



WAYNE BYRES

Chair

15 July 2020

Mr Mark Fitt
Committee Secretary
Senate Economics Legislation Committee
Parliament House
CANBERRA ACT 2600

By email: Economics.Sen@aph.gov.au

Dear Mr Fitt,

Thank you for your letter regarding the Inquiry into the Banking Amendment (Deposits) Bill 2020 being conducted by the Senate Economics Legislation Committee.

This Bill responds to a concern that deposits with authorised deposit-taking institutions (ADIs) in Australia could be used to assist an authorised deposit-taking institution (ADI) in crisis. As Treasury's submission to this inquiry makes clear, this concern is unfounded. APRA supports the Treasury submission. In addition, the following background may assist the Committee in its deliberations.

Prudential regulation is concerned with maintaining the safety and soundness of financial institutions so that the community can have confidence that they will meet their financial commitments under all reasonable circumstances. This principle was most clearly articulated in the report of 1996 Wallis Inquiry that led to the establishment of APRA as Australia's prudential regulator.¹

In banking, a key financial commitment is to repay deposits accepted from members of the public on demand or at some future time. The *Banking Act 1959* (the Banking Act) reflects the importance of this commitment; one of its main objects in section 2A(1)(a) is to 'protect the interests of depositors' and to this end, depositors are given priority of payment should an ADI become unable to meet its obligations. One of APRA's purposes is to regulate ADIs in accordance with the Banking Act (*Australian Prudential Regulation Authority Act 1998* (APRA Act), section 8(1)). **Any action by APRA to bail-in deposits with ADIs would therefore be wholly inconsistent with APRA's statutory mandate and the purposes of prudential regulation.**

The answers to the specific questions asked are below.

1. Can APRA please provide a response to each of the issues raised in the legal opinion?

¹ Financial System Inquiry (1996) *Final Report*, Chapter 5 – Philosophy of Financial Regulation: <https://treasury.gov.au/publication/p1996-fsi-fr>

The core issue arising from the legal opinion is whether deposit accounts can be bailed in under section 11CAB of the *Banking Act*. In APRA's view, section 11CAB does not allow for bail-in of deposits.

In forming a view on the core issue, the legal opinion considers three issues:

- i) hybrid securities issued by banks;
- ii) customer deposit accounts with banks; and
- iii) bank documentation implementing deposit accounts.

In respect of hybrid securities, the opinion correctly identifies that section 11CAB is intended to ensure the conversion or write-off of hybrid securities (in particular, Additional Tier 1 or Tier 2 capital instruments). The purpose of these instruments is to bear loss in the event an institution needs to be recapitalised. For a resolution to be effective, conversion of these instruments must occur unambiguously, and not be frustrated by any other law. This is to ensure that risk-bearing holders of capital instruments bear economic burden, rather than depositors or taxpayers (via a bailout). Holders of capital instruments are compensated for this risk by way of higher yield in ordinary times.

The opinion postulates that the inclusion of 'any other instrument' alongside the reference to Additional Tier 1 and Tier 2 capital is 'entirely unnecessary' if it is only intended to capture Additional Tier 1 or Tier 2 capital. The opinion further refers to the Explanatory Memorandum to the Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Act 2018 (the Act), which states:

Presently, the provisions in the prudential standards that set these requirements are referred to as the 'loss absorption requirements' and requirements for 'loss absorption at the point of non-viability'. The concept of 'conversion and write-off provisions' is intended to refer to these, while also leaving room for future changes to APRA's prudential standards, including changes that might refer to instruments that are not currently considered capital under the prudential standards."

We agree that if the intention of the Act was to only cover Additional Tier 1 and Tier 2 capital, an addition of 'any other instrument' would have been unnecessary. However, as stated in the extract above, 'any other instrument' was included in contemplation of further classes of capital which may be added in the future. Frameworks for bank capital are subject to change over time and it is prudent to anticipate those changes in the Banking Act. For instance, at the time the legislation was passed, APRA was contemplating how to implement Loss Absorbing Capacity (LAC) for resolution. One option under consideration was a new form of capital instrument (sometimes referred to as 'Tier 3' capital). The addition of 'any other instrument' would have meant 11CAB would have unambiguously applied to 'Tier 3' capital without the need for further legislative amendment. APRA ultimately determined to implement LAC using Tier 2 capital. However, the reference to 'any other instrument' was neither intended to, nor does it in fact extend to, deposits.

As a matter of policy, the core purpose of a capital framework with subordinated classes of capital instruments incorporating loss-bearing features is to protect depositors who have not bargained for the risk of conversion and do not enjoy the risk premium that apply to these instruments. Including conversion features in deposits would be contrary to the core purpose of APRA's capital framework and mandate.

As a matter of law, the reference to ‘any other instrument’ in paragraph (b) of the definition of ‘conversion and write-off provisions’ in section 11CAA cannot be interpreted to include bank deposits, because the definition refers to provisions of prudential standards relating to conversion or writing-off. This does not cover bank deposits because APRA prudential standards do not require any such provisions to be included in bank deposits. Although APRA has wide prudential standard making powers under the Banking Act, these must be used consistent with the objects of the Banking Act (particularly the paramount objective of protecting depositors). As such, the inclusion of any such requirement in respect of bank deposits in a prudential standard would be invalid. Moreover, any such addition (were it to be attempted) would be subject to disallowance by Parliament.

The issues in respect of ‘bank documentation’ are addressed in our response to question 4 below.

2. How could ADI deposit accounts be considered ‘any other instrument’ under the definition of ‘conversion and write-off provisions’ under section 11CAA of the *Banking Act*?

Deposit accounts would not be considered ‘any other instrument’ for the purposes of section 11CAA of the Banking Act. As stated above in response to Question 1, the current prudential framework does not require deposits to include conversion or write-off provisions, nor could the prudential framework be altered so as to include deposits. Furthermore, the term “any other instrument” would not be interpreted by a court as extending to deposits. Principles of statutory interpretation would require a court to view the general words to be limited by the specific reference to “Additional Tier 1 and Tier 2 capital”, so that only instruments of a similar nature would fall within the general definition. Deposits are fundamentally different to Additional Tier 1 and Tier 2 capital instruments.

3. Regardless of whether it would do so, does APRA have the power to direct ADIs to insert conversion or write-off provisions into the terms and conditions of customer deposit accounts?

APRA has broad directions powers, all of which must be used consistent with the objects of the *Banking Act* (particularly the paramount objective of protecting depositors). As such, APRA could not direct the insertion of a conversion or write-off provision into customer deposit accounts given such a direction would be inconsistent with the objective of depositor protection. Such a direction would be found to be invalid.

4. Are ADIs able to unilaterally create or change terms and conditions for customer deposit accounts to insert conversion or write-off provisions?

No. While an ADI may unilaterally change terms and conditions for customer deposits, it may not do so where the change is to facilitate a conversion or write-off of customer deposits. This is because to do so would be inconsistent with unfair contract terms legislation under the ASIC Act. A term allowing an ADI to write off or convert a retail deposit would amount to an unfair contract term.

Moreover, even if an ADI was not prohibited from changing its terms in this way by unfair contract terms legislation, APRA would use its powers under the Banking Act to protect depositors and prohibit an ADI from changing these terms to insert write-off provisions.

5. Regardless of whether APRA would take such an action, is it possible under current laws and regulations, or within APRA’s powers, to require banks to bail-in deposit accounts?

Under current laws and regulations it is not possible for APRA to require banks to bail-in deposit accounts.

I trust this information will be of assistance to the Committee.

Yours sincerely,

