APRA's Risk Culture Capital Add-on

Will APRA's announcement on 11 July that ANZ, CBA, and NAB would be subject to a temporary requirement to "hold" additional capital cause loan interest rates to increase? It shouldn't, for reasons explained below. What it will do is incentivise the banks to quickly address shortcomings found in their self-assessments of governance, culture and accountability. The first to get the temporary capital requirement removed will have public bragging rights about their superior risk management and culture vis a vis their peers.

APRA's move follows a similar impost applied earlier to CBA. For these three banks the amount of additional required capital is $500 million each.

Loan rates shouldn't be affected because the banks won't actually need to increase their use of equity funding. They have capital surplus to the regulatory minimum requirement, so the main effect is to reduce the size of this buffer (of the ratio of CET1 capital to risk weighted assets (RWA)) by 15-20 basis points. Because the capital impost is "temporary", and the buffers are still large, why raise more capital to restore the original level, only to undo that when the impost is removed?

To fully understand the implications of the impost it is necessary to delve deeper. At first sight the fact that CET1 capital ratios would be reduced seems paradoxical. Common sense would suggest that an increase in capital (the numerator of the capital ratio) would cause an increase in the ratio?

This paradox arises from the method of implementing the new requirement. APRA made a decision to apply a $500 increase in required capital - and the same, round, number applied for all three banks highlights the role of regulatory subjective judgement rather than theory or science. Then, this number is converted into a Risk Weighted Assets (RWA) equivalent by multiplying it by the 12.5 multiplier used for operational risk capital calculations. With a resulting higher level of RWA and unchanged current level of actual capital, the banks' capital ratios therefore initially decrease. The "buffer" of the excess of actual over required capital ratios declines.

Banks could try to offset the decline in the buffer by raising more capital (increasing the numerator) or shrinking RWA (reducing the denominator). But they probably won't. The impost is "temporary" - until the banks rectify the deficiencies in their risk culture. Unless they believe "temporary" really means "for a long time", and their own speed of action on improving risk culture will determine this, there is no obvious reason to take actions which will soon be reversed.

If the banks do not feel the need to raise new capital, there is no logical reason for any impact on bank lending rates. The reason, again, lies in the arcane nature of the calculation of capital requirements.

What the impost has done is to alter the mathematical relationship between the quantity of bank actual assets and the hypothetical concept of RWA upon which required capital is calculated. If there is no change in the actual level of bank equity capital (and thus the funding mix of equity, debt and deposits) used to fund that unchanged level of assets, there is no case for any change in loan interest rates.

Moreover, because there is no change in the risk weights applied to any particular type of assets, there is no justification for any change in interest rates applied to any particular type of loan.

Of course, the banks might decide that this impost is likely to be long term (which would be an admission of incompetence) and thus decide to raise additional capital, or to adjust portfolios to lower RWA. But even in that case, the change in their overall funding costs will be immaterial.

So, what is achieved by this capital impost? One is a public statement that APRA is definitely not a "toothless tiger". Another might be signalling to financial markets that weaknesses in risk culture in Australian banks are being attended to and offset by higher capital requirements. Exactly what overall effect this process will have on the cost of bank funding is though far from clear.

Perhaps the main benefit from this action is the reputation "game" it introduces. Banks have been sluggish in addressing issues in risk culture. Now each bank will want to win the public race to be first to have the capital impost removed as a signal to markets that it has a superior risk culture to its peers.

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