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APRA gives Australian banks short, sharp stress test

According to a report in today's Australian Financial Review, the Australian Prudential Regulation Authority (APRA) has asked Australia's banks to run stress test models with severe downturn assumptions, including a 30 per cent fall in house prices and unemployment rising from its current 5 per cent to 12 per cent, along with a 40 per cent fall in commercial property values.

There are several points that need to be made – firstly, as the Australian Bankers Association has pointed out, this is not a one-off test by APRA. "Nothing in the AFR article particularly surprises me," said Steven Münchenberg, the ABA's chief executive.

"APRA is running a worst case scenario. It's plausible if the situation, particularly in Europe, deteriorates badly next year. We wouldn't expect that scenario to cause any problems for the stability of the [Australian] banking system. Obviously we've got well-capitalised banks and we've got profitable banks and that's something that often gets overlooked. Profits are the first buffer against any serious economic downturn, which allows the banks to absorb a big increase in bad and doubtful debts.

APRA's views on stress testing

APRA, while not commenting on the current series of tests either, pointed to documents on its own website that indicate the agency's thinking on stress testing. "Too often, the scenarios and the modelled results are not severe enough to result in losses. This 'disaster myopia' needs to be overcome," are among the introductory comments from Paul Tattersall, the head of APRA's industry analysis team.

"Prudential regulators and central banks also see benefits in the application of stress-testing. Amongst other things, stress testing allows supervisors to better understand their regulated entities, to identify weaknesses within those entities, to identify weaknesses across sectors and also understand the systemic consequences of potential events," he added.

The APRA document also noted that in 2005-06, APRA participated in a macroeconomic stress-test of the Australian banking system under the IMF's Financial Stability Assessment Program. A three-year stress scenario, developed by the IMF in conjunction with the RBA, APRA and Treasury, involved interest rate scenarios applied to the banking and trading books of the five largest banks, in the context of a short but sizeable recession, a large fall in housing prices (down 30 per cent) and a significant depreciation of the exchange rate.

The stress-test did not reveal any near-term financial stability issues. "The banks showed considerable resilience, with profitability declining in response to bad debt expenses and higher funding costs, but no losses incurred. This was explained by several factors: the favourable macroeconomic starting point, a portfolio composition skewed towards residential mortgages (that tend to be more resilient to short-term recessions) and the short-lived recession," Tattersall reported.

A later test, with 9.8 per cent unemployment run against the 20 largest ADIs (by asset size) also showed that none of them would have failed under the downturn scenario run, nor would they have breached the (then) four per cent Tier 1 capital requirement under Basel II.

Stress test no surprise

According to Paul Dowling, principal analyst at East & Partners, industry insiders have been aware that the latest round of stress tests have been coming for a few weeks.

"There is clearly growing concern about the effects of this eurozone impasse and there's been a shift in sentiment from a couple of months ago, which was: 'Australia's well inured from all of this and there's very little bank exposure to assets in Europe, other than NAB's UK banking licences' to a point now where there's a lot more serious concern about the potential impacts on the system here," Dowling said.

"In particular, those concerns are around the [Australian] banks' 2012 whole sale funding needs. The Euro markets are closed and nobody's quite sure when they're going to re-open."

Dowling noted that Australia's banks rely on around 35 per cent of their funding needs from offshore, although that has come down "big time".

He also said that these stress tests will continue as long as the eurozone situation remains, with APRA asking the banks to run their modelling against "darker and darker" assumptions to get a feel as to whether some serious systemic damage might happen. "It's not going to be a matter of frequency, so much as urgency," Dowling said.

Stress tests have in recent times not been well received,a s the experience in Europe shows. There is plenty rising on the latest round of APRA testing as, with up to $100bn in funding due to be rolled over next year, Australia's biggest banks will need to tap international wholesale markets before too long.

"International investors are becoming weary of bank stress tests generally, and increasingly skeptical of their credibility," said James Mudie, managing director of Billarook, a boutique advisory firm with expertise in financial regulations across the Asia Pacific region.

"In the Australian context, rigorous testing of residential real estate concentration and exposure and the highly stressed funding environment will be the minimum required to help alleviate international investor concerns. Assumptions used to date will not suffice."

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