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Capital And Government Support Emerge As Key Issues In Australia's Financial System Inquiry

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MELBOURNE (Standard & Poor's) Oct. 20, 2015--Standard & Poor's Ratings Services reports that the Australian government's response to the Financial System Inquiry (FSI) announced today is in line with our previous expectations. We note that the government has accepted most of the inquiry's 44 recommendations.

Although there are a number of specific recommendations aimed at strengthening the Australian financial sector, we consider the following two broad areas have the potential for greatest impact on the credit profiles of the banks operating in Australia:

- Increase in regulatory capital requirements
- Developments on resolution framework

In our view, the Australian banking regulator, the Australian Prudential Regulation Authority (APRA), has already implemented and charted a clear path for increasing regulatory capital requirements for particularly the major Australian banks. We consider that this has the potential to strengthen the major Australian banks' stand-alone credit profiles (SACPs, in this case defined as credit profiles excluding expectation of extraordinary government support), all other things remaining unchanged. If this were to occur, we expect to raise ratings on hybrid instruments and non-deferrable subordinated debt instruments issued by such banks--because in the case of these banks, the ratings on such instruments are more sensitive to changes in the SACP. Nevertheless, we expect that in this scenario, issuer credit ratings and ratings on senior debt would remain unchanged.

Initiatives that boost the Australian major banks' regulatory capital requirements will help bridge the 200 bps gap estimated by APRA in a study completed earlier in the year. This study was aimed at positioning these banks' capital adequacy positions in the top quartile of a group of international banking peers--a position notionally deemed as "unquestionably strong" by APRA. We believe that the main impact of greater harmonization of regulatory capital requirements for the Australian banks--specifically the risk weights on residential mortgages held by the banks subject to internal-ratings-based (IRB) and standardized frameworks--is the stronger capital levels held by IRB banks. The impact of this change on relative business outcomes would be modest, in our view.

We believe that the announcements and progress to date in relation to the resolution framework suggest that there remains material uncertainty about the Australian government and regulator's plans in relation to bank crisis-resolution framework. Indeed, the Australian authorities appear to be in no hurry to implement a European-style statutory "bail-in" of all the senior debt issued by the banks, in a crisis. Nevertheless, in our opinion the announcement of a high-level time table for starting consultations on this matter next year suggests that there is potential for lessening of likely timely financial support from the government to the systemically important private sector banks, if needed. Additionally, we note that the government has endorsed taking steps in line with the emerging international practice to reduce any implicit government guarantee and the perception that some banks are too big to fail, including the use of greater loss-absorbing capital to facilitate orderly resolution. We will continue to monitor developments in this matter to review if and to what extent they weaken the likelihood of government support for the banking system.

We consider that the government and regulators' responses on the remaining topics addressed by the FSI are broadly supportive of the regulatory and governance framework, whose strengths, in our opinion, continue to underpin the stability of Australian financial system. Nevertheless, we believe that the actions on these remaining topics are less likely to have a material impact on the credit quality of Australian banking system.

We have determined, based solely on the developments described herein, that no rating actions are currently warranted. Only a rating committee may determine a rating action and, as these developments were not viewed as material to the ratings, neither they nor this report were reviewed by a rating committee.