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Dear Mr Lonsdale

Strengthening APRA's crisis management powers

The Australian Financial Markets Association (AFMA) welcomes the opportunity to comment on the Consultation Paper 'Strengthening APRA's crisis management powers' (Consultation Paper).

This response selectively deals with questions which are relevant to the scope of AFMA's industry representation activities. Accordingly our focus is on the implications for Authorised Deposit-taking Institutions (ADIs) and Non-Operating Holding Company (NOHC) groups encompassing them. AFMA broadly supports the objective of the Government on the need to review the existing legislative provisions relating to the crisis management powers for prudentially regulated financial institutions and welcomes the thoughtful quality of the Consultation Paper.

The broad scope of the Consultation Paper has proved a challenge for our members in analysing in depth the impact of the range of proposed measures on their businesses. This is particularly the case with regard to the impact of the options in terms of added costs in doing business in the financial sector. Financial sector regulation is undergoing profound reform at present on many fronts. The ability to gauge the impact of particular proposals in isolation from other changes is difficult and speculative. For example, the impact of capital adequacy reform and related capital risk requirements on the cost of providing financial services is only starting to be accurately measured as practical implementation occurs, because of the complex interactions and behavioural feedbacks that such changes bring.

As the Consultation Paper itself highlights, its proposals sit within the international context of global framework reform being overseen by the Financial Stability Board. AFMA considers this global context to be of particular importance to its members and

the need for domestic Australian reforms to work harmoniously with crisis resolution measures being reformed in other jurisdictions is a matter that we want to particularly emphasise.

AFMA suggests that the submissions being currently provided in response to the Consultation Paper should be received as initial views which should be subject to more in depth roundtable sessions which focus on particular aspects of the proposal package. Such dialogues have proven useful in relation to other recent significant financial sector reforms like those for OTC derivatives.

It is also important to take the recent Financial Stability Board's (FSB) Key Attributes of Effective Resolution Regimes (Key Attributes) in to close account before the proposals are finalised. While the momentum on this review needs to be kept up it does not need to be unduly rushed. The emphasis should be on anticipating problems so that the tools available to deal with a crisis work as well as they can when they are needed in an emergency.

Integration with International Framework

As an opening proposition, AFMA supports the enhancement of APRA's ability to deal with cross-border failure affecting the operation of ADIs operating under its jurisdiction. Our primary policy objective is to promote the integration of Australian crisis management responses to cross-border events within a globally consistent regime. The Key Attributes provide the framework for such a global regime, and they should encourage alignment of recovery and resolution practice and regulation across the G-20 jurisdictions

AFMA supports adoption of the Key Attributes in Australia. While the focus of the Key Attributes is on Global SIFIs, we agree with the proposition in the Consultation Paper that most of the Key Attributes have wider application to SIFIs and other financial institutions and should provide the benchmark for the Australian resolution framework for prudential supervised financial institutions.

Governing our response to the Consultation Paper are three guiding principles:

- Respect for the group structure when resolving a financial institution failure, and recognition of home resolution authority actions for Australian entities of international firms;
- Leaving creditors no worse off than under insolvency;
- Ensuring consistent treatment of transactional claims relating to derivatives and other financial instruments, including appropriate respect for netting and collateral rights, subject to safeguards to avoid destruction of value.

In this context the United Nations Commission on International Trade Law Model Law on Cross-Border Insolvency (Model Law), which has been given effect in Australia through the *Cross-Border Insolvency Act* 2008, may be an applicable model. The Model Law provides mechanisms to ensure that objectives such as cooperation between foreign courts, increased legal certainty for trade and investment and fair and efficient

administration of cross-border insolvencies are achieved in the conduct of cross-border insolvencies. An important aspect of the Model Law is the provisions enabling a foreign representative, such as an overseas liquidator, to apply to a court in a country such as Australia where the Model Law has been enacted, to obtain recognition by that court of a foreign insolvency law proceeding in which the foreign representative has been appointed or authorised to act. By obtaining recognition under the Model Law, a foreign representative can seek from the court a range of orders available under the Model Law to assist the representative in carrying out a cross-border reorganisation or liquidation of a corporation or individual debtor's assets.

The FSB's general guidance on recovery planning and stress testing, in particular the emphasis on an ADI itself being responsible for the design of recovery options, is sensible. Indeed, even with increasing degrees of interaction with APRA, up to the point that non-viability is declared, the firm's management should be making the decision about how to run their business in the interests of all of the ADI's stakeholders.

Effective resolution of groups

Proposal 1.1.1 Control over non-regulated entities in groups

Four options have been identified for dealing with these issues:

- Enable a Statutory Manager (SM) (in the case of ADIs) to be appointed to an authorised NOHC and the subsidiaries of an authorised NOHC and of a regulated entity.
- Amend the Corporations Act to provide that any liquidator or receiver appointed over a subsidiary or NOHC must cooperate with APRA.
- 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.
- A combination of the above options.

Question

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?

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?

Option A has a number of implications that are seen as problematic which are elaborated further on. Option B, that any liquidator or receiver appointed over a subsidiary or NOHC must cooperate with APRA, is a workable solution in our view and could be complemented with the directions power in Option C.

The possibility of appointing of a SM to a solvent NOHC is one which needs further consideration. While it is possible to contemplate a situation which might justify action while the financial institution is still technically solvent, if the decision is too precipitate it could have negative consequences for the NOHC and possibly its subsidiaries, including the ADI subsidiary. The Consultation Paper sets out situations where it is contemplated that a SM could be appointed by APRA to a solvent NOHC, including where the NOHC provides services to the ADI. The possibility that APRA could be empowered to appoint a SM to a NOHC before it is insolvent is one that could lessen financial stability in Australia rather than promote it.

Appointment of a SM prior to the insolvency of a NOHC could exacerbate a deteriorating situation and amplify its effects. In some cases, contagion can result from the mere perception that other institutions are in some respects similar to a troubled institution, even if there are limited or no direct linkages. It is recognised that for NOHCs intra-group exposures can pose contagion risk, which relates in this case to the potential for problems, and certainly insolvency, in one member of a group to lead to deterioration in the financial condition of other group entities. In times of trouble, the market may fail to draw a distinction between solvent subsidiaries and the impaired parts of a financial group. Even entities relatively insulated from the other activities of a group may have trouble financing themselves and continuing their operations under such conditions.

Accordingly, further discussion is required to place defined parameters around situations where action might be taken by APRA before the NOHC has crossed the threshold of insolvency.

In 1997, the Financial System Inquiry recommended that subject to a financial group meeting prudential requirements, the prudential regulator should permit the adoption of a NOHC structure. The FSI Review concluded that to protect against creditors of one entity seeking to pursue the other entities of a group, legal separation structured around a NOHC is the best method of quarantining the assets and liabilities of the various entities in the group. Such a structure also relieves other entities of a group of any formal obligation to support a distressed affiliate.

A NOHC structure can offer a financial group greater operational flexibility while, at the same time, provide for more efficient and effective means of meeting prudential requirements by allowing the appropriate allocation of risk between prudentially and non-prudentially regulated businesses of a group. This can be achieved by organising different types of activities into separate business lines. This type of structure can assist efforts aimed at quarantining risks in the various parts of a financial group by, for example, separating the risks of a group's investment activities from its insurance and banking operations. The NOHC structure enables group members to benefit from cost synergies associated, for example, with sharing back-office operations, accounting services, or technology infrastructure. The structure also enables the parent, and investors in debt or equity issued by the parent, to benefit from any revenue economies of scope or cross-sector diversification benefits.

In this context, prudential standards should play the primary role in creating sufficient separation to forestall contagion risk, by blocking any cross-subsidisation of risks, and

obviating the need for a more intrusive SM regime. APRA's framework for conglomerate groups addresses issues around non-regulated entities they contain. Among other requirements, APRA has proposed that groups containing material non-regulated entities would be subject to more stringent supervision, called Level 3 supervision. Level 3 supervision would enable APRA to require additional capital if it determines that the total capital in a group is not commensurate with the group's risk profile. It would also allow APRA to require that a sufficient portion of a group's surplus of eligible capital be readily transferable among group entities, through a transferability assessment.

Question

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?

AFMA supports measure to ensure that a solvent NOHC continues to provide services. The directions power is a sufficiently powerful regulatory tool as it is backed up by criminal sanctions for the NOHC, its directors and officers in the event of noncompliance.

Question

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

The appointment of an SM should be seen as a resolution tool rather than a recovery tool. However, we can see circumstances where the appointment of an SM would be appropriate in a recovery phase, for example, when a firm's management is not implementing the appropriate recovery actions, in which case a form of early intervention such as the appointment of an SM may be required.

In terms of the role of the special manager, we do not see it as their role to, if appointed, to enact a bail-in of the firm. The FSB's Key Attributes lays out its principles for executing a bail-in within resolution. We welcome the role of the bail-in tool for a resolution. However, APRA, as the resolution authority, should have the power to enact a bail-in for banks incorporated in Australia during a resolution. It is important to clarify that a bail-in is not a recovery tool, nor should it be enacted by an SM. It is a tool for resolution to be used by the resolution authority.

Proposal 1.2 Clawback

That where an authorised NOHC or member of a regulated entity's group has provided financial support to a regulated entity as part of the resolution process, and where the authorised NOHC or member has subsequently been placed into insolvency administration, the clawback provisions of the Corporations Act be temporarily prevented from having effect. After a prescribed event or time, this temporary mechanism would lapse and the clawback provisions could be reasserted.

Question

If this proposal were adopted, what safeguards and limitations should be imposed on APRA's power to temporarily limit clawback?

The ability to override provisions of the Corporations Act relating to the clawback of capital transfers is a significant one as it provides for preferential treatment. Such possible preference requires a greater degree of policy scrutiny before being contemplated as it affects other areas of major public policy such as employee entitlements.

As suggested elsewhere in this response containment of a SM's powers to deal only with those assets of a NOHC which relate to an ADI's activities would be an appropriate starting point if the proposal for limiting clawback were to be progressed.

Proposal 2.1.1 Protection from liability

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.

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?

The implications of the proposal to permit directions to be given to subsidiaries in a group which are not prudentially regulated financial institutions, raises practical questions about what capabilities and capacities are being expected of APRA. While APRA's expertise within its statutory field of responsibility is highly regarded this expertise should not be presumed or expected outside its areas of core competence.

While the need to override any civil or criminal liability and provide that compliance with a direction from APRA will not result in any civil or criminal liability for directors and will not place them in breach of any Act or common law duties when acting in

compliance with a direction from APRA is desirable, it also illustrates the dangers and conflicts that APRA would be creating in giving such directions.

This question is a good example of why more extensive dialogue is required with stakeholders to arrive at appropriate limits and guidance if APRA is to be granted extended powers.

Proposal 2.1.3 Suspending continuous disclosure requirements

Amend the industry Acts to enable APRA to direct a regulated entity (including an authorised NOHC and subsidiaries) not to make market or public disclosures of information in certain circumstances for a limited period (capped at 48 hours), where:

- APRA is of the view that a regulated entity, authorised NOHC or subsidiary is in, or is likely soon to be in, financial difficulty;
- APRA is working with the entity to implement a resolution to address its financial difficulty;
- APRA is of the view that the disclosure of the entity's financial condition ahead of the disclosure of the intended resolution would destabilise the entity and potentially impede the ability to implement the resolution; and
- APRA has consulted with ASIC and the Treasurer before giving the direction.

This proposal would require provision to be made to make clear that an entity directed not to disclose is relieved of its continuous disclosure requirements for the duration of the direction.

Questions

What are the likely implications of a specific APRA power to direct entities not to disclose materially sensitive information to the market for a limited period in certain crisis situations?

Would the existence of such a power adversely affect public confidence in regulated entities?

How might such powers affect market participants, including shareholders, creditors and other stakeholders?

What limitations should be placed on the power to direct entities not to disclose materially sensitive information to the market? What time limit should apply to the power?

AFMA supports the proposal which is consistent with the recommendations of the IMF assessment team -

> *Legislative changes should be made to forestall premature disclosure of sensitive crisis resolution information. The Australian securities law regime requires immediate and continuous disclosure to investors when a covered entity becomes aware of information which is not generally available and which a reasonable person would expect to have a material effect on the price or value of the shares, debentures or other interests in the entity.*[1]

The power would assist in maintaining public confidence and is consistent with the law reform

[1] IMF Technical Note release for Australia: Financial Safety Net and Crisis Management Framework—Technical Note from this week - at paragraph 27

recommendations made by the IMF that the law:

1. make clear that a direction by APRA to keep certain information confidential is binding and overrides any requirement to the contrary in the Corporations Act;
2. the failure of a director to disclose such information in accordance with the continuous disclosure regime will not result in liability for the director; and
3. require ASIC to consider systemic stability issues and consult APRA when evaluating contraventions of the disclosure requirements.

Proposal 3.1.1 Appointing a Statutory Manager to a branch

That the Banking Act be amended to empower APRA to appoint a statutory manager to the Australian business of a foreign ADI and its non ADI subsidiaries in Australia. The grounds for such a power could include:

- the foreign 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 in Australia;
- APRA considers that, in the absence of external support:
  - the foreign ADI may become unable to meet its obligations in Australia;
  - the foreign ADI may suspend payment in Australia;
  - it is likely that the foreign ADI will be unable to carry on banking business in Australia consistently with the interests of its creditors in Australia; or
  - it is likely that the foreign ADI will be unable to carry on banking business in Australia consistently with the stability of the financial system in Australia;
- the foreign ADI becomes unable to meet its obligations or suspends payment in Australia;
- the foreign ADI has failed to comply with a direction from APRA; or
- the foreign ADI has become financially distressed in its home jurisdiction or in other foreign jurisdictions and APRA considers it desirable to appoint a statutory manager to the Australian business of the foreign ADI and/or its subsidiaries in Australia in order to protect the interests of creditors in Australia or the stability of the Australian financial system.

Consistent with the option in item 1.1.1 to empower APRA to appoint an SM to subsidiaries of locally incorporated ADIs, it may also be desirable to empower APRA to appoint an SM to non ADI subsidiaries in Australia of a foreign ADI. If this were accepted, consideration will be given to empowering APRA to apply to the court to appoint a judicial manager to non general insurer subsidiaries of a foreign general insurer and non life company subsidiaries of an EFLIC. This would harmonise the position under the industry Acts, given that APRA is currently empowered to appoint a judicial manager to a foreign general insurer and an EFLIC but not their non insurer subsidiaries. Also, if the proposal in item 1.1.2 is proceeded with, consideration will be given to enabling APRA to appoint an SM to foreign branch insurers and their non insurer subsidiaries.

Question

Would the existence of these enhanced powers over foreign branches erode the business case for using a branch structure and potentially discourage participation in the Australian sector by foreign banks?

Could this proposal have unintended effects — such as encouraging foreign branch parent companies to more rapidly strip their Australian branches of assets?

One size does not fit all. In practice, when choosing a legal form of incorporation in foreign jurisdictions, banking groups take into account a range of characteristics of the jurisdiction such as tax and nature of business mix in the market that may outweigh the business model considerations.

While the subsidiary structure may work well for ADI's engaged in retail banking, the subsidiary structure may be less suitable for investment banks because it could constrain their ability to manage liquidity globally and to serve large corporate clients.

For the banking group as a whole, costs of doing business may be lower under the branch structure than under the subsidiary structure. Maintaining greater self sufficiency of affiliates in a subsidiary structure requires that each affiliate hold higher capital and liquidity buffers to limit the likelihood of failure. This results in higher levels of capital and funding for the banking group as a whole than under the branch structure. Greater separation between subsidiaries and the parent, while reducing the risk of contagion, also limit shifting of funds within the group to take advantage of borrowing in jurisdictions where capital may be more efficiently raised. Such separation might also mean that subsidiaries may face higher costs of external funding if they borrow in their own name as opposed to the parent bank's name, although external and internal credit ratings also play a role in the funding costs in wholesale markets.

Use of the branch structure instead of subsidiaries could provide an affiliate or parent with greater ability to withstand an idiosyncratic adverse shock for given levels of group capital and liquidity, so long as the shock is not so large as to threaten the viability of the group. This is because shocks in one part of the network may be offset by gains in another. A centralised organisation enables the banking group to mobilise and re-direct funds from healthy affiliates to an affiliate that finds itself in trouble due to country-specific shocks, or to draw on excess capital/liquidity of an affiliate at times of stress for the parent.

A key advantage of a branch model for a global universal bank is reduced counterparty and liquidity risks through internalisation of clearing and settlement of securities and cash payment obligations. These considerations may be relatively less critical for a retail bank that is more concerned with managing credit risk of retail loan books.

In summary, the Australian regime should recognise resolution actions of home authorities where branches of foreign banks are concerned, and not to initiate separate resolution proceedings unless that is consistent with the overall resolution strategy for the group.

One of the most important lessons from the last financial crisis was that regulatory bodies around the world should cooperate to ensure that they agree on plans to resolve firms, and do not act solely in their domestic interest, to the detriment of other countries and the global financial system. We would not support the local 'ring-fencing' of global banking groups as this would act against the ability of the lead resolution authority to resolve the banking entity in its entirety and in the interest of all of the creditors and the global financial system.

Question
Could this proposal have unintended effects — such as encouraging foreign branch parent companies to more rapidly strip their Australian branches of assets?

The decentralised funding and management framework of the subsidiary structure might prevent a parent bank from taking swift action due to certain restrictions on moving capital and liquidity from a subsidiary in one country to a parent or a subsidiary in a different country. While the separation of the subsidiary structure may serve to protect the interests of the individual subsidiaries, they also reduce the ability of weak individual subsidiaries to receive support from the parent compared with a branch with the same level of capital or liquidity.

Rather than imposing organisational constraints on international banks, it is preferable to make tangible and rapid progress in reaching global agreements on satisfactory and enforceable cross-border resolution regimes and co-operation arrangements (including burden sharing). Effective international coordination can provide financial stability benefits, without the potential costs of imposing subsidiary structures in situations where they are not suited to the business model.

Cross-border banking has expanded rapidly over the last decade. Many large banks now rely upon a global network of branches and subsidiaries, with centralised funding that is distributed within the financial group under a global strategic plan. The activities of these groups have expanded beyond traditional deposit-taking and lending to include a range of non-bank financial activities, such as securities broking and asset management. In addition to these 'universal' banks, the international space is now dominated by G-SIFIs that operate across borders, in multiple currencies and time zones. While international financial groups operate globally, the frameworks for addressing their distress and failure are local and apply to distinct parts of the group rather than to the group as a whole. By allowing financial institutions under their supervision to establish presences in a range of jurisdictions, home authorities expose themselves to the reality that the legal frameworks for facilitating cross border finance in stable periods are typically more effective than the cross-border resolution arrangements that are available in times of distress.

The Key Attributes address this challenge. They aim for a harmonisation of resolution regimes across markets. While the institution-specific co-operation agreements among regulators that are contemplated by the Key Attributes are helpful, effort needs to be made to align legislation with FSB principles. In this regard it is problematic that the concept of ring-fencing is implicit in existing law through section 11AF of the Banking Act and is now subject to possible extension through the proposals in the Consultation Paper.

The Key Attributes require that resolution authorities should have powers over local branches of foreign firms and the capacity to use their powers either to support a resolution carried out by a foreign home authority or, in exceptional cases, to take measures on their own initiative where the home jurisdiction is not taking action or acts in a manner that does not take sufficient account of the need to preserve the local jurisdiction's financial stability[2]. This is a clear mandate to work on the assumption of

[2] FSB Key Attribute 7.3 - *"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".*
FSB Key Attribute 7.4 - *"Jurisdictions should provide for transparent and expedited processes to give effect to foreign resolution measures, either by way of a mutual recognition process or by*

recognition provided the foreign jurisdiction complies on a reciprocal basis. The Consultation Paper position does not seem to align in our view with the Key Attributes, in proposing that which certain assets need to be preserved in Australia exclusively for the benefit of Australian liabilities, which is the very definition of ring-fencing.

A fortress Australia approach of not respecting an international notion of mutual recognition and instead applying a national ring-fencing approach is not workable long-term in a globalised world[3].

Proposal 3.1.2 Proposal Winding-up power

That APRA be given the power to apply for the winding up of the Australian business of a foreign ADI. This power could be based on grounds that include the following:

- APRA believes the ADI is unable to meet its liabilities in Australia as and when they become due and payable (or wording similar to section 14F of the Banking Act).
- APRA believes that the ADI is unable to meet its liabilities in one or more jurisdictions where it carries on business as and when they become due and payable.
- An application for winding up or similar external administration of the foreign ADI has been initiated in another jurisdiction where the foreign ADI carries on business.

Any winding up of the Australian business of a foreign ADI under this proposal would not extend to the business outside of Australia.

This proposal, together with the proposal that APRA have the power to appoint an SM to the Australian business of a foreign ADI, will promote consistency across the industry Acts and will ensure that any winding up of a foreign ADI does not compromise the interests of Australian non retail depositors, creditors or the Australian financial system. The power to apply for the winding up of a foreign ADI should not require that an SM first be appointed to the foreign ADI. This will afford flexibility in resolution depending upon the circumstances. There may be certain circumstances where it may be desirable to appoint an SM to a foreign ADI but there may be other circumstances where it should be possible to apply directly for the winding up of the ADI. For example, APRA may wish to apply directly for the winding up of a foreign ADI if that foreign ADI is clearly insolvent and the view taken is that no open resolution should be pursued in respect of that foreign ADI.

Question

Are the current grounds for APRA to apply for the winding up of a foreign ADI sufficient?

If, as proposed, the Banking Act is amended to empower APRA to appoint a statutory manager to the Australian business of a foreign ADI and its non-ADI subsidiaries in Australia, this will impact the enforceability of close-out netting and any related financial collateral arrangement entered into with a multi-branch ADI with a local branch in that country.

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taking measures under the domestic resolution regime that support and are consistent with the resolution measures taken by the foreign home resolution authority."
FSB Key Attribute 7.5 - *"Recognition or support of foreign measures should be provisional on the equitable treatment of creditors in the foreign resolution proceeding".*

[3] See for instance the UK FSA's recent consultation paper "Addressing the implications of non-EEA national depositor preference regimes" of September 2012 that specifically identifies Australia for running a regime that violates the fundamental creditor right of equal treatment (section 2.3 of the FSA Consultation Paper).

The home country resolution authority should have primary responsibility for the resolution of the parent and any branch of the parent located in the home country. While host resolution authorities would normally have resolution powers over local subsidiaries, it may be possible to reach agreement with home authorities on a 'single point of entry' resolution, affected by the home authorities. Either way, each host country resolution authority (and other relevant host country authorities such as the host country central bank, financial regulator or finance ministry) should cooperate and coordinate with the home country resolution authority effectively, to ensure that all creditors of a particular class are, as far as possible, given equitable treatment.

Question

What are the practical difficulties in winding up the Australia business of a foreign ADI?

The subjectivity of the triggers proposed in respect of the proposal to allow APRA to appoint a SM to foreign ADIs is of concern, especially as there is an element of proportionality in the trigger. In the early stages of any financial distress scenario, APRA should coordinate with home country supervisors and resolution authorities, including on resolution planning, before implementing extra powers to appoint a SM or make a direction.

If the home country regulator has put forward a feasible plan for the resolution of the branch, the home country plan should take precedence. APRA's proposed extra powers should only be implemented if the home country regulator is not being cooperative. The power to appoint a SM to a locally incorporated subsidiary should only be permitted in times of financial distress and it is important that APRA be the prime regulator once a SM has been appointed, while still co-operating with home authorities and keeping them informed about the situation .

Indeed, the Government notes that the appointment of a SM will facilitate a coordinated resolution with home regulators, but the practicalities of this, including how potentially conflicting positions between regulators would be resolved needs to be dealt with before the law is reformed.

In summary, a clear strategy should be agreed between APRA and home regulators to ensure a cooperative resolution. This is critical and the preferred option rather than APRA utilizing powers to wind down an entity or to ring fence assets. Taking the latter approach devalues the transaction and is not consistent with global solution objectives.

The Government should also clarify APRA's power to allow a branch to be transferred to a home country bridge bank, not just a bridge institution incorporated in Australia or an Australian regulated ADI.

There should be greater clarity and direction given in respect of implementing and quantifying shareholder compensation in the event APRA interferes with normal shareholder rights.

Proposal 3.1.3

That the industry Acts be amended to enable APRA to revoke the authorisation of a foreign ADI or insurer operating in Australia via a branch where the foreign regulated entity's authorisation has been revoked in its home jurisdiction.

This proposed amendment is consistent with corresponding provisions in the legislation of other jurisdictions and with the recommendations of international standard setting bodies such as the BCBS.

AFMA supports this proposal.

Proposal 3.1.4

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.

Question

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?

In relation to a subsidiary, which is not being supported by the parent this proposal makes sense.

Our concern about applying an Australia specific solution to foreign bank's branch is reiterated. It is much more likely that a branch would be kept going as long as the parent remained solvent having distinct resolution powers over a branch, including ring-fencing or compulsory transfer powers, could act as a disincentive to foreign banks in opening a branch.

In terms of practical difficulties of transferring a branch, it may be hard to separate branch assets and liabilities without causing disruption to the parent. For example, the parent may be reliant on the branch for local currency funding or payments, or may have excess liquidity there which could become trapped.

4.1.5 Proposal - Enforceability of netting and collateral arrangements

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.

Legal certainty around the enforceability of the netting and collateral arrangements in connection with OTC derivatives is critical to the stability of the market. A substantial question for the predictability and effectiveness of cross-border resolution is uncertainty as to whether the exercise of resolution powers will be recognised under the law of other relevant jurisdictions. Therefore, internationally consistent and predictable treatment of such contracts is essential.

As is common under contract terms governing financial instruments such as derivatives, the insolvency or resolution of one party generally gives rise to an event of default or other termination event, entitling the non-defaulting counterparty to terminate the agreement, liquidate, accelerate, and net obligations owing between the parties and foreclose on and set off against any collateral (commonly referred to as rights to 'close-out'). Under the normal operation of Australian insolvency law, the exercise of close-out rights are immediately stayed upon entry into insolvency proceedings. Such close-out rights are particularly important in preventing the failure of one financial institution from causing the failure of other financial institutions, and so that firms can avoid uncertainty in the size of their risk positions, which are especially important in a volatile market. For this reason, the *Payment Systems and Netting Act,* in common with many other jurisdictions, protects the exercise of such close-out rights in relation to financial instruments in the interest of promoting systemic stability.

Although the Consultation Paper states that this proposal is not intended to have an impact on netting arrangements under the *Payment Systems and Netting Act*, it will have such an impact because some of these netting arrangements are supported by collateral arrangements which do not themselves utilise netting (eg security based collateral arrangements).

These security collateral arrangements are quite often used in dealings with counterparties which are based in the United States and, in some cases, are actually required under foreign laws. Accordingly, a prohibition on enforcing security against an Australian ADI because of resolution actions taken will have an impact on the ability of

overseas counterparties to deal with those entities – and potentially the capital they will need to hold for those dealings.

Collateral arrangements in relation to close-out netting contracts should be treated in the same way in a resolution process as close-out netting contracts themselves, and be exempted from the moratorium provisions. Resolution in and of itself should not constitute a default and should not confer close-out rights. This is to be distinguished from subsequent non-payment, where rights of termination should stand.

We therefore see a need to ensure that resolution is protected, perhaps through suspensions of events of default other than those associated with insolvency and failure to pay. This will need to be balanced with the need to ensure the efficacy of netting, collateral and other risk management tools that have an impact on a firm's capital position. In this regard, we note Key Attribute 4.2 on trading documentation, which states:

> *Subject to adequate safeguards, entry into resolution and the exercise of any resolution powers should not trigger statutory or contractual set-off rights, or constitute an event that entitles any counterparty of the firm in resolution to exercise contractual acceleration or early termination rights provided the substantive obligations under the contract continue to be performed.*

Industry stakeholders are looking at how to accommodate resolution actions and assessing trading agreements in case counterparty rights could be a barrier to resolution.

While reference is made to harmonisation of moratorium provisions across APRA legislation in Part 4.1 of the Consultation Paper one outstanding harmonisation issue, which we have previously commented upon in relation Financial Sector Legislation Amendment (Close-out Netting Contracts) Bill 2011 is the conflict issue between the Payment Systems and Netting Act, the Banking Act, the Life Insurance Act and the Insurance Act. The issue relates to a 48 hour stay on closing-out if the close-out right is based on the appointment of a statutory manager or judicial manager.

Where an ADI is under statutory management, the exercise of financial contract close-out rights would be stayed for 2 business day following the initiation of resolution procedures in order to facilitate the possible transfer to a bridge institution or a solvent third party, or to avoid close-out in cases where the credit of the original counterparty is restored through debt conversion or write down techniques ('bail-in').

The FSB does consider[4] whether permanent or temporary stay techniques should be used. There is a global consensus among legal and financial market experts that a temporary stay to facilitate the transfer of financial contracts is the preferred approach.
A temporary stay would give APRA sufficient flexibility to tailor their exercise of resolution powers to the circumstances of a particular resolution and protects markets from disruption without exposing counterparties to excessive risks or unnecessarily disrupting contractually negotiated arrangements. Any discretion for a SM to extend

[4] Key Attributes Annex IV

such a stay beyond two days would expose counterparties to significant losses that are difficult to anticipate, and therefore to hedge against, which can in turn pose spill-over systemic risks to markets.

AFMA looks forward to continuing dialogue with the Treasury on the issues raised in the Consultation Paper. Please contact me at dlove@afma.com.au or on (02) 9776 7995 if further clarification or elaboration is desired.

Yours sincerely

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