CAN AUSTRALIAN BANKS WITHSTAND A LIQUIDITY CRISIS?

Australian banks have responded to tighter regulatory requirements for capital and liquidity over the past decade, which has strengthened their resilience to adverse shocks. Have they done enough to handle a liquidity crisis if it comes?

CHANGES SINCE THE GFC

Since the financial crisis in 2008–09, regulatory authorities such as the Australian Prudential Regulation Authority (APRA), financial institutions and financial markets globally have increasingly focused on risk and resilience in the banking sector by managing their capital and liquidity positions.

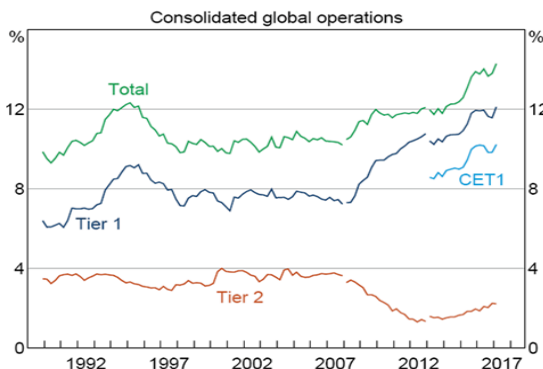
The financial crisis highlighted that banks in many countries had not always managed the risks associated with their activities appropriately. In response, a revised framework for capital and liquidity requirements was introduced globally to improve the resilience of the global financial system.

In addition to these global changes, the 2014 Financial System Inquiry introduced a number of measures to strengthen the Australian financial system. These included ensuring that capital ratios of Australian banks are 'unquestionably strong' as measured by their most secure Tier 1 capital.

STRENGTHENING OF BANKS' CAPITAL POSITION

A bank's capital provides it with the ability to absorb losses, making it a core part of their resilience against adverse shocks. Australian banks have substantially increased their capital ratios since the financial crisis in 2008 (Chart 1).

CHART 1: BANKS' CAPITAL RATIOS*

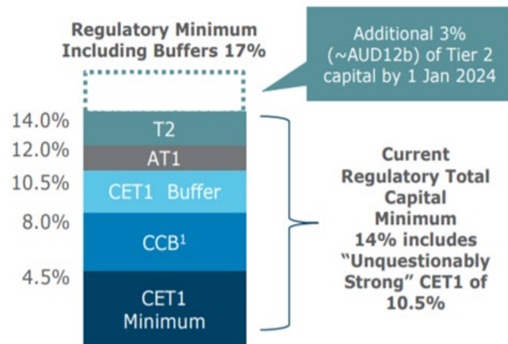


* Per cent of risk-weighted assets; break in March 2008 due to the introduction of Basel II; break in March 2013 due to the introduction of Basel III Source: APRA

The quality of banks' capital has also improved. In particular, the rise in total capital ratios is driven by an increase in Common Equity Tier 1 (CET1) capital – the highest quality form of capital, comprising of a bank's core capital and common shares. Since CET1 capital ratios measure a bank's capital strength, APRA uses this as a benchmark to maintain unquestionably strong banks.

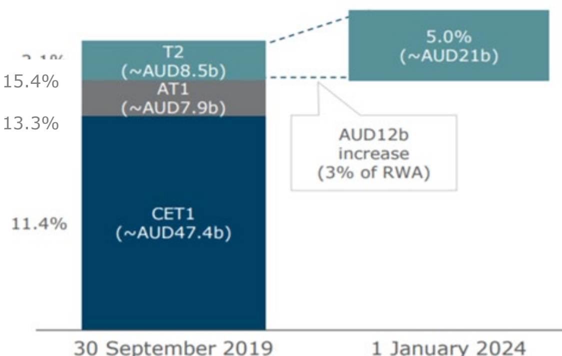
Using ANZ Bank as an example, we can see from charts 2 and 3, ANZ's balance sheet and capital buffers are in excess of 'unquestionably strong' levels.

CHART 2: REGULATED REQUIREMENTS



1. Capital conservation buffer component that forms part of the regulated minimum CET1 requirements. Source: ANZ

CHART 3: ANZ CAPITAL BUFFER



Source: ANZ

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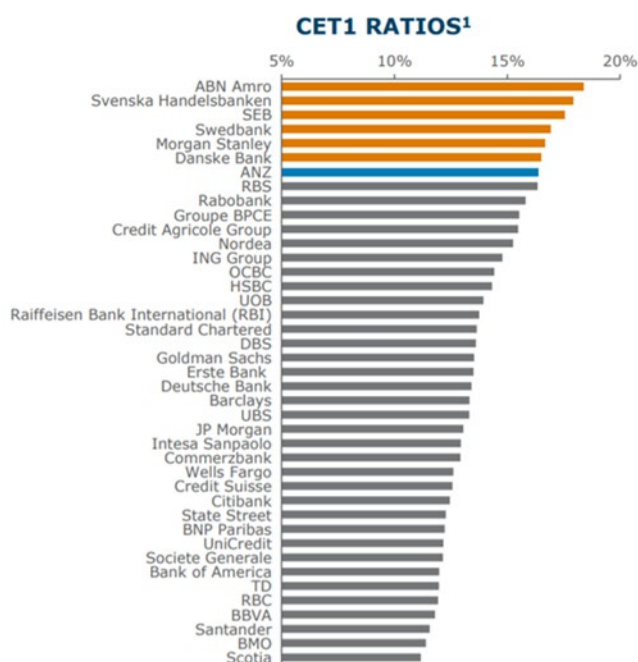
Tier 1 capital is calculated as CET1 capital plus additional Tier 1 capital (AT1). While CET1 comprises a bank's core capital and common shares, AT1 is made up of instruments such as contingent convertible or hybrid securities. ANZ currently has a combined 13.3% of CET1 and AT1 capital, well above the regulatory minimum requirement of 12%.

The combined CET1 capital ratio of the major Australian banks also appears strong relative to international banks. Chart 4 highlights ANZ's CET1 ratios relative to global peers.

CHART 4: ANZ'S CET1 RATIOS RELATIVE TO GLOBAL PEERS



1. CET1 and leverage ratios are based on ANZ estimated adjustment for accrued expected future dividends where applicable. Source: ANZ

Overall, Australian banks have a substantial buffer above APRA's minimum regulatory capital requirements.

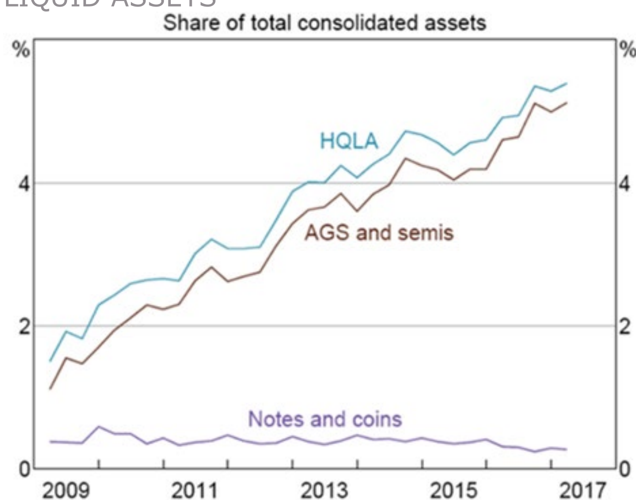
STRENGTHENING OF BANKS' LIQUIDITY POSITION

Another important component of banks' resilience is their ability to withstand significant funding withdrawals. The financial crisis highlighted that many banks globally had an over-reliance on short-term funding from the interbank lending markets. As a result, when faced with disruptions in these funding markets, banks were not adequately protected against liquidity shocks.

Regulators responded to these lessons from the crisis by introducing new prudential liquidity requirements. Banks now have to adhere to minimum liquidity standards to ensure they hold stronger buffers in case of liquidity shocks.

One of the liquidity requirements introduced is the liquidity coverage ratio which measures the bank's ability to meet its short term financial obligations. Banks are required to hold a buffer of High Quality Liquid Assets (HQLA) to cover net cash outflows in a 30-day stress scenario. Consequently, banks have increased their overall exposure to HQLA as a share of their assets (Chart 5). Securities eligible as HQLA include Australian Government Securities (AGS) and state government securities (semis).

CHART 5: AUSTRALIAN BANKS' HIGH-QUALITY LIQUID ASSETS*



* Australian dollar HQLA Source: APRA; RBA.

Another liquidity requirement is the net stable funding ratio, which requires banks to hold a minimum level of stable funding to cover the duration of their long-term assets. Stable funding includes equity, long-term debt and sticky deposits such as those from retail customers or small to medium-sized enterprises. The intention is to ensure that banks do not take on an excessive amount of liquidity risk over a one-year horizon.

CONCLUSION

Since the financial crisis in 2008–09, Australian banks have adopted stronger capital and liquidity positions to arm themselves against adverse shocks. Australian banks have responded to increasing capital requirements at 'unquestionably strong' levels while maintaining a portfolio of High Quality Liquid Assets as a buffer for any adverse liquidity shocks. In our view, the banking sector in Australia is in a much stronger capital and liquidity position now than prior to the financial crisis to weather through a liquidity storm.

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