

Mr Graeme Medhurst

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Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

Attention: Committee Secretary

Subject: FINANCIAL SECTOR LEGISLATION AMENDMENT (CRISIS RESOLUTION POWERS AND OTHER MEASURES) BILL 2017

Introduction

The Australian Senate is to be congratulated for referring the above draft legislation to committee, given the extraordinary powers that the legislation conveys to the Australian Prudential Regulation Authority (APRA) in the event of a financial and banking crisis, or the failure of any authorized deposit-taking institution (ADI) or insurer in Australia.

The purpose of this submission is to outline my key concerns with the draft legislation, and request the Committee to recommend amendments that tighten the relevant provisions of the legislation.

General

Contrary to popular opinion from within the financial industry, the Australian financial system is very poorly regulated. This is most evident in the banking system, where deregulation has allowed institutions to operate as both commercial banks and as investment banks. The risk of institutional failure is driven largely by exposure to trading and investment in financial markets, in particular to the markets in derivative and other financially engineered products. By comparison, commercial banking operations involve relatively low level of institutional risk.

I understand that the above referenced draft legislation is a reflection of the heightened risk in investment, trading and derivative markets, and as a consequence, the risk to the stability of individual banks and the overall banking sector in Australia. Whereas financial deregulation has facilitated the business growth of the banking institutions, the stability of commercial banking in Australia has clearly been compromised, and the real economy of Australia has been put at unnecessary risk.

Historically, Australia, and the world as a whole, has experienced global financial crises in the past, most notably the crash of 1929 that led to the Great Depression. The United States of America led the world out of that crisis through the "New Deal" and the Glass-Steagall Act, setting the framework that limited commercial banks to commercial operations, and preventing those institutions from engaging in investment banking and related trading activities.

Criteria in Exercise of Powers

Whereas the draft legislation establishes and clarifies various crisis management powers of APRA, the legislation is clearly deficient, in that it fails to establish clear criteria, priorities and direction for APRA in the exercise of those powers. Clearly, the highest priority must be the protection of the commercial banking operations, in particular the bank deposits and the portfolio of business and personal loans, as these are a reflection of real economic activity in Australia, and essential for financial market recovery.

Page 5 of the legislation summarizes the Crisis Management Powers, in particular "The Bill strengthens the powers of the Australian Prudential Regulation Authority (APRA) to facilitate the orderly resolution of an authorized deposit-taking institution (ADI) or insurer so as to protect the interests of depositors and policyholders, and to protect the stability of the financial system." In its current form, the legislation does not provide any criteria, direction or guidelines, as may be necessary to resolve conflicting interests of depositors, policy holders and the financial system, should that arise.

For example, consider the situation where APRA forms the view that depositor funds must be "frozen", or otherwise "bailed-in" to the institution's equity capital, in order to preserve the institution in a crisis. Currently, the draft legislation is sufficiently vague in its provisions as to allow APRA to make that decision as it sees fit, notwithstanding that such an outcome may be contrary to the interests of the depositors and borrowers.

Transfer Powers

Pages 13-14 summarise and extend the Transfer Powers of APRA, noting that "The (*existing*) Transfer Act enables some or all of the business of a regulated entity (including assets, liabilities, legal rights and obligations, data and systems) to be transferred to another regulated entity in the same category."

In crisis resolution, the real economy of Australia may best be protected by insulating the commercial banking operations, and allowing investment and trading activities of the bank to be resolved separately. The legislation may be improved by providing APRA with:

- The direction to protect the commercial operations of banking institutions in crisis as its highest priority, even if that should lead to default on its dealings with investment and trading counterparties, or ultimately the failure of the institution itself
- The powers to insulate and transfer the commercial operations of the institution to another regulated banking entity that is structured specifically for commercial banking operations only, i.e. constituted or otherwise governed in a manner that is consistent with the provisions of the Glass-Steagall Act

Conversion and Write-Off of Capital Instruments

The legislation must specifically and unambiguously state that depositor funds are **excluded** from the conversion and write-off provisions of the legislation. Write-off of depositor funds is unacceptable, as is the "bailing-in" of depositor funds to the institution's equity capital. In drafting the legislation, APRA's powers must clearly be constrained in this regard.

Under current commercial law, the depositors rank above the ordinary and preferential shareholders of the institution, in the distribution of funds when an institution is to be wound up. This priority ranking of depositors must not be compromised by this legislation, i.e. APRA's powers must be specifically and unambiguously constrained so as to preserve this ranking.

Conversion of Deposits

Given that the major ADI's in Australia are very highly leveraged and exposed to financial trading positions, circumstances may conceivably arise in a crisis where the conversion of depositor's funds into equity may become the only realistic option to refinance the commercial operations of the institution. If the legislation is to empower APRA to convert deposits into equity, then the legislation must establish clear criteria to be applied in the exercise of that power, for example:

- Conversion of depositor's funds is permitted in only the most extreme circumstances, where the institution has been placed into administration and the depositor's funds are at risk
- With APRA approval, the administrator is to excise and transfer the commercial operations of the institution to another regulated banking entity that is constituted or governed in a manner that is consistent with the provisions of the Glass-Steagall Act.
- The interim share capital of the new banking entity comprises the depositors equity (in proportion to the deposit funds converted), plus any equity capital that is raised in the form of a cash injection (on equivalent terms) by that new banking entity.
- The new banking entity will hold, manage and fund the commercial loan portfolio
- Creditor claims on the institution's commercial operations may transfer to the new banking entity; however these claims must be suspended until the new banking entity is refinanced.
- Upon refinancing of the new banking entity, holders of interim shares will have the option to convert those shares into permanent equity shares, or otherwise receive a fair return on funds

Glass-Steagall Legislation for Australia

My strongest preference is for specific Commonwealth legislation to be enacted ahead of any financial crisis, re-establishing a framework for commercial banking operations that is consistent with the provisions and intent of the Glass-Steagall Act in the United States of America.

Once established, ADI's registered under this "Glass-Steagall" legislation may attract depositor funds and conduct commercial banking activities with a knowledge that its operations are not compromised or put at risk by investment and trading activities. An orderly shift of banking business to these ADI's may well be in the interests of depositors and commercial borrowers during times of heightened financial and market risk.

In the event of financial crisis, the existence of such ADI's may provide APRA with better and more timely options for transfer of commercial banking businesses. Not only may depositor funds be protected, but personal and business loans may continue to be funded. And that is certainly in the interests of Australia's real economy and the well-being of its citizens.

Signed:



Mr Graeme Medhurst