

**AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY**

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COMMITTEE SECRETARY  
SENATE STANDING COMMITTEES ON ECONOMICS  
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Dear Secretary

APRA welcomes the opportunity to assist the Senate Economics Legislation Committee's Inquiry into the *Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Bill 2017*. This submission outlines the key reforms in the proposed legislation, and explains why strengthening APRA's crisis resolution powers is essential for building a flexible and modern framework for managing a future financial crisis in Australia.

### **Background and purpose**

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 authorised deposit-taking institutions (ADIs), insurance policyholders and superannuation fund members), and promoting financial system stability in Australia. APRA meets its purpose through its core functions of supervision, policy and resolution, which reflect its role as a prudential regulator and resolution authority.

In undertaking its core mission APRA places a strong emphasis on active prudential supervision to identify and address issues before they cause the failure of a supervised institution, or materially contribute to financial system instability. APRA does not, however, pursue a zero failure objective, and cannot eliminate the risk that any supervised institution might fail.<sup>1</sup> APRA's resolution function therefore complements prudential supervision through planning for and implementing prompt and effective responses to a failure or crisis in the financial system.

APRA considers the proposed legislation to be essential in helping it to achieve this objective in the future, by materially updating APRA's powers to plan for and manage the failure of ADIs and insurers,<sup>2</sup> in particular reflecting the lessons learnt from the severe impacts of the global financial crisis in other jurisdictions. This is supported by the Financial System Inquiry (FSI) Final Report, which made a recommendation (Recommendation 5)<sup>3</sup> to the Government to

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<sup>1</sup> <http://www.apra.gov.au/AboutAPRA/Pages/Statement-of-Intent-2014.aspx>

<sup>2</sup> The proposed legislation does not include measures relating to the superannuation and private health insurance sectors.

<sup>3</sup> <http://fsi.gov.au/publications/final-report/chapter-1/crisis-management-toolkit/>

strengthen APRA's crisis management powers. This was accepted by the Government in its response to the FSI in 2015.

The events of the global financial crisis demonstrated that, when financial institutions or complex financial groups experience distress, failure to resolve these institutions or groups in an orderly fashion can lead to severe adverse economic consequences. In aggregate, the annual real GDP growth rate of OECD countries declined from 2.8 per cent in September 2007 to -4.8 per cent in March 2009.<sup>4</sup> These figures were exacerbated by the fact that many jurisdictions were ill-prepared to manage the crisis, with legal frameworks that lacked clear and comprehensive powers for regulators to intervene to resolve failing financial groups, and inadequate crisis planning by both financial institutions and regulators.

A key part of the international developments in financial regulation since the global financial crisis has been the work in the G20 and by the Financial Stability Board (FSB) to develop effective frameworks for resolving financial distress. This has included the publication of the FSB's international standard on effective resolution regimes in 2011 (Key Attributes of Effective Resolution Regimes for Financial Institutions),<sup>5</sup> which was updated in 2014 including to address insurance-specific considerations. The Basel Committee on Banking Supervision (BCBS) and the International Association of Insurance Supervisors (IAIS) have also taken steps to further address crisis preparedness in their core principles for the supervision of banks and insurers.

Since the global financial crisis, the Treasury has released several public consultations on proposed law reforms in this area. These include Government consultation papers on reforms to the Financial Claims Scheme (FCS) (2011), on Strengthening APRA's Crisis Management Powers (2012) and on providing certainty for Contractual Loss Absorption Provisions in Regulatory Capital (2014). Together these consultations form the basis of the provisions in the proposed legislation.

The proposed legislation will make enhancements to APRA's crisis management powers to ensure they are 'fit for purpose' across the range of different circumstances that could emerge in the future. In particular, these powers need to be able to be applied, in a proportionate manner, to the diverse population of financial institutions that APRA supervises. For example, in the event of the failure of a large complex financial institution, it may not be sufficient to apply powers to the regulated institution alone where it is a member of a corporate group. Critical functions or services may be located in other group entities and contagion effects can occur within financial groups. APRA needs to be able to move swiftly to safeguard the critical operations of group entities where the need arises.

It is in the nature of crisis management powers that they need to be wide and far-reaching to ensure that APRA would be able to meet its objectives in the severe, and potentially fast-moving, circumstances of a financial crisis. Given this, and consistent with APRA's current legislative powers, the proposed reforms include certain triggers and safeguards designed to ensure they are exercised only in appropriate circumstances and in a proportionate way, while

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<sup>4</sup> OECD (2017), Quarterly Growth Rates of real GDP, change over same quarter, previous year, OECD.Stat. The Basel Committee on Banking Supervision (2010) estimated the median cumulative output loss caused by banking crises at 63 per cent of pre-crisis GDP and Bank of England research ([Bank of England Financial Stability Paper No. 35](#)) estimates the cumulative output loss from past banking crises to be 43 per cent of GDP. Noting there is considerable uncertainty in calculating the cumulative output loss caused by a banking crisis and estimates vary widely.

<sup>5</sup> <http://www.fsb.org/what-we-do/policy-development/effective-resolution-regimes-and-policies/key-attributes-of-effective-resolution-regimes-for-financial-institutions/>

at the same time maintaining the requisite level of flexibility for APRA to take prompt and effective action.

While the proposed legislation draws on international standards for resolution regimes, these are adopted in a manner that is appropriate for the Australian financial system and consistent with APRA's mandate, including the core objective of protecting the interests of depositors and policyholders. For example, while the proposed legislation includes reforms to ensure that capital instruments of 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 (often referred to as a 'bail-in' power). Furthermore, while the Government has agreed to consider implementation of a framework for additional loss absorbing capacity for ADIs, as recommended by the FSI, APRA notes that this work is being progressed separately to the reforms in the proposed legislation. APRA also notes, and fully agrees with, the statement in the FSI Final Report that, in Australia, deposits should not be included within any such framework, and should not be subject to bail-in. This is consistent with the priority status afforded to the interests of ADI depositors under the *Banking Act 1959* and with APRA's objectives noted above.

In addition to a wide and flexible set of powers through which to intervene to manage a failure or crisis, the global financial crisis also highlighted the need for greater contingency planning during normal times, both by financial institutions themselves and regulators. APRA is focussed on improving the crisis preparedness of its regulated industries in coming years, through developing its framework for recovery and resolution planning. The proposed legislation will be important in facilitating this, by providing APRA with a clear mandate to set formal prudential requirements in respect of resolution planning and, where necessary, to require an institution to take preparatory measures to address barriers to its resolution, during normal times.

The remainder of this submission summarises the more material reforms in the proposed legislation.

### **The proposed reforms**

As noted in the Explanatory Memorandum for the proposed legislation circulated by the Government, the reforms are intended to:

- enhance APRA's statutory and judicial management regimes to ensure their effective operation in a crisis;
- enhance the scope and efficacy of APRA's existing directions powers;
- improve APRA's ability to implement a transfer under the *Financial Sector (Business Transfer and Group Restructure) Act 1999* (Transfer Act);
- ensure the effective conversion and write-off of capital instruments in accordance with APRA's prudential standards;
- enhance stay provisions to ensure that the exercise of APRA's powers against one entity in a group does not trigger adverse rights under contracts of other relevant entities in the same group;
- enhance APRA's ability to respond when an Australian branch of a foreign regulated entity may be in distress;

- enhance the efficiency and operation of the FCS and ensure that it supports the crisis resolution framework;
- enhance and simplify APRA's powers in relation to the wind-up or external administration of regulated institutions, and other related matters; and
- ensure that APRA has clear powers to make appropriate prudential standards on resolution planning and to require institutions to take measures to improve their preparedness for resolution where appropriate.

### *Statutory and judicial management*

APRA's existing statutory and judicial management powers are an important part of the toolkit for dealing with an ADI or insurer that is in acute distress. They enable APRA to take control of, or ensure that a person is appointed to take control of, a failing institution (in the case of judicial management, by application to the Court) and, as such, are intended to be used as a measure of last resort to stabilise the institution's operations in order to implement an orderly resolution. The proposed legislation will make two significant enhancements to these tools, by extending the scope of statutory management to include certain group entities in order to facilitate the orderly resolution of financial groups, and by extending the statutory management regime to insurers.

The proposed legislation will extend APRA's statutory management powers to the following group entities: authorised NOHCs of ADIs/insurers; and domestically incorporated subsidiaries of authorised NOHCs or ADIs/insurers. APRA would be able to take control of a group entity to enhance its ability to stabilise the operations of the relevant ADI/insurer in a crisis situation. This is important in cases where banks or insurers are part of a financial group, because other group entities may perform services or functions that are essential to the operation of the ADI or insurer, including for example, IT and human resource services. Having the ability to apply powers to relevant group entities in these circumstances is important in limiting the type of contagion effects that could hinder the ability to resolve the regulated institution.

The proposed legislation will also extend APRA's statutory management powers to insurers in certain circumstances. In most situations it is expected that applying to the Court for the appointment of a judicial manager will remain an appropriate means of stabilising a failing insurer. However, there may be certain situations where APRA needs the ability to move quickly to appoint a statutory manager to a failing insurer, such as when the insurer is part of a wider financial group, or its failure otherwise poses an imminent risk to the financial system or economy.<sup>6</sup>

Other reforms in the proposed legislation include expanding the moratorium provisions applicable upon the appointment of a statutory or judicial manager to enable effective implementation of a resolution without the constraints of creditor or third party actions. These reflect similar moratorium provisions applicable to an administration under the *Corporations Act 2001* (Corporations Act). The proposed legislation also enhances the existing statutory immunities applying to statutory and judicial managers to ensure that those appointed to the role have confidence to take the actions required to manage and stabilise a distressed ADI or insurer, without the risk of incurring personal liabilities.

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<sup>6</sup> The failure of HIH Insurance Limited in 2001 demonstrated the potential impacts to the economy of the sudden withdrawal of particular functions provided by an insurer (for example, builders' warranty insurance in the case of HIH).

### *Directions powers*

APRA's existing powers to issue a formal direction to an ADI or insurer (or its NOHC) are also an important component of the crisis resolution toolkit, and can be used flexibly in a range of circumstances to rectify or manage prudential concerns. For example, APRA could issue a direction, which is legally binding, to compel a regulated institution to take specific action in the event of an emerging stress or to address particular prudential issues that have been identified.

However, APRA currently does not have the ability to issue a direction to subsidiaries of ADIs, insurers or NOHCs, which could impede the effectiveness of the power in situations of stress affecting an ADI or insurer that is part of a financial group. There is also a lack of clarity regarding APRA's ability to direct a regulated institution to take specified actions to facilitate resolution, which could be necessary as part of resolution planning during normal times or in an emerging stress situation.

The proposed legislation will broaden the scope of APRA's directions powers, both in respect of the matters on which directions may be given, to ensure that an institution can be directed to implement measures to address obstacles to resolution, and the entities to which directions may be given, to include subsidiaries. Together these amendments will enable APRA to respond in a more timely and decisive way to resolve a distressed ADI or insurer.

In recognition of the seriousness of the situations in which directions may be given, the current law provides that non-compliance with an APRA direction will give rise to a criminal sanction. Nevertheless, given the range of duties imposed on a company and its directors, there may be a reluctance from directors to promptly comply with an APRA direction if there is a concern that, in doing so, they could potentially breach other duties, including those under the Corporations Act. The proposed legislation will help address this issue by providing for clearer immunity for an institution, its directors, management, employees and agents when taking reasonable steps to comply with an APRA direction.

### *Transfer powers*

APRA's powers under the Transfer Act to implement a compulsory transfer of business provide an important option for achieving the prompt and orderly resolution of a failing ADI or insurer. This may be particularly relevant for safeguarding the continuity of a failed institution's critical functions and for minimising disruption to depositors and policyholders.

However, there are certain areas in which the provisions of the Transfer Act need to be enhanced to provide APRA with greater flexibility and certainty when implementing a compulsory transfer. In particular, in circumstances where all of the assets and liabilities of a failed institution are to be transferred, the ability to transfer the shares of the institution could provide a more efficient and simpler means of effecting the transfer. Accordingly, the proposed legislation will introduce an explicit power to enable APRA to compulsorily transfer the shares in a distressed ADI or insurer to another body corporate, subject to the existing safeguards in the Transfer Act.

Additional amendments in the proposed legislation will broaden the scope of the compulsory transfer of business powers so that they apply to certain related entities of an insurer, harmonising the position with ADIs. This may be necessary, for example, where an insurer's assets and liabilities are being transferred as part of a resolution, and a related entity of the insurer provides critical intra-group services essential to the insurer's continued operation.

### *Conversion and write-off of capital instruments*

Through its implementation of the Basel III capital framework, APRA's prudential standards require that Additional Tier 1 (AT1) and Tier 2 (T2) capital instruments have certain conversion



or write-off terms included in them. In order for financial instruments (for example, subordinated debt) to be recognised as AT1 or T2 capital under the prudential standards, they must include these terms in the contracts that comprise those instruments. It is important that in circumstances where an ADI or insurer is in stress, and the relevant triggers are met, these capital instruments can be effectively converted or written off in accordance with their terms. This conversion/write-off is an important means of protecting the interests of depositors and policyholders by providing additional capital to an ADI or insurer under financial stress.

To help ensure this is the case, the proposed legislation includes reforms to provide that contractual conversion and write-off provisions in AT1 and T2 capital instruments will operate in accordance with their terms, notwithstanding other laws and without giving rise to adverse rights of third parties. These amendments will ensure to the highest degree possible that such capital instruments are effective and operate as intended to absorb losses in the event an ADI or insurer experiences financial distress.

The proposed reforms are 'future-proofed' by referring not only to AT1 and T2 capital instruments but to other instruments that could be the subject of such a requirement under APRA's prudential standards 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. Notwithstanding this, the relevant amendments have been introduced for the purpose of making AT1 and T2 capital instruments effective in accordance with Basel III, and do not reflect any current proposal by APRA to change the nature of capital instruments (which would in any event be the subject of APRA's usual public consultation processes).

These reforms ensure that contractual write-off or conversion provisions in relevant instruments operate in accordance with their terms. As noted above, the reforms do not constitute a statutory power for APRA to write-down or convert the interests of other creditors in resolution, including depositors of a failing ADI.

### Stays

Stay provisions are important in ensuring that, where APRA is exercising its powers in respect of a failing ADI or insurer, this does not in itself trigger pre-emptive actions by counterparties which might impede the ability to implement an orderly resolution. The existing law prevents counterparties of a failing ADI or insurer from taking actions (that is, denying an obligation, accelerating a debt, closing-out on a transaction, or enforcing a security) on the grounds of APRA exercising its crisis powers in respect of the ADI or insurer.

The proposed legislation enhances these stay provisions to cover group entities. This will mean that an exercise of crisis powers by APRA on a group entity (that is, a member of a group comprising an ADI or insurer and its subsidiaries, or an authorised NOHC and its subsidiaries), will not trigger such rights in the contracts of entities within the same group. This is important because the triggering of pre-emptive actions under the contracts of other group entities could have a material, adverse effect on a financial group and APRA's ability to protect depositors and policyholders by implementing an orderly resolution of an ADI or insurer. Expanding the stay provisions in this way is consistent with the expanded scope of APRA's powers over group entities pursuant to the other reforms in the proposed legislation.

The interaction of stay provisions with the *Payment Systems and Netting Act 1998* (PSN Act) was the subject of legislation passed in 2016.<sup>7</sup> The PSN Act overrides a range of laws in order to ensure the validity of certain provisions relating to close-out netting contracts and the

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<sup>7</sup> *Financial System Legislation Amendment (Resilience and Collateral Protection) Act 2016*.

payments systems covered by the PSN Act. The proposed legislation will make further consequential amendments to the PSN Act to take account of the enhancements to the stay provisions, moratorium provisions for statutory and judicial management, and the extension of certain powers to group entities. This is intended to ensure that the current protections under the PSN Act are retained and the rights of counterparties to close-out netting contracts are clear.

### *Foreign branches*

The proposed legislation will enhance APRA's ability to respond when an Australian branch of a foreign bank or insurer may be in distress. Foreign ADIs and insurers play an important role in the Australian financial system by providing services and increasing competition in various financial markets and sectors. The failure of a foreign financial group with a presence in Australia could pose risks to relevant beneficiaries and/or to financial stability in Australia. It is therefore important that APRA has the appropriate tools and powers to ensure that foreign ADIs and insurers can be resolved if the branch or its foreign parent experience financial distress.

The proposed legislation will bring APRA's powers over foreign branches more in line with its powers over domestically incorporated institutions, including by:

- providing APRA with powers to appoint a statutory manager to the Australian branch of a foreign bank or insurer;
- clarifying APRA's powers to apply to wind up the Australian branch of a bank or insurer; and
- clarifying APRA's powers to implement a transfer of business of the Australian branch of a foreign bank or insurer.

These reforms will be important in ensuring that APRA is able to meet its objectives when resolving a foreign ADI or insurer, including where appropriate by exercising its powers in coordination with foreign supervisory or resolution authorities, for example on the resolution of a large, cross-border financial group. The proposed legislation also builds a stronger foundation for APRA to develop its coordination of resolution planning with foreign authorities, during normal times.

### *Financial Claims Scheme*

The FCS provides an important backstop in Australia's resolution regime.<sup>8</sup> It protects retail depositors and policyholders by providing prompt access to their funds which, in turn, contributes to financial stability, by limiting the propensity for a destabilising 'run' on deposits in the case of ADIs, and more generally by promoting confidence in the financial system.

To date, the FCS has been declared once in respect of a small general insurer and APRA's experience in administering the FCS in that case, coupled with other proposals canvassed in previous Government consultations in 2011 and 2012, provide the basis for the enhancements to the FCS in the proposed legislation. These include:

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<sup>8</sup> <https://www.fcs.gov.au/>

- establishing an additional payment mechanism to enable FCS entitlements to be satisfied through a transfer of deposits to another ADI or policyholder claims to another general insurer;
- enabling APRA to make interim payments to claimants under the FCS for general insurers to improve the efficiency of administering the scheme; and
- granting the Treasurer the discretion to declare the FCS at an earlier time, upon appointment of a statutory manager, to provide depositors and policyholders with greater certainty in the event of a failure.

These amendments will help ensure the FCS continues to provide the best possible protection to depositors and policyholders, and to support the resolution framework.

#### *Wind-up and other matters*

APRA's winding up powers enable it to act in situations where a regulated institution is insolvent or about to become insolvent. The ability to initiate the winding up of a regulated institution in a timely manner may assist to prevent further financial deterioration, improve outcomes for depositors and policyholders, and minimise impacts on the system more broadly.

The application of these powers in the past, for example in the general insurance sector, has identified areas where they could be enhanced. There are also gaps and a lack of uniformity in the way APRA's powers apply where a provisional liquidator has been appointed. The proposed legislation will address these issues, including by:

- ensuring that APRA's existing powers in the winding up of a regulated institution (e.g. to obtain information from the liquidator) extend to where a provisional liquidator is appointed;
- providing APRA with notice of proposed applications for external administration of regulated institutions; and
- enabling APRA to apply for the winding up of an ADI without the ADI having first been placed in statutory management.

Under the current law there are also gaps and a lack of consistency in relation to APRA's ability to impose conditions on, or to revoke, a regulated institution's authorisation. The proposed legislation will rectify this by harmonising the position in relation to ADIs and insurers to ensure that APRA has appropriate powers to impose conditions and revoke authorisations where certain grounds are met.

#### *Resolution planning*

One of the key lessons from the global financial crisis is the importance of adequate crisis planning, during normal times, before a failure or crisis event materialises. As a result, international regulatory developments have seen an increased focus on resolution planning, including in the FSB's Key Attributes and in BCBS and IAIS core principles.

While APRA already undertakes various forms of crisis planning with its regulated institutions, including prepositioning for the FCS and recovery planning, APRA's Corporate Plan<sup>9</sup> includes

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<sup>9</sup> <http://www.apra.gov.au/AboutAPRA/Publications/Pages/Corporate-Plan.aspx>



a strategic priority to further build its resolution planning capabilities in coming years. APRA considers this to be integral to improving the readiness of regulated institutions and the authorities for future failures or crises in the financial system.

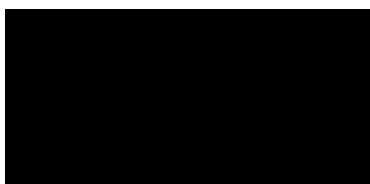
The proposed legislation includes important reforms that will facilitate this initiative, in particular by providing APRA with a clearer legislative mandate in relation to resolution planning and by clarifying APRA's ability to require regulated institutions and their groups to take actions to address potential barriers to resolution.

### **Implementation**

APRA expects the majority of the reforms in the proposed legislation to have little or no compliance cost for industry in so far as they relate to powers that would only be exercised at the time of a crisis. While there may be some compliance costs in relation to resolution planning requirements during normal times, these would be proportionate to the size and complexity of an institution, and the development of a formal prudential standard on resolution planning will be the subject of APRA's usual policy development and consultative processes.

Resolution planning will involve APRA working closely with institutions to develop viable resolution plans on a case by case basis. Plans will not be 'set and forget' but rather are likely to involve an iterative process of improving resolvability over time. The process for identifying and removing barriers to resolution would also be a collaborative one, with due account given to the relative costs and benefits of potential repositioning measures that could be taken. APRA will also continue to work closely with other relevant agencies on resolution planning, including under the auspices of the Council of Financial Regulators.

APRA strongly supports the proposed legislation, which is the culmination of several years of policy development and public consultation since the global financial crisis, and looks forward to assisting the Committee further with its inquiry.



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