Two Cheers for APRA on TLAC

After all of the misconduct exposed at the Banking Royal Commission it is somewhat fashionable to bash the regulators for their shortcomings. That's fair enough as there has been a failure to act all too often. This article leans the other way though, giving credit where it is due to APRA for their recent announcement on Total Loss Absorbing Capital (TLAC). This can be considered a fairly dry, technical area and the grand total of seven submissions, three of which are confidential, could be seen as a sign that this doesn't matter. However, when the next edition of the global financial crisis strikes TLAC will again become one of the most crucial financial system issues with APRA's actions now having a substantial difference on the outcomes then.

What APRA has Announced

In November 2018 APRA laid out its suggested pathway of a 4-5% increase in TLAC via tier 2 securities (subordinated debt) for the four major banks by December 2022. Consultation began and the lobbying machines of the four major banks went into overdrive, though mostly behind the scenes in direct discussions with APRA. The four majors painted a picture of an impossible request from the regulator that would have a huge impact on their cost of capital. In a public speech I heard from a senior APRA staff member, the impact of the heavy lobbying was clearly taking a toll with APRA at pains to state that it was consulting widely and at length, taking industry comments very seriously.

APRA's announcement this week is that it will be seeking 3% additional risk-weighted capital via tier 2 securities with the deadline extended to December 2023. The gap between the 4-5% previously flagged and the 3% announced this week will be filled with yet to be determined securities after further consultation. **My read between the lines is that APRA believes the banks can issue a lot more tier 2 securities than they claimed. By getting them to start on the task it will become clear that the full 4-5% can be implemented as originally planned.**

Why this Matters

In short, taxpayers should never be asked to foot the bill for a failing financial institution. Higher capital levels and detailed macro-prudential oversight are the key pillars to avoiding disorderly failures of authorised deposit taking institutions (ADIs). As per the Murray inquiry, Australia's banks are partially dependent upon offshore funding and therefore must be "unquestionably strong". By requiring ADIs to hold more subordinated capital the likelihood of a bank becoming distressed greatly decreases. By having a larger capital buffer protecting senior creditors, the likelihood of a distressed ADI failing in a disorderly fashion is also greatly reduced. APRA's proposed method of reducing these risks is pragmatic and entirely appropriate for the Australian banking context.

When the next financial crisis strikes, the government, taxpayers, depositors, bondholders and borrowers will all want assurance that our major banks are rock solid. It is likely that there will be another round of bank failures in Europe, with Deutsche Bank's ongoing problems the most visible part of the widespread issues. Chinese banks are also likely to face a serious test in the medium term, with decades of covering up non-performing loans likely to unravel. Australia's very high levels of household debt will only increase the focus on our banking system. Having a higher level of clearly subordinated capital will be the best possible response to the question of whether Australian banks are solvent.

How much will this cost?

APRA's direction for the four major banks to increase tier 2 capital does come at a cost, but it is very likely to be far less than what was claimed. Based on current pricing (post-announcement) and depending on how you cut the numbers, the gap between issuing 5 year senior debt and 10 year subordinated debt is 1.00-1.50%. Risk-weighted assets are typically 45-50% of total assets, a factor that reduces the capital required as APRA is measuring on a risk-weighted basis not a total capital basis. These two factors combined point to a cost of capital increase of approximately of 0.6 basis points per 1% increase, or a 3 basis points increase if the full 5% capital increase was required.

However, this number on its own is likely to overstate the actual cost. The Bank of England recently completed a study that found a 35% offset via reduced cost of senior debt when the level of subordinated debt is increased. Senior depositors will give some value to the increased capital protecting their position and will therefore demand less margin on senior debt when junior debt is increased. Including this factor points to a total cost of capital increase of around 2 basis points. This is a tiny insurance premium to pay for a far more stable banking system.

Why only Two Cheers?

APRA's courage when under attack from bank lobbying is laudable. It's easy to say they are only doing what they are paid to do, but their combatants have run a scare campaign about higher borrowing costs when arguing their case. APRA also had to face down arguments that it was being far tougher than some of its international peers that have allowed for the introduction of tier 3 securities (senior non-preferred debt). The recent announcement by the New Zealand banking regulator that higher capital levels in their jurisdiction would come solely from equity no doubt helped make APRA's position look a lot tamer.

The shortcomings of APRA's decision is that it has come late and has a very long implementation period. By 2016 it was clear that TLAC reforms would require large banks to substantially increase their subordinated capital levels, with some international regulators having announced their positions. Instead of being on the front foot and potentially adjusting the final capital levels over time, APRA has chosen to delay until almost all other banking regulators have announced their positions. It now seems probable that there will be a global slowdown in the medium term, with the potential that another financial crisis occurs well before the December 2023 implementation deadline. If this scenario plays out, APRA will be ruing its delays in getting the major banks to implement higher capital levels.

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Disclosure