Meeting Bank Capital Needs

Whether by good luck, good management or good supervision, Australian banks appear to have avoided significant direct losses on sub-prime debt and its derivatives. Indeed, they are well poised to benefit from a reflux of business from grid-locked capital markets and shell shocked borrowers and investors. In recent months, for example, that long-discarded indicator of banking sector size and the money supply, M3, has been growing at rates in excess of 20 per cent p.a.

But the banks face a major challenge of raising the equity (or other allowable forms of regulatory) capital to convert this potential growth into actuality. Under the Basel capital accord rules, and subject to a few qualifications, bank capital needs to grow at a similar rate to lending and deposit growth.

Bank capital is unlikely to grow organically at anywhere near the rate required to meet expanded demand for bank services. We know already that higher wholesale funding costs are eating into bank profits, increasing interest rate competition for retail deposits, and forcing them to increase loan interest rates. Greater provisions for losses from loans to now distressed companies are also going to eat into available capital.

And with bank equity values having been trashed by the stock market, this is not a good time to make new share issues. The cost of equity capital has increased significantly, and great care would need to be taken to ensure that the market interprets any equity raising as growth-oriented good news rather than recapitalization bad news.

Here, fortuitously, the financial engineering skills that spread the sub-prime mess, may help resolve the problem. The early 1990s, when large losses meant that at least two of the four majors needed recapitalization, and share prices of some major banks sunk below $3, provides a good example.

That situation sparked the development of converting preference shares. This innovation enabled banks to issue permanent capital which, provided share prices recovered over the next few years, avoided the dilution costs arising from the (then) low share price. Those securities had their deficiencies, and second and third generation variants have since emerged, and we should anticipate further such innovations as banks seek alternative forms of capital to underpin business growth.

Certain debt securities issued by banks can also count towards regulatory capital. While this is not a good time to issue debt, its limited maturity may make it a cheaper solution than raising equity capital, particularly for the Australian banks whose low risk debt securities would prove attractive to many superannuation portfolios.

We should expect also to see discounts on, or underwriting of, dividend reinvestment schemes by banks to ensure that dividends are reinvested and do not involve an outflow of capital. The alternative, of cutting dividend rates, may be implied by any fall in profitability, but would be a negative signal putting further downward pressure on bank share prices.

One other challenge faced by the banks arises from the Sons of Gwalia decision which places aggrieved, misled, shareholders in failed companies on potentially the same status as unsecured creditors. Where banks have unsecured loans to distressed companies, it may be to the bank's benefit to take some loss via a haircut on a loan in order to keep the company alive, even if as no more than a zombie. The alternative, of forcing liquidation, could see the pool of claimants sufficiently augmented by aggrieved shareholders to dramatically reduce the amount the bank recovers – and certainly delay its receipt.

Banks will also work hard to reduce the amount of capital needed to support business. The rationing of credit, which we have already heard about, is one such response, since lower loan-valuation ratios etc reduce the measured risk of loans and thus capital required.

Unfortunately for the banks, one option available for reducing regulatory capital requirements takes significant time to implement. This is the organizational restructuring into a non-operating holding company with separate subsidiaries for the banking business (subject to regulatory capital requirements) and for other non-banking business.

Only Macquarie has so far done this (in November 2007), with some 40 per cent of group equity capital being allocated to the non-banking subsidiary, although even for Macquarie, the major capital benefits are some time distant. The transition arrangements agreed with APRA involve no significant implications for aggregate group capital requirements for a year or so. But the increased flexibility provided by such a structure, could prove advantageous in a capital-constrained banking sector.

Kevin Davis
Commonwealth Bank Chair of Finance, The University of Melbourne
Director, Melbourne Centre for Financial Studies

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