How APRA Built an Unquestionably Strong Australian Banking System

Australia's banking strength owes much to the deliberately conservative approach of the Australian Prudential Regulation Authority (APRA). Its emphasis on capital, lending standards and resilience underpins an "unquestionably strong" banking system and provides a compelling foundation for investment in Australian bank debt.

Global shocks can still push bank bond prices lower and credit spreads wider as we have seen in recent months in 2026. The key question is whether those movements reflect deteriorating financial strength or a broader retreat from risk. APRA's framework helps Australian banks withstand these episodes by building financial capacity before it is needed.

A History of Building Resilience

The 2015–2016 commodity downturn illustrates the distinction. Falling oil prices and concerns about Chinese growth unsettled global credit markets, increasing funding pressures. Australian banks nevertheless retained access to international funding markets.

Capital strengthening was already underway. In July 2015, APRA announced higher mortgage risk weights for banks using internal ratings models, requiring more capital against their residential mortgage exposures. In 2017, it established explicit capital benchmarks to deliver the "unquestionably strong" objective. These reforms progressively strengthened the system's ability to absorb losses.

The lesson for investors remains relevant: market prices can react sharply to international uncertainty even when domestic banks retain substantial financial resources.

Mortgage Risk and Preventative Oversight

Energy shocks can affect banks through different channels. Falling commodity prices can weaken resource businesses and regional employment; rising energy costs can squeeze household budgets, sustain inflation and put pressure on borrowers.

For Australian banks, residential mortgages are therefore a natural focus. High household indebtedness makes repayment capacity important, but assessing mortgage risk also requires examining lending standards and the capital available to absorb losses. APRA addresses these risks through several complementary safeguards:

a) Testing repayment capacity: Since 2021, APRA has required banks to assess new housing borrowers at an interest rate at least three percentage points above their loan rate. This creates a margin for higher repayments or other pressures on household finances. It cannot eliminate financial hardship, but it strengthens the assessment made when a loan is approved.

b) Limiting highly indebted lending: From February 2026, APRA introduced limits allowing no more than 20% of new mortgage lending to borrowers with total debt of six times their income or more. The limits apply separately to owner-occupier and investor lending, providing an additional guardrail against an excessive concentration of highly indebted borrowers.

c) Maintaining capital to absorb stress: Lending safeguards reduce the likelihood of losses, while regulatory capital provides capacity to absorb them. APRA's capital framework is designed to allow banks to draw on buffers during difficult periods and continue lending without breaching minimum requirements.

Together, these measures support a more resilient banking system. Mortgage arrears deserve attention, but they need to be considered alongside the safeguards governing lending and the resources available if conditions deteriorate.

Substantial Capital Supporting the System

APRA reported an aggregate total capital ratio of 20.5% for Australian authorised deposit-taking institutions at June 2026. This represented approximately $480 billion of regulatory capital against $2.34 trillion of risk-weighted assets.

This is a regulatory capital ratio measured against risk-weighted exposures, rather than an equity-to-total-assets ratio. Total capital comprises Common Equity Tier 1, Additional Tier 1 (being phased out for Australian banks) and Tier 2 capital, which have different characteristics and roles in absorbing losses.

CBA provides a practical example. At June 2026, its APRA Level 2 group total capital ratio was 20.8%, comprising 12.0% Common Equity Tier 1, 1.5% Additional Tier 1 and 7.3% Tier 2. This demonstrates why a bank's total capital ratio can exceed 20% while its common equity ratio is lower.

APRA's framework also received recent international recognition. On 13 October 2026, the Basel Committee on Banking Supervision assessed Australia's leverage ratio framework as "compliant", the highest possible grade under its Regulatory Consistency Assessment Programme (RCAP). The leverage ratio complements risk-based capital requirements by providing a separate safeguard against excessive borrowing. The assessment confirms that Australia's implementation meets the international standard, reinforcing confidence in this important element of its regulatory framework. Other jurisdictions, notably Canada and the UK, received a lower "largely compliant" assessment.

What This Means for Fixed Income Investors

APRA's contribution is most valuable before a crisis emerges. Strong lending standards help contain the build-up of risk, while capital requirements strengthen banks' capacity to absorb losses when conditions weaken. For fixed-income investors, these

safeguards provide a strong foundation for assessing Australian bank issuers through periods of uncertainty.

This explains why the Financial Income Fund's investment team deliberately operates within a conservative investment universe. That focus is a conscious investment decision. Our objective is to seek regular income from the investment grade and regulated credit issuers, where we understand the issuers, the securities and the prudential framework governing them.

To borrow an Australian analogy, we prefer to swim between the flags, under the watch of the financial system's prudential lifeguard, APRA. The flags do not remove every wave or current, but they help define the waters in which we choose to invest. Within that universe, active management remains essential: assessing financial strength, selecting the appropriate position in the capital structure and ensuring the return adequately compensates investors for the credit and structural risks involved.

An equally important distinction is between mark-to-market volatility and default risk. Credit spreads can widen during periods of uncertainty, reducing a bond's market value, and subsequently contract as confidence returns. A lower market price does not, by itself, mean an issuer has become unable to meet its obligations.

For a fixed rate or floating rate bond whose issuer continues to meet its contractual obligations, market price fluctuations do not interrupt contractual coupon payments or change the principal repayable at maturity. Where that bond is held to maturity and repaid in full, an interim price decline does not result in a permanent credit loss to the portfolio. Selling before maturity, however, can crystallise that decline, making liquidity management and investment discipline important alongside credit selection. Capital preservation is not guaranteed.

Our focus is therefore on selecting securities where our credit analysis indicates a lower probability of default or permanent capital loss, while understanding the specific terms governing payments and repayment. This includes distinguishing dated bonds from securities with discretionary distributions, loss-absorption provisions or no fixed maturity. APRA's oversight supports our assessment; our own credit analysis and portfolio management give it practical effect.

A conservative fixed-income fund should be judged by the risks it takes to generate income and its capacity to preserve capital through the investment cycle. A deliberately focused investment universe, robust credit selection and a clear understanding of the difference between temporary price movements and permanent loss are central to how the Financial Income Fund seeks to manage capital risk through the investment cycle, noting that neither income nor capital preservation is guaranteed.

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