Australian Prudential Regulation Authority (APRA) chairman Wayne Byers has made it clear the bank regulator will be cracking down on bank capital levels this year.

Bank capital reserves are a loss-absorber, designed to protect creditors if banks suffer significant losses. That protection, in turn, will – ostensibly – prevent panicked withdrawals by depositors, thereby preventing financial contagion and financial crises.

Byers has decided that Australian banks' capital levels must be "unquestionably strong" in keeping with the findings of the Financial System Inquiry . But how much capital equals "unquestionably strong"? We don't know.

What we do know is that the inquiry handed down that finding in November 2014. More than two years have passed and only now is APRA getting a wriggle on.

The problem is that, according to the IMF , when it comes to Tier 1 bank capital, this time last year Australia was ranked 91st in the world. That puts us close to the bottom of the G20, the OECD and the G8. Our position has fluctuated, but at no time during the preceding four quarters have we risen above 60th.

Ranked above Australia were Swaziland, Afghanistan and even Greece. That sounds like, at best, unquestionably ordinary. Maybe even unquestionably weak. But definitely not "unquestionably strong".

The global financial crisis could've led to change

Some argue, determinedly and erroneously, that when functioning correctly bank capital levels are almost magical things. As former US Federal Reserve chair Alan Greenspan once said :

The reason I raise the capital issue so often is that … it solves every problem.

Greenspan, as Fed chair, was ultimately responsible for the health of the US financial system. Having touted capital levels, his tenure ended just before the sub-prime disaster turned into the global financial crisis. This earned Greenspan Time Magazine's moniker as one of the 25 people most to blame for the crisis .

However, bank capital levels were in place before the crisis hit. The Basel Committee – a sort-of UN for Reserve Bank governors and bank regulators – introduced global standards for bank capital as far back as 1988.

Back then, it set the capital level at 8%. In other words, for every $100 in liabilities, banks had to retain $8 in cash (or close to cash). But this level was simply a reflection of the average of the day.

Codifying the average into a global standard was an excellent trick. No-one was made to feel left out, or inadequate.

Then came the global financial crisis. It resulted in an output loss of somewhere between US$6 trillion and US$14 trillion in the US alone .

The Basel Committee said it was going to raise bank capital levels in response to the crisis. This meant it was going to do more of the thing (bolster capital levels) that had been meant to prevent such a crisis from occurring in the first place, but had failed.

What now?

The Basel Committee's latest attempt to take action on capital levels involves curbing "internal risk-based models". These models allow banks to determine how risky their assets are, and therefore how much expensive and unusable capital they have to set aside for loss-absorption, to match the risk profile of their assets.

That's like you or I determining how risky we are as borrowers, and therefore deciding how much interest we should be charged on the money we borrow.

European banks [have pushed back] against curbing internal risk-based models. They resent not being able to have absolutely everything their own way. And the Basel Committee has proven to be a push-over.

Australian banks have pushed back too, with a not-so-subtle threat that customers will bear the costs of higher capital levels. If Byers and APRA do what they are supposed to, and what the government told them to do in late 2015, Australia's banks will need to raise A$15 billion or more to rectify their thin capital position.

That's $15 billion not earning returns or bringing in bonuses. No wonder our bankers aren't happy.

And while APRA and Byers have fiddled on this issue and effectively ignored government instructions, and Australian banks remained capital-thin, conditions have arisen that economist John Adams argues may result in an "economic Armageddon" for Australia.

If that happens, guess who will be bailing out the banks? You, the taxpayer.

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