KEY ISSUES FOR THE YEAR AHEAD: BANK CAPITAL AND BOILING FROGS

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Good afternoon everyone.

As much as international news has dominated everyone’s attention this week, today I want to talk about two important domestic issues for APRA in the year ahead: bank capital and boiling frogs.

I’ll leave frogs until a bit later and start with capital, since probably our most high profile policy item for 2017 will be setting ‘unquestionably strong’ capital standards for the banking sector, as recommended by the Financial System Inquiry (FSI).

Before we do, however, the Basel Committee needs to complete the final work on Basel III. All the key components of the capital framework are still under review in one way or other, with the ambitious goal to:

- improve the risk sensitivity of some parts of the framework;
- reduce excessive variability in others; and
- not significantly increase capital requirements overall.

If the Committee achieves all these things to everyone’s satisfaction, it will be a miracle!

I’ll be happy to just get some finality to the deliberations. The Committee meets again in a couple of weeks, and hopefully an agreement will be reached that will allow the complete package of reforms to be endorsed by the Governors and Heads of Supervision of Basel Committee member countries in January. If that happens, our return to work in the New Year should be accompanied by the revised international capital framework. That process sounds relatively orderly, but behind the scenes there is still much horse trading to do.

However, the Basel framework doesn’t purport to deliver ‘unquestionably strong’ capital. It is simply the minimum international standard. In Australia, we have long applied more robust requirements\(^1\) - an approach that has stood us in good stead. Even without the reinforcing view of the FSI, there’s no reason why we would take a different path now. I mention this to dampen any enthusiasm that might be generated when the new rules are released, by calculating what would happen if APRA was to simply apply the new Basel framework to Australian ADIs. I can tell you the answer now - it would produce a material reduction in capital requirements. Before anyone gets too excited by that, I can also tell you we won’t be pursuing that course.

Once the Basel Committee has set out the minimum requirements, the task for APRA is to think through how and where we build further resilience into the new Basel framework to deliver ‘unquestionably strong’ capital ratios. But that’s not our sole objective. As we make policy choices, we’ll also be considering:

- how we make the framework more flexible, so that it is better able to respond to business and financial cycles;
- how to improve transparency, so that investor understanding of capital strength is enhanced; and
- heeding the message of the FSI, how to take account of the competitive impacts of differing approaches (albeit that any differentiated approach will inevitably lead to different capital requirements at a product level).

\(^1\) For example, our latest estimates suggest that the CET1 capital ratios of the major banks would be around 350 basis points higher if APRA only applied the minimum Basel requirements. See APRA Insight, Issue Two 2016.
The key issue, of course, is how we might calibrate the new requirements. The FSI gave us one guidepost - top quartile positioning relative to international peers - but we’ll also use others. For example, we’ll assess capital positions against rating agency measures of capital strength. The results of stress tests are also informative: banks that have difficulty demonstrating their ability to survive plausible adverse scenarios without severely curtailing lending and/or emergency capital raisings are unlikely to be seen as unquestionably strong. As with top quartile positioning, none of these are intended to be definitive benchmarks, but they do give some useful guidance against which to calibrate the final requirements.

I’ll just say a quick word on timing. Given the number and potential impact of the changes that will be proposed, 2017 will be a year of consultation. We don’t expect to have final standards before this time next year. And even if that is the case, they would not take effect until at least a year after that. But while there’s time for the changes to be worked through, that shouldn’t lead to complacency in the current environment. In that sense, the message I’ve given previously still holds: capital accumulation remains the appropriate course for most ADIs, but with sensible capital planning the actual implementation of any changes should be able to be managed in an orderly fashion.

Before I conclude on capital altogether, I want to say a few words on the FSI recommendation regarding mortgage risk weights. In July 2015, we announced higher mortgage risk weights for banks using internal model-based approach to capital. This was an interim step, but a step we were comfortable we wouldn’t need or want to materially unwind, regardless of the outcomes in Basel.

All other things being equal, we expected to raise the average mortgage risk weights for banks using internal models from around 16 per cent to at least 25 per cent. Unfortunately, in the world of internal models, all other things are rarely equal. Banks constantly refine their models, often at their own initiative but also sometimes at the request of APRA. We noted earlier this year that the impact of a range of modelling changes in the pipeline, when combined with the adjustment proposed in July 2015, would have produced an average risk weight well in excess of our interim objective of 25 per cent. So we’ve had to slightly recalibrate the adjustment, with a view to ensuring the outcomes were broadly consistent with the target we announced.2

I mention this because, for those who follow these numbers closely, there will be some noise in the system over the next few quarters. As various modelling changes come on stream, the average risk weight across all IRB banks will fluctuate somewhat, and will impact different banks at different times. But these differences will narrow over time.

That’s probably enough on capital. Let me now change tack to focus on profitability and returns in the financial system.

A couple of weeks ago, we published our Annual Report for 2015/16. As we now try to do, we included a chapter on industry developments, which provides an opportunity to briefly describe trends in the composition, concentration, capital adequacy, efficiency and profitability of each of the industries we supervise, supported by a page of charts.

One thing that’s interesting in this year’s set of charts is that for every industry we report on - banking, life insurance, general insurance, health insurance, and superannuation -

returns for the year to June 2016 were below their respective 10-year industry average. That’s not to say profitability was poor across the board, nor below average for every company, but it was notable that this was the first time this system-wide outcome has occurred since the crisis period in 2008-09.

There are a range of industry-specific reasons driving returns lower. In life insurance, for example, there has been very poor experience in group risk and disability income insurance. In banking, higher capital requirements, lower balance sheet growth and a pick-up in bad debts have provided headwinds. Some will also argue that returns in some industries have been unsustainably high, and a decline from previous years is therefore quite expected. But given the common experience across all industries, it is worth asking whether there are any common factors at play, and whether they might persist.

One obvious factor is the very low interest rate environment we’re now in. Low interest rates adversely impact all of the businesses APRA regulates. Banking organisations find their margins squeezed, as liabilities become more difficult to reprice downwards at the same speed as assets. Insurers generate lower investment returns to help cover claim and operational costs. And superannuation fund returns are lower, making retirement savings harder to generate and making fees and costs a more prominent part of the value proposition to members.

Thankfully, we are not dealing with negative interest rates, as is the case in many parts of the world. Prolonged negative rates have the potential to severely impair, and in some cases destroy, financial business models. Indeed, at a recent international gathering I attended, a regulator from a jurisdiction with negative interest rates was asked about the worst case scenarios his organisation was using to stress test his local banks. His response: ‘they can survive significant short term shocks, but they can't survive the status quo’.

While we don’t face quite the same challenge, there will inevitably be pressure in the current environment to join the ‘search for yield’. This pressure will likely grow the longer low rates persist. To date, we have not seen major shifts in asset portfolios designed to bolster returns by accepting materially greater risk. That doesn’t mean that risk-seeking isn’t happening at the margins however, and it is at the margins where we need to be most vigilant.

In my experience, rarely will an organisation consciously decide to ‘roll the dice’ and significantly raise its risk profile in order to bolster profits. More likely, it happens over time in small incremental steps, and each individual step will not be seen to materially change the organisation’s overall risk profile. Indeed, many may be seen as minor, operational decisions that do not even need the scrutiny of senior executives or Boards - small tweaks to investment portfolios designed to chase a few extra basis points of yield, changes to product design that improve sales volumes by weakening terms and conditions, or shaving headcounts and investment budgets to save a few pennies of cost.

The collective impact of these decisions, however, warrants attention. Like the anecdote about the frog in boiling water, there is a danger no one notices the ever-increasing risk profile until it is too late. I doubt there are many organisations in the Australian financial sector that are not feeling the pressure from a low rate environment. As pressure is applied

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3 Given the nature of reporting to APRA, slightly different measure of returns were used for different industry sectors. For ADIs, the measure was return on equity; for general and life insurers, the measure was return on net assets; for private health insurers, the measure was profits as a proportion of revenue; and for superannuation, it was the overall industry rate of return for members. While these measures of return are all slightly different, they nevertheless provide a useful indicator of the trend in returns in each sector.
to find ways to improve returns, it is important that risk considerations remain front of mind. I’m sure we’d all like to avoid becoming boiled frogs!

That brings me nicely to the final topic I wanted to touch on today: risk culture. There is never an environment in which having a good risk culture is unimportant, but the current environment is one in which it will likely be put to the test.

Risk culture is, in simple terms, an organisation’s attitude to risk-taking and risk management. Just as the frog is said to be oblivious of the dangers of the gradually warming water, an organisation with a poor risk culture will be oblivious, if not neglectful, of its gradually rising risk profile.

The good news is that the Australian financial sector is devoting considerably more time and attention to risk culture. We discussed the good progress that has been made in an Information Paper that we published a few weeks ago. But we also noted, and the industry participants we spoke with readily agreed, that this is an evolving area in which more can be done.

In the Information Paper, we called out the group risk insurance and mortgage lending standards as two examples from recent years where we had seen a gradual adoption of higher risk business across the industry, without in many cases the commensurate consideration of the potential downside. Those examples reinforce the need for a strong risk culture at a time when a little more risk might well be a tempting way of dealing with otherwise subdued returns. This temptation can be even harder to resist when competitors appear to be doing likewise - even though that is the weakest justification of all.

I’ll finish by simply noting that, in an environment in which interest rates and investment returns are low, and may stay that way for a while, the pressure will only grow to find ways to offset their impact. One possible short-term fix will be to move out along the risk spectrum. If that happens surreptitiously, without direction or oversight, without compensating controls and reporting, and without sufficient financial strength to deal with the risks should they come to fruition, the risk temperature can rise significantly without anyone noticing. As important as they are, our best protection against becoming boiled frogs will not be regulatory reforms such as those emanating from Basel, but a strong risk culture within financial institutions that gives appropriate weight to both sides of the risk-return trade-off.

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