# 'Bail-in' powers

## SUPPLEMENTARY SUBMISSION

Supplementary Submission to Senate Economics Legislation Committee inquiry

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

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22 January 2018

**SUPPLEMENTARY SUBMISSION**

**CITIZENS ELECTORAL COUNCIL OF AUSTRALIA**

**Provision of Terms of reference to which this Supplementary Submission applies:**

- To understand exactly what capital instruments are covered by the Bill.

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The authors are willing to appear before the committee to answer questions on this submission.

# 1. SUMMARY OF SUPPLEMENTARY SUBMISSION

In summary, this Supplementary Submission has been considered necessary as a consequence of communications by Members of Parliament to constituents which seek to allay constituents' concerns as to the Bill's provisions concerning "bail-in"—the conversion and write-off provisions—and in particular their extension to deposits. The communications contend that the Bill does not provide any authority for the Australian Prudential Regulatory Authority ("APRA") to bail-in deposits in the event of an ADI bank getting into financial difficulties.

This contention has also been repeated by various Authorities.

Bail-in of deposits has caused considerable hardship overseas where it has been employed and is of increasing concern to the Australian community.

This Supplementary Submission is accordingly being lodged to draw to the Committee's attention the relevant provisions in the Bill relating to bail-in (whether explicit or implicit) and the concerns of this organisation and the community generally as to the nature and extent of those provisions.

As elaborated in this Supplementary Submission:

- by all definitions financial "instruments" includes deposits;

- the Bill clearly states that its conversion or write-off (bail-in) provisions apply to Additional Tier 1 and Tier 2 capital or "any other instrument";

- if the Bill only intended to refer to instruments which include conversion or write-off terms, all such instruments come under the definition of Additional Tier 1 and Tier 2 capital, and the additional clause "or any other instrument" is therefore unnecessary, but sufficiently broad language to give APRA scope to extend a bail-in to deposits;

- the author/s of the Bill's Explanatory Memorandum foreshadow a future scenario under which this Bill will allow APRA to determine through its prudential standards that instruments not currently considered to be capital, such as deposits, could be reclassified as capital for the purpose of conversion or write-off—bail-in.

It therefore remains our contention that the Bill does provide APRA with power to bail in deposits and for this and the reasons appearing in our primary Submission of 18 December 2017 that the Bill should be rejected.

# 2. SUPPLEMENTARY SUBMISSION

The Explanatory Memorandum defines its *"conversion and write-off provisions"* as follows:

> *Definitions*
>
> ...
>
> *5.14 The new term 'conversion and write-off provisions' refers to the provisions in APRA's prudential standards that require certain capital instruments to be converted into ordinary shares or mutual equity interests, or to be written off, in certain circumstances described in the prudential standards. [Schedule 1, item 31, section 11CAA of the Banking Act; Schedule 2, item 17, section 36A of the Insurance Act; Schedule 3, item 64, section 230AAB of the Life Insurance Act]*
>
> *5.15 The provisions in the prudential standards that set these requirements are currently referred to as the 'loss absorption requirements' and requirements for 'loss absorption at the point of non-viability'. The term 'conversion and write-off provisions' is intended to refer to these provisions. However, the amendments leave room for future changes to APRA's prudential standards, including changes that might refer to instruments that are not currently considered capital under the prudential standards.*

The definition itself accordingly acknowledges that APRA may promulgate Prudential Standards to include instruments which are not presently considered capital. It does not exclude deposits from being among the instruments which may in turn become subject to bail-in (as to which see below).

## Hybrid securities to be bailed in

Chapter 5 of the Explanatory Memorandum deals with "***Conversion and write-off of capital instruments***". The Memorandum's outline of the Chapter states:

> *5.1 Schedules 1-3 and 7 to this Bill amend the Industry Acts and the Corporations Act to provide certainty that capital instruments can be converted or written off as provided for in APRA's prudential standards.*

The Memorandum summarises the provisions in the Bill in relation to conversion and write-off:

> *5.11 The Bill amends the Industry Acts to provide increased certainty in relation to the conversion and write-off of capital instruments, including amendments to provide that ... conversion or write-off can happen despite any impediment there may be in ... any domestic or foreign law....*

The Memorandum summarises this aspect of the "New law" as:

> *It is certain that the terms of capital instruments that provide for the instrument to absorb losses by converting or being written off are effective despite potential legal impediments.*

The provision in the Bill as to conversion of instruments where the instrument itself contains an explicit provision for conversion reads (Section 11CAB(2)):

> *(2) The instrument may be converted in accordance with the terms of the instrument despite:*
>
> > *(a) any Australian law or any law of a foreign country or a part of a foreign country, other than a specified law; and*
> > *(b) the constitution of ... the entity issuing the instrument;* [or] *any conversion entity for the instrument; and*
> > *(c) any contract or arrangement to which a relevant entity is a party; and*
> > *(d) any listing rules or operating rules of a financial market in whose official list a relevant entity is included...*

Section 11CAB(3) is in the same terms as to writing off instruments.

These provisions mean that any law which would otherwise prevent the conversion or write-off does not apply unless a particular legislative provision specifically provides that it does apply. One of the principle types of legislation that this provision would be directed towards is consumer legislation, particularly those provisions which allow a Court to set aside or vary agreements if a party has been guilty of false or misleading conduct—this is precisely the sort of argument which could be raised in the circumstances referred to by then-Australian Securities and Investments Commission (ASIC) boss Greg Medcraft in an exchange with Greens Senator Peter Whish-Wilson in the hearings of the Senate Economics Legislation Committee on 26 October 2017.

Mr Medcraft said: "*There are two reasons we believe a lot of the retail investors buy these securities. One is they don't understand the risks that are in over 100-page prospectuses and, secondly—and this is probably for a lot of investors—they do not believe that the government would allow APRA to exercise the option to wipe them out in the event that APRA did choose to wipe them out.*"

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

The over-riding provisions of Sections 11CAB(2) and 11CAB(3) are consistent with the comments of Graeme Thompson of APRA in an address on 10 May 1999 when he said: "*... APRA will have powers under proposed Commonwealth legislation to mandate a transfer of assets and liabilities from a weak institution to a healthier one. This is a prudential supervision tool that the State supervisory authorities have had in the past, and it has proved very useful for resolving difficult situations quickly. We expect the law will require APRA to take into account relevant provisions of the* Trade Practices Act *before exercising this power, and to consult with the ACCC whenever it might have an interest in the implications of a transfer of business.*" The new Sections 11CAB(2) & (3) mean that APRA does not need to consider those issues (or any other) in relation to conversion and write-off of hybrid instruments.

## Deposits are "instruments"

That these provisions as to conversion and write-off are not limited to Hybrid securities is confirmed in Section 11CAA of the Bill which also confirms that the *prudential standards* (i.e. APRA's subordinate legislation), is what determines the instruments to which the provisions apply:

> *11CAA Definitions*
> *In this Subdivision:*
> *conversion and write-off provisions means the provisions of the prudential standards that relate to the conversion or writing off of:*
> *(a) Additional Tier 1 and Tier 2 capital; or*
> *(b) any other instrument.*
> .....

"Any other instrument" must relate to instruments other than those referred to in sub-clause (a) i.e. other than Additional Tier 1 and Tier 2 capital, being instruments which themselves contain an explicit provision for conversion or write-off. All instruments that the Bill refers to being able to be converted or written off "in accordance with the terms of the instrument" come under the definition of Additional Tier 1 and Tier 2 capital; "any other instrument" is not only an entirely unnecessary addition if the Bill is intended to apply only to instruments with conversion or write-off terms, it is very broad language that can include, by the official definitions cited below, deposits.

Indeed, the Definition Section 5.14 of the Explanatory Memorandum acknowledges that the existing provisions and definitions can be broadened by an APRA Prudential Standard.

"*Instrument*" is not defined by the Bill but a "financial instrument" is defined by Australian Accounting Standard AASB 132 as "*any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity*." As confirmed by the Reserve Bank, a deposit with an ADI bank comes under such a definition—it is a contract with terms as to the deposit being set by a bank, accepted by a depositor on making a deposit and creating a financial asset (a right of repayment) and a financial liability in the bank (the obligation to repay). The Bill accordingly confirms APRA's power to promulgate a Prudential Standard for the conversion or writing off of "instruments" which, by definition, includes deposits.

## APRA can target deposits through future determination of prudential standards

Section 11AF of the *Banking Act 1959* provides that APRA can determine Prudential Standards which are binding on all ADIs. These standards are in effect regulations which have the force of legislation by virtue of the authorisation in the *Banking Act*. That Section provides, inter alia:

> *(1) APRA may, in writing, determine standards in relation to prudential matters to be complied with by:*
> *(a) all ADIs; or*
> *(b) all authorised NOHCs; or*
> *(c) a specified class of ADIs or authorised NOHCs; or*
> *(d) one or more specified ADIs or authorised NOHCs.*
> *(1A) A standard may impose different requirements to be complied with in different situations or in respect of different activities.*

The various Prudential Standards issued by APRA are accordingly headed with the phrase: "*This Prudential Standard is made under section 11AF of the Banking Act 1959 (the Banking Act).*" That power then leads into the issue of APRA using this authority to expand the meaning of "capital" the subject of conversion or write-off, to encompass deposits. Such a possibility is in fact confirmed (consistently with the provisions referred to above) by the Memorandum which states:

> *5.15 The provisions in the prudential standards that set these requirements are currently referred to as the 'loss absorption requirements' and requirements for 'loss absorption at the point of non-viability'. The term 'conversion and write-off provisions' is intended to refer to these provisions.* ***However, the amendments leave room for future changes to APRA's prudential standards, including changes that might refer to instruments that are not currently considered capital under the prudential standards.*** **(Emphasis added.)**

This formulation in the Explanatory Memorandum, written in the context of the Bill's conversion or write-off provisions, contradicts the claims that those provisions cannot apply to deposits. The committee should seek clarity from the author/s of the Explanatory Memorandum as to the future changes foreshadowed in this paragraph.

## APRA can already withhold deposits; bail-in the next step

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

> *(1) ... APRA may give a body corporate that is an ADI ... a direction of a kind specified in subsection (2) if APRA has reason to believe that:*
>
> .....
>
> *(b) the body corporate has contravened a prudential requirement regulation or a prudential standard; or*
> *(c) the body corporate is likely to contravene this Act, a prudential requirement regulation, a prudential standard or the* Financial Sector (Collection of Data) Act 2001*, and such a contravention is likely to give rise to a prudential risk; or*
> *(d) the body corporate has contravened a condition or direction under this Act or the* Financial Sector (Collection of Data) Act 2001*; or*
>
> ....
>
> *(h) there has been, or there might be, a material deterioration in the body corporate's financial condition; or*
>
> ....
>
> *(k) the body corporate is conducting its affairs in a way that may cause or promote instability in the Australian financial system.*
>
> .....
>
> *(2) The kinds of direction that the body corporate may be given are directions to do, or to cause a body corporate that is its subsidiary to do, any one or more of the following:*
>
> ....
>
> *(m) not to repay any money on deposit or advance;*
> *(n) not to pay or transfer any amount or asset to any person, or create an obligation (contingent or otherwise) to do so;*
>
> .....

This provision in its current terms was inserted into the *Banking Act* in 2003 by the *Financial Sector Legislation Amendment Act (No 1).* It is not known whether this power has been exercised by APRA. Relevantly Graeme Thompson in the address referred to above said: "*Particularly in the case of banks and other deposit-takers that are vulnerable to a loss of public confidence, APRA may prefer to work behind the scenes with the institution to resolve its difficulties. (Such action can include arranging a merger with a stronger party, otherwise securing an injection of capital or limiting its activities for a time.)*" It is a relatively smaller step to then convert or write-off what the ADI has been prohibited from paying out.

## APRA's directive powers absolute

It might be argued that APRA powers in existing Sections are not absolute and are subject to various qualifications and limitations arising out of the context or balance of the Section of the Act in which they appear. To avoid such an interpretation, the Bill proposes by Section 38 of the Bill to insert two new sub-sections to Section 11CA in the *Banking Act*:

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

APRA has already adopted the need for certain capital to be capable of conversion or write-off, the Explanatory Statement for Banking (Prudential Standard) Determination No. 1 of 2014 stating:

*The Basel Committee on Banking Supervision (BCBS) has developed a series of frameworks for measuring the capital adequacy of internationally active banks. Following the financial crisis of 2007-2009, the BCBS amended its capital framework so that banks hold more and higher quality capital (Basel III). For this purpose, the BCBS established in Basel III more detailed criteria for the forms of eligible capital, Common Equity Tier 1 (CET1), Additional Tier 1(AT1) and Tier 2 (T2), which banks would need to hold in order to meet required minimum capital holdings.*

*Basel III provides that AT1 and T2 capital instruments must be written-off or converted to ordinary shares if relevant loss absorption or non-viability provisions are triggered.*

*Banking (prudential standard) determination No. 4 of 2012 incorporated the Basel III developments into APS 111 with effect from 1 January 2013. ...*

Unless there was a prohibition in the Bill against the making of any determination to declare deposits to be capital capable of conversion or write-off, the worry would be that APRA could make such a determination.

## Possibility of alternative means of bail-in

An alternate means of effecting "bail-in" would occur if APRA, using its directive powers, caused an ADI to transfer assets to another entity leaving no assets or funds in the ADI from which to pay any deposits (or other liabilities). Unless there was a prohibition inserted in the Bill against the making of any determination to declare deposits to be capital or instruments capable of conversion or write-off or the exercise of any power to implement bail-in, the worry would be that APRA could make such a determination or exercise its already-existing powers.