if APRA followed Basel 3 rules literally, the capital levels would be c16%, which would place 3 of the major banks in top 8 banks in the world. These levels are a major improvement from the findings of the Murray Enquiry which placed the 4 majors at around median levels of capital.

APRA walks it back

COVID-19 must have rung a few bells in APRA. Here was an out of the blue event transpiring in a well capitalised banking system, but because the equity levels of 10% were reasonably close to the 8% minimum, there was a good chance banks would have felt pressure to batten down the hatches, stop lending and go and raise capital in order to not get close to the 8% minimum level. That would have been disastrous. This was in the context of what is probably the best capitalised banking system in the world. APRA's first reaction was to tell the banks that they didn't mind if bank capital levels approached 8%, so don't go and get rash on us. The second, more structural reaction, explains the recent announcement that APRA would change the way RWA is calculated and it will be smaller in the future. Everybody agrees that the absolute amount of capital in the system is fine, so if APRA changes its methodology to make RWA's smaller, and Equity (adjusted for the stuff APRA doesn't like) remains the same, the headline ratio will increase to be closer to that magical 16% that the banks tell us is the "true" Basel 3 capital level, which means they are further away from the 8% minimum.

APRA does social engineering

Small businesses are really important; in Australia they provide c45% of all jobs and 35% of the business value added. But the current financial system doesn't lend to small businesses. Small business has only 15% of the total business lending which indicates that either they don't need capital or that it's simply too difficult to borrow. Everyone agrees it's the latter.

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Small business finance is hard to get and it's expensive. The average small business lending rate offered by banks is well north of 5%, if they can get it. If they can't, they wander off to one of the non bank lenders and pay 20%. There are a few reasons banks can't or won't lend to small business; defaults are higher, administration costs are higher and APRA requires much higher capital levels for loans to small business than they do for housing. This recent announcement includes provisions for reducing the risk weighting and subsequently the amount of capital backing which should make it easier for small business to borrow.

And making up the numbers as they go

But if the amount of capital is about right and you are reducing the capital backing business loans, by definition you have to increase the amount of capital backing on other loans and for Australian banks, that is housing loans. So, APRA have increased the risk weightings for mortgage loans and especially what they claim are "high risk" loans (ie) investment and interest only loans. The table below, sourced from Westpac, illustrates what is going on. It shows the changes in risk weights for APRA's new "more granular" model. Its messy but you can see there are more categories - some have gone up and some have gone down, and the risk weighting change when mortgage insurance is applied etc.

Standardised Mortgage Risk Weights

LVR(%)	Current Risk Weights			Proposed Risk Weights					
				OO / P&I		Other*		Non-Standard	
	No LMI	with LMI	Non-Standard	No LMI	LMI	No LMI	LMI	Reverse Mtge	Other
<50	35	35	50	20	20	25	25	50	100
<60	35	35	50	25	25	30	30	50	
<70	35	35	50	30	30	40	40		
<80	35	35	75	35	35 (30) ↑	45 (40)	45 (40) ↑	100	
<90	50	35	100	55 (50) ↑	40 (45) ↓	65 (70)	50 (60) ↓		
<100	75	50		70	55 (60) ↓	85	70 (75) ↓		
>100	100	75		85	70 (80) ↓	105 (95)	85 (90) ↓		

* Includes investor & interest only categories

Source: APRA & Westpac Strategy

↑: Updated proposed risk weights are higher than original proposal (in brackets)

↓: Updated proposed risk weights are lower than original proposal (in brackets)

Shaded Area is a new bracket (70-80%)

No data precedent

The only problem is that there absolutely no data basis for changing the risk weightings for either small business or mortgage loans. There have been no losses on residential mortgages for the past 30 years (except in Port Hedland and Moranbah). How do you decide, for example that an 85% LVR loan that is owner/occupied with P&I, is risk weighted at 55% but the same loan applied to an investor on an interest only basis is 65%, or why (in fact) the weighting has changed from 50% for the past decade? While the investor loan might be riskier, it might not be as well; there has simply been insufficient defaults to make a case on a fundamental basis for coming to those conclusions. We suspect it's a backdoor attempt by APRA to stop "speculative" borrowing and encourage "healthier" borrowing.

Whatever…

Basel 3 is going to remain a dog's breakfast and APRA's crusade to change what Australians borrow for may continue, but for us the underlying message is that the health of the banking system is probably stronger than most thought. We think there has been an understandable

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over reaction to the widespread near failure of world banks during the GFC, which has led to the migration to really high capital levels. We have seen a couple of inflection points recently.

- In 2019, the RBNZ proposed to increase bank total capital levels from 10.5% to 19% to bulletproof the NZ banks from events that might occur to their Australian parents. In November 2020, the RBNZ pushed out the start date out another year to 2022. Reasons provided by the RBNZ include "supporting economic recovery" because the higher capital levels would inevitably lead to higher interest rates and growth in unregulated non-bank lending.
- The European Central Bank (ECB), in common with most regulators, called for a dividend ban in early 2020, in order to preserve capital within the banking system. In late November, a number of the board members want that ban ended because they have come to the realisation that investors won't buy banks and insurers unless they pay dividends and if investors won't inject capital into a financial institution when it needs it, the regulators have a far bigger problem than capital levels falling a few percent. In the Vietnam war there was the apocryphal quote that the Americans had to "destroy a village to save it". Regulators aiming for a risk-free financial system have the same issue: it might be a laudable goal, but it has lots of side effects: lower economic growth, greater fragility and a higher probability of total implosion.

So, what does it mean for hybrids?

Hybrids currently trade at around 3.5% over risk free rates. Bank senior debt trades at around 0.3% above risk free rates. As an investor in a bank hybrid you receive an additional 3 ¼% for the risk that the bank won't be able to repay the hybrid at its maturity (say) in around 5 years' time, or the bank may defer hybrid distributions. In other words, the bank may be sufficiently solvent to pay senior debt, but it may not be solvent enough to pay the hybrid (which then gets extended or converted to equity). We think the excess margin for this risk is too high. Australian banks got through the GFC with 1st degree burns. Since then capital levels have doubled and profitability remains high. The COVID-19 experience of a 15% fall in GDP is going to look like a temporary, small blip in bank profitability. No distributions have been missed. There will be further periods of bank stress within the next 5 or so years, but we can't think of a likely scenario whereby Australian banks get close enough to trouble anything that would justify the additional 3 ¼% excess margin.

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