Last week, the Australian Prudential Regulation Authority (APRA) issued an information paper comparing the capital ratios of Australian banks against 98 international competitors, noting that the largest banks were above the median, but not in the top group of their peers.

Today the regulator announced an increase (from roughly 16% to 25%) in the "average risk weight" for residential mortgage exposures which the larger banks use to calculate their minimum capital requirements. Despite APRA warning that the new 25% minimum was an interim measure, the intended targets (the Four Pillars) appeared not to be fazed by the announcement, claiming that everything was already in hand.

When turkeys start voting for Christmas, one might begin to worry that they may know something the rest of us don't and that festivities might be on hold.

Capital adequacy in banks is a bit of a shell game, as there is considerable debate about what capital ratios actually mean. In a report commissioned by the Australian Bankers' Association (ABA), PWC acknowledged the subjectivity involved, but then constructed a measure which it called an "Internationally comparable CET1 ratio".

To the delight of the ABA, PWC concluded that, "in their best judgement, on average, the big four Australian banks were at or above the 75th percentile of bank capital relative to the most appropriate comparator set of global banks". As befits an auditor, this opinion is heavy with caveats – "best judgement", "on average", "at or above" and "most appropriate".

However, the term "internationally comparable" struck a nerve with APRA, who noted that "computing a precise 'internationally harmonised' capital ratio is not practically possible" and disagreed with the ABA's conclusions. APRA noted that the ABA ratio of 12.69% was "significantly higher than the 11.7% capital adequacy ratio" reported in their study. While less than 1% may not seem much, it is significant in terms of the profits that can be generated from such a reduction in capital requirements.

But APRA and the ABA are not the only ones with a shell in the game. The Murray report noted that, although capital levels at Australian banks are not weak, another study by the Basel

Committee on Banking Supervision also does not suggest they are “unquestionably strong”. The inquiry goes on to recommend “setting Australian bank capital ratios such that they are unquestionably strong by being in the top quartile of internationally active banks”, i.e. in the top 25% of banks in the world.

The differences in comparing capital ratios, using different methods and different samples, are not esoteric accounting exercises but of vital importance to the taxpayers of Australia. In a recent speech , APRA’s chairman Wayne Byres reported the findings of the regulator’s 2014 stress tests of the Australian banking system and warned that, although capital levels were not breached by individual banks:

“It is unlikely that Australia would have the fully-functioning banking system it would like in such an environment [and …] In short, we would have survived the stress, but the aftermath might not be entirely comfortable”.

In other words, Australian banks need to hold more capital for emergencies. Banks will strenuously oppose higher capital requirements, already warning that “the cost of holding higher capital will inevitably be borne by customers and shareholders". But the largest banks have already been given a free pass on some of the more onerous regulations being implemented following the global financial crisis. For example, the new increase in risk weights for mortgages was at the lower end of the range suggested by the Murray inquiry (of 25%-30%).

In a move to reduce the damage caused by Too Big To Fail (TBTF) banks, the Basel Committee identified so-called “Systemically Important Financial Institutions” (SIFIs) and increased capital requirements for these behemoths. None of the big four Australian banks made the list of Global-SIFIs but did top the list of Domestic-SIFIs and were then required by APRA to hold an additional 1% capital for “higher loss absorbency”. This 1% figure is the lowest assigned in the SIFI system and is comparable with Canada and China but well behind other jurisdictions, such as Singapore, the European Union and the USA (2%) and much less that Sweden and Switzerland (5% plus).

Australian banks also got a break with the new Basel III rules for managing liquidity. Because of an anomaly of the Australian debt system, there are very few so-called “highly liquid assets”, such as long-term government bonds, for managing an immediate run on a bank. To make it easier for the banks, the RBA and APRA have cobbled together a solution called the

Committed Liquidity Facility (CLF) which, for a miserly annual fixed fee, dumps the liquidity management problem into the taxpayers' lap.

As amply demonstrated by the APRA analysis , the big four banks totally dominate the Australian banking system. However, not considered in that analysis is the fact that the Four Pillars also dominate the Australian share market (four of the top five stocks on the ASX 200 by market capitalisation), are among the largest retail superannuation fund managers (four of the top five by total assets) and, to boot, they own some of the largest insurance subsidiaries.

In effect, these four banks **are** the Australian financial system and, for the health of the financial system, cannot be allowed to fail.

APRA has served Australian taxpayers well in the past, especially prior to the financial crisis, and should be permitted to enforce higher standards of risk and capital management on banks, especially those too big to fail. As recommended by Murray, the Australian banking system should, to protect taxpayers, be "unquestionably strong" and if that means slightly lower profits for the major banks for next few years that would be a price worth paying.

Read more http://theconversation.com/australian-banks-are-still-too-big-to-fail-44913