

Capital Adequacy of Australian Banks

This article introduces a new Bulletin table, Table B.17, which, for the first time, gives details of the capital adequacy of the Australian banking system. The aggregate capital ratio is an important indicator of the health of the banking system and is obtained by aggregating data from individual banks.¹ The first part of this article gives a brief description of the capital adequacy framework adopted in Australia which individual banks must adhere to, while the second section describes recent trends in the aggregate data shown in the table.

Capital Adequacy Framework

An important part of the Bank's prudential supervision of banks in Australia is the setting of capital adequacy guidelines with which banks must comply. A bank's capital can be viewed as evidence of the willingness of shareholders to commit their own funds to a bank on a permanent basis, as interest free resources and, ultimately, as a cushion to absorb possible future losses. A strongly capitalised banking system engenders

confidence in the banking and payments systems as a whole.

In August 1988, the Bank introduced a new approach to the supervision of banks' capital adequacy in which allowance was made for differences in credit risk in different classes of bank assets.² The Bank's approach is consistent with that agreed during July 1988 by the Basle Committee on Banking Supervision as a basis for the international convergence of capital measurement and capital standards of banks.

The focus of the current measure of capital adequacy is on credit risk – the potential risk that a borrower from a bank or a bank's counterparty will default on its obligations. The capital adequacy arrangements require that credit exposures (on- and off-balance sheet) be risk-weighted according to three broad types of counterparty (namely government, banks and all others) – the higher the credit risk involved, the greater the capital backing required. There are five general categories of risk weights: 0, 10, 20, 50 and 100 per cent. The sum of risk-weighted assets plus risk assessed from off-balance sheet business is then related to the bank's capital base. The resulting 'risk ratio' is used as a measure of capital adequacy.

1. The aggregate data do not include statistics of foreign bank branches, which are not required to hold capital in Australia.
2. Details of the Bank's capital adequacy framework are contained in Prudential Statement C1; a summary of the guidelines appeared in the September 1988 issue of the *Bulletin*.

The guidelines apply to the global consolidated operations of a bank and its subsidiaries. It, therefore, includes the overseas operations of a bank, whether conducted through a subsidiary or branch operation, as well the operations of a bank's domestic subsidiaries.

Definition of Capital

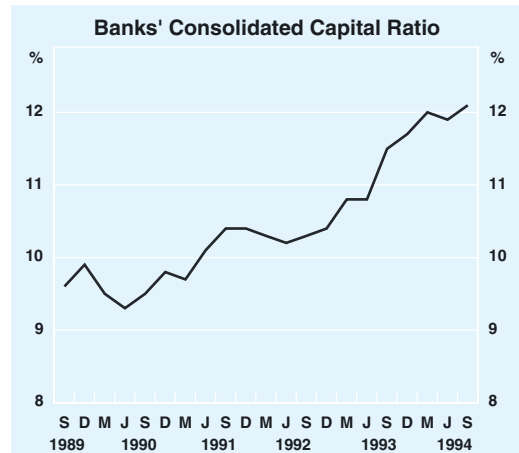
For supervisory purposes, capital is disaggregated into two tiers. Tier 1 (or 'core') capital comprises the highest quality capital elements and includes paid-up ordinary shares, non-repayable share premium account, general reserves, retained earnings, non-cumulative irredeemable preference shares and minority interests in subsidiaries. Tier 2 (or 'supplementary') capital, represents other elements which fall short of some of the characteristics of core capital but which contribute to the overall strength of the bank as a going concern. Tier 2 capital is, in turn, divided into two further tranches, reflecting differing degrees of 'permanence' associated with the respective capital instruments. Upper Tier 2 capital comprises general provisions³ for doubtful debts, asset revaluation reserves, cumulative irredeemable preference shares, perpetual subordinated debt, and mandatory convertible notes and similar capital instruments. Lower Tier 2 capital is ranked behind upper Tier 2 capital and comprises limited life redeemable preference shares and term subordinated debt. Lower Tier 2 capital cannot exceed 50 per cent of Tier 1 capital and total Tier 2 capital cannot exceed core capital.

In line with international capital standards, Australian banks are required to maintain a ratio of capital to risk-weighted assets of not less than 8 per cent, with at least 4 per cent in core capital.

Recent Trends

Graph 1 shows the aggregate risk-weighted capital ratio of Australian banks. The latest figures for end September 1994 show the capital ratio at 12.1 per cent, well above the 8 per cent minimum requirement.

Graph 1



As shown in Table B.17, the total capital base of the banking system has risen steadily in recent years. Between September 1989 and September 1994, the total capital base of the Australian banking system rose from \$37 billion to \$48 billion, an average increase of 5 per cent per annum over the period.

The rise reflects the net effect of a number of factors. Working to reduce the level of banks' capital were the losses sustained by some banks in the late 1980s and early 1990s, changes to the capital adequacy framework which required the deduction of some elements from the capital base of banks and, more recently, the conversion of some foreign bank subsidiaries to branches, which do not require the holding of capital in Australia. Those factors were more than offset, however,

3. Under the capital adequacy guidelines, general provisions for doubtful debts (those which do not relate to identified potential losses) may count as part of a bank's Tier 2 capital to a maximum of 1.25 per cent of risk-weighted assets.

by the additions to the capital base flowing from the retention of bank profits, new capital raisings – both ordinary share capital and debt capital raisings – and capital injections to the system associated with new bank entrants. As shown in the table, there has been no net change in Tier 2 capital over the period but a strong rise in Tier 1 capital. This has resulted in the system having a strong ‘Tier 1’ capital ratio. Since December 1993, this ratio alone has exceeded the minimum total requirement of 8 per cent.

The level of banks’ total risk-weighted assets is also affected by a number of factors, overall demand for bank credit and changes in the mix of banks’ business being the most important. Banks’ acquisitions can also

produce significant movements in banks’ total risk-weighted assets from time to time. Since about one-quarter of Australian banks’ aggregate assets are offshore, movements in the Australian dollar exchange rate can also be a source of fluctuation in banks’ total risk-weighted assets.

The combination of these factors tends to make short-term movements in banks’ total risk-weighted assets fairly volatile. Nevertheless, over the past four years, the overall trend in the level of banks’ total risk-weighted assets has been generally downward. At end September 1994, banks’ risk-weighted assets totalled \$393 billion, compared with \$403 billion a year earlier and a peak of \$428 billion in December 1990.