TREASURY

SENATE QUESTION
Notice Given: 25 January 2018

Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Bill 2017 Written Questions on Notice – Treasury – January 2017

1. Submissions received
a. Can you please provide a response to issues raised in the following submissions and supplementary submissions:
i. Dr Wilson Sy (submission 1)
ii. Banking and Finance Consumers Support Association (submission 6) – specifically particularly dot point 3 on page 3.
iii. Citizen's Electoral Council (submission 11 and supplementary submission 11.1)
2. Section 11CAA of the bill defines "conversion and write-off provisions" as:
conversion and write-off provisions means the provisions of the prudential standards that relate to the conversion or writing off of:
(a) Additional Tier 1 and Tier 2 capital; or
(b) any other instrument

a. What was the intent of including section (b) in the legislation?
b. Can section (b) be interpreted to include bank deposits as an instrument that could be converted or written off?
c. If yes, does this imply that bank deposits could be subject to, in the words of some submitters, a "bail-in"? If no, please explain how deposits are specifically excluded in the legislation.
3. Hybrid Securities
During the last round of Senate Estimates, former head of ASIC Mr Greg Medcraft raised a number of concerns about sales of hybrid securities to retail investors (page 30 of Treasury Estimates Thursday 26 October)
a. Can you confirm that hybrid securities sold by authorised ADIs and insurers that comply with either Tier 1 or Tier 2 capital requirements could be subject to write-down or write-off under this bill?
b. Of the reported $43.3 billion of hybrid securities that exist as of June 2017, can you provide breakdowns by:
i. How much was issued by Authorised ADIs and complies with Tier 1 or Tier 2 capital requirements?
ii. How much was issued by insurers and complies with Tier 1 or Tier 2 capital requirements?
iii. Of 3(b)(i) – how much is held by retail investors or SMSFs (both total value and average/median value held per owner)
iv. Of 3(b)(ii) – how much is held by retail investors or SMSFs (both total value and average/median value held per owner)
v. What disclosure requirements are required before a retail investor or SMSF can invest in such a security? Are there requirements for disclosure of risks, including the risk of conversion or write-off should the issuer become insolvent?
4. Can you please confirm for the Committee how this legislation assists APRA in regulating the compliance of ADIs and insurers with the Basel III Accords?
5. Can you confirm that in times of severe financial distress or near insolvency, retail depositors will not be affected by actions taken by APRA during the course of a wind-up
6. Does this legislation create greater incentive for ADIs and insurers to act prudently, ultimately giving greater protection to their customers?

ANSWER

Treasury has prepared the following answers, with input from the Australian Prudential Regulation Authority (APRA) and the Australian Securities and Investments Commission (ASIC).

Question 1.

Similar issues are raised in submissions from Dr Wilson Sy, the Banking and Finance Consumers Support Association and the Citizens Electoral Council. These issues are addressed as follows.

Protection of depositors

Suggestions in the submissions that deposits are not protected under the *Banking Act 1959* (Banking Act), that the Bill provides APRA with bail-in powers, and that these powers are to be extended to deposits, are incorrect.

Depositors are protected by the Government's Financial Claims Scheme (FCS), which guarantees deposits up to a cap of $250,000 per person, per authorised deposit-taking institution. A wide range of deposits are covered under the FCS, including term deposits, savings accounts, call accounts, pensioner accounts, trustee accounts and retirement savings accounts.

As APRA noted in its submission to the Committee dated 18 December 2017, while the proposed legislation includes reforms to ensure that capital instruments of authorised deposit-taking institutions (ADIs) and insurers can be written down or converted in accordance with their contractual terms, it does not include a statutory power for APRA to write-down or convert the interests of other creditors in resolution, including depositors of a failing ADI (a so-called 'bail-in' power).

Further, deposits will not be subject to the provisions in the Bill which deal with the conversion and write-off of capital instruments – see answer to Question 2 for further details.

The existing law, as further strengthened by this Bill, provides a high level of other protections for the interests of depositors in a crisis. In particular, APRA's statutory objectives include protecting the interests of depositors and promoting financial system stability in Australia. Both Treasury and APRA consider that, in the case of the failure of an ADI, the objectives of protecting depositors and promoting financial system stability would be very closely aligned.

This is further reflected by the depositor-preference provisions in the Banking Act, which give depositors priority over most other creditors in the winding up of an ADI, to the extent that depositors have not already been paid out under the Financial Claims Scheme in the Act.

Finally, we note that this Bill includes an amendment that, for the avoidance of doubt, explicitly adds the words "to protect the interests of depositors of any ADI" into the definition of the 'prudential matters' on which APRA makes prudential standards under the Banking Act.

Implementing Glass-Steagall legislation in Australia

The Government has no plans to introduce Glass-Steagall legislation in Australia.

Glass-Steagall legislation was introduced in the United States following the Great Depression and legally ensured the separation of retail and investment banking, with the intent of reducing risk of failure in the US banking sector. The legislation was repealed in the US by the Clinton Administration in 1999.

The Australian financial system already exhibits a high degree of structural separation. Foreign bank branches play a major role in investment banking but only have a small presence in retail and commercial banking. By contrast, Australia's major banks dominate retail and commercial banking, but do not have large investment banking businesses.

The Government's approach to minimising risk in the banking sector has been to focus on strong prudential supervision across each bank's business and ensuring that Australian bank capital is 'unquestionably strong' relative to international peers, rather than trying to separate retail activities from investment banking activities.

Secrecy provisions in the Bill

The proposed legislation allows APRA to determine that the giving of a direction by it should be confidential in certain circumstances, where APRA considers that such a determination is necessary to protect depositors/policyholders or to promote financial system stability in Australia. This would be relevant where, for example, public knowledge of an APRA direction might lead to a run on an ADI's funding which would exacerbate the position of the ADI, and where a short period of 'breathing-space' maybe required in order for APRA to achieve an orderly resolution which meet its statutory objectives (including to protect depositors and promote financial system stability in Australia).

It should be noted that, as stated in paragraph 3.78 of the Explanatory Memorandum, these new provisions seek to address an erroneous reference to Part 6 of the *APRA Act 1998* in the existing secrecy provisions for directions under the APRA Industry Acts.

Suggestions in the submissions that these provisions will allow APRA to subordinate the interests of depositors in favour of financial system stability in a crisis are not a correct reading of the legislation. The confidentiality provisions in the proposed legislation only relate to APRA's ability to determine that an APRA direction should be confidential. This would not detract from APRA's wider statutory objectives to protect depositors under the Banking Act.

Consumer protections for investments in hybrid instruments

From a prudential perspective, hybrid capital instruments are important because they provide some capacity for an ADI to recapitalise if they experience losses that threaten their viability as a going concern. However, the Government recognises that hybrid securities may not be suitable for all investors, particularly where such investors may not be aware of the increased risks they would be exposed to in the event of a conversion or write-off.

The key consumer protection mechanism is the requirement for comprehensive disclosure about the financial product through a prospectus for securities that are offered to retail investors, as required under the *Corporations Act 2001* (Corporations Act). Advertising about hybrid securities is regulated in the same way as advertising for other financial products under the Corporations Act. Conduct in relation to hybrid instruments that is misleading and deceptive is prohibited under the Corporations Act and consumers have a range of remedies, including taking civil action for loss or damage where there is misleading or deceptive conduct.

Further, the Government has agreed to implement a number of consumer outcome measures designed to give consumers confidence to participate in the financial system and the confidence that they are being treated fairly. This includes improving the accountability of issuers and distributors of financial products such that they only market their products to appropriate target markets or investors.

Question 2.

a. The intention of paragraph (b) of the definition of ‘conversion and write-off provisions’ in section 11CAA is to appropriately ‘future-proof’ the legislation by referring not only to AT1 and T2 capital but to other instruments that could be the subject of such provisions under APRA’s capital framework in the future. This reflects that prudential requirements can change over time and the instruments that are recognised as capital under APRA’s prudential standards could be referred to differently in the future. The use of the word ‘instrument’ in paragraph (b) is intended to be wide enough to capture any type of security or debt instrument that could be included within the capital framework in the future. It is not the intention that a bank deposit would be an ‘instrument’ for these purposes.

b. We do not believe that paragraph (b) of the definition could be interpreted to include bank deposits as an instrument that could be converted or written off. The operative section to which this definition applies, new section 11CAB, would only apply where an ‘instrument’ contains terms providing for conversion and/or write-off and those terms reflect requirements in APRA’s prudential standards (which are disallowable by Parliament). As noted in the answer to a. above, this applies to instruments included within APRA’s capital framework. It is not intended to apply to bank deposits.

c. As discussed above, paragraph (b) of the definition cannot reasonably be interpreted to include deposits as an instrument that could be converted or written off. Therefore they cannot be ‘bailed-in’.

Question 3.

a) For an instrument to be recognised as AT1 or T2 capital under APRA’s capital framework, the instrument is required (if it is classified as a liability for accounting purposes) to include contractual terms which provide for it to be written off or converted to equity at certain pre-specified trigger points. Therefore, in the event a trigger point is met, the relevant instrument would be converted or written off pursuant to its contractual terms. The Bill will facilitate this process by providing that, in those circumstances, the relevant contractual provisions in the capital instruments are effective notwithstanding any legal impediment that might exist.

b) Please note: the $43.3 billion figure referred to in this question represents the market capitalisation of all hybrids listed on the Australian Stock Exchange. This figure does not reconcile with the value of hybrids referred to in our answers because our figures include all issuances (not just those listed on the ASX) and is the value that counts towards regulatory capital rather than the market value of the securities.

Although there is limited data available on the holders of Additional Tier 1 and Tier 2 instruments, retail investors are less likely to hold hybrid instruments if they are not listed. The amount of listed hybrids therefore provides some indication of the amount of hybrids that may be held by retail investors. However, some of the $43.3 billion will comprise instruments issued by institutions other than ADIs and insurers, and it is likely that institutional investors hold a portion of listed ADI and insurer hybrids.
i) As at June 2017, the value of Additional Tier 1 (hybrids that count toward Tier 1 regulatory capital) and Tier 2 instruments issued by ADIs was $37 billion and $42 billion respectively.

ii) As at June 2017, the value of both Additional Tier 1 and Tier 2 instruments issued by general and life insurers was around $5 billion in total.

iii) & iv) There is limited data on the holders of Additional Tier 1 and Tier 2 instruments. Further, for the available data it is difficult to look through nominee structures, custodians and other corporate structures to identify the ultimate beneficiary of the security. It is generally accepted however, that Additional Tier 1 instruments are largely (though not wholly) held by high net worth individuals, selfmanaged superannuation funds and other domestic retail investors while Tier 2 instruments are largely held by institutional investors (both domestic and foreign).

v) Offers of hybrid securities are subject to the disclosure obligations under the Corporations Act. Almost all offers of hybrid securities to retail investors are made using a prospectus, which must be lodged with ASIC.

A prospectus must contain all the information that investors (and their professional advisers) would reasonably require to make an informed assessment of: the rights and liabilities attaching to the securities offered (in this case, the hybrid securities); the rights and liabilities attaching to any securities into which those hybrid securities may convert (in this case, ordinary shares in the bank or insurer who is issuing the hybrid); and the effect of the offer on the issuing body (the bank or insurer).

A prospectus is also required to be clear, concise and effective.

ASIC has provided guidance on the kind of information it expects to see in a prospectus: Regulatory Guide 254 Offering securities under a disclosure document and Regulatory Guide 228 Prospectuses: Effective disclosure for retail investors (RG 228). ASIC has also made specific comments on prospectus disclosure for hybrid securities in Report 365 Hybrid securities (REP 365).

The prospectus content requirements in the Act, together with ASIC's regulatory guidance, require disclosure of risks relevant to the securities being offered (including the risk of conversion or write-off) and relevant to the issuer itself.

Hybrid securities are complex products and, like many such products, they test the limits of a disclosure-based regulatory regime. In recognition of this, for a period of approximately 3 years beginning in late 2012, ASIC departed from its usual practice of reviewing disclosure documents only after lodgement, and provided comments on draft documents to issuers of hybrid securities and their advisers prior to lodgement of the prospectus. This was done with the particular aim of improving the clarity of disclosure for retail investors. ASIC ceased this practice once market-standard disclosure began to emerge, and as the results of its pre-lodgement review identified that limited additional changes could be made to further improve the clarity of disclosure given the complexity of the hybrid securities in question.

The Act allows for offers of hybrid securities to be made using an offer information statement (OIS) where the amount of money to be raised does not exceed $10 million. An OIS contains limited information prescribed by the Act, and ASIC does not have the power to preclude the use of an OIS where it considers the more fulsome disclosure required by a prospectus would be desirable. The ability to use an OIS was introduced by the *Corporate Law Economic Reform Program Act 1999* (CLERP Act) for the purposes of promoting and encouraging fundraising for small-to-medium size enterprises.

ASIC is only aware of one offer of hybrid securities made using an OIS, which sought to raise less than $10 million. The issuer, a credit union, provided risk disclosure addressing both the risk of conversion and the risk of write-off should the issuer become insolvent.

Question 4.

The Basel III Accords include a globally-recognised regulatory framework for minimum capital requirements and buffers, including criteria for financial instruments (such as hybrid securities and subordinated debt) to be recognised as capital under this framework. A key criterion for an instrument to be recognised as Additional Tier 1 or Tier 2 capital under this framework is that, if the instrument is classified as a liability for accounting purposes, it must be able to, at a pre-specified trigger point, either convert into common equity or be written down. APRA's prudential framework implements this requirement, and one of the reforms in this legislation will assist this by ensuring that such conversion or write-down provisions in capital instruments will function as intended in a crisis notwithstanding any legal impediment.

More broadly, the reforms in the proposed legislation seek to provide a framework for resolution that is consistent with international standards (including those of the Financial Stability Board, Basel Committee on Banking Supervision and International Association of Insurance Supervisors), tailored in a manner that is considered appropriate for the Australian financial system.

Question 5.

The various protections afforded to deposits/depositors under Australian law mean that APRA will seek to prioritise the interests of depositors in the event of the failure of an ADI.

<u>APRA's statutory objectives:</u> As APRA noted in its written submission to the Committee dated 18 December 2017, APRA's core mission is to establish and enforce prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by institutions it supervises are met within a stable, efficient and competitive financial system. This reflects APRA's statutory objectives, which include protecting the interests of beneficiaries (depositors of ADIs, insurance policyholders and superannuation fund members), and promoting financial system stability in Australia.

<u>Depositor Preference:</u> section 13A(3) of the Banking Act gives holders of protected accounts (that is, depositors) priority over most other creditors in the winding up of an ADI, to the extent that depositors have not already been paid out under the Financial Claims Scheme.

This Bill will further strengthen these protections by reforming and updating APRA's resolution powers, and by amending the definition of 'prudential matters' to explicitly reference protection of the interests of depositors. This will strengthen APRA's powers to manage the failure of an ADI is an orderly way in order to protect the interests of depositors.

In the case of the failure of an ADI, the objectives of protecting depositors and promoting financial system stability would be very closely aligned. It is highly unlikely that there would be circumstances in which taking action that adversely affects the interests of depositors would be conducive to promoting financial stability in Australia. As certain examples from the global financial crisis demonstrated, retaining the confidence of retail depositors in a crisis is crucial to minimising wider contagion affects across the banking system. Where attempts were made to impose losses on depositors, such as in the case of Cyprus, this led to severe contagion impacts which effectively undermined the whole financial system.

Question 6.

A credible resolution regime, with appropriate planning and prepositioning, is important in helping to mitigate moral hazard risks. It means that, in the event of failure of an ADI or insurer, the authorities can achieve an orderly resolution which protects beneficiaries (depositors and policyholders) and other functions critical to the financial system, while at the same time ensuring that management, shareholders and other providers of capital bear the appropriate consequences for the failure. Without this, those responsible for managing and monitoring the actions of ADIs and insurers may be incentivised to take less prudent actions due to the belief that they will not ultimately bear the consequences in the event of failure. For this reason, a credible resolution regime is consistent with a stable and efficient financial system, which provides greater protection to customers.