Chapter 2

Views on the bill

2.1 The committee received submissions from a range of organisations and individuals. Many submitters to the inquiry agreed with the overall objectives of the proposed legislation to strengthen the Australian Prudential Regulation Authority's (APRA) powers in relation to crisis resolution and resolution planning. However, support for the objectives of the bills notwithstanding, concern was expressed regarding various provisions of the bill and whether they were the best way to ensure the stability of Australia's financial system in the future.

2.2 This chapter examines in more detail the varied views on the bill, particularly those views expressed that relate to the new statutory and judicial management powers, the conversion and write-off provisions and the Financial Claims Scheme (FCS).

General comments

2.3 A number of submitters agreed that the stated objective of the bill, to strengthen Australia's financial system and prepare for any potential future financial distress, was a positive step towards safeguarding Australia's economy into the future.

2.4 The Reserve Bank of Australia (RBA) noted the importance of the proposed reforms and submitted that the passage of the bill is 'critical for ensuring that APRA has the appropriate powers to manage the resolution of financial institutions in distress'.[1] The RBA's submission summarised that:

> The reforms clarify APRA's current regulatory powers and remove uncertainty regarding when they can be used and their scope of operation. They also provide new powers to support resolution planning outside times of crisis and resolution management in the event of a crisis.[2]

2.5 The Chairman of APRA, Mr Wayne Byres, appeared at the committee's Supplementary Budget Estimates hearings in October 2017 and commented that the bill, which has been many years in the making, would provide 'vital infrastructure for the well-being of the financial system'.[3]

2.6 The Australian Bankers' Association (ABA) agreed with Mr Byres' view and noted that they also recognise the importance of maintaining a 'sound and stable financial system'.[4]

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1 Reserve Bank of Australia, *Submission 2*, p. 1.

2 Reserve Bank of Australia, *Submission 2*, p. 2.

3 Mr Wayne Byres, Chairman, Australian Prudential Regulation Authority, *Tabled Document 5*, Supplementary Budget Estimates, 26 October 2017, p. 1.

4 Australian Bankers' Association, *Submission 8*, p. 1.

2.7 The Australian Institute of Company Directors (AICD) supported the bill in principle, commenting that:

> While the proposed powers in the Bill are extremely broad, it is desirable that, in the event of a crisis or an impending financial crisis, APRA has as many options in the 'regulatory toolkit' as are reasonably necessary to ensure the effective management of a crisis.[5]

2.8 That said, support for the bill was not universal. As noted in the previous chapter, the Citizens Electoral Council (CEC) and its members did not support the passage of the bill:

> The CEC urges the committee to act on behalf of all of the Australian people, by rejecting this bill, and using the committee to lead a process of establishing a Glass-Steagall separation of the Australian banking system that can guarantee financial stability and protect Australians' financial security.[6]

International best practice

2.9 As explained in Chapter 1, the Global Financial Crisis (GFC) in 2008 prompted a global response as many nations began searching for ways to ensure that, if a financial crisis were to occur again, their financial systems would be better prepared and more able to maintain their stability in the event of any distress.

2.10 In 2011, the international body that monitors the global financial system, the Financial Stability Board (FSB) developed an international standard for resolution regimes, referred to as Key Attributes, and encouraged member countries to undertake the necessary legal reforms to equip their national authorities with the capacity to respond effectively and quickly to financial institutions in distress. Australia endorsed the FSB's Key Attributes of Effective Resolution Regimes for Financial Institutions at the G20 in 2011.

2.11 A number of submitters noted the importance of bringing Australia's resolution system in line with international standards and thought that the proposed legislation would achieve this outcome. In particular, the International Swaps and Derivatives Association Inc. (ISDA) believed that the proposed legislation would better align Australia with international best practice in crisis resolution and supported regulatory consistency across jurisdictions.[7]

2.12 The RBA commented that the implementation of the FSB's Key Attributes is designed to allow a financial institution that is no longer viable and has no prospect of becoming so to 'be resolved in an orderly manner without severe systemic disruption or exposing taxpayers to the risk of loss'.[8]

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5 Australian Institute of Company Directors, *Submission 12*, p. 1.

6 Citizens' Electoral Council of Australia, *Submission 11*, p. 10.

7 International Swaps and Derivatives Association Inc., *Submission 3*, pp. 2–3.

8 Reserve Bank of Australia, *Submission 2*, p. 1.

2.13 The Australian Financial Markets Association (AFMA) also agreed that strengthening APRA's powers in a manner consistent with the FSB's Key Attributes would create an effective resolution regime that could resolve financial institutions without 'severe systemic disruption and without exposing taxpayers to loss'.[9]

Statutory and judicial management

2.14 The bill proposes to allow APRA to appoint a statutory manager to a greater range of entity types, including authorised non-operating holding companies (NOHCs) of authorised deposit-taking institutions (ADIs) and insurers as well as domestically incorporated subsidiaries of authorised NOHCs or ADIs/insurers.

2.15 The AFMA explained that APRA's ability to appoint a statutory manager to a failing entity was an important tool for dealing with a financial institution in acute distress. Specifically, AFMA stated that:

> In some crisis situations, it will be important that an SM [statutory manager] or JM [judicial manager] can take prompt and decisive control of a distressed or failing entity. Depending on the situation, the SM or JM may need to assess rapidly what the entity's financial position is, whether the entity can be restored to financial soundness or what option will facilitate an outcome in the best interests of depositors and policyholders. It is vital that a decision to keep the business going is made quickly, particularly in the case of an ADI given the nature of its business (that is large amounts of on-call funding, the provision of payment services and the need to maintain market confidence).[10]

2.16 APRA noted in its submission that the new powers set out in the bill, allowing it to appoint a statutory manager, will only be used in certain situations where quick action is vital to the outcome of a failing financial institution. APRA pointed out that in a majority of situations, the process of applying to the court for a judicial manager will remain 'an appropriate means of stabilising a failing insurer'.[11]

Directions powers

2.17 The broadening of APRA's directions powers would give APRA the authority to direct subsidiaries of ADIs, insurers or NOHCs, as well as the main ADI or insurer. An important part of the directions powers provisions is the increased immunity from prosecution for an institution, its directors, or its officers in complying with a direction issued by APRA.

2.18 The RBA commented that ensuring that there are 'no barriers to directors complying with any APRA direction' is an important provision of the bill.[12]

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9 Australian Financial Markets Association, *Submission 10*, pp. 2–3.

10 Australian Financial Markets Association, *Submission 10*, p. 3.

11 Australian Prudential Regulation Authority, *Submission 9*, p. 4.

12 Reserve Bank of Australia, *Submission 2*, p. 2.

2.19 The AICD further noted that as it is a criminal offence not to comply with a direction from APRA, the increased immunity the bill provides is crucial. The ability for an officer of an institution to be able to fulfil a direction without 'reluctance, distraction or delay' was considered to be a key part of the provisions by the AICD.[13]

2.20 The AICD also suggested that, in addition to the immunities already included in the bill, the government might consider 'appropriate checks and balances such as merits review mechanisms, direct ministerial oversight and court supervision as appropriate'.[14]

Conversion and write-off provisions

2.21 As noted in Chapter One, specified capital instruments can be converted or written off in order to ensure the stability of the affected ADI or insurer when it is in distress. The bill seeks to increase certainty in relation to the conversion and write-off of capital instruments by ensuring that any terms set out in AT1 and T2 capital instruments cannot be overturned due to any legal impediment.

2.22 The conversion and write-off of capital instruments to support an ADI or insurer in distress was an important concern for a majority of submitters to the inquiry. Submitters, and particularly the CEC and its members, expressed concern that the conversion and write-off provisions could see many Australians unexpectedly lose their investments.

2.23 For example, the CEC noted that the capital instruments AT1 and T2 include bank hybrid securities. Bank hybrid securities are a form of investment that include both debt and equity elements. They propose to pay a set rate of return until a certain date, in the same way a fixed term deposit might. Unlike term deposits, the contracts of AT1 and T2 bank hybrid securities include conversion and write-off provisions in their terms. Bank hybrid securities are an increasingly mainstream investment option and require the holder to sign a contract indicating that he or she understands the terms of the investment.

2.24 However, CEC highlighted that often the individuals buying bank hybrid securities may not understand the terms of the associated contract when they sign up for this type of investment.[15] Unfortunately, in not making themselves appropriately aware of the high-risk nature of their investment, investors are inadvertently opening themselves up to the potential of significant and unexpected losses.

2.25 In its submission, the CEC drew on the words of the former Chairman of the Australian Securities and Investments Commission, Mr Greg Medcraft, who said that retail investors buying hybrid securities were at risk for two main reasons:

> One is they don't understand the risks that are in over 100-page prospectuses and, secondly—and this is probably for a lot of investors—they do not believe that the government would allow APRA to exercise the

13 Australian Institute of Company Directors, *Submission 12*, p. 1.

14 Australian Institute of Company Directors, *Submission 12*, p. 1.

15 Citizens' Electoral Council of Australia, *Submission 11*, pp. 6–7.

> option to wipe them out in the event that APRA did choose to wipe them out.[16]

2.26 It is important to note that when AT1 and T2 capital instruments are sold, they are required by law to include in their terms, the conversion and write-off provisions, alerting the investor to the higher level of risk involved. The explanatory memorandum specifically states that:

> In order for the amendments to apply, any such instrument will need to be issued with terms included for the purposes of conversion and write-off provisions in APRA's prudential standards at that time.[17]

2.27 In answers to questions on notice from the committee, APRA clarified that its capital framework provides for CET 1, AT1 and T2 capital in accordance with Basel III, and further, that APRA does not have any proposal to change this. APRA also noted that any changes would be subject to consultation and other requirements of best practice regulation.[18]

Protection of depositors' savings and 'bail-in'

2.28 As noted above, an overwhelming majority of stakeholders, particularly members of the CEC, expressed fear that the proposed legislation would allow APRA to 'bail-in' the savings of depositors in order to stabilise a failing financial institution. The term 'bail-in' refers to the conversion of capital instruments into cash that is then used to support an institution in distress.

2.29 Dr Wilson Sy, a former analyst with APRA, considered that the bill was not clear enough on the topic of depositors' savings. Dr Sy suggested that whilst the *Banking Act 1959* (Banking Act) includes a section on the protection of depositors, it also says in Subdivision A, subsection 12(1), Division 2 of Part II:

> It is the duty of APRA to exercise its powers and functions under this Division for the protection of the depositors of the several ADIs and for the promotion of financial system stability in Australia.[19]

2.30 Dr Sy explained that this statement 'may provide some comfort to ordinary people, but it is illusory because deposit protection is to be balanced against financial system stability, without the law clearly stating which has higher priority'. Dr Sy claimed that the bill is 'designed to confiscate bank deposits to 'bail-in' insolvent banks to save the financial system'.[20]

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16 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, Estimates, 26 October 2017, p. 30.

17 Explanatory Memorandum, p. 108.

18 Australian Prudential Regulation Authority, Answer to a question on notice, 25 January 2018 (received 30 January 2018), p. 2.

19 Dr Wilson Sy, *Submission 1*, p. 2.

20 Dr Wilson Sy, *Submission 1*, pp. 2–3.

2.31 Dr Sy and the Australian Movement for Sustained Development (AMSD) cited Cyprus as an example of where citizens' bank deposits had been 'bailed-in'. In particular, Dr Sy explained that following the GFC in 2008, Cyprus' financial system was failing; and that to remedy the situation in 2013, bank deposits were 'confiscated' and used to support the failing financial system.[21]

2.32 The AMSD also commented that the effects of the Cyprus 'bail-in' were devastating and recommended that the bill be amended to specifically exempt unsecured deposits from bail-in.[22]

2.33 The CEC also commented that the bill was unclear regarding how APRA might treat deposits. It noted that in the bill, under the Section 11CAA Definition, it states that:

> ***conversion and write-off provisions*** means the provisions of the prudential standards that relate to the conversion and writing off of:
>
> (a) Additional Tier 1 and Tier 2 capital; or
>
> (b) Any other instrument[23]

2.34 In this instance, the term 'any other instrument' has been interpreted by the CEC as being open ended. However, as noted previously, any instrument that can be converted or written off must specifically indicate this in their terms at the time of sale.

2.35 Treasury stated that the above interpretation of the bill by the CEC is incorrect and clarified that:

> 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.[24]

2.36 Treasury further stated that they did not believe that paragraph (b) 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).[25]

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21 Dr Wilson Sy, *Submission 1*, p. 3.

22 Australian Movement for Sustained Development, *Submission 5*, pp. [1–2].

23 Citizens' Electoral Council of Australia, *Submission 11*, pp. 7–8.

24 Department of the Treasury, Answer to a question on notice, 25 January 2018 (received 31 January 2018), p. 4.

25 Department of the Treasury, Answer to a question on notice, 25 January 2018 (received 31 January 2018), p. 4.

2.37 Treasury confirmed that because deposits are not classified as capital instruments, and do not include terms that allow for their conversion or write-off, they cannot be 'bailed-in'.[26]

2.38 Treasury also noted that the current law and the proposed bill both provide a high level of protection 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.[27]

2.39 The reforms in this bill ensure that contractual write-off or conversion provisions in relevant instruments operate in accordance with their terms. Further, APRA has specifically stated that 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.[28]

Australian branches of foreign ADIs or insurers

2.40 The bill proposes to expand APRA's crisis management powers to include Australian branches of foreign regulated entities. Specifically, APRA will be given the power to:

- appoint a statutory manager to the Australian branch of a foreign ADI or insurer;
- apply to wind up the Australian branch of a foreign ADI or insurer; and
- implement a transfer of business of the Australian branch of a foreign ADI or insurer.[29]

2.41 The RBA commented that despite the important role that foreign ADIs play in the Australian economy, APRA currently has limited powers to manage their potential resolution. The RBA noted that:

> The Bill will provide APRA with stronger powers to manage resolution and thereby better respond to and contain the resulting impact on the domestic financial system, as well as meeting its obligations to support overseas regulators during a cross-border resolution.[30]

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26 Department of the Treasury, Answer to a question on notice, 25 January 2018 (received 31 January 2018), p. 4.

27 Department of the Treasury, Answer to a question on notice, 25 January 2018 (received 31 January 2018), p. 2.

28 Australian Prudential Regulation Authority, *Submission 9*, p. 6.

29 Australian Prudential Regulation Authority, *Submission 9*, p. 7.

30 Reserve Bank of Australia, *Submission 2*, p. 2.

2.42 APRA and the ABA noted that the failure of a foreign branch in Australia could pose a risk to the stability of the Australian financial system, and that preventing this risk was an important provision of the bill.

Financial Claims Scheme

2.43 As discussed, the Financial Claims Scheme (FCS) provides protection to deposits held in financial institutions and to policies with general insurers in the event that a financial institution fails. The FCS will be activated by the Australian Government when an institution fails; and once activated will be administered by APRA.[31]

2.44 The FCS aims to ensure the stability of the financial system as a whole following the failure of a financial institution by protecting the interests of depositors and policyholders.

2.45 A number of submitters expressed deep concern over the effectiveness of the FCS in the event of a financial crisis. In particular, the CEC commented that:

> …there is a very real question of whether the FCS is any guarantee at all. Both the 19 June 2009 meeting of Australia's Council of Financial Regulators, which includes APRA, ASIC and the Reserve Bank, and the FSB in its 21 September 2011 'Peer Review of Australia' noted that the government's $20 billion provision per ADI would not be sufficient to honour its deposit guarantee in the event of a failure of any of the Big Four banks.[32]

2.46 Dr Wilson Sy echoed the CEC's concerns, and expressed further doubt that the Government would actually activate the FCS in the event of the failure of a financial institution, and concluded that bank deposits are not protected or guaranteed.[33]

2.47 Treasury did not agree with the assertion made by Dr Sy, highlighting that 'the various protections afforded to deposits/depositors under the Australian law means that APRA will seek to prioritise the interests of depositors in the event of the failure of an ADI'.[34]

2.48 The RBA also commented that:

> Under the FCS, the Australian Government guarantees the prompt repayment of deposits at a failed Australian ADI of up to $250 000 per depositor.
>
> Deposits in excess of the FCS cap in Australian ADIs benefit from the legislated 'depositor preference'. Under the *Banking Act 1959*, depositors

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31 Australian Pudential Regulation Authority, 'About the Financial Claims Scheme', https://www.fcs.gov.au/about-apra (accessed 11 January 2018).

32 Citizens Electoral Council, *Submission 11*, p. 8.

33 Dr Wilson Sy, *Submission 1*, p. 1.

34 Department of the Treasury, Answer to a question on notice, 25 January 2018 (received 31 January 2018), p. 6.

> are granted a priority claim on the assets of a failed ADI ahead of other unsecured creditors (once the Government has been reimbursed for any payouts and expenses arising from the FCS).[35]

2.49 The Australian Government and APRA have activated the FCS once before:

> 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.[36]

Other matters raised

2.50 The Australian Restructuring Insolvency and Turnaround Association (ARITA) expressed only one concern in relation to the bill; that is, the requirement to provide at least one week written notice to APRA of the intention to appoint or apply to appoint an external administrator to a regulated entity or an authorised NOHC. ARITA explained that:

> If a regulated entity or authorised NOHC is in a position whereby a decision is made that the appointment of an external administrator is necessary, timely action will be required. We are concerned that the notice requirement may create an unacceptable delay to the making of the appointment. [37]

2.51 ARITA agreed that notice should be given; however, it suggested that the current requirement to provide notice in section 62B of the Banking Act (and later in the *Insurance Act 1973* and *Life Insurance Act 1995* also) without a specified notice period is satisfactory.[38]

Committee view

2.52 The committee believes that the bill will ensure the protection and stability of Australia's financial system. The enhancement of APRA's powers to plan for and execute the resolution of a failing ADI or insurer is a vital part of Australia's crisis management toolkit. The reforms proposed in this bill are consistent the FSB's Key Attributes and will bring Australia's crisis resolution framework in line with international best practice.

2.53 The committee acknowledges the concerns raised by the CEC and other stakeholders to the inquiry in relation to the conversion and write-off provisions. The committee notes, however, that the bill does not propose to change the current arrangements for the conversion and write-off provisions of capital instruments. The

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35 Reserve Bank of Australia, Answer to a question on notice, 25 January 2018 (received 30 January 2018), pp. 1–2.

36 Australian Prudential Regulation Authority, *Submission 9*, p. 7.

37 Australian Restructuring Insolvency and Turnaround Association, *Submission 7*, p. 1.

38 Australian Restructuring Insolvency and Turnaround Association, *Submission 7*, p. 2.

bill only proposes to ensure that the conversion and write-off of capital instruments cannot be legally inhibited.

2.54 Whilst the sale of bank hybrid securities does not fall within the scope of this bill, the committee acknowledges that this is an important issue raised by submitters. The committee believes that the underlying issues appear to be centred on consumer education, financial literacy and adequate consumer protections. The need for individuals to be equipped to better understand the contracts they are entering into, or know where to seek appropriate advice, is crucial. The committee understands the importance of consumer education and financial literacy, and also notes that the Senate Economics References Committee is currently inquiring into consumer protection in the banking, insurance and financial sector.

2.55 The committee notes that recent reforms have contributed to a financial system that is unquestionably strong and, as a result, does not consider that Glass-Steagall legislation is warranted in Australia.

2.56 The committee believes that the protection of depositors' interests is paramount and does not consider that the bill would allow the 'bail-in' of Australians' savings and deposits. The stability of the financial system depends on its depositors having confidence in its financial institutions. By ensuring the security of depositors' savings, the overall protection of the financial system can be ensured.

2.57 The committee also notes that the bill includes an amendment to the definition of 'prudential matters' which includes the words 'to protect the interests of depositors of any ADI', which further enshrines in law the importance of protecting depositors' interests.

2.58 The committee is satisfied that depositors are protected both by the FCS and under the Banking Act. Under the FCS, the Australian Government guarantees the prompt repayment of deposits at a failed Australian ADI of up to $250 000 per depositor. The Banking Act includes 'depositor-preference provisions' which give depositors priority over most other creditors in the winding up of an ADI or insurer, to the extent that depositors have not already been paid out by the FCS.

Recommendation 1

2.59 The committee recommends that the bill be passed.

Senator Jane Hume
Chair