



“Historically, Australia has maintained a strong and stable financial system supported by effective stability settings. However, the Australian financial system has characteristics that give rise to particular risks, including its high interconnectivity domestically and with the rest of the world, and its dependence on importing capital.” (*Financial System Inquiry Final Report, page xvii*)

“More can be done to strengthen the resilience of Australia’s financial system to avoid or limit the costs of future financial crises”. (*Financial System Inquiry Final Report, page xvii*)

“Although no system can ever be ‘bulletproof’, Australia should aim to cultivate financial institutions with the strength to not only withstand plausible shocks, but also to continue to provide critical economic functions.” (*Financial System Inquiry Final Report, page 33*)

“In the Inquiry’s view, although Australian authorised deposit-taking institutions (ADIs) are generally well capitalised, further strengthening would assist in ensuring capital levels are, and are seen to be, unquestionably strong”. (*Financial System Inquiry Final Report, page 34*)

The Inquiry’s recommendations seek:

“To make institutions less susceptible to shocks and the system less prone to crises, reducing the costs of crisis when they do happen, and supporting trust and confidence in the system. They aim to minimise the use of taxpayer funds, protect the broader economy from risks in the financial sector and minimise perceptions of an implicit guarantee and the associated market distortions.” (*Financial System Inquiry Final Report, page 35*)

“To strike a balance between system stability and competitiveness, and, where possible, aspire for competitively neutral regulatory settings.” (*Financial System Inquiry Final Report, page 36*)

Recommendations relating to resilience are listed in Table 1.

Table 1: Resilience recommendations

Recommendation	Description	Page Reference
1	Capital levels	41
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Source: Derived from *Financial System Inquiry Final Report, page xxii*

Unquestionably strong capital ratios are necessary

“Evidence available to the Inquiry suggests that the largest Australian banks are not currently in the top quartile of internationally active banks.” (*Financial System Inquiry Final Report, page 41*)

“A baseline target in the top quartile of internationally active banks is recommended.” (*Financial System Inquiry Final Report, page 41*)

“Based on the evidence available for the purposes of comparing with the global distribution, a plausible range for current Australian major bank CET1 capital ratios is 10.0-11.6 per cent.” (*Figure 1 in this brief: Adjusted average Australian major bank CET1 capital ratios – see following page*) (*Financial System Inquiry Final Report, page 48*)

The Inquiry has made the following recommendation:

“Set capital standards such that Australian authorised deposit-taking institution capital ratios are unquestionably strong”

(Recommendation 1) (Financial System Inquiry Final Report, page 41)

“The target should be aided by adopting *Recommendation 4: Transparent reporting*, which aims to improve the international comparability of Australian ADI capital ratios”. (*Financial System Inquiry Final Report, page 41*)

“The quantum of any change should take account of the effect of other recommendations, particularly *Recommendation 2: Narrow mortgage risk weight differences*, which aims to improve competitive neutrality of regulatory settings.

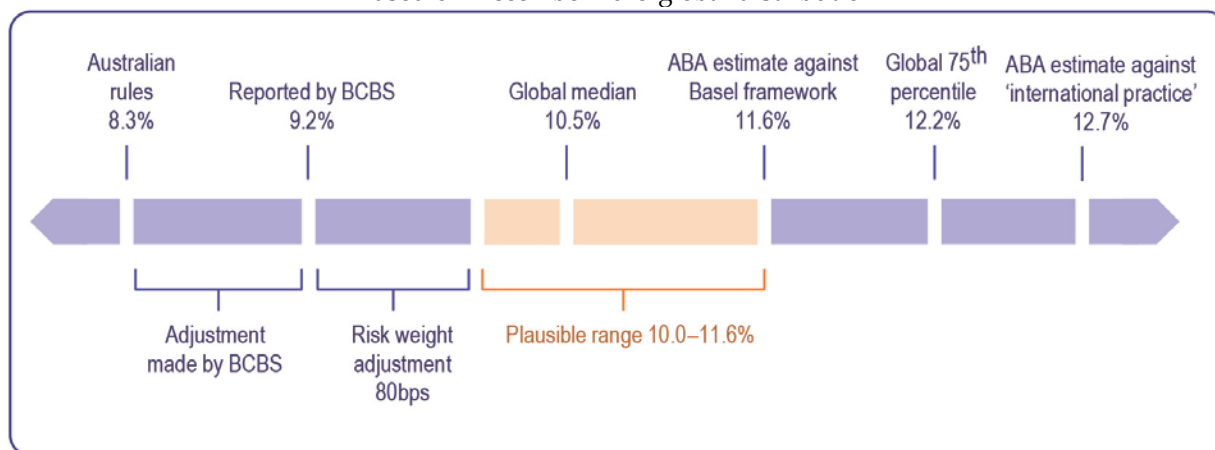
This recommendation seeks to:

- Make banks less susceptible to extreme but plausible adverse events;
- Create a financial system that is more resilient to shocks and less prone to crises;
- Protect the government balance sheet from risks in the financial system, to minimise the burden on taxpayers; and
- Reduce perceptions of an implicit Government guarantee for ADIs and the associated economic inefficiency. (*Financial System Inquiry Final Report, page 41*)

“The Inquiry recommends that increases in capital ratios from current levels should primarily take the form of increases in CET1... However, APRA should use its discretion regarding whether part of such change should be through Tier 1 capital or total capital requirements.” (*Financial System Inquiry Final Report, page 59*)

Figure 1: Adjusted average Australian major bank CET1 capital ratios

Based on December 2013 global distribution



Source: *Financial System Inquiry Final Report*, page 49

Narrow mortgage risk weight differences

“Australia’s current capital framework for ADIs includes two approaches to determining risk weights for the purpose of calculating capital ratios:

- Standardised approach: This is the default approach... a common set of risk weights that seek to reflect general risks of different broad asset classes.
- Internal ratings-based (IRB) approach: Accredited ADIs (IRB banks) use their own internal models to determine risk weights for credit exposures... To date, APRA has only accredited the four major banks and Macquarie Bank to use IRB models.” (*Financial System Inquiry Final Report*, page 60)

“Since the IRB approach was introduced, the divergence in mortgage risk weights between the two approaches has widened... The gap between average IRB and standardised mortgage risk weights means IRB banks can use a much smaller portion of equity funding for mortgages than standardised banks... this translates into a funding cost advantage” (*Financial System Inquiry Final Report*, page 61)

“In the Inquiry’s view, the relative riskiness of mortgages between IRB and standardised banks does not justify one type of institution being required to hold twice as much capital for mortgages than another.” (*Financial System Inquiry Final Report*, page 61)

The Inquiry has made the following recommendation:

“Raise the average internal ratings-based (IRB) mortgage risk weight to narrow the difference between average mortgage risk weights for authorised deposit-taking institutions using IRB risk-weight models and those using standardised risk weights.”

(*Recommendation 2*) (*Financial System Inquiry Final Report*, page 60)

This recommendation seeks to:

“improve the competitive neutrality of capital regulation by limiting distortions caused by the differential regulatory treatment of different classes of ADI”. (*Financial System Inquiry Final Report, page 60*)

Loss absorbing and recapitalisation capacity

“Australia’s prudential framework is not, and should not be, premised on the assumption that ADIs will never fail, nor that unsecured bank creditors will never be exposed to loss.” (*Financial System Inquiry Final Report, page 69*)

“APRA should develop a loss absorbing and recapitalisation framework... it should not generally seek to move outside international frameworks or ahead of global peers unless there are specific domestic circumstances to warrant this.” (*Financial System Inquiry Final Report, page 67*)

The Inquiry has made the following recommendation:

“Implement a framework for minimum loss absorbing and recapitalisation capacity in line with emerging international practice, sufficient to facilitate the orderly resolution of Australian authorised deposit-taking institutions and minimise taxpayer support”

(*Recommendation 3*) (*Financial System Inquiry Final Report, page 67*)

“Total loss absorbing and recapitalisation capacity should consist of an ADI’s equity as well as debt instruments on which losses can credibly be imposed in a resolution. This includes debt instruments that can be converted to equity or written off where specified triggers are met to recapitalise the ADI or its critical functions. .” (*Financial System Inquiry Final Report, page 67*)

“Deposits are protected by a guarantee under the Financial Claims Scheme (FCS) of up to \$250,000 per account holder per ADI....In Australia, deposits are not and should not be subject to bail-in.” (*Financial System Inquiry Final Report, page 67-68*)

“This recommendation seeks to reduce perceptions that some banks are subject to an implicit Government guarantee to lessen market distortions... and improve competition in the banking sector.” (*Financial System Inquiry Final Report, page 68*)

“High ADI funding costs could result in small increases in loan prices for customers.Competitive pressure could see banks share some of the cost with investors through a lower return on equity. Thus, the effect on loan interest rates is likely to be limited, even for a large increase in bail-in debt.” (*Financial System Inquiry Final Report, page 71-72*)

“The Inquiry expects the effect of higher lending rates on GDP to be minimal. An upper bound would be to assume that the full funding cost increase is passed through to loan interest rates, and that the RBA does not offset this through its setting of monetary policy.” (*Financial System Inquiry Final Report, page 72*)

Improving the international comparability of Australian banks' capital ratios

"APRA should develop a common reporting template that...identifies the effect of areas where Australia's capital framework for ADIs is different to the minimum requirements set out in the Basel framework". (*Financial System Inquiry Final Report, page 76*)

This recommendation seeks to "Reduce disadvantages that may arise for Australian ADIs due to difficulties in comparing Australian ADI capital ratios to international peers." (*Financial System Inquiry Final Report, page 76*)

"APRA also sees value in comparing capital ratios appropriately, particularly for the largest banks operating internationally, and has no objection to ADIs reporting a capital ratio based on Basel minimum requirements". (*Financial System Inquiry Final Report, page 77*)

"Without action, investors may not be able to assess Australian banks' relative capital position. This can reduce access to funding and raise funding costs, particularly at times when investors are more sensitive to risks." (*Financial System Inquiry Final Report, page 78*)

The Inquiry has made the following recommendation:

"Develop a reporting template for Australian authorised deposit-taking institution capital ratios that is transparent against the minimum Basel capital framework"

(*Recommendation 4*) (*Financial System Inquiry Final Report, page 76*)

Direct borrowing by superannuation funds

"Over the past five years, the amount of funds borrowed using LRBAs increased almost 18 times, from \$497 million in June 2009 to \$8.7 billion in June 2014." (*Financial System Inquiry Final Report, page 87*)

"Because of the higher risks associated with limited recourse lending, lenders can charge higher interest rates and frequently require personal guarantees from trustees ... As a result, LRBAs are generally unlikely to be effective in limiting losses on one asset from flowing through to other assets, either inside or outside the fund" (*Financial System Inquiry Final Report, page 87*)

"In addition, borrowing by superannuation funds implicitly transfers some of the downside risk to taxpayers, who underwrite adverse outcomes in the superannuation system through the provision of the Age Pension." (*Financial System Inquiry Final Report, page 87*)

"The GFC highlighted the benefits of Australia's largely unleveraged superannuation system. The absence of leverage in superannuation funds meant that rapid falls in asset prices and losses in funds were neither amplified nor forced to be realised." (*Financial System Inquiry Final Report, page 87*)

"The absence of borrowing benefited superannuation fund members and enabled the superannuation system to have a stabilising influence on the broader financial system and the economy during the GFC." (*Financial System Inquiry Final Report, page 87*)

“Although the level of borrowing is currently relatively small, if direct borrowing by funds continues to grow at high rates, it could, over time, pose a risk to the financial system.” (*Financial System Inquiry Final Report, page 87-88*)

The Inquiry has made the following recommendation:

“Remove the exception to the general prohibition on direct borrowing for limited recourse borrowing arrangements by superannuation funds.”

(Recommendation 8) (Financial System Inquiry Final Report, page 86)

“Government should restore the general prohibition on direct borrowing by superannuation funds by removing Section 67A of the *Superannuation Industry (Supervision) Act 1993* (SIS Act) on a prospective basis. This section allows superannuation funds to borrow directly using limited recourse borrowing arrangements” (*Financial System Inquiry Final Report, page 86*)

This recommendation seeks to:

- “Prevent the unnecessary build-up of risk in the superannuation system and the financial system more broadly”; and
- “Fulfil the objective for superannuation to be a savings vehicle for retirement income, rather than a broader wealth management vehicle”. (*Financial System Inquiry Final Report, page 86*)