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Malcolm Turnbull paves way for more bank rate increases

by Christopher Joye

The government's response to the financial system inquiry endorses its recommendation that the major banks must have "unquestionably strong" capital in the top quartile of internationally active peers and implicitly paves the way for rate increases.

As a capital-importing nation with banks reliant on offshore funding and focused on residential-mortgage lending, the government said "Australia's financial sector ... needs to be stronger than those of comparable economies".

By giving the Australian Prudential Regulation Authority discretion to implement the FSI reforms as it sees fit, the government backs APRA's arguably even tougher stance on bank capital and the importance of introducing a "leverage ratio" back-stop.

The FSI found that "the major banks have a leverage ratio of around 4.5 per cent ... [and] an overall asset-value shock of the range experienced overseas during the GFC would be sufficient to render Australia's major banks insolvent".

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Buried deep within the FSI report is analysis that supports the idea that the majors are in fact justified in lifting loan rates to compensate them for the cost of carrying more equity and less debt.

"A one percentage point increase in capital requirements would increase the average interest rate on a loan by less than 10 basis points," the FSI explained. "This is the figure if the full cost is passed on to consumers with no offset in interest rates by the RBA."

NOT WASTING TIME

APRA has wasted no time acting on the FSI's guidance to double the capital the majors have to hold against home loans and prepare for an "unquestionably strong" benchmark, which APRA believes necessitates equity capital ratios increasing by "at least" 2 percentage points (or 200 basis points).

DEFINING PURPOSE OF SUPER SYSTEM

The government will enshrine in law the "fundamental purpose" of the super system to create a "yardstick" against which competing proposals for change are held up to scrutiny.

COMPETITIVE SUPER DEFAULT MEASURES

The government will task the Productivity Commission to look at alternative ways of allocating default funds to savers, including a regular national competition among super providers.

REJECTED - SUPER FUND BORROWING

The government has REJECTED the Murray inquiry's recommendation to prohibit limited recourse borrowing by super funds, particularly self-managed funds for property.

To their credit, the majors have just as quickly responded, lifting their "common equity tier one capital" (CET1) ratios by more than 100 basis points with around $31 billion of money raised through rights issues, dividend reinvestment plans (DRPs), asset sales and retained earnings. Additional tier one (AT1) capital hybrids have furnished another $4 billion, although Standard & Poor's warns this is a much "weaker form of capital than common equity".

Prior to Westpac's decision to unilaterally hike owner-occupied loan rates last week, which represent 40 per cent of its assets, the banks had generally limited themselves to raising investment loan rates, which account for an even smaller 20 per cent share of total assets.

There are good reasons for targeting home loans. Net interest margins on these products are much skinnier than business and personal loans. And there is the case that the housing market has become overheated and a source of systematic risk.

If the banks continue to leave business and personal loan rates alone, they will have to boost overall residential mortgage costs by about 20 basis points to compensate for 100 basis points of extra CET1. Crucially, they have not yet done this.

And since APRA expects equity capital ratios to climb by at least 200 basis points, this implies home loan rates will have to eventually expand by roughly 40 basis points assuming no changes elsewhere.

Another option is cutting deposit and/or bond rates, which is where the banks get funding for their loans. The issue here is that APRA is pushing banks to rely more heavily on longer-term deposits and bonds, which impose more expenses again. It is not, therefore, obvious that the banks can easily reduce the cost of their liabilities.

BENEFIT OF DELEVERAGING

One important benefit from this deleveraging is that the majors are very likely to benefit from an improvement in their credit ratings. Standard & Poor's hinted at this last week after Westpac's rights issue.

In July S&P said that APRA's more exacting capital standards would likely "boost [the majors'] credit profiles". S&P was specifically referring to the "stand alone credit profile" (SACP), which is the majors' underlying credit rating before government support. This currently sits at the single "a" level, which places them in the top 32 per cent of large banks that S&P rates.

"If the major banks proceeded with further strengthening of their capital by an additional 120 bps [after the initial 80 basis points attributable to APRA's mortgage risk-weight changes], we expect that the SACPs of some or all of these banks could improve by one notch," S&P's Sharad Jain wrote.

"[This] should translate into higher ratings on the hybrid and subordinated debt instruments issued by these banks, as the starting point of ratings on these instruments is the SACP."

Underlying the SACP is the "risk-adjusted capital" (RAC) ratio, which S&P says is the "cornerstone of banks' capital analysis in our ratings process". In August S&P published a new study on the "top 100" banks it covers as at March 2014, which is notably before the major banks' recent capital-raising efforts.

My analysis of the S&P data finds that the median "a+" rated bank had an RAC of 8.7 per cent while the 75th percentile bank had a 9.2 per cent RAC. In contrast, the majors were at 8.1 per cent in March.

After the massive CET1 and AT1 raisings this year, the majors should have RACs around 9 per cent or better, which puts them above the median "a+" bank and close to the top quartile.

Last week, S&P said Westpac's initiatives would "propel its CET1 ratio by about 100 basis points" and combined with DRPs and asset sales "boost Westpac's RAC ratio closer to 10 per cent". This is the level at which S&P thinks an "a+" SACP is a no-brainer.

If the majors' credit ratings get enhanced in this way they should benefit from lower funding costs in the debt capital markets. Combined with loan repricing, this should help mitigate the drop in their world-beating returns on equity.

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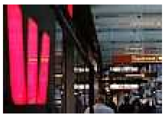

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