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MY REF: Bail-in:RHB

YOUR REF:

27h 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,

RE: BANKING AMENDMENT (DEPOSITS) BILL 2020

I refer to the letter of 15 July 2020 from APRA responding to questions put to APRA by the Committee in relation to various aspects of the Bill on which I had previously expressed opinions.

I welcome the opportunity to comment on APRA's responses and hope to provide the Committee with further matters which I would suggest could be considered by the Committee in its deliberations.

I apologise for the length of this letter which I initially thought to be brief, but thought it of benefit to the Committee to consider the response from APRA to the Committee's questions in their full context.

The Wallis Enquiry referred to in the letter was a step in the process of deregulation started in Australia with the Campbell Inquiry (1981, p.1) which stated:

> *"The Committee starts from the view that the most efficient way to organise economic activity is through a competitive market system which is subject to a minimum of regulation and government intervention.*"

The process was continued later in the Wallis Inquiry (1997, p.18):

> *"Where industry standards and performance suggest that the most practicable method involves self-regulation or co-regulation, such methods should be preferred."*

Not including the potential cost of regulatory failures, the Wallis Inquiry (1997, p. 21) used lower cost as the rationale for less regulation and for structural separation from the RBA of a regulatory entity which later became APRA:

> *"Such an entity will be better placed to reduce the intensity of regulation, and so lower its cost, in the likely event that new technologies or other developments facilitate a reduction in systemic risk.*"

The current Department of Finance was called the Department of Finance and Deregulation until 2013 with a special deregulation group to implement the government's deregulation agenda of reducing cost or "*regulatory burden*".

Whilst, as quoted in APRA's response, that "*One of APRA's purposes is to regulate ADIs in accordance with the Banking Act*", the conclusion claimed that "*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*" does not follow.

There is no provision of the Banking Act which would prevent APRA from bailing-in deposits.

The two provisions of the Banking Act 1959 quoted as "protecting depositors" are "Depositor Preference" and the Financial Claims Scheme ("FCS"). The former only provides for payment of bank deposits in priority to other unsecured creditors on winding up of a failed bank, and is not relevant to bail-in, and the FCS needs to firstly be implemented by government and would occur after a bank has failed i.e. after bail-in would have been implemented in an endeavour to save it.

The Reserve Bank of Australia (RBA) website states:

> *"Responsibility for financial stability policy in Australia is spread across several agencies.*
>
> - *The RBA has had a longstanding responsibility for financial stability, which was reconfirmed in the context of the 1998 reforms to financial sector regulation in Australia (which, inter alia, created APRA), and more recently was outlined in the September 2010 Statement on the Conduct of Monetary Policy.*
> - *APRA is required to promote financial system stability in Australia while balancing its objectives of financial safety and efficiency, competition, contestability and competitive neutrality.*
> - *ASIC is responsible for taking certain regulatory actions to minimise systemic risk in clearing and settlement systems, working with the RBA.*
> - *The Australian Treasury has responsibility for advising the Government on financial stability issues and on the legislative and regulatory framework underpinning financial system infrastructure.*
>
> *The specifics of the RBA's mandate rest on the provisions in section 10 of the Reserve Bank Act 1959 requiring the Bank to 'ensure that the monetary and banking policy of the Bank is directed to the greatest advantage of the people of Australia' and that its powers are 'exercised in such a manner as, in the opinion of the Reserve Bank Board, will best contribute to: (a) the stability of the currency of Australia; (b) the maintenance of full employment in Australia; and (c) the economic prosperity and welfare of the people of Australia'. Given the serious damage to employment and economic prosperity that can occur in times of financial instability, the Act has long been interpreted to imply a mandate to pursue financial stability. This implicit goal has been made more explicit by successive governments. In 1998, the then Treasurer explicitly referred to financial stability being the regulatory focus for the RBA, in the Second Reading Speech in support of the APRA Act. More recently, in 2010 the RBA and the Government recorded their common understanding of the RBA's longstanding responsibility for financial system stability, as part of the periodically updated Statement on the Conduct of Monetary Policy.*
>
> *APRA's objectives, including its mandate to pursue financial stability considerations in concert with its other goals, are set out in the Australian Prudential Regulation Authority Act 1998 (APRA Act). Section 8(2) of that Act states: 'In performing and exercising its functions and powers, APRA is to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, is to promote financial system stability in Australia.' This was reinforced by the*

> *Treasurer's Statement of Expectations in 2007 which noted that prudential regulation seeks to reduce market failure by limiting the systemic risks associated with breaches of financial promises.*" - RBA website - ***Macroprudential Analysis and Policy in the Australian Financial Stability Framework – September 2012***

Section 2A(1) of the Banking Act 1959 (part only of which has been quoted in the APRA response) provides that:-

> "*The main objects of this Act are:*
>
> *(a) to protect the interests of depositors in ADIs in ways that are consistent with the continued development of a viable, competitive and innovative banking industry;* ***and***
>
> ***(b) to promote financial system stability in Australia.***" (Emphasis added)

The Banking Act 1959 in Division 2 of Part II relating to protection of depositors, states in Subdivision A 12(1):

> "*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***." (Emphasis added)

The Banking Act accordingly provides for two main objects of the Act and that APRA accordingly has a dual mandate - the protection of depositors and financial stability - and the Act does not provide which of the objects has priority.

The lack of direction as to priority is important because these objectives may be conflicting.

Subdivision D Section 11CH(2) of the Banking Act 1959 inserted by the Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Act 2018 provides authority for APRA to make decisions under secrecy provisions and in doing so to determine in its discretion whether such a step is necessary for either depositor protection or stability of the system. The section states:

> ***"D Secrecy and disclosure provisions relating to all directions.***
>
> .....
>
> *(2) APRA may determine, in writing, that the direction is covered under this subsection if APRA considers that the determination is necessary to protect the depositors of any ADI* ***or to promote financial system stability in Australia.***" (Emphasis added)

This section again refers to the dual objectives but replaces the earlier "*and*" with "*or*", confirming the potential conflict of objectives.

APRA's web site acknowledges the dual objects, and that they required balancing, stating:

> "*APRA's prudential objectives are clear: the financial safety of institutions and the stability of the Australian financial system. In meeting these objectives, however, APRA has a number of supplementary considerations — efficiency, competition, contestability and competitive neutrality. These objectives are interlinked. Sometimes they can be mutually reinforcing; at other times, a balance between competing objectives needs to be found. APRA must also seek to maintain a sustainable balance over the longer run, focusing not on the circumstances of the day but the longer term financial health and sustainability of the Australian system.*
>
> *In performing this role, APRA is responsible for protecting the interests of*

> *depositors, insurance policyholders and superannuation fund members—collectively referred to in this paper as beneficiaries. The financial interests of these beneficiaries lie at the centre of APRA's mission. APRA fulfils this purpose by promoting the financial safety of institutions through measures to address financial, operational and behavioural risks with a view to achieving sound outcomes for beneficiaries.*
>
> *In doing so, APRA also seeks to promote financial system stability. This objective is critical to the Australian community's long-term financial well-being. Financial failures and shocks have broad and significant negative consequences, both for individuals and for the general economy. APRA therefore seeks to reduce both their likelihood and impact.*
>
> .....
>
> *All* [Industry Acts - RHB] *emphasise APRA's role as seeking the financial safety of prudentially regulated institutions to protect beneficiaries' interests. The APRA Act also provides that, in carrying out this role, APRA must balance other desired objectives of efficiency, competition, contestability and competitive neutrality of the financial system. The APRA Act also says that, in balancing these considerations, APRA is to promote financial system stability in Australia. These objectives are referred to as APRA's mandate.*"

If APRA were, for example, to determine that a bail-in of part of depositor accounts was necessary to provide financial stability to the system, that decision would not be inconsistent with the provisions of the Banking Act or APRA's mandate.

This is precisely the logic behind the FSB concept of bail-in - the need to bail-in deposits in a Bank so that depositors lose some money and the Bank will be saved or alternatively the Bank will collapse and depositors will lose all their money.

In considering APRA's dual mandates, it is useful to consider the source of the legislation which gives rise to the issue addressed by the Bill under consideration.

In its February 2018 report on the Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Bill 2017 the Senate Economics Committee acknowledged that the Financial Stability Board and its 2011 ***Key Attributes of Effective Resolution Regimes for Financial Institutions*** was the source of the 2017 Bill, stating:

> *"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.*"

The Financial Stability Board ("FSB") web site states that "*The FSB was established in April 2009 ... The FSB has assumed a key role in promoting the reform of international financial regulation and supervision*" and that "*At the Los Cabos Summit on 19 June 2012, the Heads of State and Government of the G20 endorsed the FSB's restated and amended Charter which reinforces certain elements of its mandate, including its role in standard-setting and in promoting members' implementation of international standards and agreed G20 and FSB commitments and policy recommendations.*"

Australia is a member of the FSB and the G20.

The Financial Stability Board's Forward to its October 2011 report ***Key Attributes of Effective Resolution Regimes for Financial Institutions*** addresses "*the core elements that*

the FSB considers to be necessary for an effective resolution regime. Their implementation should allow authorities to resolve financial institutions in an orderly manner without taxpayer exposure to loss from solvency support, while maintaining continuity of their vital economic functions."

The report deals specifically with bail-in, providing:

> "***General resolution powers***
>
> *3.2 Resolution authorities should have at their disposal a broad range of resolution powers, which should include powers to do the following:*
> *.....*
> *(ix) Carry out bail-in within resolution as a means to achieve or help achieve continuity of essential functions either (i) by recapitalising the entity hitherto providing these functions that is no longer viable, or, alternatively, (ii) by capitalising a newly established entity or bridge institution to which these functions have been transferred following closure of the non-viable firm (the residual business of which would then be wound up and the firm liquidated) (see Key Attribute 3.5);"*
>
> "***Bail-in within resolution***
>
> *3.5 Powers to carry out bail-in within resolution should enable resolution authorities to:*
> *(i) write down in a manner that respects the hierarchy of claims in liquidation (see Key Attribute 5.1) equity or other instruments of ownership of the firm, unsecured and uninsured creditor claims to the extent necessary to absorb the losses; and to*
> *(ii) convert into equity or other instruments of ownership of the firm under resolution (or any successor in resolution or the parent company within the same jurisdiction), all or parts of unsecured and uninsured creditor claims in a manner that respects the hierarchy of claims in liquidation;*
> *(iii) upon entry into resolution, convert or write-down any contingent convertible or contractual bail-in instruments whose terms had not been triggered prior to entry into resolution and treat the resulting instruments in line with (i) or (ii).*
>
> *3.6 The resolution regime should make it possible to apply bail-in within resolution in conjunction with other resolution powers (for example, removal of problem assets, replacement of senior management and adoption of a new business plan) to ensure the viability of the firm or newly established entity following the implementation of bail-in.*"

In respect of the specific questions asked of APRA by the Committee:

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

In relation to the reference to "any other instrument" in Section 11CAB, I do not agree with the APRA statement that "*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*."

The quote from the Explanatory Memorandum makes clear that the intention was to "*refer to instruments that are not currently considered capital under the prudential standards*." It does not say that the intention was to refer to future "*classes of capital*" only and such an interpretation is totally at odds with the words used in the Explanatory Memorandum. It clearly states that it refers to "*instruments that are not currently considered capital*".

The statement in APRA's response that "*This does not cover bank deposits because APRA prudential standards do not require any such provisions to be included in bank deposits*", merely begs the question. The fact that no prudential standard presently requires such a provision does not mean that APRA does not have the power to require or authorise such a provision in the future.

I do not agree with APRA's contention that "*the inclusion of any such requirement in respect of bank deposits* [ie of bail-in - RHB] *in a prudential standard would be invalid."* I would suggest that there is no legal basis for such a contention and certainly not within the provisions of the Banking Act 1959.

I agree with the next sentence that "*Moreover, any such addition (were it to be attempted) would be subject to disallowance by Parliament*" as Prudential Standards are subject to disallowance by Parliament, but that process does not determine the validity of the Standard in the first place and does not take into account the processes involved in Parliament actually resolving to disallow such a Standard.

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?

I would refer to my comments above in relation to the meaning of the words "*any other instrument*".

The references to Statutory Interpretation referred to in APRA's response overlooks 2 new sub-sections to Section 11CA inserted into the Banking Act by Section 38 of the *Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Act 2018.* In the absence of that provision it might be argued that APRA's powers in sections of the Act are not absolute and are subject to various qualifications and limitations arising out of their context within the Act or the balance of the section or sections of the Act in which they appear. To avoid such an interpretation, the 2 new sub-sections to Section 11CA were inserted into the Banking Act and provide that:

> "*(2AAA) The kinds of direction that may be given as mentioned in subsection (2) are not limited by any other provision in this Part (apart from subsection (2AA)).*
>
> *(2AAB) The kinds of direction that may be given as mentioned in a particular paragraph of subsection (2) are not limited by any other paragraph of that subsection.*"

Subsection 2 provides that:

> *(2) The kinds of direction that the body corporate* [i.e. an ADI - RHB] *may be given are directions to do, or to cause a body corporate that is its subsidiary to do, any one or more of the following:*
> .....
> *(a) to comply with the whole or a part of a prudential requirement regulation or a prudential standard;*

The Part of the Banking Act 1959 referred to in the Subsection is Part II which is headed: ***"Part II—Provisions relating to the carrying on of banking business"***.

I would suggest that the very purpose of the reference to "*any other instrument*" is wide and is a reference to instruments different from "*Additional Tier 1 and Tier 2 capital*" and cannot be read down as suggested.

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?

I do not agree with the contention that such a direction would be inconsistent with APRA's objects under the Banking Act 1959 or that APRA's "*paramount objective*" is "*protecting depositors*". For the reasons set out above, the protection of deposits is merely one of the objectives.

The statement that "*Such a direction would be found to be invalid*" again merely begs the question that the Bill under consideration seeks to clarify.

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

I believe the answer to the Question is "Yes" but I agree that a Court could, and in appropriate circumstances in all likelihood would, intervene and prevent the implementation of such an insertion in the event of its unilateral insertion by an ADI. The Court's power to do so comes from various consumer protection legislation, not "*unfair contract terms*" as provided for in ASIC legislation as that legislation only refers to "*unfair contract terms*" in a "*standard form contract*" which ASIC's website refers to as "*one that has been prepared by one party to the contract, without negotiation between the parties – that is, it is offered on a 'take it or leave it' basis*". ASIC's website also relevantly notes that "*Only a court can determine whether a contract term is unfair.*"

But a different scenario would arise if the insertion was brought about by a direction or authorisation by APRA in accordance with a Prudential Standard.

In the latter event, Section 11CAB of the Banking Act 1959 would be relevant, that Section providing that in relation to "*an instrument that contains terms that are for the purposes of the conversion and write off provisions"*, any law which would otherwise prevent the conversion or write-off does not apply unless a particular legislative provision specifically provides that it does apply. One of the principle types of legislation that this provision would be directed towards is consumer legislation, particularly those provisions which allow a Court to set aside or vary contracts under provisions such as the Australian Consumer Laws - this is precisely the sort of argument which could be raised in the circumstances referred to by outgoing Australian Securities and Investments Commission (ASIC) Chairman Greg Medcraft in an exchange with Senator Peter Whish-Wilson in the hearings of the Senate Economics Legislation Committee on 26 October 2017. Referring to Hybrid Securities, Mr Medcraft said: "*There are two reasons we believe a lot of the retail investors buy these securities. One is they don't understand the risks that are in over100-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 option to wipe them out in the event that APRA did choose to wipe them out.*"

When Senator Whish-Wilson raised the spectre of "bail-in", Mr Medcraft confirmed: "*Yes, they'll be bailed in. The big issue with these securities is the idiosyncratic risk. Basically, they can be wiped out - there's no default; just through the stroke of a pen they can be written off. For retail investors in the tier 1 securities - they're principally retail investors, some investing as little as $50,000 - these are very worrying. They are banned in the United Kingdom for sale to retail. I am very concerned that people don't understand, when you get paid 400 basis points over the benchmark* [4 per cent more than normal rates - RHB], *that is extremely high risk. And I think that, because they are issued by banks, people feel that they are as safe as banks. Well, you are not paid 400 basis points for not taking risks…*" He emphasised: "*I do think this is, frankly, a ticking time bomb.*"

Section 11CAB addresses the issues arising from the examples in the comments of Graeme Thompson of APRA in an address on 10 May 1999 when he said: "... *APRA will have*

powers under proposed Commonwealth legislation to mandate a transfer of assets and liabilities from a weak institution to a healthier one. This is a prudential supervision tool that the State supervisory authorities have had in the past, and it has proved very useful for resolving difficult situations quickly. We expect the law will require APRA to take into account relevant provisions of the Trade Practices Act before exercising this power, and to consult with the ACCC whenever it might have an interest in the implications of a transfer of business." Section 11CAB means that APRA does not need to consider those issues (or any other) in relation to conversion and write-off of "*an instrument that contains terms that are for the purposes of the conversion and 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?**

APRA already has a power to prohibit the repayment of deposits by ADIs, a power which already verges on the writing off of those deposits. The Banking Act Section 11CA provides:

> "*(1) ... APRA may give a body corporate that is an ADI ... a direction of a kind specified in subsection (2).....*
>
> *(2) The kinds of direction that the body corporate may be given are directions to do, or to cause a body corporate that is its subsidiary to do, any one or more of the following:*
> *....*
> *(m) not to repay any money on deposit or advance;*
> *(n) not to pay or transfer any amount or asset to any person, or create an obligation (contingent or otherwise) to do so;*
> *.....*"

This provision was inserted into the Banking Act in 2003 by the Financial Sector Legislation Amendment Act (No 1).

It is a relatively small step to then convert or write-off what the ADI has been prohibited from repaying or paying out.

I would suggest that it is clear that there is an "*intention*" that a regime of bail-in be implemented, despite the protestations to the contrary of various authorities which dispute the meaning of the words of the Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Act 2018 based on the claim that that is not the "*intention*".

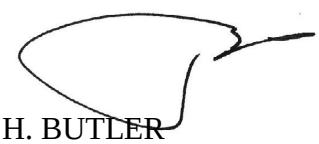
It remains my opinion that, whilst not beyond doubt, the provisions of the Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Act 2018 do provide for a power of bail-in of bank deposits which did not exist prior to the passing of that Act.

I would suggest that it equally clear from the extent of the debate and various opinions which have been expressed as to the power of bail-in, that the law should be clarified.

It is such a clarification that the passing of the Bill seeks to bring about.

I would be happy to amplify further if required.

Yours faithfully,



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