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Financial System Inquiry – Submissions in response to consultation by the Treasury

We refer to the *Financial System Inquiry – Final Report* (**FSI Final Report**) released on 7 December 2014, and the request by the Treasury for submissions on the recommendations made under the FSI Final Report.

We welcome the opportunity to make a submission as the issues set out in the FSI Final Report are of great importance to the future development and functioning of our financial system.

Our submission relates to the following recommendations from the FSI Final Report:

- Recommendation 3 – Loss absorbing and recapitalisation capacity;
- Recommendation 5 – Crisis management toolkit;
- Recommendation 8 – Direct borrowing by superannuation funds;
- Recommendation 9 – Objectives of the superannuation system;
- Recommendation 11 – The retirement phase of superannuation;
- Recommendations 14 and 18 – Collaboration to enable innovation; and Crowdfunding;
- Recommendations 21 and 22 – Introduce a targeted and principles-based product design and distribution obligation; and Introduce product intervention power;
- Recommendation 23 – Facilitate innovation disclosure;
- Recommendation 31 – Compliance costs and policy processes;
- Recommendation 37 – Superannuation member engagement; and
- Recommendation 43 – Legacy products.

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Recommendation 3 – Loss absorbing and recapitalisation capacity

- **A regime for the bail-in of senior creditors needs careful consideration and refinement before it is introduced into Australia**
- **A general bail-in of all senior debt (other than depositors) is likely to place the risk of the failure of an Australian bank largely on foreign investors, given Australia's reliance on foreign capital markets and the preference accorded to Australian depositors under the Banking Act. It is unlikely to be fair, effective or economical**
- **It is preferable to promote the creation of a new class of senior instruments, under which relevant creditors agree to be bailed-in after the holders of regulatory capital instruments**

Recommendation 3 under the heading "*Resilience"* is that:

> *"Australia should implement a framework for minimum loss absorbing and recapitalisation capacity in line with emerging international practice, sufficient to facilitate the orderly resolution of Australian authorised deposit banking institutions and minimise taxpayer support*".

Popularly, this is referred to as bailing-in senior debt. If the bank is in need of resolution, some (or all) of the senior debt is turned into ordinary shares, or written off.

In this section of our submission we argue that:

- it is not self-evident that the existence of a power to bail-in senior creditors by itself will reduce the moral hazard associated with an institution being "too big to fail";
- any bail-in power needs to operate clearly and fairly. This may be difficult to achieve. Further, the burden of a general bail-in of senior debt is likely to fall most heavily on foreign investors, given Australia's reliance on foreign capital markets and its preference to Australian depositors. The likely effect on funding costs should be considered; and
- rather than bailing-in all senior debt (or all senior debt other than deposits), it may be preferable to recognise a class of senior debt that contains an agreement to be bailed in as a category of obligation that contributes to the capital structure of the bank. This would also assist to navigate possible legal impediments to the operation of a bail-in power (for example, where bonds are governed by a foreign law which does not recognise the Australian bail-in law, but which may be circumvented by contract).

Should there be a bail-in power?

There are two reasons commonly advanced for introducing a bail-in regime. The first (the "preventive argument") is that its mere existence would contribute to financial stability.[1] The second (the "fair distribution of loss argument") is that, if losses must be absorbed, it is fairer that these

[1] See e.g. the argument in the first para of the International Monetary Fund (**IMF**) Staff Discussion Note of 24 April 2012, *From Bail-out to Bail-in: Mandatory Debt Restructuring of Systemic Financial Institutions* (SDN/12/03) (**IMF Paper**), p 3:

> *Large-scale government support of the financial institutions deemed too big or too important to fail during the recent crisis has been costly and has potentially increased moral hazard. To protect taxpayers from exposure to bank losses and to reduce the risks posed by too-big-to-fail (TBTF), various reform initiatives have been undertaken at both national and international levels, including expanding resolution powers and tools.*

losses be allocated among creditors who have contracted with the institution rather than be socialised by government and general taxation.[2] These reasons are open to question.

For the "preventative argument" and financial stability:

(a) first, does the mere existence of these powers reduce the expectation that there would be public sector support for the institution should it get into difficulty? Or is it the reality that our large banks are so big, and the effect of bailing in their senior creditors is likely to cause such a blow to confidence, that some government intervention is likely to happen in any event? There are different views;

(b) secondly, does reducing an expectation of public sector support temper the tendency of management to engage in risky behaviour? Are banks really inclined to take more risk than is prudent because they expect government support in a crisis? If so, why are they less likely to take risks if they are assured the government will relieve them of their obligations to senior creditors by a bail-in? and

(c) thirdly, does the reduction in that expectation make the creditors who may be bailed-in more reluctant to extend excessive credit to the institution or in some other way to discipline its activities? The disciplines that a bondholder can exert are limited to pricing and withdrawing or withholding funding. Are these too blunt or too liable to be distorted, (e.g. by the lack of alternative investments) to be useful?

The "fair distribution of loss argument" rests on the premise that if losses have to be absorbed, it is fairer that they be visited upon the private sector than on society as a whole. Put crudely, bankers, shareholders and bondholders enjoy the profits of financial expansion, so they should bear the losses of any contraction. This thinking informs the manner in which smaller failures, or potential failures, have been addressed to date, by having a stronger bank take over a weaker bank. Of course, that approach may not work with a weak major bank, whose merger may result only in a large impaired entity. Better then that the bank's shareholders and bondholders have absorbed losses. As with most assertions of what is fair, that premise may be questioned. Financial crises may have many causes. Government and its agencies may share in the blame, for example, through lax monetary policies, irresponsible public spending or gross supervisory failure, factors thankfully absent from Australia for many decades. The argument also tends to assume that bondholders (and shareholders) are a body divorced from the public at large, which in Australia is untrue (except so far as many bondholders are foreigners). It also discounts the fact that the perception of implied support may lower the costs of importing capital into Australia through the banking system and that the continuance of the financial institution is likely to be of great public utility, as it avoids the disruption to the economy as a whole that would otherwise result.

That said, it may be that, as belief in bail-in is so widespread internationally,[3] Australia has little choice other than to introduce it in order that its regulatory regime appears compliant with international norms.[4] Even so, it is still nonetheless reasonable to require that the regime:

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2 Bank of England, *Resolution and Future of Finance* (Speech given by Paul Tucker, Deputy Governor Financial Stability, Member of the Monetary Policy Committee, Member of the Financial Policy Committee and Member of Prudential Regulation Authority Board, 20 May 2013), p 14:

<www.bankofengland.co.uk/publications/Documents/speeches/2013/speech658.pdf>;

Board of Governors of the Federal Reserve, *Remarks on "The Squam Lake Report: Fixing the Financial System*" (Speech by Chairman Ben S. Bernanke, 16 June 2010):

<www.federalreserve.gov/newsevents/speech/bernanke20100616a.htm>.

3 See footnotes 1 and 2 above.

- operates in a manner that is likely to achieve its objects; and
- operates fairly among the creditors.

In Australia this would require very careful consideration of the details and definition of the power. The Inquiry is correct to note that this is a complex topic and that international ideas are developing.[5] It is not a question of simply plugging a gap in existing powers. It will involve a re-examination of some long-standing provisions in the *Banking Act 1959* (Cth) (**Banking Act**). We set out our reasons for saying this below.

How would bail-in work in Australia?

Three points in particular need to be considered:

(a) what is the trigger point for the operation of the bail-in and how does it relate to other elements of the prudential regulatory regime?

(b) which creditors are to be bailed in? Are they being treated fairly compared to other creditors and shareholders?

(c) will measures of the Australian Parliament be effective without further international cooperation?

– Trigger Point

It is important that the trigger point for the operation of a bail-in is defined with sufficient certainty. A failure to achieve this would frustrate the regulator's ability to use the power with confidence, and does not assist the efficient pricing of liabilities that are likely to be bailed in. It may also contribute to the exercise of the power undermining, rather than improving, confidence in the bank[6].

The choice of the trigger point can also have important economic consequences. A trigger point close to insolvency is less costly, and more easily understood than one removed from it. On the other hand, a point close to insolvency runs a greater risk of the bail-in failing to restore the confidence necessary for the bank to continue to trade.

Here an important point is the relationship of the trigger point to the triggers on conversion of lower ranking regulatory capital instruments (so called "non-viability" triggers).

The current Banking Act and prudential standards are also relevant to the definition. APRA's current powers to appoint a statutory manager to a bank or to order a recapitalisation of a bank are likely to be triggered at the point where APRA considers that in the absence of external support the bank may become unable to meet its obligations or may suspend payment[7]. Under the prudential

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4 See the FSI Final Report, p 69.

5 See the FSI Final Report, p 69.

6 Note in this regard the IMF Paper, p 10-12, but we would not agree with the comments about excluding the role of the judiciary: that may not be constitutionally possible.

7 Section 13A(3) of the Banking Act provides that APRA may appoint a statutory manager to an authorised deposit-taking institution (**ADI**) if:

(a) the ADI informs APRA that the ADI considers that it is likely to become unable to meet its obligations or that it is about to suspend payment; or

(b) APRA considers that, in the absence of external support:

(i) the ADI may become unable to meet its obligations; or standards for regulatory capital instruments, all instruments of a bank constituting regulatory capital[8] must contain a loss absorption provision under which the instrument will be converted into ordinary shares or written off if a non-viability trigger event occurs. This is defined as:

> *the earlier of:*
>
> *(a) the issuance of a notice, in writing, by APRA to the ADI that conversion or write-off of capital instruments is necessary because, without it, APRA considers that the ADI would become non-viable; or*
>
> *(b) a determination by APRA, notified to the ADI, in writing, that without a public sector injection of capital, or equivalent support, the ADI would become non-viable.*[9]

Instruments constituting Additional Tier 1 Capital that are accounting liabilities must also be converted or written off if the bank's common equity capital falls to or below 5.125% of its risk weighted assets.[10]

The prudential standards reflect requirements of the Basel Committee on Banking Supervision.[11] Terms reflecting these requirements are included in regulatory capital instruments issued by Australian banks.[12]

If other creditors ranking senior to regulatory capital are to be bailed in, the trigger point cannot be earlier than the measures for the conversion and write-off of regulatory capital. To provide otherwise would be to completely subvert the hierarchy of creditors' claims.[13] Whether it should be the same

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(ii) the ADI may suspend payment; or

(iii) it is likely that the ADI will be unable to carry on banking business in Australia consistently with the interests of its depositors; or

(iv) it is likely that the ADI will be unable to carry on banking business in Australia consistently with the stability of the financial system in Australia; or

(c) the ADI becomes unable to meet its obligations or suspends payment.

Assuming a vigilant regulator it would seem more likely that (b) would arise before (a). The same grounds apply to an order by APRA requiring the ADI to increase its capital in Section 13E of the Banking Act.

8 Very broadly, perpetual non-cumulative preference shares and their equivalents and certain term subordinated debt.

9 APRA's Prudential Standard APS 111 – Capital Adequacy: Measurement of Capital (January 2013) (**APS 111**), Attachment J para 3.

10 APS 111, Attachment F para 1.

11 Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems* (December 2010 (revised June 2011)), p 56: www.bis.org/publ/bcbs189.pdf>.

12 For recent examples, see:

- National Australia Bank Limited, *NAB Convertible Preference Shares II (NAB CPS II) Prospectus*, 20 November 2013 and *Prospectus NAB Capital Notes Prospectus* dated 17 February 2015;
- Westpac Banking Corporation, *Westpac Capital Notes Prospectus*, 7 February 2013 and *Westpac Capital Notes 2 Prospectus* dated 18 June 2014;
- Australia and New Zealand Banking Group Limited, *ANZ Capital Notes 2 Prospectus*, 19 February 2014 and *ANZ Capital Notes 3 Prospectus,* 23 January 2015;
- Commonwealth Bank of Australia, *Commbank PERLS VII Prospectus*, 18 August 2014; and
- Macquarie Bank Limited, *Macquarie Bank Capital Notes Prospectus*, 23 September 2014.

13 See FSB, *Effective Resolution of Systemically Important Financial Institutions: Recommendations and Timelines* (Consultative Document dated October 2011), Principle 5.1, p 11:

> *Resolution powers should be exercised in a way that respects the hierarchy of claims while providing flexibility to depart from the general principle of equal (pari passu) treatment of creditors of the same class,*

test as regulatory capital, or a later point, is a matter of some difficulty: how "non-viability" relates to traditional concepts of insolvency is not clear, as the term is not further defined in the prudential standards and APRA has so far declined to provide guidance as to its meaning.[14]

– Creditors to be bailed in

Since capital instrument holders are already subject to a bail-in regime through the terms of their instruments, bail-in is necessarily a matter of selecting the unsubordinated creditors who are to be affected. Unsubordinated creditors of a bank come in many classes: they include depositors, bond creditors, holders of bills of exchange or promissory notes, derivatives counterparties, trade creditors, employees, the ATO and the RBA. Any law mandating a bail-in has to consider which classes of creditors are affected and to what extent.

At this point, we note three general propositions.

First, it is critical to the effectiveness of the bail-in to keep payments being made by the bank as its customers require. They need to be made to or as directed by the customer - for example, to enable it to settle the customer's debts. Payments are made from current deposit accounts. To some extent, these need to be insulated from bail-in. The problem is how to define that extent. Defining the extent of insulation by amounts is arbitrary and problematical - what might be an extraordinary payment to one customer might be in the ordinary course for another and the systemic effect of disrupting large payments may be significant. This leads to a comprehensive exclusion of current deposit accounts.

Secondly, it does not seem appropriate for a resolution regime to bail-in creditors on whom the law has conferred a preferred position in the event of a liquidation, at least until after the lower ranking creditors have been bailed-in.[15]

A third general principle might be that it is important to protect the position of essential suppliers, so that the bank can continue to operate.

Here, some awkward facts in the existing legal regime intrude: a great many creditors of an Australian bank enjoy a preferred position over general creditors: holders of protected accounts in Australia have a priority over general creditors for payment out of the bank's Australian assets.[16] Unlike the FCS, the amount of these claims is unlimited. The FSI Final Report supports maintaining this regime.[17] Claims of the RBA are preferred for payment out of the bank's Australian assets.[18]

with transparency about the reasons for such departures, if necessary to contain the potential systemic impact of a firm's failure or to maximise the value for the benefit of all creditors as a whole. In particular, equity should absorb losses first, and no loss should be imposed on senior debt holders until subordinated debt (including all regulatory capital instruments) has been written-off entirely (whether or not that loss absorption through write-down is accompanied by conversion to equity).

14 See APRA's response in its information paper of 4 March 2013:

Non-viability trigger event

Submissions also requested that APRA provide guidance on the definition of a non-viability trigger event.

APRA has considered whether it would be helpful to provide broad guidance, However, it is not possible to define in advance all the circumstances or factors that would lead to APRA triggering the non-viability provisions. Consequently, APRA will not, at this time, provide any further guidance in relation to non-viability trigger events.

15 FSB, Principle 5.1 (see reference in footnote 13 above).

16 Section 13A(3) of the Banking Act.

17 FSI Final Report, p 68.

18 Section 13A(3) of the Banking Act.

Holders of covered bonds have their specific security (and to compromise that would be to defeat the purpose of the covered bond).[19] Holders of derivatives under a close-out netting contract can net their positions and the collateral by exercising rights of close out. The integrity of those rights is protected by statute and to interfere with that would raise profound systemic issues.[20]

The hierarchy of claims from the point when a bank suspends payment can be illustrated as follows:

	Type of obligation or security	**Examples of obligations and securities**
Higher ranking	Secured obligations	- Covered bonds - Collateralised derivatives
	Preferred senior obligations	- Claims in respect of the FCS (liabilities to APRA for claims paid under the FCS) - Liabilities in Australia in relation to protected accounts under the Banking Act (e.g. savings accounts and term deposits in Australia in Australian dollars) - Other liabilities mandatorily preferred by law (e.g. employee entitlements)
	General creditors	- Unsubordinated unsecured debt (bonds and notes; saving accounts and term deposits outside Australia or in Australia in foreign currency; trade and general creditors)
	Subordinated creditors	- Term subordinated unsecured debt (e.g. Tier 2 subordinated notes)
	Preference share holders	- Preference shares and other equally ranking instruments (e.g. Additional Tier 1 capital instruments)
Lower ranking	Common equity	- Ordinary shares

These arrangements have been added piecemeal over time.[21] Each has its justifications but the scheme as a whole lacks clarity of concept and certainty of application. Core concepts, including the concept of an “account” and when assets and liabilities are in Australia for the purposes of the definition, are undefined and could be contested in a situation of distress.[22]

However, if all the existing preferred creditors are excluded from the bail-in regime, and trade creditors are also immune in the interests of the bank continuing to trade, that throws the whole or primary burden of the bail-in of senior creditors on a smaller group of creditors, principally:

19 This is recognised in sections 11CA(2AA), 13A(4A) and 31B of the Banking Act.

20 Section 14 of the *Payment Systems and Netting Act 1998* (Cth).

21 Section 13A(3) was originally section 16 of the Banking Act 1959 and conferred a preference on deposit liabilities in Australia. The section was amended to refer to “protected accounts” in 2009 and was last amended in 2011 in connection with the introduction of covered bonds.

22 By way of analogy see the arguments as to the location of insurance liabilities in *AssetInsure Pty Ltd v New Cap Reinsurance Corp Ltd (in liq)* (2006) 225 CLR 331 and also *Re HIH Casualty & General Insurance Ltd* (2005) 215 ALR 562.

- holders of bonds and bills;
- holders of accounts located outside Australia; and
- holders of accounts in a foreign currency.

If these creditors bear the brunt of the bail-in, is that fair? And what costs are likely to flow from this?

A principle of bail-in is that losses should be imposed on senior creditors only after shareholders. Shareholders should have their claims written off or eliminated first.[23] Merely converting the senior creditors to equity does not eliminate the claims of shareholders. It dilutes them, but they will participate equally with the bailed-in creditors in the recovery of the bank. Even that dilution would be limited, if the number of shares into which the bailed in debt could convert is capped, as it is in the case of regulatory capital instruments.[24] If the shareholders are truly to absorb losses ahead of the creditors, the rights attaching to their shares would need to be cancelled[25]. Similarly the senior debt holders should not be converted at the same rate as applies to holders of regulatory capital instruments. Either the regulatory capital instrument holders should have their rights to receive shares cancelled or the senior debt holders should be converted at a more favourable rate. What certainty would be given to creditors that this would be the case? European requirements seem to leave the conversion formulae to the discretion of the regulators.[26]

The likely location of the bailed in creditors should also be considered a factor. It is likely that a large proportion, perhaps the majority, will be foreigners. As is well known, much of the major banks' wholesale funding is raised offshore. For medium term notes the figure is presently about 73%.[27] For short term commercial paper it would be about 45%.[28] The bulk of deposits located outside Australia for the purposes of the Banking Act are likely to be owed to foreign investors.[29] They might also be expected to hold a percentage of accounts in Australia in foreign currency.

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23 FSB, Principle 3.5, p 9:

> *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).*

IMF Paper, p 13:

> *To avoid the possibility that pre-restructuring shareholders and junior creditors could benefit from haircuts imposed upon senior creditors, the debt restructuring under a bail-in should reflect the order of priority applicable to liquidation.*

24 See APS 111, Attachment F para 8(c), p 43, Attachment J para 12(c), p 57.

25 As a statutory manager is empowered to do under section 14AA of the Banking Act.

26 See the European Banking Authority Consultation Paper, *Draft guidelines on the role of conversion of debt to equity in bail-in*, 11 November 2014.

27 Australian Bureau of Statistics, *Australian National Accounts: Finance and Wealth* (December Quarter 2014), Table 16, where the amount of Australian issued bonds and offshore issued bonds is $120.5 billion and $325.7 billion respectively.

28 *Ibid*, where the amount of Australian commercial paper and offshore commercial paper is $159.6 billion and $128.8 billion respectively.

29 It is likely that this is only a small proportion of all depositors.

Thus, the losses of a bail-in, constructed consistent with the existing hierarchy of creditors' claims, is likely to fall largely on foreign investors. These are the investors on whom the nation depends to fund the gap between domestic savings and investment. It may be said that they currently understand the risk of coming behind protected account holders and other preferred creditors in the event of a bank's failure.[30] But it is a different question to ask what price they will charge if, after only holders of capital instruments, they are expected to bear the primary burden of recapitalising a distressed Australian bank. It might also be asked whether it is fair that they bear the primary burden of the mismanagement of an Australian bank and the failure of Australian prudential regulation. And it might be asked whether we have considered that a by-product of a bail-in, at least where it involves a conversion into shares, might be to transfer ownership of a large Australian bank to offshore interests.[31]

In this regard, we note that preferring domestic claims in the manner currently provided by the Banking Act is not consistent with the principles of the Financial Stability Board (**FSB**).[32] It is not a feature of many other countries' banking laws, including New Zealand. Introducing a bail-in regime that operates in accordance with the existing hierarchy exacerbates the effect of the hierarchy. Removing or modifying the priority of protected accounts would spread losses from the bail-in among a wider class of creditors. Of course, that would represent a major change of policy.

– *Effectiveness of Australian government action*

Most of the indebtedness liable to bail-in is raised offshore, usually raised under contracts governed by English law or New York law. What effect will an Australian bail-in law have on those contracts?

Absent express words, an Australian statute bailing-in creditors would be read by an Australian court as not affecting contracts governed by a foreign law.[33] Express words in the statute can alter that result, so as to bind an Australian court.[34] Express statutory provisions are also desirable where Australian law is uncertain.[35] However, Australian statute will not determine the result before a foreign court, which will decide the matter by its own rules and which, if they are like Australian rules, will not give effect to the Australian statue. Avoiding this outcome requires one of three courses of action:

- increased international cooperation to recognise banking resolution laws;
- requiring Australian banks to conduct all their debt issues under Australian law; or

30 The ranking is disclosed to bondholders in most debt information memoranda or other disclosure documents.

31 Certainly, the interaction between a bail-in proposal and shareholding laws affecting ownership of banks, principally the *Financial Sector (Shareholdings) Act 1998* (Cth) and the *Foreign Acquisitions and Takeovers Act 1975* (Cth), as well as the *Corporations Act 2001* (Cth) (**Corporations Act**) and the ASX Listing Rules would need to be considered — see the IMF Paper.

32 FSB principle 7.4:

> *7.4 National laws and regulations should not discriminate against creditors on the basis of their nationality, the location of their claim or the jurisdiction where it is payable. The treatment of creditors and ranking in insolvency should be transparent and properly disclosed to depositors, insurance policy holders and other creditors.*

33 *Barcelo v Electrolytic Zinc Co of Australasia Ltd* (1932) 48 CLR 391; *Antony Gibbs & Sons v La Societe Industrielle et Commerciale des Metaux* [1890] 25 QBD 399; *Adams v National Bank of Greece SA (Greek Bank case)* [1961] AC 255.

34 Examples are in the sections 13N, 14AC and 15C of the Banking Act.

35 See for instance the matters canvassed by Treasury in its Consultation Paper, *Providing Certainty for Contractual Loss Absorption Provisions in Regulatory Capital*, 2 June 2014.

- requiring Australian banks to include in the terms of their foreign bond issues a clause under which the foreign bondholders agree to be bound by an Australian bail-in order.[36]

As regards the first of these options, so long as Australia maintains its preference for local protected accounts, that would require remarkable generosity and co-operation on the part of foreign governments. The second option would be a significant departure from market practice and would come at some cost. The third may be the best available solution to this problem.[37]

Contractual agreement of creditors is also the best way to traverse the question of whether the Australian government action may be the constitutional limitation that an acquisition of property must be on just terms.[38]

Bonds issued by a bank are property, as much as are its shares.[39] Extinguishing the bond may arguably be an acquisition and the justness of the terms through conversion into shares may be a matter of debate.[40] It is likely that attempting to limit the role of the courts in the bail-in process, as advocated by the IMF, may be liable to challenge in so far as it purports to exclude any role of the courts in determining the justness of the terms of an acquisition.[41] It should be noted that including a requirement for government to compensate bondholders to some extent for the acquisition of their rights (for example, by compensating them to the extent the bail-in puts them in a worse position than they would have been in a liquidation) detracts from the purpose of a bail-in regime, namely to avoid exposing the public sector to the costs of the bank failing. This risk can be defused by having holders agree in the terms of the bonds to be bound by the regulatory regime so that their property in the bonds is always defined and limited by the regulation.

An alternative approach?

The legal advantages of having willing creditors agree to be bailed-in prompts a further thought.

For Australia, rather than introducing a regime for the bail-in of all senior creditors (other than the holders of protected accounts) which may not work fairly or efficiently, would it be better to promote

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36 For the second and third options see the IMF Paper, p 15:

> *The analysis outlined below assumes that a restructuring would be implemented on the basis of the following principles and applied on a legal-entity-specific basis:*
>
> - *The home-country authorities would initiate, approve, and implement the restructuring process.*
> - *The statutory bail-in powers could, in principle, apply to all liabilities of the ailing bank, including liabilities "held" abroad and claims governed by foreign laws (foreign lex contractus).*
>
> *The process of debt restructuring would be governed by the law of the home country (lex fori concursus). However, as noted below, this process could be undermined by separate proceedings in third countries, including concurrent territorial insolvency procedures of jurisdictions hosting branches.*

37 It should be noted that merely including a description in the disclosure of the bail-in mechanism in an Australian statute would not by itself mean that the holders were contractually bound to accept the results of exercise of the power.

See <www.lse.ac.uk/fmg/events/conferences/past-conferences/2011/DBWorkshop_14Mar2011/6-IBAFull.pdf>; *Report of the International Bar Association in connection with Legal Issues arising in relation to Proposals for Bank "Bail-in" Measures* (2010), Australia, para 1.2.

38 Constitution, section 51(xxxi). See e.g. *Telstra Corp Ltd v Commonwealth* (2008) 234 CLR 210; *Commonwealth v WMC Resources* (1998) 194 CLR 1; *Re: Dohnert Muller Schmidt & Co Ltd* (1961) 105 CLR 361.

39 For the latter, see *Bank of New South Wales v Commonwealth* (1948) 76 CLR 1.

40 The point is recognised in the current Banking Act in relation to the cancellation of shares or the variation of their rights under section 14AA: see sections 14AB 69E of the Banking Act.

41 See *Bank of New South Wales v Commonwealth* (1948) 76 CLR 1.

the creation of a new class of instruments, under which willing senior creditors agree to be bailed-in, after the holders of regulatory capital instruments? The agreement of creditors, who can price freely for the risk they assume, answers any arguments about fairness or the limitations on Australian government action. An appropriate target could be set for the total of these instruments and qualifying regulatory capital, which institutions could meet by issuing these instruments or more regulatory capital. Non-bailable senior debt can still be issued. There are proposals along these lines under consideration internationally, as noted by the FSI Final Report.[42]

Key recommendations

A regime for the bail-in of senior creditors needs careful consideration and refinement before it is introduced into Australia.

A general bail-in of all senior debt (other than depositors) is likely to place the risk of the failure of an Australian bank largely on foreign investors, given Australia's reliance on foreign capital markets and the preference accorded to Australian depositors under the Banking Act. It is unlikely to be fair, effective or economical.

It may be preferable to promote the creation of a new class of senior instruments, under which relevant creditors agree to be bailed-in after the holders of regulatory capital instruments.

Recommendation 5 – Crisis management toolkit

- **The package of additional powers to be considered for the crisis management toolkit should be revised to take account of the practical and legal issues raised in the previous consultation process for the Crisis Management Powers Paper**

As part of the original consultation process by the Treasury on the *Strengthening APRA's Crisis Management Powers: Consultation Paper* issued in September 2012 (**Crisis Management Powers Paper**), we provided comments on a number of the proposals identified by that paper. A copy of our submission to the Treasury in connection with that consultation process is attached.[43]

In the FSI Final Report there is recognition of certain practical and legal issues raised in the 19 industry submissions (including our own) relating to the package of resolution powers proposed. There is also a recommendation that a view be taken as to whether additional proposals warrant inclusion and that all proposals should go through appropriate consultation, regulatory assessment and compliance cost assessment processes.

The package of proposals to be subject to the new consultation process should take account of the industry submissions made in connection with the original consultation process on the Crisis Management Powers Paper and this consultation process on the FSI Final Report. In this way, the

42 FSI Final Report, p 70.

This is part of the proposals for setting a "total loss absorbing capacity" (or TLAC) for globally systematically important banks as including, as well as regulatory capital, long term unsecured debt that is clearly identified as subject to the anticipated future bail-in power: see FSB, *Adequacy of loss-absorbing capacity of global systematically important banks in resolution: Consultative document*, 10 November 2014; Andrew Gracie (Bank of England) speech titled *Total Loss-Absorbing Capacity – the thinking behind the FSB Term Sheet*, 4 December 2014, available at:

<www.bankofengland.co.uk/publications/pages/speeches/default.aspx>.

43 Also available at <www.treasury.gov.au/ConsultationsandReviews/Consultations/2012/APRA/Submissions>.

package of proposals will assume the benefit of work already done, and the issues previously identified can be narrowed or solutions proposed.

Recommendation 8 – Direct borrowing by superannuation funds

- **Borrowing to invest is a legitimate investment strategy which should be available to superannuation fund members so long as it is subject to appropriate safeguards**
- **Accordingly, we recommend against removing the limited recourse borrowing exception to the general borrowing prohibition. However, we consider there to be scope to reframe the exception to remove unnecessary complexity and introduce improved safeguards**

It is the FSI Final Report's observation that limited recourse borrowing magnifies the gains and losses from fluctuations in the prices of assets held in funds and that this increases the probability of large losses within a fund. This concern lies at the heart of the FSI Final Report's recommendation to remove the exception to the general prohibition on direct borrowing for limited recourse borrowing arrangements by superannuation funds. Of course, by implication, the result of doing so would be to eliminate the opportunity for funds to experience the enhanced gains, as well as the enhanced losses, that can be achieved through the use of gearing. We consider that borrowing to invest is a legitimate investment strategy which should be available to superannuation fund members so long as it is subject to appropriate safeguards. In our view, the exception should be reviewed to eliminate unnecessary complexity and introduce additional safeguards, such as limits on the extent of borrowing permitted in reliance on the exception.

The limited recourse exception to the general borrowing prohibition was drafted to mimic the features of an instalment warrant and arose from a concern that investment in instalment warrants might result in superannuation trustees breaching the borrowing prohibition. The primary prudential control under this regime is the requirement that the borrowing be undertaken on a limited recourse basis, however there are no limits on the amount that can be borrowed relative to the size of the fund.

We believe that the warrant-like requirements (such as the requirement for a trust structure and for the assets purchased to be either a single asset or multiple identical assets) introduce an unnecessary and artificial structure into these arrangements while serving no prudential purpose. Ensuring that the conditions of the exception are satisfied creates a significant and ongoing compliance burden. In our view, the exception should be redrafted so as to capture only those safeguards which provide some prudential benefit, such as a requirement for the borrowing to be limited recourse, and to introduce a limit on the amount that may be borrowed.

If the exception is simply removed, the uncertainty concerning investment by superannuation trustees investing in instalment warrants will re-emerge.

Accordingly, we recommend against removing the limited recourse borrowing exception to the general borrowing prohibition.

Recommendation – Do not remove the limited recourse borrowing exception, but reframe the legislative requirements to better reflect the policy settings.

Recommendation 9 – Objectives of the superannuation system

- **We strongly agree with the recommendation to enshrine objectives for superannuation within legislation. We consider the primary objective / subsidiary objectives model to have merit**
- **However, we recommend that primary objective be framed in terms of both the desired level of support provided by superannuation and by reference to a decreasing reliance on the age pension**
- **Further, the subsidiary objectives should be more specific and measurable than those set out in the FSI Final Report**

For many years, the superannuation system has been besieged by constant changes to the legislative framework (many introduced at or around budget time each year) resulting in legislative "confetti", with different changes serving inconsistent policy aims. These constant changes have had a destabilising effect on those operating within the system and only serve to undermine public confidence in the system.

Accordingly, we consider that steps need to be taken to reduce legislative confetti. We see the introduction of objectives for superannuation as an important factor in this regard. Accordingly, we are a strong proponent of the FSI Final Report's recommendation to introduce binding objectives for superannuation. We see this as an important means of framing superannuation policy moving forward[44].

However, merely establishing superannuation objectives will not of itself have any effect unless additional legislative measures are introduced. In particular, such objectives would only be of use if:

- the objectives are enshrined in legislation;
- there is a mandatory legislative requirement for all changes impacting superannuation (whether in the *Superannuation Industry (Supervision) Act 1993* (Cth) or any other Commonwealth law) not to be inconsistent with the statutory objectives;
- there is a mandatory legislative requirement to set out in explanatory material why any proposed regulatory change is not inconsistent with the objectives; and
- the superannuation objectives must be reviewed periodically, for example, within the scope of successive Intergenerational Reports.

Importantly, we recommend that the mandatory requirements be formulated in the negative (ie "not inconsistent" with the objectives). There are many legislative changes which are neutral and, while it would be difficult to justify how they are consistent with the objectives, it would be a relatively straight forward exercise to explain how they are not inconsistent with the objectives. Examples of such a change would be technical amendments to the law and changes to changes to APRA reporting.

[44] The superannuation law currently contains a "sole purpose" requirement which effectively requires each trustee to maintain the superannuation fund for retirement (and certain other purposes). However, the sole purpose test operates to limit the activities engaged in by the trustee, and does not impact superannuation policy.

Before commenting on the actual objectives of superannuation, we wish to make two overarching comments:

(1) The objectives of superannuation cannot be determined in isolation. Both compulsory and voluntary superannuation are part of a broader retirement incomes framework and, as a result, there are many interconnections between superannuation and other sources of retirement incomes. It is our view that the objectives should be determined after considering the place of superannuation within the overarching three pillar retirement incomes policy in Australia. In particular, the objectives of superannuation should be determined after considering the role of the age pension. For example, is the age pension intended to be a safety net or a supplement?

Further, it is becoming clear that concerns are being raised within the Government and by the public at large that tax concessions for superannuation should not be provided to high net wealth individuals, beyond those that would support an objectively determined "adequate" level of retirement income.

As a result, we consider that the objectives of superannuation should be set within the wider framework involving the age pension, superannuation and non-superannuation savings.

(2) We support the framework proposed by the FSI Final Report of an overarching primary objective and a series of subsidiary objectives which are consistent with the primary objective. Having cascading objectives does come at the cost of greater complexity. However, a simple high level objective could well be too general to address the many different policy issues surrounding superannuation.

Having regard to the role of the age pension and non-superannuation savings, we consider the primary objective of superannuation should be framed in terms of both the desired level of support that superannuation should be providing Australians, and the adequacy of that support – for example, the primary objective of superannuation could be something along the following lines:

> *To provide a high proportion of Australians with a comfortable level of income in retirement without recourse to the age pension.*

In our view, the subsidiary objectives should not expand the objectives of superannuation beyond the primary objective, but should provide greater clarity on various aspects of the primary objective. For example, we would see the subsidiary objectives specifying what "proportion" should be targeted over different time periods and define a comfortable level of income for the purpose of the primary objective.

We consider that the subsidiary objectives should identify more specific and measurable objectives , such as the desired income replacement rate, the percentage of retired Australians relying on the age pension and what constitutes a comfortable retirement.

For these reasons, we are not attracted to the subsidiary objectives set out in the FSI Final Report. We are concerned that the subsidiary objectives set out in the FSI Final Report are too general to guide superannuation policy and provide a measure of its effectiveness.

Recommendation – The objectives for superannuation be enshrined within legislation adopting the primary objective / subsidiary objectives model. However, we recommend that primary objective be framed in terms of both the desired level of support provided by superannuation and by reference to a decreasing reliance on the age pension. Further, the subsidiary objectives should be more specific and measurable than those set out in the FSI Final Report.

Recommendation 11 – The retirement phase of superannuation

- **It is recommended that the Government proceed with a default-based comprehensive retirement income product**

We endorse the FSI Final Report's proposal to provide for a comprehensive income product for members on retirement (**CIPR**).

There are two aspects to the FSI Final Report's recommendations in relation to the CIPR, being that the product is to be "pre-selected" and that the product's features should allow for both flexibility and longevity.

We agree with the FSI Final Report's rejection of making CIPR compulsory. Each member's circumstances would vary dramatically and there would be many situations where a CIPR would not produce the best outcomes for a member eg. a member with a low account balance.

However, it is not clear to us what the FSI Final Report intends in its reference to "pre-selected". It appears that this is something different to a default (ie. a CIPR would be paid unless the member elects otherwise), however, it is not clear. In our view, for CIPR products to achieve an appropriate level of scale and deliver value to members as a whole, it is appropriate for the product to be offered on a default basis – but with the ability of the member to opt out. The cost benefits of a CIPR would be less likely to be achieved if a member was required to exercise a positive decision on retirement to receive the CIPR.

In practice, there should be sufficient opportunity for a member to opt out as trustees would need to obtain up-to-date information about the member for payment purposes, such as a member's bank account details.

We recommend that the legislative requirements for the product features of a CIPR be entirely principles-based and outcomes-based. If the product features are too prescriptive, this will serve to limit the choices available to members.

We support law reform to facilitate the provision of deferred lifetime annuities since these products can be offered on a more affordable basis than immediate annuities and naturally complement the dominant retirement income product, the account-based pension. We welcome the release of the Australian government's *Review of retirement income stream regulation* Discussion Paper in July 2014 and look forward to the introduction of the law reforms foreshadowed by it.

We make the following additional comments about retirement incomes in Australia for the Government to consider:

- We have seen a general consensus within the superannuation industry that the current arrangements do not provide retirees with an adequate suite of retirement income product options. We therefore consider that reform is needed to simplify the rules which a retirement income product needs to satisfy in order to be treated as "complying" for superannuation purposes. This simplification extends beyond the default-based CIPR to all retirement income products offered in superannuation.

- There is little interface between the tax, superannuation and social security legislation in relation to retirement income products. Introducing common terminology across these areas would assist in the development of new retirement income products, as would a set of policy principles to categorise retirement income products.

- The effect of this recommendation should be to establish a platform for the further development of the retirement incomes market in Australia, and in particular, to expand the offering of products that address longevity risk. (While there are longevity products available in the market, these are limited to a small number of market participants). We consider that given that Australia's annuity market is in its early stages, it would be worthwhile for the Government to consider the experience of other jurisdictions with greater experience than ours. In particular, we draw the Government's attention to the UK Financial Conduct Authority's Thematic Review of Annuities, released in February 2014 which identified some concerns in relation to the annuities market in the UK and made some recommendations about how to improve consumer protection.

Recommendation – It is recommended that the Government proceed with a default-based comprehensive retirement income product.

Recommendations 14 and 18 – Collaboration to enable innovation; and Crowdfunding

- **We endorse the recommendation for a permanent public-private collaborative committee, the Innovation Collaboration (IC), to facilitate financial system innovation**
- **We recommend the IC be mandated to liaise / co-ordinate with AusIndustry's Entrepreneurs' Infrastructure Program and to liaise with and support the Fintech hubs that are rapidly evolving in each State and Territory, to draw on insights for those hubs**
- **The impact of digitisation, and the breadth of start-up ventures that are developing will go beyond pure Fintech and the IC should have flexible remit**
- **To achieve timely regulatory change, a more flexible power to make regulations and regulatory instruments should be considered – with relevant legislation to be quickly identified**
- **Amongst other things, ASIC should be given a clear mandate to use its modification powers under the Corporations Act to facilitate Fintech innovation and start-up funding**
- **Establishing more flexible start-up financing structures and regulation is an imperative, and the input of an IC and industry hubs will be invaluable**

We endorse the FSI Final Report's proposal to establishing an Innovation Collaboration, to facilitate innovation and enable timely and co-ordinated policy and regulatory responses.

While the principal focus of an IC would presumably be Fintech innovation, the financial sector is not the only sector significantly affected by digital disruption and start-up activity. Innovations that support Fintech start-ups may equally help foster other start-up activity – as a result, we would suggest that the IC have a broad and flexible mandate.

In the Fintech space, important initiatives are being driven by AusIndustry's Entrepreneurs' Infrastructure Program and at State and Territory levels, in particular the establishment of Fintech hubs with the collaboration of industry (including financial institutions and professional services firms). We suggest that the IC should draw on the insights coming from these programs and hubs, and support them.

In our view, early initiatives should focus on:

- smoothing regulatory "red tape" (while balancing interests of consumer protection and transparency);
- providing funding pathways with clear legal frameworks, and tax and accounting treatment;
- drawing on industry support to establish standard industry documentation to reduce costs for start-ups (including legal, tax and accounting costs), with improved quality of documentation also reducing commercialisation costs as ventures grow, and to better manage risk for investors.

We support recommendations for more flexible funding for start-ups, including crowdfunding (in the sense of raising equity or debt from the "crowd" via online platforms, and including crowd-sourced equity funding and peer-to-peer lending).

However, the limitations proposed by the Corporations and Markets Advisory Committee for crowdfunding appear to propose only minor modifications to existing categories of relief or streamlined disclosure from Chapter 6D (e.g. $2 million in 12 month relief; Offer Information Statement simplified disclosure for raisings up to $10 million). Those limitations would appear to discourage platforms that would offer committed interval funding, supported by performance hurdles, which would be valuable to encourage start-up growth.

We recommend consideration of more flexible options, drawing on international examples, and using streamlined cost-efficient disclosure, as well as consideration of streamlining and reducing the costs of licensing processes and administration.

ASIC's powers under Chapters 6D and 7 of the Corporations Act to develop interim class order relief are broad and can offer the opportunity to test streamlined fundraising models in a cost effective and streamlined way, paving the way for the later introduction of those measures into legislation. These powers can overcome the delays that are inherent in legislative and political processes, and ensure that when legislative changes are introduced, they work well and meet market needs. ASIC should be supported to use these powers for those purposes and given a clear mandate to do so.

Recommendations 21 and 22 – Introduce a targeted and principles-based product design and distribution obligation; and Introduce product intervention power

- **The introduction of product design and distribution obligations (suitability reforms) will have far reaching consequences – many of which may be unintended**
- **A broader process of industry consultation should be undertaken before any steps are taken to introduce suitability reforms**
- **ASIC should not be provided with an intervention power that extends its regulatory mandate into pre-emption and which will be very difficult to apply within the parameters set for its exercise (and may create effects beyond what is intended)**
- **Regulatory 'bans' on financial products and intrusion into structuring will cause harm to the market, to innovation and to access to funding for Australian banks and businesses, and will not achieve the intended aim**
- **Such bans may also prevent genuinely experienced or well-advised investors from accessing sophisticated products, cognisant of the relevant risk profile**

- **These initiatives will tend to drive the market towards simplistic offerings that will be ineffective for wealth creation but still exposed to significant market risk which is inherent in investments in securities**

Suitability reforms

We consider that it is premature to introduce suitability reforms, and that substantial consultation is required before any reforms should be proposed.

We share the concern regarding instances of mis-selling certain complex products, targeting investors who were clearly not genuine sophisticated investors. However, we think that it would be short-sighted to use those examples of mis-selling to impose measures that may stifle legitimate product development and limit access to wealth creation tools to only wealthy investors.

The proposals for suitability reforms, that the commentary in the FSI Final Report has stimulated, are broad-reaching, overlap into areas that are already well regulated and, in our view, could inhibit the market generally and reduce choice for investors. For instance:

- The way some commentators are interpreting the proposals could require product issuers and distributors effectively to give "personal financial product advice", driving them into a costly regulatory regime that may cause a withdrawal of some products from retail markets, including legitimate, well-structured products.

- For issuers, the introduction of a duty beyond their duty to the entity as a whole may create tensions which cannot practically be navigated. The limits of the proposed reforms are not clear, and if they extend beyond highly structured products issued by specialist promoters, may place a burden on issuers that they are not in a position to meet.

- Even if implemented initially in a relatively 'light touch' manner, we expect any such obligations would be interpreted in an increasingly strict way, as has been the case with credit regulation around suitability.

- The additional costs and compliance burdens may also be borne to a more significant extent by smaller product issuers, who may not have the resources to enter or continue to operate in a market that is regulated in this way. This would provide for an outcome which is anti-competitive (which impacts upon market efficiency), and could create an additional barrier to entry for particular classes of issuers that may not be justified.

- While the withdrawal of any complex products from retail markets may be perceived to be desirable from a philosophical perspective for regulators, the limitation that is created has some disadvantages for retail investors. For instance, it will reduce opportunities for legitimate wealth creation and diversification for retail investors, reduce innovation and competition in the Australian market generally and affect the ability of retail investors to fund their retirement through Australian market investments, while leaving them exposed to the risks of products that appear simple but that may involve significant market risk (e.g. ordinary equity). Product complexity and risk are not synonymous, and product innovation will usually involve some complexity.

- Some proposals have suggested that the reforms should extend also into sophisticated and institutional markets – this will significantly inhibit innovation in the Australian market, and reduce the efficiency of funding for Australian financial institutions.

- Some proposals could increase moral hazard, where retail investors assume that anything that is offered to them must be "safe" or "risk free" and see the reforms as justifying a decision to refuse to obtain appropriate advice.

These are some of the possible costs, limitations and flaws associated with the suitability reforms. They are at odds with other aims that are rightly to be promoted, such as competition, free markets, alignment of interests and innovation.

There will be alternatives that, with industry consultation, strike a better balance with investor protection and do not impose obligations that could severely restrict legitimate sectors of the Australian market. In our view, these alternatives should aim to enhance market efficiency, prudence and standards of conduct. Indeed, the FSI Final Report does include other recommendations which would advance these aims – including the proposals which promote best practices in disclosure and clear expression[45] and improved quality of advice and alignment of interests[46].

These measures, combined with a review of the policy that underlies the regulatory preference to protect retail investors and of the effectiveness of the existing statutory provisions and regulatory powers that support that policy, would be better suited for the delivery of the intended outcomes, without need for regulatory overhaul and the potential for significant disruption to the financial industry and the market.

Intervention powers

We also do not support a proposal that ASIC be given additional powers to "intervene" in financial product issues, or to temporarily "ban" certain categories of products. We maintain this position, notwithstanding that the power may be designed to be limited to circumstances where there is risk of "significant detriment" to a class of consumer and to provide for regulator accountability.

There are a number of reasons for this:

- The introduction of any intervention powers of this type would be a radical and very significant change in Australian regulation.

  Notwithstanding the overseas precedent, we think that the degree of interference in the Australian market caused by the very existence of such powers is unwarranted. Australian regulatory concerns about the nature of particular forms of highly structured products have so far been addressed, swiftly and effectively, by regulatory guidance and consultation with financial intermediaries.

  These powers would also significantly extend ASIC's regulatory role – from a regulator with statutory objects of market supervision, market surveillance and law enforcement[47] to one with an additional proactive market intervention (or intrusion) and a law making mandate.

[45] See, for example, FSI Final Report, Recommendations 23 and 26.

[46] See, for example, FSI Final Report, Recommendations 24 and 25.

[47] Australian Securities and Investments Commission Act 2001 (Cth) (**ASIC Act**), section 1(2), which reflects a developed policy view of the regulatory role that ASIC should strive to fulfil. Indeed, ASIC recognises its own value as an effective regulator by achieving appropriate balance in performing this role; see, for example, ASIC, *Opening address: Creating confidence to grow* (speech by Greg Medcraft, ASIC Chairman made at the ASIC Annual Forum 2015 (Hilton, Sydney) on 23 March 2015), available at:

- ASIC has very broad formal powers at present, including to restrain (or take other actions in respect of) any offering that is misleading or deceptive – properly used, these powers are sufficient to address any concerns regarding product descriptions and investigate and prosecute for non-disclosure and other misconduct.

  ASIC also exerts significant "soft power" with financial product issuers and financial intermediaries – gained through *trust and confidence* in its established practices and transparent approach to policy and guidance – giving it the ability to partner with industry and lead financial services and markets participants towards a desired set of behaviours or outcomes. This may be significantly undermined by any change in the market's perception of ASIC to it being a "pro-active" and overbearing regulator.

- The design for these powers, which the FSI Final Report posits would address concerns raised in the Inquiry's consultation process, requires ASIC:

  - to use the power effectively, carefully, infrequently and as a last resort or a pre-emptive measure, and only after having engaged with potentially affected firms and in consultation with relevant Council of Financial Regulators colleagues;

  - not to use the power for pre-approval or to alleviate consumer responsibilities; and

  - to be accountable for the use of its power, by having the exercise of the power subject to judicial review and the use of the power subject to post-implementation review by the legislature.

  There are a number of difficulties with this design.

  - Absent a statutory prohibition on ASIC using the powers other than as a "last resort" the powers would simply be created under relevant legislation, without subjective bounds. Here, however well-intended the creation of this power may be as a political and policy matter, the delivery of the powers to ASIC will tend to create effects beyond what was originally intended.

  - Post-implementation review by government of the effective use of the powers will require an assessment of the circumstances where the powers were used, and also of instances where they could have been used but were not.

    For ASIC to ensure that it uses the power effectively – which would require it to minimise the number of occurrences where it should have exercised the power, but did not – the regulator may be minded to consistently consider its use, which is contrary to it being intended to be used infrequently.

  - The mitigants compelling proper exercise of the powers – engagement, consultation, accountability and judicial review – are likely to be ineffective in practice. We think it is very likely that the 'threat' of exercise of the power will, in most cases, be used by ASIC as leverage in negotiations, and so it may potentially rarely actually be exercised. This reflects the UK experience and has been noted by ASIC in public comments as a potential use of the power.

<download.asic.gov.au/media/3045087/speech-opening-address-asic-annual-forum-published-23-march-2015.pdf>

- That the powers are not to be used to require pre-approval does not alleviate moral hazard concerning products that are not banned. That is, the fact that the regulator has not taken steps to ban a particular product arguably may raise consumer expectations that risks have already been assessed for them, or that the regulator will intervene if there are risks that are inappropriate for a class of investors to which the consumers belong or before losses are incurred. This cuts across other investor education, empowerment and responsibility objectives.

  To properly navigate this, and in furtherance of the effective use of the powers, ASIC would need to review all financial products – whether they are existing or new products, or a variation of them – after they have reached the market (so as not to offend the 'no pre-approval' mandate). This is a task of a scale that is well beyond the capabilities of ASIC as it is presently resourced.

- It seems unlikely to be the case that Governmental review after 5 years will result in any repeal of the power if it is not being used effectively. History suggests that, instead, it will be enhanced or further powers added.

- There are also considerable inconsistencies and issues in the scope of the powers as described by the FSI Final Report:

  - We query whether, in most cases, exercise of the powers could really be "temporary", with permanent action having been taken in 12 months? This would be a short period in which a proper consultation and assessment is to be concluded and legislative reform effected, and many relatively minor reforms in these areas have taken a considerably longer time to effect.

  - In its own submissions to the Inquiry, ASIC did not indicate that such powers would be used in instances of "significant detriment". This signals that the powers may be administered by the regulator (used or threatened to be used) having regard to its own interpretation of the powers, rather than in the way in which government and the lawmakers subjectively intend.

  - Pricing and value of financial products in a free market should not be affected by regulation or regulatory intervention. Rather, the market should be informed by principles of fairness (equal access theory), which underpins other facets of Australian securities law and policy. The risk that the price or value of a financial product, which otherwise complies with law, may be subject to the influence of the risk of regulatory intervention, or by direct regulatory intervention, is an unacceptable outcome. Again, while the intention may be that the powers are not used to address mis-pricing of financial products[48], by ASIC simply having these powers it will tend to create effects beyond what was originally intended.

- The dampening effect on financial product and market innovation caused by the existence of such powers, and the commercial uncertainty they create, bears consideration.

  In circumstances where there is any doubt as to the potential application of a regulatory power – which may arise because of ambiguity of the language which a regulator uses in its policy disclosures, and even by its own interpretation of its own policy language – financial product issuers and financial intermediaries will ordinarily be dissuaded from considering a particular product or service, or engaging in product or service design, where the relevant

48 See FSI Final Report, p 206.

product or conduct *may* be subject to the power and, in effect, regulatory approval is required for any offering of that product or service.[49]

- Banning measures can tend to deny genuinely experienced investors, or investors who have received skilled advice, access to sophisticated investments that they can use to drive returns. They can prevent some structured instruments from being listed which in turn can negatively impact legitimate funding markets for key institutions, because of liquidity requirements in institutional mandates.

- These sorts of powers, if used without prior market-wide consultation, can create a degree of disruption to the ability of companies and banks to fund themselves that is not commensurate with the concern surrounding the relevant product or service or supported by evidence of a problem.[50] There are limited forms of seeking review of the exercise of these sorts of powers where they have been applied in an inappropriate way (such as, where their use has been threatened, but not exercised).

Navigating the above concerns by granting the powers subject to an alternative design or detailed regulatory guidance does not alleviate the other issues that are unavoidably embedded in the creation of the powers. In particular, ASIC should not be perceived by consumers to be a government agency that acts to prevent investment losses for retail clients. There are sufficient powers already available to ASIC for it to discipline market participants who have breached the law.

[49] For example, ASIC's policy position under QFS 150 *When financial services are provided to a trustee of a superannuation fund, are they provided to a retail client?* (**QFS 150**, now withdrawn) had indicated that ASIC considered any financial services provided to an SMSF would generally *relate to* a superannuation product – influencing the vast majority of market participants to apply the superannuation product test in section 761G(6) of the Corporations Act when dealing with an SMSF (except where the financial services was the issue of a product) for over 10 years. This was recognised as a case of regulatory interpretation risk, notwithstanding that there were alternative legal interpretations of the relevant statute available. In August 2014, ASIC withdrew QFS150 under its Media Release 14-191MR *Statement on wholesale and retail investors and SMSFs* (**14-191MR**) and, in doing so, enabled market participants to review their approach to applying the superannuation product test in section 761G(6) in all relevant cases. However, 14-191MR does not remove all doubt in relation to how ASIC will interpret the provision of financial services provided to an SMSF and, in our experience, financial product issuers and financial intermediaries continue to seek legal advice on the application of the relevant statutory provisions and ASIC's policy position.

[50] For example, in 2003, prospectus anti-avoidance provisions in section 707 of the Corporations Act were revised in response to regulatory concerns that companies could potentially work "around" the existing anti-avoidance provisions. The result was a test in section 707(5) that effectively prevented any institutional investors from investing in legitimate institutional placements, and collapsed the placements market. This had to be urgently remedied by class orders to "wind back" the application of the legislative reform.

This also contradicts the statutory aim that ASIC should "strive to: (a) maintain, facilitate and improve the performance of the financial system and the entities within that system in the interests of commercial certainty, reducing business costs, and the efficiency and development of the economy; and (b) promote the confident and informed participation of investors and consumers in the financial system…" (ASIC Act, section 1(2)).

Recommendation 23 – Facilitate innovative disclosure

- **Remove regulatory impediments to innovative product disclosure and communication with consumers, and improve the way risk and fees are communicated to consumers**

We strongly support this recommendation.

Barriers to innovation in this area should be removed to allow improved engagement with investors and increased understanding of financial products and how they work.

Recommendation 31 – Compliance costs and policy processes

- **Increase the time available for industry to implement complex regulatory change**
- **Conduct post-implementation reviews of major regulatory changes more frequently**

We strongly support this recommendation.

The pace of regulatory reform and the administrative impact on the industry imposes cost burdens and drains resources that could otherwise be applied to product enhancement. Assessing the effectiveness of regulatory change is also important in shaping and informing future reforms.

Recommendation 37 – Superannuation member engagement

- **Publish retirement income projections on member statements from defined contribution superannuation schemes using ASIC regulatory guidance**
- **Facilitate access to consolidated superannuation information from the Australian Taxation Office to use with ASIC's and superannuation funds' retirement income projection calculators**

We support measures that would assist in providing retirement income projections to members. However, we consider the current ASIC regulatory guidance to be too narrow and inflexible.

Calculators and benefit projections are important tools to assist in engaging members in their superannuation arrangements. The prevalence of defined contribution arrangements in Australia, and the regulatory reporting surrounding them, means that member attention is on return on investment rather than adequacy of retirement savings. Benefit projections and calculators can assist in shifting the focus towards retirement income.

ASIC has historically taken the view that since calculators and benefit projections allow a degree of tailoring to the individual, both constitute financial product advice and, as such, cannot be provided other than by those entities that hold an Australian financial services licence, the conditions of which permit them to provide personal financial product advice. ASIC has provided some relief by way of class orders to allow for the publication of calculators and the use of benefit projections. However, the relief is narrow and unduly restrictive, inhibiting the use of both tools.

By way of illustration, benefit projections can be provided by a super trustee in a super statement in accordance with ASIC Class Order [11/1227] and ASIC Regulatory Guide 229. ASIC Class Order

[CO 11/1227] contains a set of very prescriptive requirements, including setting the permitted assumptions that a trustee must adopt in order to obtain regulatory relief.

There are several specific restrictions associated with ASIC Class Order [CO 11/1227], including:

- it is not possible for superannuation fund trustees to show the impact of different contribution levels, different retirement ages, investment in other funds or receiving the age pension on a member's retirement benefit projection. This is because trustees are required to provide retirement estimates as a lump sum (at age 65) and annual income stream (from age 65 to age 90) and to rely on the applicable fees, contribution levels and insurance premiums over the last 12 months when providing these estimates;

- although there is no formal restriction on the type of superannuation funds that may provide retirement income projections, the ASIC relief is best suited to accumulation schemes and may not readily lend itself to defined benefit schemes; and

- trustees must not provide a member with a retirement estimate if doing so would be misleading (or likely to mislead) and it is up to the trustee to determine whether this would be the case. In some cases, use of the assumptions prescribed in ASIC Class Order [CO 11/1227] could produce misleading and deceptive results.

As a result, the take up of ASIC Class Order [CO 11/1227] has been extremely limited despite the recognised advantages of providing projecting retirement savings in super statements.

We think it would be preferable to clarify in the legislation that a calculator or benefit projection does not comprise personal financial product advice unless its output includes an express recommendation to acquire or deal in a financial product. Of course, a person who publishes a calculator or benefit projection would still need to comply with general legal restrictions, such as ensuring that the material is not misleading or deceptive.

Recommendation 39 – Technology neutrality

- **Identify, in consultation with the financial sector, and amend priority areas of regulation to be technology neutral**
- **Embed consideration of the principle of technology neutrality into development processes for future regulation**
- **Ensure regulation allows individuals to select alternative methods to access services to maintain fair treatment for all consumer segments.**

We strongly support this recommendation.

Barriers to the use of technology to access financial services should be removed to allow improved engagement with investors.

Recommendation 43 – Legacy products

- **Introduce a mechanism to facilitate the rationalisation of legacy products in the life insurance and managed investments sectors**

We strongly support this recommendation.

Introducing a mechanism to allow for rationalisation of legacy products on a basis that is streamlined and cost efficient while protecting the interests of consumers would help reduce cost in the sector.

* * * * * * *

We are making these submissions on behalf of our firm, and the views expressed are our own and not those of any of our clients.

We would welcome the opportunity to discuss these submissions with the Treasury. Please contact:

- Berkeley Cox, the firm's Managing Partner, Banking & Finance and Dispute Resolution on 07 3244 8149 / berkeley.cox@au.kwm.com; or
- Ian Paterson or Jim Boynton (partners) on 03 9643 4237 / ian.paterson@au.kwm.com and 02 9296 2086 / james.boynton@au.kwm.com, respectively,

if there are any queries arising from these submissions.

Yours faithfully

King & Wood Mallesons

1 April 2015

Attachment

King & Wood Mallesons submission dated 18 December 2012 to the *Strengthening APRA's Crisis Management Powers: Consultation Paper* issued in September 2012

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18 December 2012

General Manager
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The Treasury
Langton Crescent
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safefinancialsector@treasury.gov.au

Dear Sir/Madam

Response to Treasury Consultation: Strengthening APRA's Crisis Management Powers

We refer to our letter of 14 December 2012 foreshadowing comments on Treasury's proposals set out in *Strengthening APRA's Crisis Management Powers: Consultation Paper* issued in September 2012 (**Consultation Paper**).

We welcome the opportunity to comment on the Consultation Paper as the issues raised in the Consultation Paper are of great importance to the safety and stability of our financial system. We support modernising Australia's legislation so it will be effective in the event of a crisis affecting a regulated institution.

We have specific comments on the following proposals:

- Proposal 1.1.1: Control over non-regulated entities in a group
- Proposal 2.1.1: Clarifying directions powers
- Proposal 2.1.2 : Protection from liability when complying with an APRA direction
- Proposal 2.1.4: Directions on pre-positioning for resolution
- Proposal 2.2.2: Remove the requirement in the Business Transfer Act that complementary State or Territory legislation be in place
- Proposal 3.2.2: Directing a compulsory transfer of business to or from a foreign branch
- Proposal 4.1.1: Broaden the grounds for appointing a statutory manager to enable earlier appointment
- Proposal 4.1.2: Enable a statutory or judicial manager to be appointed to a regulated entity if an authorised NOHC is placed into external administration
- Proposal 4.1.3: Broaden the grounds to appoint a judicial manager to an insurer

- Proposal 4.1.5: Clarify that the appointment of a statutory / judicial manager (or a compulsory transfer of business) does not enable a party to a contract with a regulated entity to access security/collateral lodged under the contract
- Proposal 4.2.1: Widen the moratorium provisions applicable where a statutory and judicial manager is appointed
- Proposal 4.3.1: Ensure that a statutory manager's ability to manage an ADI's business is not compromised by the priority provision in the Banking Act
- Proposal 4.3.2: Statutory immunity for statutory and judicial managers
- Proposal 8.5.1: Refinement and simplification of the definition of 'prudential matters'

Our comments on these proposals are set out in the schedule.

We are making these responses on behalf of our firm because the proposals raise matters on which we may be called upon to advise. The views expressed are our own and not those of any of our clients.

We would welcome the opportunity to discuss this further with you.

Yours faithfully,

[*Signed*]

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SCHEDULE

Capitalised terms used in this Schedule have the same meanings as in the Consultation Paper unless otherwise defined.

2 Effective Resolution of Groups

Proposal 1.1.1: Control over non-regulated entities in a group

Proposal

Four options have been identified for dealing with these issues:

- *Enable an SM (in the case of ADIs) or JM (in the case of insurers) to be appointed to an authorised NOHC and the subsidiaries of an authorised NOHC and of a regulated entity (**Option A**).*
- *Amend the Corporations Act to provide that any liquidator or receiver appointed over a subsidiary or NOHC must cooperate with APRA (**Option B**).*
- *Enhance and strengthen APRA's direction-making powers over NOHCs and related entities - including in a receivership or liquidation situation. This option can be viewed as a supplement to the above options, as opposed to being an alternative (**Option C**).*
- *A combination of the above options (**Option D**).*

Discussion questions

Are there other options to ensure that APRA has adequate power to resolve distress within groups, especially where a subsidiary provides essential services to a regulated entity?

Would there be any unintended consequences of enabling APRA to appoint or seek to appoint an SM or JM to an authorised NOHC and subsidiary?

What would be the implications of APRA being empowered to give directions to a subsidiary of a regulated entity or of an authorised NOHC?

If an entity is in receivership or liquidation, should any power for APRA to give directions to subsidiaries be limited to defined instances, such as to the giving of directions to continue to provide essential services to the distressed entity for fair value?

Would a combination of Options A and C (or other combinations) provide a more flexible tool for resolving financial distress in groups, such that the ability for APRA to give directions to subsidiaries might reduce (but not necessarily eliminate) the need to appoint a statutory or judicial manager to a subsidiary?

Would any of the options discussed increase the cost of doing business?

Comments on Proposal 1.1

Any proposal to extend resolution powers to otherwise non-regulated related entities of an ADI or insurer has serious implications.

Government policy since the Wallis Inquiry[1] has promoted the formation of NOHC structures. The structure is thought both prudent and efficient on the basis that it allows for financial conglomerates (or non-financial conglomerates containing a regulated entity) to develop while protecting depositors and policy holders by legally separating regulated from non-regulated businesses.[2] A number of institutions have adopted a NOHC structure on the basis of that policy. Conglomerate groups have arisen where the regulated entity (whether an ADI or insurer) forms only a small part of the overall group.

A policy which maintains that in order to resolve a regulated entity it is necessary for a prudential regulator to have resolution powers with respect to related entities not conducting a regulated business is to deny that the NOHC structure has effectively separated risk from the regulated entity. That is a conclusion which should be taken only on the basis of evidence that the findings of the Wallis Inquiry in this regard were incorrect.

Secondly, such measures have a potentially very serious impact on the rights of persons who have dealings with those non-regulated entities, in particular, creditors, contractual counterparties, minority shareholders and employees. Persons will have dealt with those companies on the basis that they are not regulated and are not subject to the kinds of regulatory intervention that are now proposed - for example, a non-regulated entity is free to grant effective security over its assets, free to pay dividends as determined by their directors, free to pay salaries and bonuses regardless of the capitalisation of the non-regulated entity and the management of a non-regulated entity is not liable to be removed, or given directions, by a prudential regulator.

This is particularly the case if, at the same time as implementing the measure, the grounds for appointment of an SM or JM are being broadened and the consequences of the appointment (for example, the breadth of moratorium provisions) are proposed to be broadened.[3]

In relation to Option A (enabling an SM or JM to be appointed an authorised NOHC and subsidiaries of an authorised NOHC of a regulated entity), it is proposed to limit the grounds for appointing an SM or JM to an authorised NOHC or other related entity to circumstances where:

(a) the entity to be placed in statutory or judicial management provides services or conducts functions or business that are considered to be essential to the core functions of the regulated entity; or

(b) where their inclusion in statutory or judicial management is necessary to effectively resolve the regulated entity and relevant parts of the group's affairs.

However, these grounds are not satisfactory, since:

- the assessment of what are a regulated entity's "core" or "essential" functions or what is "necessary" to resolve the regulated entity are likely to be a subjective; and
- the judgments will not be apparent to third parties dealing with non-regulated subsidiaries.

It is noted that to the extent there are concerns that regulated entities are exposed to the performance of other group entities, for example through dependence upon them for services, the extent and terms of those

1 Financial System Inquiry, Final Report (March 1997) (**Wallis Committee Report**).

2 See Wallis Committee Report, Chapter 8, in particular Recommendation 49.

3 See below Proposals 4.1.1 and 4.2.1.

arrangements are already regulated through the prudential standard regulating outsourcing.[4] That standard should be administered so that risk is avoided in the first place.

At the very least, consideration of fairness to persons dealing with non-regulated entities dictates that, if these powers are to be extended, the prudential regulator should periodically assess which subsidiaries are liable to be the subject of regulatory intervention and that assessment should be made be made public so that persons dealing or proposing to deal with those entities have an opportunity to reorganise their affairs.

Option B (requirement for a liquidator or receiver to cooperate with APRA) is the least intrusive of the three options. However, consistent with our comments in relation to Option A above, this proposal also has the potential to unduly affect creditors' rights.

The requirement that a liquidator or receiver "co-operate" with APRA could entail a broad range of measures. It is conceivable that "co-operation" could extend to requiring a liquidator or receiver to expend the assets of the entity or interfere with the enforcement of a security. Alternatively, it could be limited to actions such as complying with reasonable requests for provision of information or reporting to APRA. In our view, if Option B is adopted, it should be appropriately limited to ensure that the concept of 'co-operation' is clearly defined and does not unduly affect the interests of creditors of unregulated entities.

Option C (enhanced directions powers) has the potential to be overly intrusive as regards non-regulated entities for the same reasons as those given above in relation to Option A above.

Finally, we note that the Consultation Paper raises concerns as to the efficacy of APRA's existing directions-giving powers. In our view, these concerns may be overstated, given that section 11CG of the Banking Act specifies that an ADI or authorised NOHC may be subject to criminal penalties for doing or failing to do an act, where doing or failing to do that act results in a contravention of a direction given to it by APRA. Moreover, we are not aware of any circumstances where a regulated entity has failed to give effect to a direction given by APRA.

* * * * * * *

3 Enhancing APRA's Direction Powers – Scope and Efficacy

Proposal 2.1.1: Clarifying directions powers

Proposal

That the industry Acts be amended to ensure that APRA has a broad 'catch all' directions power that gives it the flexibility to issue directions appropriate to any situation that may arise.

The provisions in the industry Acts could, for example, enable APRA to issue directions 'to take or not take specific action in relation to the structure or organisation of the business, or the conduct of the business, of the regulated entity or authorised NOHC'. (The same provision would apply to subsidiaries if the proposal to extend direction-making powers to subsidiaries is implemented.)

Discussion questions

Is it appropriate to clarify APRA's directions powers in the manner outlined above?

4 See Prudential Standard CPS 231 (current and as taking effect on 1 January 2013).

Are there likely to be any unintended consequences?

Are there reasons why APRA's directions powers should be limited or subject to added safeguards?

Comments on Proposal 2.1.1

We do not object to the proposal to strengthen the catch all power in section 11CA(2)(p) so long as any extension is necessary and appropriate.

However we note the following:

(a) we would not read the existing catch all power as being limited to general directions as to systemic matters. It allows specific as well as general directions, so long as they can be characterised as relating to "the way in which the affairs of the body corporate are to be conducted or not conducted". The power may not extend to directions to change what constitutes the affairs of the body corporate, for example that it cease one business or enter another. Nor in our view should it. For clarity it should be sufficient to add into the section words such as "including any specific action" after "else" in the existing paragraph.

(b) there are some other provisions in section 11CA which are a cause of difficulty and which should be reviewed in conjunction with any review of the directions powers:

  (i) section 11CA(2)(m) allows APRA to order not to repay any money on deposit or advance; and

  (ii) section 11CA(2)(n) allows APRA to order not to pay or transfer any amount or asset to any person, or to create an obligation (contingent or otherwise to do so).

The relationship between sections 11CA(2)(m) and (n)is unclear. The repayment of money on deposit or advance in paragraph (m) is a subset of the payment of an amount in paragraph (n). However, different consequences flow according to the classification of the payment obligation as within paragraph (m) or (n): thus the concluding words of section 11CA(2) provide that a direction under (n) does not apply to a payment pursuant to an order of court or a process of execution. Suppose then that APRA orders a payment not to be made on a bond. The bond creditor brings proceedings to enforce payment of the bond. The direction does not give the bank a defence to any proceeding. The bondholder gets judgement. So far as the direction is taken to be under paragraph (n), the bondholder will be paid. If the bondholder is treated as having advanced money (and the direction is under paragraph (m)), the position is less clear: does the direction stop the payment or can this judgement be enforced?

Further, in section 11CD(2) it is provided that if a subsidy is "prevented from fulfilling its obligations under a contract" because of a direction under section 11CA, the other party is relieved from obligations owed to the ADI under the contract. This does not apply to a direction not to repay money on deposit or advance, and is subject to orders made by the Federal Court on the application of a party to the contract and the effect of the direction on the contract. There are a number of technical difficulties and uncertainties with the application of the provision, including:

- Does it only apply if the ADI is prevented by the direction from fulfilling all its obligations under the contract, or only some of them?

- What is the effect of relieving a party from its obligations under the contract? Is it relieved only from future obligations, or is it entitled to recover benefits already provided?

- Why carve out directions not to repay a deposit or advance? For example, if a creditor has promised to make periodic advances to an ADI and APRA has ordered that the ADI not repay any such advances, why should the creditor still be obliged to lend?

In the context of revising the directions powers and considering moratorium arrangements, it would be useful to reconsider how these provisions are intended to work.

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Proposal 2.1.2: Protection from liability when complying with an APRA direction

Proposal

That the industry Acts be amended to make clear that any reasonable steps taken by directors and other officers of a regulated entity, authorised NOHC or subsidiary (if the direction power is extended to subsidiaries) in compliance with a direction from APRA will not result in any civil or criminal liability and will not place them in breach of any Act or common law duties.

Discussion question

Are there any circumstances in which the industry Acts should not provide protection from civil and criminal liability where a person acts in good faith and without negligence in the exercise of their duties in compliance with an APRA direction?

Comments on Proposal 2.1.2

This proposal has particular implications for entities which conduct business in multiple jurisdictions. Compliance with a direction from APRA may not only raise questions of the incurring of civil or criminal liability, or breach of statutory obligations or common law duties, under the federal and State / Territory laws in force in Australia, but also similar questions in relation to the incurring of liability, or the breach of obligations / duties under foreign law.

Consideration should be given to, among other possibilities:

- restricting APRA's power to give a direction which may require a regulated entity, or the directors and other officers of a regulated entity, authorised NOHC or subsidiary (if the direction power is extended to subsidiaries) to take action in a place outside Australia if to do is likely to result in the incurring of civil or criminal liability, or breach of statutory obligations or other duties, under the laws in force in that place;

- APRA being required to provide an indemnity to a regulated entity, or the directors and other officers of a regulated entity, authorised NOHC or subsidiary (if the direction power is extended to subsidiaries) acting in good faith and without negligence in complying with a direction (or a direction requiring action to be taken in a place outside Australia), prior to giving such a direction; and/or

- restricting the enforcement of foreign judgements predicated on the judgment debtor (i.e. the regulated entity, or the directors and other officers of a regulated entity, authorised NOHC or subsidiary (if the direction power is extended to subsidiaries)) having incurred civil or criminal liability, or breached statutory obligations or other duties, under the laws in force in a place outside Australia as result of compliance with an APRA direction in good faith and without negligence.

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Proposal 2.1.4: Directions on pre-positioning for resolution

Proposal

That the industry Acts be amended to include a specific provision in the direction sections of these Acts to empower APRA to direct a regulated entity, authorised NOHC and subsidiaries (if the direction power is extended to subsidiaries) to take such actions as specified by APRA to facilitate preparation for a resolution of an entity's distress, including (but not limited to) making specified changes to its systems, functionality, operations and group structure.

Discussion question

Is the direction power to require pre-positioning appropriate, having regard to the need for APRA to be able to implement a range of resolution options in a crisis situation?

Comments on Proposal 2.1.4

In our view, Proposal 2.1.4 has the potential to be overly intrusive and to extend APRA's powers beyond what is reasonably necessary to ensure effective resolution of a regulated entity in distress. The proposal raises particular concerns in the context of non-regulated subsidiaries (although our comments in respect of this proposal also apply in respect of regulated entities).

Pre-positioning for resolution will impose substantial compliance costs on affected business units. In a complex group structure where essential functions are spread across a range of different entities, pre-positioning may impose a substantial burden and require significant changes to operating procedures. Whilst we accept that a higher level of compliance costs associated with prudential requirements is inevitable as regards regulated entities, it is questionable whether there is sufficient justification to impose such costs on non-regulated entities within a broader corporate group.

Issues of compliance costs are, of course, matters of policy. However, in the event that Proposal 2.1.4 is implemented, we note that this proposal does not make clear what criteria (if any) would trigger APRA's power to give a direction as to pre-positioning. Given the potentially wide-ranging consequences of this extension to APRA's direction-giving powers, such powers should be subject to appropriate criteria limiting the circumstances in which they may be exercised. In particular, such criteria should ensure that APRA does not have the power to give such a pre-positioning direction whilst an institution remains financially sound.

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Proposal 2.2.2: Remove the requirement in the Business Transfer Act that complementary State or Territory legislation be in place

Proposal

That the Business Transfer Act be amended to remove this requirement in relation to transfers of business. In particular, that the provisions of the Business Transfer Act to be amended include:

- *section 11(1)(d);*
- *section 14;*
- *section 26(1)(a); and*
- *section 28.*

The Business Transfer Act would be amended to ensure that the absence of legislation in the State or Territory in question does not, in any way, impede the transfer of business, and would avoid any need for APRA to be satisfied that such State/Territory legislation be in place.

Discussion question

Is there any reason why this statutory precondition should be retained?

Comments on Proposal 2.2.2

The removal of this statutory precondition may provide opportunities for disgruntled customers of a transferor entity under the Business Transfer Act to challenge the validity and effectiveness of the transfer on the grounds that it is ineffective under the laws of a particular State or Territory.

The business of banking involves the entry into of contracts governed by the laws of, and the taking of security over tangible and intangible property located in, a particular State or Territory including, in some cases, property created under the laws of the particular State or Territory (for example, mining licences) and the registration of interests with State or Territory authorities or agencies.

Our concern is not whether or not such a challenge would be ultimately successful, whether on constitutional or other grounds, but rather that the removal of this statutory precondition raises, in our opinion, the mere possibility of such a challenge. The costs and uncertainty which would result from such a challenge should be avoided.

In order to ensure the stability of the financial system, and provide maximum certainty in relation to the power of APRA to direct a transfer to occur, there should be no doubt as to the validity and effectiveness of a transfer under the Business Transfer Act. The requirement for complementary legislation to facilitate the transfer to be in place in the State or Territory in which each of the transferring body and the receiving body are established assists in providing this certainty. In our opinion, there is a case for requiring complementary legislation to facilitate the transfer to be in place in each State or Territory in which the transferring body carries on business or holds assets.

If the only justification for removing this statutory precondition is to avoid any need for APRA to be satisfied that the relevant State or Territory legislation is in place, then in our opinion this is an insufficient reason to risk the increased uncertainty which would flow from the removal of the statutory precondition. Surely it is not too much to ask that APRA maintain an up to date register of such legislation.

4 Australian Branches of Foreign Entities

Proposal 3.2.2

Proposal

That the Business Transfer Act be amended to make it clear that the voluntary and compulsory transfer provisions in the Business Transfer Act apply to the Australian business of foreign ADIs, general insurers and life insurers, and their respective related parties, including subsidiaries.

Discussion questions

Would a power to compulsorily transfer the Australian business of a branch of a foreign ADI or insurer discourage foreign ADIs or insurers from opening branches in Australia?

Would there be practical difficulties in implementing such a transfer?

Comments on Proposal 3.2.2

In our experience, if it had been clear that the voluntary and compulsory transfer provisions in the Business Transfer Act applied to the Australian business of foreign ADIs, general insurers and life insurers, then the resolution of a number of issues resulting from foreign re-organisations of financial conglomerates would have been able to have been addressed in a more effective manner than proved to be the case over recent years. Subject to our comments in relation to Proposal 2.2.2 above, we also see a benefit in APRA having the power to facilitate a voluntary or compulsory transfer of business of the Australian business of foreign ADIs, general insurers and life insurers in the event of the implementation of a recovery or resolution plan for the foreign regulated entity.

In order to ensure that such a transfer was effective:

- it may be necessary or desirable to restrict the transfer to assets and liabilities located in Australia or governed by the laws of a State or Territory; and
- in relation to assets and liabilities located outside Australia or governed by the laws of a place outside Australia, for complementary legislation (or other authorisation) to facilitate the transfer to be in place in the relevant place outside Australia.

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5 Enhancing the Statutory Management and Judicial Management Legislative Frameworks

Proposal 4.1.1: Broaden the grounds for appointing a statutory manager to enable earlier appointment

Proposal

That section 13A of the Banking Act be amended to enable APRA to appoint an SM where (in addition to the existing grounds for appointment):

- *there has been, or APRA has reasonable grounds to believe there will be, a material deterioration in the ADI's financial condition that could pose a risk to the ADI's depositors or to the stability of the financial system in Australia; or*
- *the ADI has failed to comply with a direction given to it by APRA.*

An amendment along these lines would make the triggers for appointment of an SM in the Banking Act more consistent with those applicable to judicial management in the Insurance Act and Life Insurance Act.

Discussion questions

Is it appropriate that APRA's power to appoint an SM to an ADI be expanded in the manner proposed?

Are there any safeguards that should be attached to the power?

Comments on Proposal 4.1.1

In our view, the proposed grounds for appointment of an SM set out in Proposal 4.1.1 are overly broad.

The first ground requires only that there be reasonable grounds to believe that there will be a material deterioration in the ADI's financial position that could pose a risk to the ADI's depositors or to the stability of the financial system in Australia. Pursuant to this proposal, the deterioration need not have occurred and it need only have the potential to pose a risk (and the nature of that risk is not defined).

The second ground requires only that there be a failure to comply with a direction given by APRA to an ADI. Since the appointment of a SM is a most serious step this ground should be subject to appropriate qualifications, including requiring that:

- the non-compliance was material in nature;
- the direction with which the ADI has failed to comply was lawful and proper; and
- the non-compliance extended in duration beyond an appropriate 'grace period' in respect of non-compliance.

The appointment of an SM to an ADI represents a very substantial interference in the affairs of the ADI and is likely to have severe flow-on effects a range of stakeholders and the stability of the broader financial system. As is noted in the Consultation Paper,[5] it is a power reserved for extreme situations, such as severe

5 Refer to Consultation Paper section 2.1.1, page 24.

financial distress. The power is an administrative, not a court order, and its exercise is currently not a reviewable decision under the Banking Act.

Notwithstanding provisions such as section 15C, the practical effect of an appointment may be that counterparties cease to deal with the ADI. If the power to appoint an SM is exercised prematurely, it has the potential to undermine confidence in the ADI and result in further deterioration in its financial position. As such, appropriate safeguards must be in place to ensure that the appointment of an SM is a measure which is reserved for situations where the ADI is in severe distress.

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Proposal 4.1.2: Enable a statutory or judicial manager to be appointed to a regulated entity if an authorised NOHC is placed into external administration

Proposal

That section 13A of the Banking Act be amended to permit APRA to appoint an administrator to take control of an ADI's business in the event that an administrator, receiver or liquidator is appointed to the authorised NOHC of an ADI, where APRA believes that this poses a significant threat to the operation or soundness of the ADI. Under this proposal, similar amendments would be made to corresponding provisions in the Insurance Act and Life Insurance Act to trigger the appointment of a JM where a general or life insurer's authorised NOHC comes under external administration.

Comments on Proposal 4.1.2

In our view the appointment of a SM to an ADI is something which requires the ADI to be the subject of severe distress. Assuming for the purposes of the discussion that APRA is given a power in certain circumstances to appoint a SM to a NOHC, it would not seem appropriate that this by itself should be a ground to appoint a SM to an ADI which is otherwise in a sound condition.

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Proposal 4.1.5: Clarify that the appointment of a statutory / judicial manager (or a compulsory transfer of business) does not enable a party to a contract with a regulated entity to access security/collateral lodged under the contract

Proposal

That section 15C of the Banking Act and the equivalent provisions in the Insurance Act, Life Insurance Act and Business Transfer Act be amended to make it clear that the mere appointment of an SM or JM, or the compulsory transfer of a business does not trigger terms in contracts entitling counterparties to realise or otherwise obtain the benefit from security or collateral lodged by regulated entities with these counterparties.

It is not intended that this proposal have an impact on:

- *Covered bonds under the Banking Act. Subsection 31B(2) of the Banking Act currently provides that section 15 does not prevent the exercise of a contractual right in relation to an asset that secures liabilities to holders of covered bonds or their representatives if payments under the covered bonds to the holders or representatives are not made.*
- *Netting arrangements under the Payment Systems and Netting Act 1998.*

The proposed amendment would apply to the direction powers in the industry Acts.

Comments on Proposal 4.1.5

An extension of section 15C(2) to prevent the appointment of a SM being a ground for enforcing security is reasonable provided that proper consideration is given to the relevant exceptions.

The proposal notes that it is not to have effect on covered bonds, or close-out netting contracts under the Payment Systems and Netting Act 1998 (Cth). This is welcome, however, care will need to be taken if the legislation were to refer to security interests as defined in the Personal Property Securities Act 2009 (Cth) (**PPSA**). This legislation includes within the scope of security interest certain transactions which are not by way of security, but in some cases by way of outright assignment.[6] These include assignments of receivables which are fundamental to securitisation transactions in which banks commonly engage and, so long as they are conducted within relevant prudential standards, their operation should not be affected by section 15C (or the moratorium provisions).

The perfection of assignment in these circumstances should not be treated as the enforcement of a security interest as the transactions are in substance sales of the relevant property, not security interests over it.

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Proposal 4.2.1: Widen the moratorium provisions applicable where a statutory and judicial manager is appointed

Proposal

That the current moratorium provisions be repealed and replaced with a new, standardised set of provisions in the industry Acts, drawing on relevant provisions in the Corporations Act and in the external administration regimes in other jurisdictions. The new set of provisions would be modified as appropriate to take into account the differences between statutory management (as a process under APRA's control) and judicial management (as a process under the Court's control).

Discussion questions

Do the measures proposed in this section strike the right balance between the protection of depositor/policyholder interests and Australian financial system stability on the one hand, and the recognition of creditor and counterparty rights on the other?

Are there any other matters that should be addressed in this context, in addition to those listed above?

Comments on Proposal 4.2.1

In our view, it is correct that the existing moratorium provisions in relation to statutory management are in need of harmonisation and improvement.

However, any amendments need to be considered in the light of the overall purpose, circumstances and duration of statutory management and must produce results that fairly balance the interests of the ADI and counterparties. It will also be necessary to consider the interrelationship of Proposal 4.2.1 and other

6 Section 12(3) of PPSA.

proposals raised in the Consultation Paper (in particular, the proposal to extend the statutory management regime beyond the ADI or insurer to NOHCs and subsidiaries or related entities, as outlined in Proposal 1.1.1 above).

In particular, we note:

- the breadth of the stay on proceedings;
- the duration of statutory management; and
- the impact on the enforcement of security.

Defining a court broadly to include tribunal or other body with power to effect a reduction in the company's assets or otherwise thwart or frustrate the SM / JM is sensible, and is consistent with the scope of the equivalent stay provisions in the Corporations Act.[7]

In respect of the impact on the enforcement of security, the proposal contemplates that creditors should be prevented from enforcing any security that may be attached to any property that the company owns, uses, possesses, occupies or otherwise has an interest in. While the administration provisions in the Corporations Act contain a stay on enforcement of securities, it should be noted that:

- there are exceptions for security interests over all (or substantially all) of the company's property (while an ADI or insurer would not be expected to have created comprehensive security, if the power to appoint a SM is extended to subsidiaries of such entities, it is quite possible that subsidiaries will enter into financing arrangements of that kind);
- administration is not an indeterminate proceeding: it leads to a creditors' meeting (generally after 20 business days) and the result of that will be either the entry into a DOCA or winding up. A DOCA does not bind a secured creditor unless the creditor agrees;[8]
- in a winding up, the creditor is generally free to exercise its rights as a secured creditor; and
- administration and liquidation are subject to the oversight of the court under the Corporations Act.

In contrast, statutory management may last for an indefinite time. There is no judicial oversight, and it is proposed that the immunities of the SM be further extended (see below).

Further, the concept of what is a security interest has been greatly expanded following the introduction of the PPSA. Staying the enforcement of a quasi-security interest (eg, flawed asset arrangements) or as mentioned above in relation to our comments on section 15C of the Banking Act, may result in considerable interference with contractual rights. Certainly, any security arrangements which are not affected by section 15C (including security arrangements and securitisation as mentioned above in our in relation to Proposal 4.1.5) should be excluded from the stay.

Similar concerns to those relating to security interests apply to the stay on claiming or repossessing property.

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7 Section 471B of the Corporations Act provides that while a company is being wound up, a person cannot bring or proceed with a proceeding in a "court" in relation to the property of the company or the enforcement process in relation to such property. For the purposes of section 471B, a "court" has been held to include the Australian Industrial Relations Commission: see *Australian Liquor, Hospitality and Miscellaneous Workers Union v Home Care Transport Pty Ltd* (2002) 20 ACLC 820.

8 In relation to length of the convening period, refer to section 439A of the Corporations Act. In relation to the effect of a deed of company arrangement on secured creditors, refer to section 444D of the Corporations Act.

Supply of essential services: it is proposed that suppliers of essential services cannot refuse services to an ADI or insurer under external management on the sole basis of a debt owing to them and cannot refuse to make further supply conditional on payment of an outstanding debt. We anticipate that the provisions contemplated would follow the form of section 600F of the Corporations Act.

We note that the provision applies to prevent a supplier of an essential service from refusing a request for supply or making it a condition of further supply that a debt owing before the appointment of the insolvency official is paid. It does not prevent the supplier from refusing to supply for non-payment of post-appointment debts. A power to require supply in terms broader than the terms of section 600F if the Corporations Act would be unfair to suppliers as their sole right is to be paid for what they supply and they should not be a source of finance to an ADI.

Dispensing with AGM: it is proposed that provision be made to permit the AGM to be dispensed with by an SM. Relief from the Corporations Act requirements for annual general meetings and related reporting is available from ASIC for administrators in certain circumstances.[9] However, if this is to apply to SMs, what reporting will the SM undertake to shareholders and creditors? Reports to members and creditors are a feature of other insolvency procedures[10] Further, whatever justification there might be for this in relation to the ADI or insurer itself, it is an extraordinary degree of interference with creditors' rights of a non-regulated entity in the same group as a ADI or insurer.

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Proposal 4.3.1: Ensure that a statutory manager's ability to manage an ADI's business is not compromised by the priority provision in the Banking Act

Proposal

That the Banking Act be amended to put beyond doubt that an SM is able to manage an ADI's business in accordance with the provisions of the Banking Act without being constrained by the operation of subsection 13A(3).

Comments on Proposals 4.3.1

In our view, these proposals need to be reconsidered. Where an SM has been appointed despite the fact that the ADI is not actually unable to meet its obligations or has not actually suspended payment, section 13A(3) of the Banking Act does not operate and the SM should be free to carry on business. Once, however, the point has been reached where the entity is actually unable to meet its obligations or has suspended payment, then section 13A(3) should apply.

If there is concern that there may be some dispute or uncertainty as to when that point is reached, this could be addressed by providing that:

- section 13A(3) only applies where the ADI has been ordered to be wound up; and

9 In respect of exemptions from requirements relating to AGMs, see sections 250PAA-250PAB of the Corporations Act. In respect of exemptions from reporting requirements, see Part 2M.6 of the Corporations Act.

10 An externally administered company is obliged to comply with such requirements, subject to the provisions of the Corporations Act cited in above fn 9: see ASIC Regulatory Guide 174.

- the SM's determination of that inability is conclusive, subject only to review by the Federal Court of Australia.

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Proposal 4.3.2: Statutory immunity for statutory and judicial managers
Proposal
That the immunity provisions in the industry Acts be amended to ensure that the higher level of protection currently applicable to APRA staff and agents under the APRA Act is accorded to SMs and JMs.

- **Comments on Proposal 4.3.2**

The question of this immunity for SM is an important matter if it is proposed that the SM can carry on the business of the ADI for some time, as seems to be contemplated, from proposals such as Proposal 4.3.1.

In other insolvency regimes, where an insolvency official runs the business it incurs liabilities for goods and services provided after its appointment.

For instance, where a receiver takes control of a corporation's property the receiver is liable for debts incurred for services rendered, goods purchased or hired.[11] The receiver may also agree by contract to be liable for certain payments.[12] Similarly, an administrator is liable for certain debts incurred in the course of the administration.[13]

In return, the insolvency official usually enjoys an indemnity and a priority claim over the assets of the business. In a receivership, this is usually a function of the terms of the charge. In an administration, it is a function of section 443D and 443E of the Corporations Act. This reflects the commercial reality that counterparties will be reluctant to deal with an entity that is the subject of regulatory intervention without some assurance that they will be paid for their services and supplies.

As with many businesses, regulated institutions will have many contractual arrangements which are not long term supply contracts but are uncommitted commercial relationships in the course of which contracts for particular services or supplies are formed. Examples include most derivatives and foreign exchange dealings, money-market operations, legal services etc. A combination of an indeterminate moratorium and comprehensive immunity for the SM is liable to cause suppliers and service providers to be reluctant to deal with the SM and the ADI. This will defeat one of the purposes of the appointment, in particular in the case of an institution that was otherwise capable of being resolved. Consideration should be given as to whether some provisions of the kind shall be reflected in the statutory management provisions for ADI.

Without it any with a concept for immunity for the SM, and when combined with other (expanded) moratorium provisions, how will the ADI continue to trade?

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[11] Section 419 of the Corporations Act

[12] See e.g. in *Sheahan v Carrier Air Conditioning* (1997) 71 ALJR 1223.

[13] See sections 443A-443E of the Corporations Act.

6 Refinement of the Scope of Prudential Standards

Proposal 8.5.1: Refinement and simplification of the definition of 'prudential matters'

Proposal

That a standardised definition of prudential matters be introduced into the industry Acts. This would replace the existing definitions in the Banking Act and the Insurance Act. The proposed definition could be along the following lines:

***prudential matters** means matters relating to:*

(a) the conduct by a regulated entity, an authorised NOHC, a relevant group of bodies corporate, or a particular member or members of such a group, of any part of its or their affairs, or the structure or organisation of a regulated entity, an authorised NOHC, a relevant group of bodies corporate, or a particular member or members of such a group, in such a way as:

(i) to keep the regulated entity, authorised NOHC, relevant group of bodies corporate, or a member or members of the group in a sound financial position;

(ii) to protect the interests of depositors or policyholders (as the case may be);

(iii) to facilitate the effective resolution of the regulated entity, its authorised NOHC, a relevant group of bodies corporate, or member or members of the group;

(iv) not to cause or promote instability in the Australian financial system; or

(v) not to cause or promote instability in the New Zealand financial system [this is applicable only under the Banking Act];

(b) the conduct by a regulated body, an authorised NOHC, a relevant group of bodies corporate, or a particular member or members of such a group, of its or their affairs with integrity, prudence and professional skill.

Comments on Proposal 8.5.1

We welcome the proposal to simplify the meaning of *prudential matters*, but are of the opinion that in doing so the current anomalies in the Banking Act regarding the expression *depositors* should also be addressed and resolved.

As a result of the introduction of the FCS, some of the provisions of the Banking Act relating to the protection of *depositors* (in particular sections 13A(3) and (4)) have become increasingly difficult to explain to investors. The provisions are complex and lack certainty and clarity.

The concept of a *deposit* is central to many provisions of the Banking Act (but undefined) including:

(a) in the definition of *banking business* and the use of the term A*uthorised Deposit-taking Institution* itself;

(b) the ability of APRA to take a range of actions by reference to the interests or protection of *depositors* or not do so if the action would have a specified impact on *depositors*;

(c) the power of APRA to direct an ADI not to accept or repay a *deposit* in prescribed circumstances;

(d) the provisions for the protection of *depositors* in Division 2 of Part II of the Banking Act (and the obligations of a foreign ADI to notify *depositors* that it is not subject to the provisions for the protection of depositors in Division 2 of Part II); and

(e) the requirements of section 13A(4) (but no longer the requirements of section 13A(3) – see below).

However, following the changes to section 13A(3) introduced in 2010 by the Financial Sector Legislation Amendment (Prudential Refinements and Other Measures) Act 2010 (Cth), the concept of a *deposit* is no longer relevant to those liabilities which have priority if an ADI becomes unable to meet its obligations or suspends payment.

The Banking Act currently refers to *deposits*, *deposit liabilities*, *accounts, protected accounts*, *depositors* and *account-holders*. It is unclear as to whether these terms are intended to be synonymous and, if not, the extent of the overlap between them. For example, a negotiable or transferable certificate of deposit may be a *deposit* and *deposit liability*, but may not be an *account or protected account*.

Accordingly, we recommend that, consistent with the 2010 changes to section 13A(3), consideration be given to:

- all references to *depositor* be replaced by the existing defined term *account-holder* or, alternatively, both the terms *depositor* and *account-holder* be replaced by a new term *protected depositor* to be defined in similar terms to the existing definition of *account-holder*;
- all references to *deposit* be replaced by a new term *protected deposit* (and hence *protected depositor*) which could be defined by reference to the concept of a basic deposit product as used in section 761A of the Corporations Act, rather than the concept of an *account*; and
- the term *deposit liabilities* be replaced by a new defined term, *protected liabilities* to be defined by reference to the liabilities owed to *account-holder* or the new term *protected depositor*.

In addition, some or all the references to a *deposit* could be replaced by references to an *account* or *protected account*, but we do not regard such a change as being essential as the majority of these references are of a generic nature.

These changes would provide greater clarity to the proposed definition of *prudential matters* (and APRA's powers and duties under the Banking Act) – under our recommendation the expression *depositor* in that definition would be replaced by *account-holder* or the new term *protected depositor*.

There are a number of other uncertainties and ambiguities in sections 13A(3) and (4) which could be addressed at the same time, but as these do not relate to the definition of *prudential matters*, we have not outlined them in this response to the Consultation Paper, but we would be more than happy to discuss them with Treasury.

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