18 December 2017

Committee Secretary
Senate Standing Committee on Economics
Department of the Senate
PO Box 6100
Parliament House
CANBERRA

By email: economics.sen@aph.gov.au

Dear Mr Fitt

Financial Sector Crisis Resolution Bill

The Australian Financial Markets Association (AFMA) is commenting on the *Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Bill 2017* (the Bill).

AFMA supports the strengthening of Australian Prudential Regulation Authority's (APRA) powers consistent with the Financial Stability Board's (FSB) Key Attributes of Effective Resolution Regimes (Key Attributes[1]). The Key Attributes set out twelve essential features that should be part of the resolution regimes of all jurisdictions. They relate to:

1) Scope
2) Resolution authority
3) Resolution powers
4) Set-off, netting, collateralisation, segregation of client assets

[1] The FSB adopted the Key Attributes in 2011. At that time it was agreed to develop further guidance on the implementation of the Key Attributes, taking into account the need for implementation to accommodate different national legal systems and market environments and sector-specific considerations (e.g., insurance, financial market infrastructures) to promote effective and consistent implementation across jurisdictions.

On 15 October 2014, the FSB adopted additional guidance that elaborates on specific Key Attributes relating to information sharing for resolution purposes and sector-specific guidance that sets out how the Key Attributes should applied for insurers, financial market infrastructures (FMIs) and the protection of client assets in resolution.

5) Safeguards
6) Funding of firms in resolution
7) Legal framework conditions for cross-border cooperation
8) Crisis Management Groups
9) Institution-specific cross-border cooperation agreements
10) Resolvability assessments
11) Recovery and resolution planning
12) Access to information and information sharing

The objective of an effective resolution regime is to make feasible the resolution of financial institutions without severe systemic disruption and without exposing taxpayers to loss, while protecting vital economic functions through mechanisms which make it possible for shareholders and unsecured and uninsured creditors to absorb losses in a manner that respects the hierarchy of claims in liquidation. An effective resolution regime can be summarised as having the following attributes:

i) ensure continuity of systemically important financial services, and payment, clearing and settlement functions;
ii) protect, where applicable and in coordination with the relevant insurance schemes and arrangements such depositors, insurance policy holders and investors as are covered by such schemes and arrangements, and ensure the rapid return of segregated client assets;
iii) allocate losses to firm owners (shareholders) and unsecured and uninsured creditors in a manner that respects the hierarchy of claims;
iv) not rely on public solvency support and not create an expectation that such support will be available;
v) avoid unnecessary destruction of value, and therefore seek to minimise the overall costs of resolution in home and host jurisdictions and, where consistent with the other objectives, losses for creditors;
vi) provide for speed and transparency and as much predictability as possible through legal and procedural clarity and advanced planning for orderly resolution;
vii) provide a mandate in law for cooperation, information exchange and coordination domestically and with relevant foreign resolution authorities before and during a resolution;
viii) ensure that non-viable firms can exit the market in an orderly way; and
ix) be credible, and thereby enhance market discipline and provide incentives for market-based solutions.

1. Reasons for supporting the Bill

This Bill achieves the aim when combined with existing law, particularly in the Banking Act of providing an effective resolution regime for prudentially regulated financial institutions in Australia. This is a very complex legislation which affects the rights of many actors in the financial sector. The Bill was in gestation for a very long period from when policy approval was granted in 2015. AFMA considers it poor practice by the Government of only allowing a three week consultation when the draft Bill was released in August as the entire sum of consultation time during the long period the Bill was in preparation. There continues to be concern that unintended consequences may not have been detected. Nevertheless, AFMA supports the passage of the Bill subject to one major point concerning the need for a cross-border regulatory cooperation framework and a few following technical comments. Our reasons for making this point are set out in Section 3A Comments.

The existing statutory and judicial management regimes in the Banking and other relevant Acts currently provide APRA with important powers for dealing with a financial institution in acute distress. The Bill extends the law in an important way to group holding company arrangements. APRA may require a body corporate to hold a Non-Operating Holding Companies (NOHC) authority as a condition for permitting its subsidiary to carry on banking or insurance business in Australia. The authorisation of a NOHC ensures that APRA has some level of control over the group that it manages. Most of the powers APRA has in respect of an Authorised Deposit-taking Institution (ADI) or insurer, APRA has in relation to an authorised NOHC, including the ability to apply prudential standards and to give directions to the NOHC. However, APRA is not empowered to appoint a statutory manager (SM) to an ADI's authorised NOHC and cannot apply to the Court for the appointment of a judicial manager (JM) to an insurer's authorised NOHC. Similarly, APRA does not have the power to appoint a SM to the subsidiaries of an ADI or of an authorised NOHC, and does not have the power to apply to the Court for the appointment of a JM to the subsidiaries of an insurer or of an authorised NOHC.

APRA can impose prudential standards, in respect of subsidiaries, on an ADI, insurer or authorised NOHC and can give directions to the ADI, insurer or NOHC to take specified actions in relation to subsidiaries. However, APRA does not have the power to impose prudential standards directly on ADI subsidiaries or to give directions to them.

APRA's powers in relation to the appointment of an SM or JM are currently limited to the regulated entity itself. APRA can appoint an SM to an ADI and similarly APRA can make an application to the Federal Court for the appointment of a JM to an insurer. APRA may appoint an SM to an ADI where APRA considers that (in the absence of external support) the ADI:

- may become unable to meet its obligations;
- may suspend payment; or
- it is likely that the ADI will be unable to carry on banking business in Australia

consistent with the interests of depositors or financial system stability in Australia.

Where an SM or JM is appointed to a regulated entity, it replaces the board of directors and takes control of the regulated entity. An SM or JM also has indirect control of any subsidiaries of the regulated entity through the capacity to exercise shareholder powers. The SM or JM can take the steps it considers best to resolve the entity, whether by reorganising its business, selling its business or assets, arranging new finance or support, recapitalising the entity, or ultimately applying for the entity to be wound up. Statutory or judicial management is a flexible tool, generally used as a measure of last resort. It can be used to maintain some or all of a regulated entity as a going concern, to facilitate the transfer of some or all of the business to another entity as part of a resolution, or to progress the entity to partial or complete winding up.

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

Where the failing entity is part of a group, it may be necessary to maintain the cooperation of other members of the group to ensure the best outcome. This is particularly so where other entities in the group are vital to the business of an ADI or insurer. This is becoming increasingly the case with larger financial institutions, where essential business functions are typically conducted via non-regulated entities in a group. In some cases a NOHC, subsidiary or associated entity will provide the regulated entity with financial or other services, such as staffing, IT, or custodial services, which may be critical to the continued functioning of the regulated entity. In other cases, the holding company or subsidiaries may hold essential assets or liabilities required for the continued functioning of the ADI or insurer. The NOHC also has an important role as the controlling shareholder of the ADI or insurer; its cooperation is important in any resolution measures taken to recapitalise the ADI or insurer or otherwise strengthen its financial position.

If a regulated entity is in financial distress, and is part of a group, it may be necessary to maintain the continued operation of the NOHC and/or subsidiaries in order to achieve an orderly resolution of the regulated entity. The inability to control such entities could jeopardise the capacity to implement an effective resolution. It may also be necessary to ensure that the NOHC, in its capacity as the controlling shareholder of the ADI or insurer, takes the steps required to facilitate the resolution of the ADI or insurer.

Crisis situations are difficult to predict in their precise nature. APRA is equipped with tools to take control of an entity in cases where it does not have confidence that the board and management is capable of resolving a crisis satisfactorily, or where the board and management are mismanaging the entity, including where it is insolvent or near insolvent. Given the importance of these powers, particularly as a measure of last resort, the enhancements expand the regulatory toolkit to deal with many scenarios.

These enhancements include ensuring the statutory management tool can be applied in a group context where necessary. The structures of financial groups can be complex, involving numerous business lines and support services linked through different ownership and contractual arrangements. In the absence of effective group resolution powers, it may be particularly difficult to resolve a distressed regulated entity or group quickly and effectively.

2. Care with stay provisions

The operation of the current stay provisions in the Banking Act have previously received considerable attention with regard to the length of time they are in place and the degree of discretion which is granted APRA as this directly affects market assessments of credit risk. These provisions prevent counterparties of a failing entity from taking action on the grounds of APRA exercising its powers (including directions, recapitalisation directions, statutory and judicial management and transfer powers) in respect of the entity. This is blocks pre-emptive actions by counterparties from impeding the ability of APRA to implement an orderly resolution as it sees fit. The amendments in the Bill extend the scope of certain powers to group entities. The Bill supplements the stay provisions to ensure that the exercise of crisis powers by APRA does not give rise to termination or other legal rights in contracts of entities within the same relevant group of bodies corporate (a group comprising an ADI / insurer and its subsidiaries or an authorised NOHC and its subsidiaries).

AFMA has paid particular attention to the interaction of the stay provisions with the Payment Systems and Netting Act 1998 (PSN Act). The PSN Act overrides a range of laws in order to ensure the validity of certain provisions relating to netting and the payments systems covered by the PSN Act. Consequential amendments are made to the PSN Act to take into account enhancements to the stay provisions, the moratorium provisions for statutory and judicial management, and the extension of certain powers to group entities. This is intended to ensure that current protections under the PSN Act are retained and the rights of counterparties to close-out netting contracts, and other arrangements covered by the PSN Act, are clear.

The consequential amendments to the PSN Act, which include ensuring:

- that an exercise of a power in relation to an entity does not give rise to termination rights or other rights (that is, denying an obligation, accelerating a debt, closing-out on a transaction, or enforcing a security) in contracts of entities within the same relevant group of bodies corporate (that is, any group comprising the ADI or insurer and its subsidiaries or an authorised NOHC and its subsidiaries); and
- that the current protections afforded to counterparties to certain close-out netting contracts under the PSN Act are retained (with appropriate amendments to take into account stays applying to cross-default rights),

are considered to be of particular importance by AFMA for preserving legal certainty in the market. Care and vigilance needs always to be applied to the drafting and application of stay provisions. AFMA believes that such care has been taken with the Bill.

3. Comments

A. Cross-border regulatory cooperation

AFMA welcomes the acknowledgement of the importance of cross-border regulatory cooperation in the resolution of foreign regulated entities, as mentioned in Section 7.7 and Section 7.28 of the revised Explanatory Memorandum. But more than this is needed.

Financial integration and the growth of global and regional banks give rise to the risk of contagion of financial instability across national borders in times of crisis. However, international experience reveals the inherent difficulty of cross-border cooperation between authorities in home and host countries in this area, particularly in times of crisis. Such cooperation is central to the effective implementation of internationally prescribed resolution frameworks for cross-border banking groups. These frameworks aim to achieve the smooth resolution of financially distressed financial institutions without jeopardising systemic stability or burdening the tax-payer. Cross-border cooperation is vital to the implementation of group-wide resolution plans in a crisis. Effective resolution requires resolution authorities in host countries to give effect to resolution action in relation to assets and liabilities in their jurisdiction. In the absence of cooperation, territorial approaches, under which national authorities focus on the interests of domestic creditors and other domestic stakeholders to the exclusion of foreign or cross-border interests, are likely to result in less efficient outcomes for cross-border financial groups and exacerbate financial instability. Cross-border cooperation is central to various stages of resolution.

The development of resolution plans, resolvability assessments, and information-sharing, particularly when there are material adverse developments, are premised on effective cross-border cooperation. The Key Attributes propose that institution-specific cross-border cooperation agreements should detail procedures for information-sharing and set out the roles and responsibilities of home and host authorities in resolution planning and crisis management. A coordinated response requires the support of legal and statutory frameworks to facilitate the implementation of cross-border resolution plans and give effect to foreign resolution action.

It is therefore disappointing to AFMA that there are no clear provisions in the Bill to provide for a legal framework for regulatory cooperation (e.g. by way of recognition or support). A broad statement of intent in the Explanatory Memorandum is insufficient to provide the legal certainty needed for this very important subject.

AFMA believes it is important that the Bill provides for a legal framework for regulatory cooperation to make the Australian regime fully consistent with the Key Attributes.

B. Revocation of authorisation of a foreign regulated entity

AFMA supports the principle set out in paragraph 7.50 of the Explanatory Memorandum that the power for APRA to revoke a body corporate's section 9 authority should only be used where the authorisation in a foreign country has been withdrawn for reasons that give rise to prudential concern in Australia.

It is therefore logical that section 9A(2)(j)(ii) of the Banking Act should be amended to clarify that it only applies where an authority to carry on banking business in a foreign country has been revoked or otherwise withdrawn in that foreign country for reasons that give rise to prudential concern in Australia.

C. Definition of Australian business assets and liabilities

In the definition of "Australian business assets and liabilities" set out in section 43 of the Bill amending section 11E(3) of the Banking Act, the second part of the definition refers to "any other assets and liabilities that the foreign regulated entity has as a result of its operations in Australia". The meaning of "as a result of its operations in Australia" in the current drafting of the Bill is potentially very broad and the scope is not entirely clear, e.g. where a foreign ADI adopts a global booking model with trades booked in a branch or subsidiary of the foreign ADI outside Australia, would seem to be unintentionally captured by the definition.

If trades / transactions conducted by the Australian branch of a foreign ADI are booked in a branch or subsidiary of the foreign ADI outside Australia, such assets and liabilities resulting from these transactions would apparently be subject to APRA's power of statutory management and / or compulsory transfer. AFMA considers that the scope of the definition should be clarified by amending the proposed definition of "Australian business assets and liabilities" in section 11E(3) of the Banking Act 1959 with regard to other assets by enabling specific ones to be brought in by a regulation if necessary rather than an overly broad catch-all provision. The revised section 11E(3) could be changed to reads as follows in sub-paragraph b):

Australian business assets and liabilities, of a foreign ADI, means the following:

a) the assets and liabilities booked in the accounts of the Australian branch of that entity; and

b) if regulations are made for the purposes of this regulation, any other assets and liabilities of a kind specified in those regulations.

D. Effect on non-APRA regulated entities

One aspect of the Bill remains unclear. It is not clear as to how a non-APRA regulated entity (which is part of larger banking group) that is a subsidiary of a foreign ADI would be resolved and whether APRA's resolution powers are intended to apply to such non-APRA regulated entities. AFMA suggests that APRA's powers (other than applying to APRA-regulated subsidiaries) be limited to the Australian branch of the foreign regulated entity, consistent with the approach taken by APRA in CPS 226 (margining and risk mitigation for non-centrally cleared derivatives) and the proposed Banking Executive Accountability Regime reforms.

Please contact David Love either on [redacted] or by emai[redacted] if further clarification or elaboration is desired.

Yours sincerely

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David Love
General Counsel & International Adviser