AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY
1 Martin Place (Level 12), Sydney, NSW 2000
GPO Box 9836, Sydney, NSW 2001

T 02 9210 3000 | W www.apra.gov.au

WAYNE BYRES
Chair

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

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

Dear Mr Fitt,

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

Before answering your further questions, it might be helpful to clarify a recent public misconception about the interaction between APRA's twin objectives – to protect depositors and financial system stability. Following my previous response to this committee of 15 July 2020, APRA's financial system stability objective has been characterised as an alternative to depositor protection that could be used to implement measures contrary to depositor protection (such as bail-in of deposits).

This characterisation is incorrect. As the *Banking Act 1959* (Banking Act) makes clear, APRA's twin objectives are complementary.[1] This is evident when considering 'depositor bail-in'. A 'bail-in of deposits' would offend both APRA's depositor protection objective and its financial stability objective. A bail-in of deposits would not only cause depositors at the 'bailed-in' institution to lose a portion of their deposit funds, it would reduce the confidence of depositors across the banking system thereby reducing financial system stability. It would also starve authorised deposit-taking institutions of the stable deposit funding on which they rely to provide credit to the economy. This is why APRA has described depositor protection as a paramount objective – it lies at the heart of both of our statutory objectives under the Banking Act. As such, APRA has never sought, nor supports, a 'bail-in of deposits' power.

The answers to your specific questions are set out below.

1. The Financial Stability Board (FSB) released on 28 June 2020 a consultation report, Evaluation of the effects of too-big-to-fail reforms. The report makes the following statement (p. 14):

The evaluation has therefore focused on the mechanisms through which the reforms are expected to operate and on the observed reactions of banks and investors to reforms. For reforms to succeed:

[1] See Banking Act s. 2A(1) and the use of 'and' rather than 'or' when setting out APRA's twin objectives.

- *Governments must have the powers, the information and the incentives to move from bailout to bail-in. Banks must have financial resources and legal and operational structures that facilitate the effective use of resolution tools by the resolution authorities.*
- *The behaviour of banks must be affected by the prospect of resolution rather than bailout, together with capital surcharges and enhanced supervision.*
- *Market participants must have sufficient information to price these changes and to exert market discipline.*
- *These mechanisms must be sufficiently strong to affect aggregate outcomes, for example by reducing risk in the financial system.*

Could APRA please respond to this statement, in particular, the suggestion by the FSB that until such time as bail-in reforms are implemented, financial institutions will not face sufficient incentives to manage risk appropriately?

It is important not to confuse the broad concept of 'bail-in' with the narrower 'bail-in of deposits'. 'Bail-in' in the broad sense refers to the conversion of certain prescribed liabilities, usually subordinated debt instruments, into equity. The purpose of bail-in is to avoid a 'bail-out', where taxpayers' funds are used to rescue banks. A key problem with 'bail-out' is that those who receive a benefit (a risk premium) in good times (such as shareholders and subordinated debtholders) are protected from bearing the usual burden of restoring the institution to health in bad times (as would happen with any other company). Instead this burden is transferred to taxpayers in a bail-out. Shareholders and subordinated debtholders that are protected from the risk of failure in bad times may incentivise banks to engage in riskier behaviour – this is commonly known as moral hazard.

There are two ways APRA addresses this moral hazard risk. The first is a requirement to hold relatively high levels of equity – Australia maintains higher requirements than most peer jurisdictions, meaning more at risk for shareholders and less likelihood of the need for taxpayer support. The second approach is requiring banks have additional 'Loss Absorbing Capacity' (LAC), which mandates that certain capital instruments convert into equity at specified trigger points if an entity gets into financial difficulty. These instruments, known as 'Additional Tier 1' or 'Tier 2' capital, ensure that loss is borne by the appropriate risk holders rather than taxpayers. This is why – as APRA and ASIC have often emphasised – it is essential that retail holders of these instruments are aware of the risk built into them. In contrast, depositors are protected from loss in the event of non-viability – and they do not enjoy the higher yield of Additional Tier 1 or Tier 2 instruments. Together, APRA considers its regulatory capital requirements and LAC provide sufficient 'skin in the game' to address moral hazard risk – especially as our regime is calibrated to provide comparable levels of total LAC as elsewhere.

Following the GFC the FSB put in place a series of measures to address the risks posed by too-big-to-fail banking institutions. In Australia, in line with the recommendation of the Financial System Inquiry in 2014, the key mechanism for implementing the market-based incentives and financial resources required to 'bail-in' such banking institutions is APRA's approach to LAC, which APRA finalised on 9 July 2019. LAC ensures that certain larger banking institutions hold sufficient financial resources (in the form of regulatory capital, largely Tier 2 capital instruments) to implement a 'bail-in' in order to recapitalise at the point of non-viability, and in doing so significantly reduce the risk of taxpayers having to 'bail-out' Australian banking institutions.

APRA's approach to LAC, through the use of regulatory capital instruments, has therefore achieved the objectives of the FSB's bail-in reforms without the need to implement a statutory bail-in power that can be applied to a wider range of liabilities, as is the case in some other jurisdictions. The Australian regime did not implement a power to 'bail-in' deposits, precisely because this would have been contrary to APRA's purpose and objectives as noted in my previous response.

2. Why does APRA consider it is unnecessary to implement bail-in legislation in Australia in order to bring an appropriate level of discipline to risk management by Australian financial institutions?

APRA implemented LAC under its existing capital framework, which uses contractual conversion provisions rather than a standalone statutory power. As such, it was not necessary to implement 'bail-in legislation' in order to apply the LAC regime in Australia.

The addition of s11CAB in the *Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Act 2018* ensured that the contractual 'bail-in' provisions within capital instruments would operate according to their terms, as there was previously some doubt about the interaction of those contractual terms with other laws (particularly the *Corporations Act 2001)*. As such, the amendment merely reinforced the pre-existing position in relation to contractual conversion provisions and does not constitute a new statutory 'bail-in' power.

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

Yours sincerely,