The Senate

Economics
Legislation Committee

Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Bill 2017 [Provisions]

February 2018

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Abbreviations and acronyms

ABA	Australian Bankers' Association
ADI	Authorised Deposit-taking Institution
AFMA	Australian Financial Markets Association
AICD	Australian Institute of Company Directors
AMSD	Australian Movement for Sustained Development
APRA	Australian Prudential Regulation Authority
AT1	Additional Tier 1
CEC	Citizens Electoral Council
CET1	Common Equity Tier 1
FCS	Financial Claims Scheme
FSB	Financial Stability Board
FSI	Financial System Inquiry
GFC	Global Financial Crisis
ISDA	International Swaps and Derivatives Association Inc.
NOHCs	Non-Operating Holding Companies
T2	Tier 2

Chapter 1
Introduction

1.1 On 16 November 2017, the Senate referred the provisions of the Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Bill 2017 (the bill) to the Senate Economics Legislation Committee (the committee) for inquiry and report by 9 February 2018.[1]

1.2 The bill seeks to strengthen the powers of the Australian Prudential Regulation Authority (APRA) to facilitate the orderly resolution of an authorised 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 case of crisis.[2]

1.3 The bill also provides for an increase in APRA's powers to set appropriate prudential requirements and take action in relation to resolution planning so that ADIs and insurers are better prepared for resolution.[3]

1.4 In his second reading speech, the Treasurer, the Hon. Scott Morrison MP, highlighted the prudent management of Australia's financial system, particularly over the last 26 years, noting that 'the resilience of the financial system is the first line of defence against financial crises'.[4] He explained that, in implementing these reforms, the government is 'taking action to put in place a far-sighted framework to protect Australians'.[5] By affording APRA the power to work with ADIs and insurers in order to plan for economic stress events, the cost to the taxpayer will be significantly reduced in the event of a financial crisis.

Conduct of the inquiry

1.5 The committee advertised the inquiry on its website and wrote to relevant stakeholders and interested parties inviting submissions by 18 December 2017.

1.6 Following the call for submissions to the inquiry, the committee received a large amount of correspondence from individuals around the country. The large public response was in part prompted by an email campaign organised by the Citizens Electoral Council (CEC) which is a national political party.

1.7 The CEC wrote to all of its members outlining why it believed the bill should not be passed by the Parliament and encouraging its members to write to the committee to let them know that they thought the bill should not be passed.

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1 *Journals of the Senate, No. 71*, 16 November 2017, p. 2249.

2 Explanatory Memorandum, p. 5.

3 Explanatory Memorandum, p. 5.

4 The Hon. Scott Morrison MP, Treasurer, Second Reading Speech, *House of Representatives Hansard*, 19 October 2017, p. 11272.

5 The Hon. Scott Morrison MP, Treasurer, Second Reading Speech, *House of Representatives Hansard*, 19 October 2017, p. 11272.

1.8 The correspondence received from individuals made two main points in opposition to the bill: firstly, they believed that this bill gives APRA the power to 'bail-in' depositors' savings to stabilise a failing financial institution; secondly, in place of the bill, the Australian Parliament should legislate a Glass-Steagall[6] style separation of the banks. These points echo the arguments put forward in *Submission 11* made by the CEC. The committee has published a selection of submissions which represent the types of views expressed in the correspondence received from these individuals. All correspondence and submissions were considered by the committee during the course of the inquiry.

1.9 In total, the committee published 46 submissions, which are listed at Appendix 1.

1.10 The committee thanks all individuals and organisations who assisted with the inquiry, especially those who took the time to write to the committee.

Background

1.11 The Global Financial Crisis (GFC) in 2008 highlighted the importance of ensuring the stability of financial systems around the world. Since the GFC, Australian Governments have conducted numerous consultation processes and reviews in order to determine what action should be taken to ensure Australia's continued economic growth and to maintain the stability of the financial system.

1.12 In October 2011, the Financial Stability Board (FSB) issued its *Key Attributes of Effective Resolution Regimes for Financial Institutions* (Key Attributes). These Key Attributes set out the 'core elements that the FSB considers to be necessary for an effective resolution regime'.[7] According to the FSB, the following features should form part of a jurisdiction's resolution regime:

1. Scope
2. Resolution authority
3. Resolution powers
4. Set-off, netting, collateralisation, segregation of client assets
5. Safeguards
6. Funding of firms in resolution
7. Legal framework conditions for cross-border cooperation
8. Crisis Management Groups (CMGs)
9. Institution-specific cross-border cooperation agreements

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6 Glass-Steagall legislation refers to four provisions of the United States' Banking Act that were in force between 1933 and 1966. The provisions legislated a separation of commercial and investment banking. It is widely thought, though not proved, that the legislation prevented a financial crisis during that period.

7 Financial Stability Board, *Key Attributes of Effective Resolution Regimes for Financial Institutions*, October 2011, p. 1. http://www.fsb.org/wp-content/uploads/r_111104cc.pdf (accessed 15 January 2018).

10. Resolvability assessments

11. Recovery and resolution planning

12. Access to information and information sharing.[8]

1.13 The FSB has 'urged member countries to undertake necessary legal reforms to equip the national authorities with the capacity to respond effectively and quickly to financial institution distress'.[9]

1.14 The legislation proposed in the bill draws on these criteria in forming its plan for financial crisis resolution and resolution planning.

1.15 The changes set out in the bill also draw on the work of a number of consultation papers and reviews conducted over the last seven years, since the release of the FSB's Key Attributes. The legislation particularly builds on the work of two publications: a government consultation paper 'Strengthening APRA's Crisis Management Powers' (2012); and, the final report of the Financial System Inquiry (2014).

1.16 The Australian Government released the consultation paper entitled 'Strengthening APRA's Crisis Management Powers' in September 2012. The paper sought submissions in relation to 'possible enhancements and streamlining of financial services legislation, particularly the prudential supervision of ADIs, insurers and superannuation funds regulated by APRA'.[10]

1.17 The consultation paper outlined the need for Australia to develop a financial crisis management strategy, noting that, since the GFC, there had been a substantial increase in international initiatives to promote and ensure financial stability.[11]

1.18 The consultation paper also commented on the Financial Claims Scheme (FCS). The FCS was established in 2008, following the GFC, and provides protection to deposits held in financial institutions and to policies with general insurers in the event that a financial institution fails. A number of the changes to the FCS set out in

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8 Financial Stability Board, *Key Attributes of Effective Resolution Regimes for Financial Institutions*, October 2011, p. 1. http://www.fsb.org/wp-content/uploads/r_111104cc.pdf (accessed 15 January 2018).

9 The Treasury, *Strengthening APRA's Crisis Management Powers—Consultation Paper*, September 2012, p. 4. https://static.treasury.gov.au/uploads/sites/1/2017/06/Discussion-Paper-1.pdf (accessed 5 January 2018).

10 The Treasury, *Strengthening APRA's Crisis Management Powers—Consultation Paper*, September 2012, p. iii. https://static.treasury.gov.au/uploads/sites/1/2017/06/Discussion-Paper-1.pdf (accessed 5 January 2018).

11 The Treasury, *Strengthening APRA's Crisis Management Powers—Consultation Paper*, September 2012, p. 4. https://static.treasury.gov.au/uploads/sites/1/2017/06/Discussion-Paper-1.pdf (accessed 5 January 2018).

the bill were discussed in the consultation paper.[12] These changes are set out in the next section.

1.19 The Financial System Inquiry (FSI), led by Mr David Murray AO and finalised in November 2014, also examined the need for Australia to develop what it termed a 'crisis management toolkit'. The FSI explained that:

> Given the importance of ADIs, insurers, superannuation funds and FMI [financial market infrastructure] to the functioning and stability of the financial system and economy, regulators need comprehensive powers to facilitate the orderly resolution of these institutions.[13]

1.20 The FSI also highlighted the significant costs associated with the failure of an ADI, particularly where such a failure has the potential to cause damage to the financial system as a whole.[14]

1.21 Recommendation 5 of the FSI report suggested that the Australian Government:

> Complete the existing processes for strengthening crisis management powers [as set out in the 2012 consultation paper] that have been on hold pending the outcome of the Inquiry [FSI].[15]

1.22 The Government response to the FSI agreed with Recommendation 5 and proposed that 'regulatory settings should provide regulators with clear powers in the event a prudentially regulated financial entity or financial market infrastructure fails'.[16]

Overview of the Bill

1.23 The bill contains seven schedules which make amendments to eight separate Acts to give APRA additional powers for crisis resolution and resolution planning in relation to regulated entities. The Acts amended by the bill are the following:

- *Banking Act 1959*;

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12 The Treasury, *Strengthening APRA's Crisis Management Powers —Consultation Paper*, September 2012, pp. 82–83. https://static.treasury.gov.au/uploads/sites/1/2017/06/Discussion-Paper-1.pdf (accessed 5 January 2018).

13 The Treasury, *Financial System Inquiry,—Final Report*, November 2014, p. 79. http://fsi.gov.au/files/2014/12/FSI_Final_Report_Consolidated20141210.pdf (accessed 4 December 2017).

14 The Treasury, *Financial System Inquiry—Final Report,* November 2014, p. 80. http://fsi.gov.au/files/2014/12/FSI_Final_Report_Consolidated20141210.pdf (accessed 4 December 2017).

15 The Treasury, *Financial System Inquiry—Final Report*, November 2014, p. 133. http://fsi.gov.au/files/2014/12/FSI_Final_Report_Consolidated20141210.pdf (accessed 27 November 2017).

16 The Australian Government, *Improving Australia's Financial System—Government response to the Financial System Inquiry*, 2015, p. 10. https://treasury.gov.au/publication/government-response-to-the-financial-system-inquiry/ (accessed 4 December 2017).

- *Insurance Act 1973*;
- *Life Insurance Act 1995* (Life Insurance Act);
- *Australian Prudential Regulation Authority Act 1998*;
- *Payment Systems and Netting Act 1998*;
- *Financial Sector (Business Transfer and Group Restructure) Act 1999* (Transfer Act);
- *Corporations Act 2001*; and
- *Income Tax Assessment 1997*.

1.24 The explanatory memorandum outlines that the schedules to the bill make amendments in relation to crisis resolution in order 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 Transfer Act;
- ensure the effective conversion and write-off of capital instruments to which the conversion and write-off provisions in APRA's prudential standards apply;
- enhance stay provisions and ensure that the exercise of APRA’s powers does not trigger certain rights in the contracts of relevant entities within the same group;
- enhance APRA's ability to respond when an Australian branch of a foreign regulated entity (foreign branch) may be in distress;
- enhance the efficiency and operation of the FCS and ensure that it supports the crisis resolution framework; and
- enhance and simplify APRA's powers in relation to the wind-up or external administration of regulated entities under the Industry Acts[17], and other related matters.[18]

1.25 Each of these proposed reforms is explained in detail below.

Statutory and judicial management

1.26 Under the current law, APRA has the power to appoint a statutory manager to an ADI when it is in distress. The bill expands the range of entity types to which APRA can appoint a statutory manager to include authorised non-operating holding companies (NOHCs) of ADIs/insurers as well as domestically incorporated subsidiaries of authorised NOHCs or ADIs/insurers. In practice, APRA would be able

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17 The term 'Industry Acts' refers collectively to the Banking Act 1959, Insurance Act 1973 and the Life Insurance Act 1995.

18 Explanatory Memorandum, pp. 10–11.

to take control of a group entity to ensure the stability of the relevant ADI/insurer's operations when an entity is in distress.[19]

1.27 The bill also proposes to incorporate insurers into APRA's statutory management regime in certain circumstances. For example, if the insurer is part of a wider financial group or if its failure would pose an imminent risk to the financial system or economy, APRA would have the authority to appoint a statutory manager directly, rather than having to apply to the Court for a judicial manager. This measure would only be taken if APRA believed that quick action was necessary.

1.28 The bill also enhances the existing immunities afforded to statutory and judicial managers, to ensure that a manager can act with confidence when stabilising a distressed ADI or insurer without fear of incrimination.[20]

Directions powers

1.29 APRA currently has the authority to give instructions to an APRA regulated entity in certain circumstances; this authority is referred to as a directions power. The bill proposes to enhance the scope and efficacy of APRA's directions powers. The proposed broadening of APRA's powers will apply in respect of the matters on which direction can be given as well as the types of entities to which directions can be given.[21] Under the new law, APRA would have the authority to direct subsidiaries of ADIs, insurers or NOHCs, as well as the main ADI or insurer.

1.30 The new law would also provide clearer immunity from prosecution for an institution, its directors, or its officers as they comply with a direction from APRA. Non-compliance with a direction from APRA is an offence that gives rise to a criminal sanction.[22]

Transfer powers

1.31 The bill proposes to amend the Transfer Act to allow the three following changes:

- give APRA the power to compulsorily transfer the shares in a failing regulated entity to another body corporate;
- allow APRA to compulsorily transfer the business of a regulated entity of an ADI or insurers; and
- allow APRA to complete a transfer of business despite a lack of complementary state or territory legislation to facilitate the transfer.[23]

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

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

21 Explanatory Memorandum, p. 65.

22 Australian Prudential Regulation Authority, *Submission 9*, p. 5.

23 Explanatory Memorandum, p. 92.

1.32 These changes will give APRA the ability to act quickly when necessary. The bill will also amend the title of the Transfer Act to become the *Financial Sector (Transfer and Restructure) Act 1999*.

Conversion and write-off of capital instruments

1.33 A capital instrument is a form of financial security (for example, a share, note or bond). Equity instruments, such as shares, allow investors to own a portion of the company commensurate with their investment. Debt instruments, such as bonds and notes, lend money to businesses with the expectation that interest will be paid. Some capital instruments, such as preferences shares and subordinates notes, contain conversion and write-off provisions so that they can be included as regulatory capital.

1.34 Capital instruments are categorised based on the level of risk that they carry. Through its implementation of the Basel III capital framework, APRA's prudential standards require that capital instruments categorised as Common Equity Tier 1 (CET1), Additional Tier 1 (AT1), and Tier 2 (T2) include certain conversion and write-off terms. Importantly, the terms of AT1 and T2 instruments must provide that they absorb losses in the event that an ADI or insurer is in distress.[24] This means that when an ADI or insurer is in distress, these specified capital instruments can be converted or written off in order to ensure the stability of the affected ADI or insurer.

1.35 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.

1.36 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. These concerns are addressed in detail in Chapter 2 of this report.

Stays

1.37 A stay is a legal provision that stops creditors from pursuing debtors for amounts owed. APRA has the power to effect a stay on ADIs and insurers in certain circumstances.

1.38 The bill amends APRA's existing stay provisions in respect of a failing ADI or insurer. The new legislation would extend APRA's stay provisions to cover group entities including a body corporate, an authorised NOHC of an ADI or insurer or a subsidiary of an authorised NOHC or ADI or insurer.

1.39 In practice, other entities dealing with the bodies described above will not be able to deny an obligation, accelerate a debt, close-out a transaction or enforce a security.[25]

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24 Explanatory Memorandum, p. 107.

25 Explanatory Memorandum, p. 123.

Australian branches of foreign ADIs and insurers

1.40 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.[26]

Financial Claims Scheme

1.41 The FCS was established in 2008 following the GFC. The 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.[27]

1.42 The bill proposes to make the following minor changes to the FCS:

- establish an additional payment mechanism to enable FCS entitlements to be satisfied when there has been a transfer of deposits to another ADI or policyholder claims to another general insurer;
- enable APRA to obtain information from third parties in relation to the FCS;
- facilitate the effective payout of FCS entitlements to third party claimants of a policyholder of a failed general insurer where the policyholder is in liquidation;
- enable APRA to make interim payments to claimants under the FCS applicable to general insurers;
- grant the Treasurer the discretion to declare the FCS at an earlier time, on appointment of a statutory manager; and
- reduce the reporting burden regarding withholding tax in relation to interest on amounts paid under the FCS.[28]

1.43 These proposed changes are administrative only and the FCS will continue to guarantee deposits up to $250 000. 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.

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

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

28 Explanatory Memorandum, p. 162.

Wind-up and other matters

1.44 The bill proposes to expand APRA's current powers as they relate to wind-up and other external administration, as well as enhancing APRA's powers to impose conditions on, or revoke, a regulated entity's authorisation.[29]

1.45 The bill seeks to increase uniformity in its approach to the wind-up of an institution 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.[30]

Resolution planning

1.46 The bill includes reforms to APRA's approach to resolution planning in advance of any possible future financial crisis, including changes to:

- refine and harmonise the definition of 'prudential matters' (which includes inserting a definition of this term in the Life Insurance Act for the first time);
- clarify which entities must comply with prudential standards set by APRA; and
- enable APRA to require a regulated entity to have an authorised NOHC, where appropriate.[31]

1.47 An authorised NOHC does not carry on a business, other than a business 'consisting of the ownership or control of other bodies corporate'.[32] In practice, this means that if a regulated entity is in distress, APRA can manage its resolution by directing the NOHC. The NOHC would be directed to act to stabilise the entity as a whole by prioritising the liabilities of all of the regulated entity's bodies (subsidiaries, bodies corporate, etc.).

Financial impact and regulatory impact statement

1.48 The explanatory memorandum to the bill states that the bill does not have any budget impact. The regulation impact statement notes that the bill will give rise to a compliance cost of $1.3 million annually for business affected by the bill.[33]

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29 Explanatory Memorandum, p. 179.

30 Australian Prudential Regulation Authority, *Submission 9*, p. 8.

31 Explanatory Memorandum, p. 203.

32 Section 5, *Banking Act 1959*, https://www.legislation.gov.au/Details/C2017C00067 (accessed 17 January 2018).

33 Explanatory Memorandum, p. 215.

Legislative scrutiny

1.49 The explanatory memorandum to the bill states that the proposed legislation does not engage any of the applicable rights or freedoms under the *Human Rights (Parliamentary Scrutiny) Act 2011*, and, as such, is compatible with human rights.

1.50 The Parliamentary Joint Committee on Human Rights (PJC on Human Rights) considered the bill in its *Report 12 of 2017* and made a number of observations relating to the right not to incriminate oneself and privacy.[34]

1.51 The PJC on Human Rights noted that the bill would give APRA a new power to require a person who has, at any time, been an officer of the body corporate to give the statutory manager information relating to the business of the body corporate that the statutory manager requires. Further, failure to comply with this requirement may result in imprisonment for up to 12 months; and self-incrimination is not a justification for non-compliance with this requirement.[35]

1.52 The PJC on Human Rights considered that this requirement might place an undue limitation on the right not to incriminate oneself.

1.53 This limitation on the right not to incriminate oneself was also considered by the Senate Standing Committee for the Scrutiny of Bills in its Scrutiny Digests 13 and 15 of 2017.

1.54 The Scrutiny of Bills Committee suggested that derivative use immunity could be included in the proposed legislation to ensure that 'information or evidence indirectly obtained from an officer compelled to provide [such information] could not be used in evidence against them'.[36]

1.55 The Scrutiny of Bills Committee also commented that the bill proposes a reversal of the evidentiary burden of proof onto the defendant and that this would interfere with the common law right to be presumed innocent until proven guilty.

1.56 Specifically, the Scrutiny of Bills Committee noted that the bill's explanatory memorandum states that 'the evidentiary burden rests on the person bound by the secrecy provision because they are best positioned to provide the evidence as it is within their knowledge'.[37] The Scrutiny of Bills Committee considered that this requirement is unreasonable as 'it is not possible to say if a disclosure made in accordance with circumstances set out in the regulations would be peculiarly within the defendant's knowledge, given those regulations have not yet been made'.[38]

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34 Parliamentary Joint Committee on Human Rights, *Report 12 of 2017*, November 2017, p. 25.

35 Parliamentary Joint Committee on Human Rights, *Report 12 of 2017*, November 2017, p. 25.

36 Senate Standing Committee for the Scrutiny of Bills, *Scrutiny Digest 15 of 2017*, December 2017, pp. 72–73.

37 Senate Standing Committee for the Scrutiny of Bills, *Scrutiny Digest 15 of 2017*, December 2017, p. 62.

38 Senate Standing Committee for the Scrutiny of Bills, *Scrutiny Digest 15 of 2017*, December 2017, p. 66.

Structure of this report

1.57 The report has two chapters including this introductory chapter. Chapter 2 discusses certain measures in the bill in more detail, and the related issues raised by participants in the inquiry.

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

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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

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

Appendix 1
Submissions and additional documents

Submissions

1. Dr Wilson Sy
2. Reserve Bank of Australia
3. International Swaps and Derivatives Association Inc.
4. Macquarie Critical Thinkers Society
5. Australian Movement for Sustained Development
6. Banking & Finance Consumers Support Association (Inc.)
7. Australian Restructuring Insolvency & Turnaround Association
8. Australian Bankers' Association
9. Australian Prudential Regulation Authority (APRA)
10. Australian Financial Markets Association
11. Citizens Electoral Council
12. Australian Institute of Company Directors (AICD)
13. Office of the Australian Small Business and Family Enterprise Ombudsman (ASBFEO)
14. Mr Graeme Medhurst
15. Farmers Marketing Network Pty Ltd
16. Mr John Dahlsen
17. Mr Richard Sanders
18. Mr Anthony Allison
19. Mr Rob & Mrs Lesley McCormick
20. Mr Rick McAllister
21. Mr Jeremy Beck
22. Mr Sleiman Yohanna
23. Mr Robert Marotta
24. Mr John Marsh
25. Bob & Kerrie Ifield
26. Reg & Margaret Went
27. Mr John Atkins
28. Mr Garth Gilbert
29. Mr Vince Maxwell
30. Mr Adrian Collier
31. Mr Keith Barry
32. Mr Graeme Chapman

33 Mr Brandon Potter
34 Mr Walter Abetz
35 Mr Glen Isherwood
36 Ms Heidi van Schaik
37 Mr Brett Wilson
38 Mr Graham Crowther
39 Mr Stephen Liddicut
40 Mr Philip Harris
41 Mr Michael Clayton
42 Name Withheld
43 Mr Tom Marwick
44 Mr Peter Hagen
45 Mr Phillip McGibbony
46 Mr Bryan Robb

Form letters received

1 Form letter A: Total received: 15

Answers to questions on notice

1 Reserve Bank of Australia: Answers to written questions taken on notice (received 30 January 2018).
2 Australian Prudential Regulation Authority: Answers to written questions taken on notice (received 30 January 2018).
3 Australian Securities and Investments Commission: Answers to written questions taken on notice (received 31 January 2018).
4 Treasury: Answers to written questions taken on notice (received 31 January 2018).