



Australian Government  
The Treasury

# Strengthening APRA's Crisis Management Powers

Consultation Paper

September 2012



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ISBN 978-0-642-74848-5

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## CONSULTATION PROCESS

### REQUEST FOR FEEDBACK AND COMMENTS

This paper seeks submissions on a range of possible options for enhancing and streamlining financial services legislation, in relation to the prudential supervision of authorised deposit-taking institutions, insurers and superannuation funds regulated by the Australian Prudential Regulation Authority.

While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please submit responses sent via email in a Word or RTF format. An additional PDF version may also be submitted.

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### Closing date for submissions

Submissions should be lodged by Friday, 14 December 2012.

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## ABBREVIATIONS AND ACRONYMS

<b>2010 Act</b>	<i>Financial Sector Legislation Amendment (Prudential Refinements and Other Measures) Act 2010</i>
<b>ADI</b>	Authorised deposit-taking institution
<b>APRA</b>	(the) Australian Prudential Regulation Authority
<b>APRA Act</b>	<i>Australian Prudential Regulation Authority Act 1998</i>
<b>ASIC</b>	(the) Australian Securities and Investment Commission
<b>ASIC Act</b>	<i>Australian Securities and Investments Commission Act 2001</i>
<b>ASX</b>	Australian Securities Exchange
<b>Banking Act</b>	<i>Banking Act 1959</i>
<b>BCBS</b>	Basel Committee on Banking Supervision
<b>BCBS Core Principles</b>	Basel Committee on Banking Supervision <i>Core Principles for Effective Banking Supervision</i>
<b>Business Transfer Act</b>	<i>Financial Sector (Business Transfer and Group Restructure) Act 1999</i>
<b>Corporations Act</b>	<i>Corporations Act 2001</i>
<b>Council</b>	Council of Financial Regulators
<b>CBRG</b>	Cross-border Bank Resolution Group, established by the Basel Committee on Banking Supervision
<b>Cross-Border Insolvency Act</b>	<i>Cross-Border Insolvency Act 2008</i>
<b>DOCA</b>	Deed of company arrangement
<b>DMFs</b>	Discretionary mutual funds
<b>DOFI</b>	Direct offshore foreign insurer
<b>EFLIC</b>	Eligible foreign life insurance company
<b>FCS</b>	Financial Claims Scheme
<b>FMI</b>	Financial market infrastructure
<b>Foreign ADIs</b>	Foreign bank branches

## ABBREVIATIONS AND ACRONYMS (CONTINUED)

<b>FSB</b>	Financial Stability Board
<b>FSCODA</b>	<i>Financial Sector (Collection of Data) Act 2001</i>
<b>FSSA</b>	<i>Financial Sector (Shareholdings) Act 1998</i>
<b>GDP</b>	Gross domestic product
<b>GIRA</b>	<i>General Insurance Reform Act 2001</i>
<b>IAIS</b>	International Association of Insurance Supervisors
<b>IAIS Core Principles</b>	International Association of Insurance Supervisors <i>Insurance Core Principles</i>
<b>IT</b>	Information technology
<b>Industry Acts</b>	Refers collectively to the <i>Banking Act 1959</i> , <i>Insurance Act 1973</i> and <i>Life Insurance Act 1995</i> but does not include the <i>Superannuation Industry (Supervision) Act 1993</i>
<b>Insurance Act</b>	<i>Insurance Act 1973</i>
<b>JM</b>	Judicial manager
<b>Key Attributes</b>	The Financial Stability Board's <i>Key Attributes of Effective Resolution Regimes for Financial Institutions</i>
<b>LAGIC</b>	Life and general insurance capital (standards)
<b>Life Insurance Act</b>	<i>Life Insurance Act 1995</i>
<b>MABRA</b>	<i>Mutual Assistance in Business Regulation Act 1998</i>
<b>MAS</b>	Monetary Authority of Singapore
<b>Model Law</b>	United Nations Committee on International Trade Law Model Law on Cross-Border Insolvency.
<b>NOHC</b>	Non-operating holding company. This is a holding company that does not carry on a business, other than a business consisting of the ownership or control of other bodies corporate. In this paper, NOHC will generally refer to a holding company with an ADI and/or insurer as a subsidiary.
<b>RBA</b>	Reserve Bank of Australia

## ABBREVIATIONS AND ACRONYMS (CONTINUED)

<b>Regulated entities</b>	Refers to ADIs, general insurers and life insurers regulated by APRA. In some cases, it will also refer to superannuation entities.
<b>RSE</b>	Registrable superannuation entity
<b>SIFIs</b>	Systemically important financial institutions
<b>SIS Act</b>	<i>Superannuation Industry (Supervision) Act 1993</i>
<b>SM</b>	Statutory manager
<b>SMSF</b>	Self-managed superannuation fund
<b>UK</b>	United Kingdom
<b>US</b>	United States of America

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## INTRODUCTION

Australia's relatively strong economic performance during the global financial crisis can be attributed, to a substantial degree, to both the policy and institutional frameworks put in place prior to the crisis and the actions taken during the event. These frameworks include a sound prudential regulatory regime overseen by the Australian Prudential Regulation Authority (APRA).

In order to keep our financial sector strong and resilient in the face of any further external shocks, it is necessary to maintain constant vigilance. For that reason, the Government is continuously engaging with financial regulators, particularly APRA and the Australian Securities and Investments Commission (ASIC), to identify ways to strengthen further the regulatory framework that protects depositors, policyholders and other consumers of financial services. This process has also had close regard to international developments in financial regulation, particularly the initiatives under way by the G20 and the Financial Stability Board (FSB) to promote resilient financial systems and frameworks to resolve financial distress.

The result to date has been a series of reform Acts in 2008, 2009 and 2010, which have implemented measures designed to enhance prudential regulation and have protected consumers through important measures such as the introduction of the Financial Claims Scheme (FCS).

This discussion paper forms part of this ongoing review process to ensure our financial regulation remains ready to meet the needs of Australians.

The financial services industries are of key importance to any country, given the essential functions they perform. The authorised deposit-taking institution (ADI) industry, including banks, building societies and credit unions, provides a range of core functions essential to the day-to-day operation of the Australian economy and the ability of individuals and businesses to manage their economic affairs. These core functions include financial intermediation, maturity transformation, payment system functions, and credit creation. ADIs provide customers with the means by which they can manage their interest rate and currency risks. The ADI sector also provides the household, business and not-for-profit sectors with a safe and liquid means of holding their wealth; ADI deposits represent the dominant form of low-risk, liquid asset for all sectors of the economy. A sound and efficient banking system is essential to a strong economy.

Similarly, the insurance sector — general and life insurance — provides vital services needed for the management of risk and the functioning of the economy. Insurance provides the means by which all sectors of the economy can protect themselves against a wide range of risks to their property, their businesses and their lives. Without insurance, many businesses would be heavily constrained in the nature of the services and products they could provide. Similarly, households would be unable to acquire and hold assets and undertake their day-to-day activities in an efficient manner without the protection that insurance provides. Insurance also provides a core source of investment funds to the economy through the accumulation and investing of insurance premiums.

Complementing the ADI and insurance sectors, Australia's superannuation system contributes significantly to economic growth and development. The primary reason for the existence of Australia's superannuation system is to provide income for Australians in their retirement. The Government supports Australians in their retirement through a regulatory framework that includes

compulsory superannuation contributions for most employees, taxation concessions for compulsory and voluntary contributions, robust prudential regulation and consumer protection through comprehensive disclosure requirements. This framework applies across a diverse industry utilising a range of commercial structures that cater to the needs of superannuation savers in different ways. Trustees perform an important role in Australia's superannuation system, as they control the superannuation fund's assets and operate the fund solely for the benefit of its members and beneficiaries. The trustee has a fiduciary obligation to the members and beneficiaries, which involves taking ultimate responsibility for the entity, and an obligation to manage the assets of the entity with competence, diligence, prudence and honesty.

As a result of Australia's system of compulsory superannuation contributions, superannuation has grown over the past quarter century to be an increasingly significant component of Australia's financial sector. Superannuation assets currently stand at around 100 per cent of gross domestic product (GDP), up from around 30 per cent of GDP in the late 1980s. With further planned increases in the contribution rate, superannuation assets are projected to exceed 160 per cent of GDP by 2050. Superannuation is also a significant component of household wealth, with equity in superannuation funds and life offices accounting for 21 per cent of total household assets and 60 per cent of household financial assets. The industry is currently undergoing a period of significant change following the Government's response to the Super System Review. The Government's Stronger Super reform package includes the introduction of a new low cost and simple default superannuation product called 'MySuper', heightened duties for superannuation trustees, and support for the Super System Review's SuperStream proposals. It provides APRA with new powers and an expanded role within the superannuation industry. These reforms include providing APRA with the ability to make prudential standards, to have a greater role in data collection and publication and to authorise trustees to offer MySuper products.

As at December 2011, APRA supervised institutions holding some \$5.1 trillion in assets for 23 million Australian depositors, policyholders and superannuation fund members. At the same date, the ADI sector had total assets of around \$3.5 trillion, representing approximately twice the Australian GDP.

Given the importance of ADIs, insurers and superannuation funds to the economy and society, it is important that our regulators continue to have appropriate powers to minimise the probability of financial institution distress. In the event that a financial institution does become distressed, it is essential that regulators also continue to have the powers needed to facilitate the orderly resolution of the institution in such a way as to protect the interests of depositors, policyholders and superannuation beneficiaries and to protect the stability of the financial system.

APRA is Australia's prudential supervision authority and the primary agency responsible for the resolution of distressed ADIs and insurers. It is responsible for ensuring that Australia's ADI and insurance sectors remain in a sound financial condition and that any episode of financial distress is resolved quickly and effectively, with a minimum adverse impact on the financial system and economy, and at a minimum cost to the taxpayer.

## REVIEW PROCESS

Taking into account domestic and international developments in financial sector issues, the Government, with the assistance of APRA and other regulators, is reviewing the existing legislative provisions relating to the regulation of ADIs, insurance and superannuation. This paper forms part of this review and seeks submissions on a range of possible options for enhancing and streamlining

financial services legislation, primarily in relation to the prudential supervision of ADIs, insurers and APRA-regulated superannuation funds. In some instances, questions are provided which are intended to assist stakeholders in preparing submissions.

Submissions need not be limited to the questions in the paper. They can raise other issues related to each of the options or the legal framework for the regulation of the financial services sector more generally. The Government is particularly interested in comments on the impact of the options in terms of any potential added costs of doing business in the financial sector.

While the approaches taken in other jurisdictions have been examined in developing many options in this paper, submissions could also bring particular approaches taken in other jurisdictions to the Government's attention.

As part of the review, the Government will consult with stakeholders, including financial sector enterprises, representative associations, and State and Territory governments. The consultation process will provide an opportunity to discuss the issues canvassed in this paper in more detail.

The Treasury, in consultation with financial regulators, will consider the feedback from consultation before providing advice to Government as to any reforms that may be warranted.

## PART A — CRISIS RESOLUTION

### BACKGROUND

#### Multilateral initiatives

Since the global financial crisis, there has been a substantial increase in international initiatives on financial crisis management. In 2009, the G20 reconstituted the Financial Stability Board (FSB) with a mandate to promote financial stability. The FSB and the Basel Committee on Banking Supervision's Cross-border Bank Resolution Group (CBRG) have been the main international forums involved in this work. Their primary focus has been to promote:

- guidance on the legal powers needed to respond effectively to financial institution distress;
- policies and processes to respond to financial institution distress in ways that minimise or avoid taxpayer assistance; and
- frameworks for managing cross-border financial institution distress.

#### Financial Stability Board

In October 2011, the FSB issued its *Key Attributes of Effective Resolution Regimes for Financial Institutions* (Key Attributes). The Key Attributes set out relatively comprehensive principles on the resolution of Systemically Important Financial Institutions (SIFIs) and other financial institutions. The G20 has endorsed the Key Attributes as an international standard on financial crisis resolution and they will be incorporated into the Financial Sector Assessment Program (FSAP) administered by the International Monetary Fund (IMF) and the World Bank. As such, in future FSAP assessments, countries' resolution frameworks will be evaluated by reference to the Key Attributes, among other matters. The International Monetary Fund and World Bank, in association with the FSB, are currently developing assessment criteria and methodologies to facilitate assessments against the Key Attributes.

Although some parts of the Key Attributes apply only to global SIFIs (of which there are none in Australia), most of the Key Attributes have been drafted for wider application to domestic SIFIs and other financial institutions, including insurers. Accordingly, the Key Attributes provide an international benchmark relevant to much of the Australian framework for resolving prudentially supervised financial institutions.

The FSB has urged member countries to undertake necessary legal reforms to equip the national authorities with the capacity to respond effectively and quickly to financial institution distress. It has stressed the need for clear and comprehensive legal powers to enable financial distress to be managed in a manner consistent with minimising financial system instability, avoiding or minimising taxpayer risk and facilitating effective cross-border crisis resolution.

In the Key Attributes, the FSB stated that an effective resolution regime should:

- ensure continuity of systemically important financial services and payment, clearing and settlement functions;

- protect, where applicable and in coordination with the relevant insurance schemes and arrangements such as depositors, insurance policyholders and investors as are covered by such schemes and arrangements, and ensure the rapid return of segregated client assets;
- allocate losses to firm owners (shareholders) and unsecured and uninsured creditors in a manner that respects the hierarchy of claims;
- not rely on public solvency support and not create an expectation that such support will be available;
- 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;
- provide for speed and transparency and as much predictability as possible through legal and procedural clarity and advanced planning for orderly resolution;
- provide a mandate in law for cooperation, information exchange and coordination domestically and with relevant foreign resolution authorities before and during a resolution;
- ensure that non-viable firms can exit the market in an orderly way; and
- be credible and thereby enhance market discipline and provide incentives for market-based solutions.<sup>1</sup>

In this context, the FSB's Key Attributes set out the types of resolution powers that jurisdictions should have available for dealing with financial institution distress. These include the need for robust statutory powers to:

- issue binding directions to ADIs, general insurers and life insurers supervised by APRA (regulated entities), including the removal and replacement of directors and management;
- appoint an administrator to assume control of a regulated entity;
- implement resolution of distress in respect of financial groups, including holding companies and subsidiaries;
- implement resolution of distress in a branch of a foreign bank or insurer;
- transfer some or all of the business of an entity or group to another entity as part of a resolution process;
- override shareholder rights where required;
- establish a bridge institution;
- suspend or cancel financial obligations; and
- facilitate bail-in.

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<sup>1</sup> Available at: [www.financialstabilityboard.org/publications/r\\_111104cc.pdf](http://www.financialstabilityboard.org/publications/r_111104cc.pdf).



## Basel Committee's Cross-border Bank Resolution Group (CBRG)

The Basel Committee's CBRG released a report in March 2010 setting out guidance on bank crisis resolution. It contains a number of recommendations to improve domestic and cross-border crisis resolutions. These include:

- the introduction of effective national resolution tools and frameworks for the coordinated resolution of financial groups;
- mechanisms to facilitate cross-border resolution;
- firm-specific contingency planning;
- a reduction of complexity and interconnectedness within group structures;
- cross-border information-sharing and effective risk mitigation techniques, such as netting; and
- policy frameworks for addressing domestic and cross-border crisis resolution.

In July 2011, the CBRG released a report summarising member country progress in implementing reforms to their crisis resolution arrangements. It revealed that member countries had made considerable progress since the global financial crisis in strengthening crisis resolution capacity, but that much remains to be done. In particular, the CBRG report noted the need for further progress in:

- strengthening the powers needed for crisis resolution, particularly the powers required for resolving distress in complex groups, including holding companies and subsidiaries;
- implementation of recovery and resolution plans for SIFIs and potentially other (less systemically important) financial institutions; and
- implementation of arrangements required to facilitate cross-border crisis resolution.

In many respects, Australia's financial crisis resolution capacity compares well to those of other Organisation for Economic Co-operation and Development (OECD) countries and against the principles enunciated by the FSB and CBRG. Australia generally has comprehensive and robust financial crisis resolution powers, both in respect of ADIs and insurance. Recent reforms in 2008 and 2010 have enhanced these arrangements. Australia also has many of the desired arrangements in place in respect of crisis resolution inter-agency coordination, cross-border coordination and crisis resolution testing.

However, the response to the CBRG survey, and assessment of Australia by reference to FSB and CBRG principles, reveals that some enhancements may need to be made to Australia's current crisis resolution framework. This part of the paper sets out proposals to address these matters, among others.

## International experience

A number of countries or jurisdictions have reviewed their resolution frameworks, having regard to the international developments in this area.

- The United States (US) has introduced the Dodd-Frank Wall Street Reform and Consumer Protection Act.

- The European Commission has released a proposed European Union (EU) Directive on resolution, which seeks to strengthen the crisis resolution framework across the EU, modelled closely on the FSB's Key Attributes.
- The United Kingdom established a Special Resolution Regime legislative framework following the financial collapses in 2007/08, it established an independent commission on banking and has considered a range of regulatory reforms proposed by that commission.
- Canada made a number of significant amendments to its regulatory framework during the global financial crisis and is currently conducting a periodic review of its financial regulatory framework.

Keeping pace with international developments will ensure that Australia's prudential regulatory system remains up-to-date and at the forefront of regulatory best practice.

# 1. EFFECTIVE RESOLUTION OF GROUPS

Australia's strong prudential regulatory framework has been a significant factor in enabling our financial sector to remain resilient during the global financial crisis. However, in order to make our system even stronger, there are lessons we can learn from the experience of foreign jurisdictions. For example, the experience of some jurisdictions has suggested regulators may need to have wide-ranging powers to resolve a failing financial institution expeditiously. The crisis also demonstrated that it is particularly difficult to resolve a failing entity effectively where it is part of a group of companies. Group structures can be very complex, involving numerous administrative and business lines linked through intricate ownership and contractual arrangements. It may not be clear exactly how all the members of the group are linked and where the risks and control in the group ultimately lie. Understanding the position of the failing entity, disentangling its affairs from those of the rest of the group and ensuring its affairs can be effectively resolved quickly and convincingly provides considerable challenges. In the absence of effective resolution powers and resolution pre-positioning, it is particularly difficult to resolve the distress of a group quickly and effectively and with minimum cost to the taxpayer.

Both the FSB and the CBRG have identified areas in which they believe the powers of regulators to act in relation to the resolution of financial groups should be enhanced. Australia has been fortunate in that it has been very rare for regulated entities to fail in this jurisdiction. While such failures should continue to be rare in Australia, it is important to instil community confidence in the knowledge that, if a crisis or failure in a regulated financial institution were to arise, the Australian Government and regulators have the powers needed to deal with the situation efficiently, swiftly and effectively.

This section of the paper sets out proposals to enhance the capacity to resolve distress in a group of companies that includes an APRA-regulated entity.

## 1.1 BROADENING THE SCOPE FOR THE RESOLUTION OF GROUPS

Regulated entities are often part of large and complex corporate groups. Some of these groups are headed by non-operating holding companies (NOHCs), which may also control more than one regulated entity. ADIs and insurers also frequently have large numbers of their own subsidiaries. ADIs and insurers may depend on the services of NOHCs and other entities within their corporate group to conduct their businesses. For example, other entities in the group may provide corporate services, including staff, information technology (IT) services, treasury services and funding to an ADI or insurer. It is for this reason that APRA supervises ADIs and insurers on a consolidated group basis, as well as supervising the regulated entity on a solo basis.

Financial sector reforms from 1998 to 2009 permitted the use of NOHC structures, allowing groups greater commercial freedom in selecting their appropriate business structure. These reforms were intended to lower business costs and reduce barriers to entry into the industry. These reforms gave APRA the power to authorise NOHCs. There are currently 25 authorised<sup>2</sup> NOHCs across the banking and insurance sectors (as at March 2012).

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2 For the purposes of this discussion paper, authorisation of a business should be taken to include registration of a business under the Life Insurance Act.

Even where there is no authorised NOHC, there are situations where regulated entities are part of a complex group structure — for example, where an ADI is the head of a group comprising many companies. In these cases, non-regulated entities in the group may perform functions that are essential to the operation of the ADI, such as IT functions, custodial services, lending vehicles, specialist financial services or human resource functions. Equally, groups can be structured so that non-regulated entities in the group hold important assets or liabilities.

## APRA's existing powers

In order to ensure that the use of NOHCs does not compromise the safety or stability of the regulated entity, APRA may require a body corporate to hold a 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 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.

Broadly similar requirements exist for APRA to apply to the Court to appoint a JM to an insurer.

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.

To date, no SM has been appointed to an ADI, reflecting the long period of financial stability that Australia has enjoyed. In the case of insurers, the Court has only appointed a JM on APRA's application on two recent occasions. Both instances involved small general insurers that had been in run-off for many years (that is they were unable to write any new insurance business).

## What is the issue with groups in a crisis situation?

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.

It could be argued that a regulated entity is equally vulnerable where it obtains essential services from a third party which is not part of the group. However, unlike in the case of contractual arrangements with independent third parties, in the case of business arrangements with other members of the *same* group there is a high risk that the distress of one part of the group will quickly affect other parts through various intra-group contagion channels. This is particularly so in the case of a NOHC, where a substantial proportion of its assets comprise its investment in the regulated entity. In this situation, a collapse in the value of the shares in the regulated entity could cause the NOHC to be in breach of its funding covenants or even itself become insolvent. There may also be cross-defaults and intra-group funding stresses that cause multiple entity failures across the group, triggered by the distress of the ADI or insurer. It is therefore likely that the distress of a regulated entity will be accompanied by the simultaneous distress of members of its group, potentially including an authorised NOHC and its subsidiaries. Therefore, essential services provided by related parties are more likely to be withdrawn in association with the distress of a regulated entity than in the case where the services or business assets/liabilities are provided by an unrelated third party.

A further concern is the impact that insolvency law may have on group resolution. If a NOHC or a subsidiary of a NOHC or regulated entity becomes distressed at the same time as the regulated entity, there is a high risk of that NOHC or subsidiary being placed into receivership (where it has secured funding) or liquidation. In either case, the control of the NOHC or subsidiary would pass from the board to the receiver or liquidator. In these circumstances, there is no assurance that the receiver or liquidator will necessarily act in the interests of the ADI or insurer. Indeed, their duties would cause them to put the interests of the creditors of the NOHC or subsidiary ahead of other parties, in accordance with the terms of the debenture/mortgage (in the case of receivership) or in accordance with insolvency law under the *Corporations Act 2001* (Corporations Act). In this situation, there is no assurance that the NOHC or subsidiary would continue to provide essential services to the ADI or insurer. Moreover, in such circumstances, APRA would have limited capacity to exercise control over an authorised NOHC and its direction powers would be of little practical force. It would have no capacity to exercise control over the subsidiaries of the ADI or insurer. As a result, it is unlikely that APRA could achieve an effective group resolution.

### 1.1.1 Control over non-regulated entities in a group

An SM or JM appointed to a regulated entity can exercise control over the subsidiaries of the regulated entity as a shareholder or indirectly through their boards. However, it has no control over the regulated entity's NOHC or over other entities in the group that are not its subsidiaries. Therefore, in the case of a NOHC and subsidiaries of the NOHC, there may be a case for providing APRA with the means of ensuring adequate control in circumstances where necessary to implement a resolution of the ADI or insurer.

In the case of subsidiaries of an ADI or insurer, an SM or JM of an ADI or insurer can exercise some measure of control via shareholding and control of the board. However, if the boards of the subsidiaries were not cooperative in complying with a direction or request from an SM or JM, this could significantly impede the implementation of an effective resolution of the financial group's affairs. The board or management of a subsidiary might not cooperate with an SM or JM for several reasons. These include the possibility of a perception on their part that the directions from an SM or JM are not in accord with the interests of the subsidiary or where they foresee legal risks to themselves in carrying out directions from the SM or JM. Even if the board and management of a subsidiary are not being obstructive, they might not necessarily act promptly in complying with a request or direction from an SM or JM because of concerns over their potential legal risks.

These risks may suggest the need for a more direct form of control over an authorised NOHC and its subsidiaries, and over the subsidiaries of an ADI or insurer in a crisis.

APRA currently has power to give directions to authorised NOHCs. Moreover, APRA can indirectly influence the activities of other entities in the group by giving directions to the authorised NOHC or the regulated entity to give instructions to their respective subsidiaries. However, there are two main limitations on the effectiveness of such methods.

The first limitation is that there is a risk of delay in the directions being acted on by the subsidiary, particularly if the board of the subsidiary in question is uncooperative or slow to comply with instructions. Time may be of the essence in resolving a failing regulated entity, particularly an ADI. It is therefore crucial to avoid delays that could compromise a successful open resolution of a regulated entity.

The second limitation is that the existing methods may be ineffective where the NOHC or subsidiary is, or is about to be, placed in liquidation or receivership. While a regulated entity can enter into contracts with its service providers for continued supply of essential services, those contracts may terminate once a receiver or liquidator is appointed to the service provider.

A liquidator or receiver has duties to the creditors of the entity in liquidation, which may conflict with the interests of depositors or policyholders of the regulated entity. Where a NOHC is in liquidation or receivership, the liquidator's or receiver's other specific obligations might override any obligation to ensure that the NOHC complies with an APRA direction. Where a related entity is in liquidation or receivership, the NOHC as shareholder could not override the authority of the receiver or liquidator and so APRA's direction to the NOHC would not be sufficient to ensure compliance by that related company.<sup>3</sup>

Moreover, in a liquidation or receivership, it is possible that legal actions could be brought by interested parties (for example, shareholders or creditors of the NOHC or subsidiary seeking injunctions), which could impede the ability to action APRA's directions promptly, even if a liquidator or receiver were willing to do so. Third parties could also attempt to accelerate debt repayments, deny obligations or close out transactions under contract with the entity in receivership or liquidation, which could have a material impact on the regulated entity. This is a particularly significant risk if the group undertakes risk-hedging activities via a NOHC or subsidiary, such that receivership or liquidation has the potential to immediately provide the grounds for close-out and netting, with flow-on effects to the regulated entity.

In summary, there is a risk that APRA's existing powers may not be sufficient to enable it to intervene effectively in the event of crisis in a financial group, particularly where a company in the group is in receivership or liquidation, or where a risk of that occurring exists.

## 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.
- 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.

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<sup>3</sup> The outcome in such a situation would also depend on the constitution of the particular company and on whether a receiver is appointed as receiver and manager or simply as receiver over assets of the company.

## **Option A — Power to appoint a statutory or judicial manager to an authorised NOHC and other companies in the group**

One option for addressing the concerns discussed above is to empower APRA to appoint an SM to the authorised NOHC of an ADI and to relevant subsidiaries of an authorised NOHC and of the ADI in specified circumstances. The specified circumstances would be where:

- APRA has appointed or is about to appoint an SM to the ADI, pursuant to the existing powers under the Banking Act, and where APRA is satisfied that the authorised NOHC or subsidiary, as the case may be, provides services or conducts business essential to the capacity of the ADI to maintain its core services; or
- APRA has appointed or is about to appoint an SM to the ADI, pursuant to the existing powers under the Banking Act, and APRA is satisfied that it is necessary to appoint an SM to the authorised NOHC or subsidiary in order to satisfactorily resolve the affairs of the ADI or any parts of the group that are necessary to protect depositors or maintain the stability of the financial system; or
- an authorised NOHC or subsidiary of an authorised NOHC or ADI is about to be, or has been, placed into receivership, liquidation or some other form of external administration, and APRA considers it necessary to appoint an SM to the authorised NOHC or subsidiary in order to enable the ADI to maintain its core services or enable APRA to implement an effective resolution of the ADI.

Under this option, a parallel set of amendments would also be made to the Insurance Act and Life Insurance Act, whereby APRA could apply to the Federal Court for the Court to appoint a JM to an authorised NOHC and to a subsidiary of an authorised NOHC or of an insurance company in the circumstances specified above. Under this option, subsidiaries would include extended licensed entities as defined and approved by APRA under prudential standards. (As discussed later in item 1.1.2, a proposal that APRA be empowered to appoint an SM to an insurer, an authorised NOHC, and subsidiaries of the NOHC or insurer is being considered. If that proposal were to be implemented as well, it would also allow APRA to appoint an SM to the authorised NOHC of an insurer and to relevant subsidiaries of an authorised NOHC and of the insurer.)

Where an SM or JM has been appointed to a regulated entity in the group, enabling an SM or JM to also be appointed to the authorised NOHC and its subsidiaries would enable the SM or JM to secure essential services for the regulated entity and facilitate a group-wide resolution. Applying statutory or judicial management to an authorised NOHC may also assist in facilitating the recapitalisation of the regulated entity by causing the NOHC to give the necessary approvals as shareholder of the ADI or insurer to enable recapitalisation. The application of statutory or judicial management to some or all of the regulated entity's group may also assist in facilitating the transfer of relevant parts of the business of the group to other entities or to a bridge institution, where this is part of the resolution of the distress situation, and is appropriate after having regard to all the circumstances.

In addition, when an SM or JM is appointed to an entity, persons are prohibited from commencing or continuing any legal proceeding, unless permitted by APRA or given the leave of the Court (for ADIs this can only be granted where hardship would be caused if leave were not granted). This provides the scope required to implement a resolution of the regulated entity's or group's situation.

This option has a number of important benefits in resolving a financial group. It provides a mechanism whereby a liquidator or receiver cannot be appointed to an authorised NOHC and/or



subsidiary, thereby ensuring APRA retains the ability to direct the resolution of the group. It provides clarity and certainty in ensuring that essential functionality and services are maintained, while potentially preserving the rights of other affected parties. It provides the capacity to facilitate the transfer of an essential business to another entity (for fair value) where this is essential to the intended resolution.

Although the proposal potentially affects existing rights of creditors to the extent that it would pre-empt rights to appoint a receiver or liquidator, the justification for this is the need for a set of resolution arrangements that meet the overriding policy objective of maintaining the stability of the financial system and protecting depositors or policyholders. These objectives have been long recognised as justifying a range of extensive powers to enable prudential risks to be appropriately managed and to enable financial institution distress to be resolved effectively. The proposal to extend the statutory and judicial management powers to authorised NOHCs and subsidiaries can be justified on the same grounds — the need to maintain the stability of the financial system and protect depositors and policyholders.

In recognition that the proposed powers do affect some existing creditor rights, certain limitations on the powers and safeguards against their potential abuse are proposed. These include the following:

- The grounds for appointing an SM or JM would be relatively narrow — that is where the entity to be placed into 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 where their inclusion in statutory or judicial management is considered by APRA to be necessary to effectively resolve the regulated entity and relevant parts of the group's affairs. This narrows the scope to only a subset of related parties of the regulated entity.
- Any actions taken by the SM or JM would need to consider fair value — that is they would not have the capacity to transfer a business (such as IT systems) to another entity, as part of a wider resolution package, or to provide services to the regulated entity or another entity, other than for fair value.
- An SM or JM in control of a NOHC would not have the power to use the funds of the NOHC or subsidiaries to recapitalise the ADI or insurer in circumstances where the NOHC's shareholders did not agree to that action.

It is noted that this option is consistent with the FSB's Key Attributes and the recommendations made by the CBRG given that they emphasise the need for measures to provide for the effective resolution of financial groups. It is also consistent with the powers available in a number of comparable jurisdictions, such as the US, some European countries, New Zealand and Singapore, among others, where the authorities have the power to appoint an SM or equivalent to a NOHC, and in some cases (New Zealand and Singapore) to a subsidiary. The European Commission has proposed a new EU directive on resolution that would, if implemented, confer on EU member states group resolution powers, including the power to appoint a special manager to a holding company and subsidiaries.

If Option A is implemented, consideration will be given to consequential amendments to provisions of the industry Acts (the *Banking Act 1959*, *Insurance Act 1973* and *Life Insurance Act 1995*), such as extending the application of certain provisions in the industry Acts to authorised NOHCs and subsidiaries of regulated entities and NOHCs, where appropriate. These include provisions on:

- involving APRA in applications to appoint external administrators to regulated entities and in external administration of regulated entities;
- the effect of appointing an SM or JM on directors of regulated entities;
- the effect of appointing an SM or JM on existing external administrators of regulated entities; and
- the effect of appointing an SM or JM on legal proceedings against regulated entities.

### **Option B — Amend the *Corporations Act 2001* to ensure that a liquidator or receiver of a company must cooperate with APRA**

As discussed above, concerns about the ability to effectively resolve a regulated entity are most acute where a NOHC or related company, which provides essential services, is in receivership or liquidation.

As an alternative to enabling an SM or JM to be appointed to a NOHC or subsidiary (Option A), consideration could be given to the possibility of requiring a liquidator or receiver to cooperate with APRA. There is a precedent for this in the Banking Act, where a liquidator of an ADI is required to cooperate with APRA where the ADI has been declared to be subject to the FCS.

This option might involve measures such as requiring an external administrator to:

- advise APRA of the progress of external administration;
- inform APRA in advance of any major decisions or actions to be taken by the external administrator; and
- comply with directions given by APRA or a statutory or judicial manager appointed to a regulated entity.

These obligations could apply wherever APRA informs a liquidator or receiver that the company being liquidated or put into receivership is related to a regulated entity and performs essential services for the regulated entity or is otherwise integral to the operation of the regulated entity.

This option would have less impact on creditors' and shareholders' existing legal rights compared to the first proposal. Moreover, as with the option to extend statutory or judicial management to authorised NOHCs and subsidiaries, a proposal to require an external administrator to comply with directions from APRA or a statutory/judicial manager could be accompanied by protections for affected parties. These could include the explicit provision that no shareholder or creditor may be left worse off than they would have been if the entity had been liquidated and that no services or functions may be required to be provided on other than just terms.

However, this option would not address the concerns referred to above as sufficiently as Option A. First, it fails to address a situation where the NOHC or subsidiary is not in, or will not be placed into, receivership, liquidation or other form of external administration. Statutory or judicial management provides a direct means of assuming control of an authorised NOHC or subsidiary where this is essential for the effective resolution of the regulated entity — regardless of whether the NOHC or subsidiary is in external administration. Second, if the NOHC or subsidiary were in some form of external administration, this option would not provide a satisfactory alternative to statutory or judicial management, given the existence of conflicts of interest between the normal duties of a

liquidator to the creditors of the entity in question and the interests of the financial system and depositors/policyholders. Third, this option could create significant impediments and delays to implementing an effective resolution of the regulated entity and its group, particularly given the potential for an external administrator to challenge directions from APRA or a statutory or judicial manager.

As a result, any amendments to implement this option would need to take these matters into account.

### **Option C — Enhance and strengthen APRA’s direction making powers over NOHCs and related entities**

APRA currently has a power to issue directions to an authorised NOHC. This could be extended so that related entities, such as subsidiaries of an authorised NOHC and of the regulated entity itself, are also subject to directions from APRA.

Directions powers could be strengthened so that they explicitly override other obligations. A positive duty could be imposed so that the board of an authorised NOHC or a related entity, and the liquidator or receiver of an authorised NOHC or a related entity, must take reasonable steps to ensure compliance with a direction from APRA, despite any countervailing Corporations Act or common law or equitable obligations.

This option, unlike appointing an SM or JM to NOHCs and related entities, would not displace the management of the affected entity (unless the directions were used to achieve that outcome) or transfer day-to-day control of the entity to an external administrator. It thus avoids some of the risks involved in an SM or JM taking complete control over the NOHC.

This option would give a considerable degree of control over the NOHC and relevant parts of the group, and would enable APRA to ensure that essential services continue to be provided to a regulated entity, even where the supplier was in liquidation or receivership. As with the proposal to extend statutory or judicial management to authorised NOHCs and subsidiaries, a proposal to extend direction powers to subsidiaries could be accompanied by protections, including the explicit provision that no shareholder or creditor may be left worse off than they would have been if the entity had been liquidated and that no services or functions may be required to be taken on other than just terms.

A problem with relying on direction powers alone is that the board or management of the NOHC or subsidiary might not necessarily comply with the directions, particularly in a distress situation, such as where the board has priorities that conflict with the directions being given by APRA or where the board has become dysfunctional. In that situation, APRA could pursue remedies through the Courts, but this could delay resolution and introduce an element of considerable uncertainty. Even if the board and management of the NOHC or subsidiary were cooperative with APRA, they may defer taking actions in compliance with an APRA direction pending legal advice, particularly if they have concerns over their legal risks. For these reasons, there is a risk that relying on a direction making power alone may not meet the objectives of ensuring that APRA can implement a resolution quickly and with certainty, so as to protect depositors or policyholders and maintain the stability of the financial system. In contrast, statutory or judicial management provides a direct means of ensuring that a group-wide resolution is implemented quickly and with certainty. Given that speed and certainty are essential elements in effective crisis resolution, this is a particularly important consideration in assessing resolution options.

## Option D — Combination of Options A to C

An option for consideration is to combine Options A to C, such that APRA is given the power to:

- appoint a SM to an ADI's authorised NOHC and subsidiaries of the NOHC and of the ADI, or to apply to the Court to appoint a JM to an insurer's authorised NOHC and subsidiaries of the NOHC and of the insurer; and
- to extend APRA's direction making power to subsidiaries of NOHCs and regulated entities.

This combined option could provide a set of tools for dealing with group distress. The extension of direction powers to subsidiaries may reduce the need for the appointment of a statutory or judicial manager to subsidiaries, depending on the cooperation of the subsidiaries' boards and management. The combination of both options therefore may provide a flexible set of tools and lower the need for excessive reliance on statutory or judicial management.

### 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?

### 1.1.2 Management of insurers in a crisis

Under the Insurance Act and Life Insurance Act, APRA may apply to the Federal Court for the appointment of a JM to assume control of an insurer in a range of circumstances, such as where an insurer has failed to comply with a prudential standard or a direction from APRA, or is in financial distress. In contrast, under the Banking Act, APRA has direct power to appoint an SM to an ADI.

Judicial management is a satisfactory resolution framework for most insurance distress situations. However, in situations where the insurer is large, or its distress poses a risk to the financial system or economy, or it is part of a complex financial group, or a rapid resolution response is needed, judicial management could be considered a less satisfactory resolution framework than statutory management. This is because:

- The Court appoints a JM, not APRA. In a situation where an insurer's financial condition is deteriorating quickly, and a rapid, authoritative response is needed to protect policyholders and maintain financial system stability, the need to apply to a Court may result in significant delays in the appointment of a JM. This has the potential to undermine and impede the effectiveness of the resolution process.
- Under the judicial management regime, APRA has no control over who will be appointed as JM or over the terms of their appointment. APRA can make recommendations on these matters to the Court, but there is no assurance that a Court will act on these recommendations. In contrast, under the Banking Act, APRA can specify the person to be the SM, having regard to the needs of the situation, and can specify the terms of reference for the SM.
- In some situations, it may be particularly important for APRA to have the flexibility to determine which person is appointed. For instance, there may be a desire to have the same person in control of multiple regulated entities in a financial group because an ADI, a general insurer and a life insurer are all impacted by intra-group contagion. Equally, it may be desirable to ensure that the administrator of the different entities in a group are appointed under the same or similar terms of reference, in order to facilitate effective and consistent group-wide resolution.
- APRA has no ability to issue directions to a JM. The JM is an officer of the Court and is subject to directions only from the Court. APRA can apply to the Court to issue instructions to the JM, but the Court would retain discretion to decline to issue the instructions. In contrast, under the Banking Act, APRA is empowered to give binding directions to an SM, without recourse to the Court. The inability for APRA to issue directions directly to a JM may impede the speed with which APRA can respond in certain circumstances, potentially frustrating the implementation of particular solutions, such as recapitalisation or business transfer.
- The splitting of responsibility in the judicial management process between APRA, the Court and the JM creates a risk of contradictory or inconsistent actions being taken by the respective parties, and delays in reaching critical decisions. It also dilutes the accountability of the resolution process — no one person or entity can be held to account for the way the resolution is managed. In contrast, under the Banking Act arrangements, APRA is fully responsible for managing the resolution process and is therefore accountable for it.

In this context, an option being considered is to amend the Insurance Act and Life Insurance Act to empower APRA to appoint an SM to a general or life insurer, an authorised NOHC and subsidiaries of an authorised NOHC and insurer in particular situations. Under this option, APRA would have the power to appoint an SM on any of the existing grounds in the Insurance Act and Life Insurance Act for applying for the appointment of a JM, and where one or more of the following additional conditions are met:

- Where an insurer is part of a financial group, the insurer is in distress or is likely to become distressed, and APRA has appointed or is about to appoint an SM to an ADI (or its NOHC or subsidiaries) in the same group.
  - In this situation, it may be desirable to have the same person in charge of the various entities in the group, appointed under the same or similar terms of reference, and subject to directions from APRA. Statutory management provides a framework for ensuring coherence and co-ordination in the resolution of a distressed conglomerate, potentially under the control of one SM, answerable to APRA.

- Where an insurer’s deterioration is, or may become, rapid and action needs to be taken urgently to implement a resolution — for example, a recapitalisation or a transfer of policy liabilities to another insurer, or to prevent a foreign parent from taking actions that could adversely impact on Australian policyholders.
  - For the reasons outlined above, statutory management provides a quicker and more certain means of achieving a specific resolution than judicial management. Speed of action and certainty are particularly important in situations where an insurer’s financial condition is deteriorating rapidly, such as where it is part of a financial group and is adversely affected by intra-group contagion.
- In the case of a foreign insurer operating in Australia via a subsidiary or branch, and where the home resolution authority seeks the cooperation of APRA to facilitate a joint resolution with the home authority — for example, transferring policy liabilities to another entity or facilitating a restructuring of the group.
  - In such a case, APRA is likely to need the flexibility to be able to move quickly to appoint an SM and to issue directions to the SM to facilitate the desired resolution, consistent with the resolution agreed with the home authority. Judicial management gives APRA no control over the resolution process, whereas statutory management provides considerably greater control.
- Where an insurer is sufficiently large or dominant in a particular sector as to make it systemically or economically important, and rapid action is needed in the interests of financial stability.

It is noted that several other jurisdictions have statutory management frameworks for insurance, including Singapore and New Zealand. In addition, the proposal is consistent with international principles, including the FSB’s Key Attributes and the IAIS *Insurance Core Principles* (IAIS Core Principles). The European Commission’s recently released proposed EU directive on resolution includes a proposal that regulators have the power to appoint a special manager to prudentially supervised financial institutions, potentially including insurers.

### Proposal

That APRA be empowered to appoint an SM to an insurer, an authorised NOHC, and subsidiaries of the NOHC or insurer, where:

- One or more of the grounds for applying to the Court to appoint a JM exist, as set out in the Insurance Act and Life Insurance Act; and
- APRA is satisfied, on reasonable grounds, that one or more of the following situations applies:
  - the insurer is part of a financial group and APRA has appointed or plans to appoint an SM to another entity in that group;
  - an insurer’s financial position is rapidly deteriorating or is expected to rapidly deteriorate and there is a need to respond quickly to the situation; or
  - the insurer’s circumstances have the potential to pose a risk to the stability of the Australian financial system, the economy, or a significant part of the economy.

The powers of an SM under the Insurance Act and Life Insurance Act would be the same as those available under the Banking Act, and APRA would be empowered to give directions to an SM. APRA would also be empowered to replace an SM in similar circumstances to those proposed for the Banking Act in item 4.4.2 of this paper.

This proposal is not intended to remove the current regime of judicial management under the Insurance Act and Life Insurance Act.

#### Discussion questions

Are there any reasons why APRA should not be empowered to appoint an SM (in addition to its existing power to apply to a Court for the appointment of a JM) to insurers (and related parties, as discussed above) in the circumstances outlined above?

Are the proposed limits on the power outlined above appropriate?

Are there other circumstances in which APRA should be empowered to appoint an SM to an insurer?

## 1.2 CLAWBACK OF CAPITAL TRANSFERS FROM REGULATED ENTITIES

In the event a regulated entity faces financial distress (such as serious breaches of capital or liquidity requirements), APRA may request an authorised NOHC or another member of the entity's group to provide assistance to the regulated entity. That assistance could take a number of forms. One such form might be where an authorised NOHC decides to provide financial assistance to the regulated entity — example capital support or liquidity funding.

A NOHC or related company that is placed into insolvency administration, like other companies, is subject to the provisions of the Corporations Act that provide for reversal ('clawback') of funds transferred pursuant to uncommercial transactions in the period leading up to the commencement of insolvency proceedings. Uncommercial transactions of the company are transactions that a reasonable person in the company's circumstances would not have entered into that were made in the four years before the relation-back day (where a related entity is party to the transaction), at a time when the company was insolvent. This mechanism is directed at protecting the rights of shareholders and creditors of the company that entered into the uncommercial transaction.

A capital transfer from a NOHC or other related party to a regulated entity as part of a resolution of the entity could potentially be subject to the clawback provisions of the Corporations Act. There is a risk that such a transaction could be considered voidable. If so, there would be an obligation to return the capital to the NOHC or related entity (although the industry Acts prevent the liquidator from bringing legal proceedings against a regulated entity while a [statutory or judicial] manager is in control unless permitted by APRA or the Court grants leave on hardship grounds). Whilst this result would be consistent with the rights of shareholders and creditors and should be retained, there is arguably a case to delay any such clawback temporarily. This is because the effect of the clawback could be to exacerbate the situation of an entity in distress. A temporary stay on clawback would provide the time needed to assess the situation and provide alternative financial support to the regulated entity if necessary.

## Proposal

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.

### Discussion questions

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

For what period would it be appropriate to suspend clawback?



## 2. ENHANCING APRA'S DIRECTION POWERS — SCOPE AND EFFICACY

APRA's power to give binding directions to regulated entities and their authorised NOHCs is a fundamental legislative tool for the enforcement of prudential supervision requirements and the implementation of financial crisis management. The direction power can be used in several ways, including enforcing prudential requirements where a regulated entity has failed to comply, as an early intervention tool to enable APRA to manage problems affecting ADIs and insurers before they cause failure or systemic problems, and as a means of limiting further deterioration in a period of emerging stress. Direction powers are also a key element in the resolution process for a distressed regulated entity; directions can be used to implement a range of resolution options, including facilitating recapitalisation. In this latter context, directions are an enabling mechanism, given that they assist directors and senior management of a regulated entity to take the steps required to implement an effective resolution of an entity's financial distress by providing directors and senior management with a clear and certain legal basis for taking action.

The ability of prudential regulators to give binding directions to regulated entities is being considered as part of the broader discussions internationally on improving the capacity of authorities to resolve failing financial institutions or prevent their failure. The FSB, in its peer review of Australia in June 2011, noted that APRA's powers are wide-ranging. The powers enable APRA to direct a regulated entity to undertake (or cease) specified actions or activities, to remove and replace directors and senior management, and to direct ADIs and insurers to take actions to recapitalise (by-passing normal shareholder consent requirements and other regulatory processes). The FSB also noted that these powers had recently been extended and enhanced through statutory amendments.

The *Financial Sector Legislation Amendment (Prudential Refinements and Other Measures) Act 2010* amended the industry Acts to significantly strengthen APRA's power to correct breaches of the prudential framework by issuing directions. Specifically, it enhanced the triggers for issuing directions, made it an offence for an authorised NOHC of a general insurer to fail to comply with a direction to remove a director or senior manager, and clarified that APRA may issue directions to foreign ADIs relating to their control of assets in Australia and their responsibility for liabilities in Australia.

In the FSB peer review, the FSB noted that the scope and nature of the direction powers is being reviewed by the Government, taking into account relevant international developments in supervisory and crisis resolution policy. In this chapter of the paper, the Government seeks to consult on whether the existing framework requires further improvements to ensure that APRA has an appropriate range of directions powers to facilitate crisis resolution effectively. In this context, the Government is seeking comment on both the triggers for issuing directions and the scope of the obligations that may be imposed by those directions.

The Government is also seeking comment on the range of entities to which APRA should be empowered to give directions.

This paper also seeks comment on how the directions power should operate where it may cause conflict with other legal obligations and whether individuals complying with a direction should be protected from any liability when doing so.

As with other crisis resolution issues outlined in this paper, the Government has paid close attention to international developments on crisis resolution. As noted earlier in this paper, the Government has taken into account the FSB's Key Attributes and the recommendations made by the CBRG. The

Key Attributes and recommendations stress the need for robust legal powers to resolve financially distressed institutions, including powers for early intervention and powers for wide-ranging and binding directions.

## 2.1 EFFECTIVE ENFORCEMENT AND RESOLUTION POWERS

In most situations, APRA is able to address any prudential concerns that arise in relation to regulated entities by working cooperatively with the board and management of a supervised entity and, where applicable, its authorised NOHC. In these instances, the board and senior management maintain full responsibility for decisions made by the entity and, where applicable, the group of which it may be part.

However, there may be times where APRA judges that it is necessary to use more direct tools to rectify or manage prudential concerns. In particular, direction powers enable APRA to specify how an entity must resolve compliance issues and therefore enable APRA to compel an entity to take specific action to address particular prudential risks that have been identified. Direction powers may also be necessary to limit further deterioration in the financial condition of a regulated entity in a period of emerging stress, to implement 'holding actions' pending the resolution of a distress situation, and to implement a resolution of a distressed financial institution. Directions may also be necessary in the context of requiring regulated entities to 'pre-position' for resolution.

APRA may use directions to assist the board and management of a regulated entity to implement effective resolution arrangements. This is because a direction, when issued to a regulated entity, provides a clear and certain legal basis for the board and management of the entity to take action to ensure compliance with the direction. A regulated entity has a statutory duty to comply with a direction even if this may be contrary to provisions in its constitution, contracts to which it is a party, and the Corporations Act (at least in the context of the Banking Act). This can assist the board and management of an ADI, for example, to implement a capital-raising or take other remedial measures more quickly than would otherwise be possible.

The industry Acts all enable APRA to issue directions to regulated entities and authorised NOHCs in specified circumstances. Refining and, where appropriate, enhancing the triggers that allow the issue of directions would help to ensure that APRA can respond in a timely and decisive way to emerging prudential concerns that affect an entity. Equally, broadening the scope of the direction powers, both in respect of the matters for which directions may be given and the entities to which directions may be given, may also assist APRA to respond effectively, decisively and promptly to resolve financial distress situations.

This paper identifies some key options for the enhancement of APRA's directions powers:

- clarifying the scope of existing powers;
- ensuring that compliance with an APRA direction will not be cause for directors or management to be held liable under any other law;
- providing APRA with a specific direction power to temporarily suspend an entity's continuous disclosure obligations, to put beyond APRA's powers in this regard;

- extending the ability to issue directions to subsidiaries of authorised NOHCs and subsidiaries of ADIs, general insurers and life insurers; and
- empowering APRA to issue directions to regulated entities and authorised NOHCs (and to subsidiaries if the direction power is extended to subsidiaries) to require the entities to take specified actions to facilitate the resolution of their financial or operational distress.

### 2.1.1 Clarifying directions powers

The directions powers in the industry Acts provide an indicative list of the different kinds of directions that APRA may give to a regulated entity. For example paragraph 11CA(2)(e) of the Banking Act allows APRA to make directions ‘to appoint a person or persons as a director or senior manager of the body corporate for such terms as APRA directs’ and paragraph 11CA(2)(m) provides for directions ‘not to repay any money on deposit or advance’. Since the circumstances under which APRA should be able to make a direction are difficult to identify before the event, the list also includes a power to make a direction to do anything else as to the way in which the affairs of the body corporate are to be conducted or not conducted.

This ‘catch-all’ direction power is intended to provide APRA with the flexibility to make directions about other matters regarding the affairs of the regulated entity. At first sight this provision seems broadly cast. However, it is possible that the reference to ‘the way’ in which the affairs of the body corporate are to be conducted could be interpreted narrowly to mean that directions under the ‘catch-all’ power are limited to general directions as to systemic matters, and the power might not necessarily extend to directions regarding specific transactions.

If the provision were interpreted in this way, it is possible that a situation could arise in which APRA was prevented from issuing an effective direction on a specific matter in reliance on the ‘catch-all’ provision. In such a case, if the situation were sufficiently serious, APRA’s only option would be to arrange for the appointment of an SM or JM. The appointment of an SM or JM is a power reserved for extreme situations, such as where a regulated entity is not complying with directions or is, or is likely to become, severely financially distressed.

Widening the scope of directions is consistent with international policy thinking in relation to dealing with the distress of financial institutions. The FSB, in its Key Attributes, has identified the need for resolution authorities to have unambiguous and broad-ranging powers to respond to institutional distress. The same argument has been advanced by the CBRG in its proposals for bank crisis resolution.

#### 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?

Are there likely to be any unintended consequences?

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

## 2.1.2 Protection from liability when complying with an APRA direction

In recognition of the gravity of situations in which directions may be given, the industry Acts provide that non-compliance with a direction gives rise to criminal sanction. It is also grounds for revocation of an authority to act as an ADI, insurer or NOHC. Under the Banking Act, and in similar provisions under the Insurance Act and Life Insurance Act, directors and other officers of a regulated entity must take reasonable steps to ensure the entity complies with a direction.

The Corporations Act also imposes certain duties and obligations on company directors and other officers. Under the Corporations Act, directors and officers are required to exercise their powers and discharge their duties with care and diligence in good faith in the best interests of the corporation and for a proper purpose. These duties are designed to promote good governance and ensure that directors and other officers act in the interests of the company — including putting the company's interests ahead of their own. In ensuring compliance with a direction from APRA, directors or other officers may breach what would normally be their obligations or duties under the Corporations Act.

In addition to directors' and officers' duties and liabilities under the Corporations Act, common law and equity, there are other statutes at Commonwealth, State and Territory level that impose both civil and criminal personal liability on company directors and officers for some actions of their companies. Some of these provisions impose sanctions on a strict liability basis; others deem a director liable for breaches by the company.

The Banking Act obliges directors and other officers to take all reasonable steps to ensure that the relevant ADI complies with a direction. Failure to do so is an offence. Section 70B of the Banking Act provides that the Banking Act has effect despite any provision in the Corporations Act. Section 70A of the Banking Act provides protection from liability where a person acts in good faith and without negligence in the exercise of their duties under the Act. There is, however, no explicit statement of the officers' duty to arrange compliance with a direction and therefore some uncertainty as to the extent of the protection for directors and other officers when they are doing so. An officer's actions may not necessarily constitute actions that are in the performance of duties or functions under the Banking Act for the purposes of section 70A and therefore they may not be protected from liability under the Corporations Act.

Under the Insurance Act and Life Insurance Act there is no provision equivalent to section 70A of the Banking Act that provides a person with protection from liability where they act in good faith and without negligence in exercising their duties. In addition, while there are some provisions that expressly 'roll back' the Corporations Act, the Acts do not provide an express provision in relation to APRA's general power to direct under section 104 of the Insurance Act and section 230B of the Life Insurance Act.

Given the range of duties imposed on directors and other officers under the different statutes and in common law, there is a potential risk that directors and other officers could be held liable for actions

they take to ensure that regulated entities comply with directions from APRA. This could result in reluctance to comply with an APRA direction if there is a concern that, in doing so, they could potentially breach a duty under the Corporations Act. This has the potential to impede the implementation of measures needed to ensure that the regulated entity is restored to compliance with prudential requirements. It also has the potential to impede the resolution of financial distress.

The FSB's Key Attributes released in October 2011, which sets out principles on crisis resolution matters and refers to the need for directors and other key officers of financial institutions to be immunised from liability arising from compliance with directions from a resolution authority.

### 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?

### 2.1.3 Suspending continuous disclosure requirements

Timely disclosure by companies of price-sensitive and other important information is fundamental to market integrity and investor protection. Continuous disclosure is an important component of the current Australian market regulation framework and aims to ensure that investors have timely and equal access to materially price-sensitive information about securities traded on secondary markets. Corporations legislation and market rules require companies to make continuous disclosure of relevant information as it comes to hand.

However, there is a potential tension between the continuous disclosure requirements and the interests of financial stability in circumstances where a bank or insurer is in distress. In such a situation, the disclosure of the entity's distress before APRA and the Government have had the opportunity to develop options for resolution is likely to exacerbate the distress situation. In the case of an ADI or other regulated entity with significant callable funding, the disclosure of serious adverse information before a proposed resolution is announced is very likely to further destabilise the ADI or other regulated entity. This could render a resolution unworkable, to the detriment of depositors, other creditors and investors and potentially the stability of the financial system.

It may therefore be desirable, in order to facilitate an effective resolution of a distressed regulated entity and to maintain financial stability, for APRA to have the explicit power to direct that the entity not disclose the relevant information for a short period (example up to 48 hours), pending the announcement of a resolution.

It is recognised that any delay in the disclosure of adverse information — even for a short period — creates a conflict with the policy rationale underlying the continuous disclosure regime, and conflicts with the obligation to immediately disclose information that a reasonable person would expect to have a material effect on the price or value of the entity's securities.

Therefore, a careful assessment is required to arrive at a suitable balance between the operation of the continuous disclosure regime and the desirability, from a systemic stability perspective, of confidential resolution of financial distress of a listed prudentially regulated and systemically important entity.

## **Continuous disclosure**

The primary rationale for continuous disclosure is to ensure that investors can make informed decisions about the allocation of their funds. This can be expected to enhance the depth, liquidity and efficiency of securities markets. Continuous disclosure of materially price sensitive information should ensure that the price of securities reflects their underlying economic value and that all investors have equal opportunity to trade in the market. In most situations, continuous disclosure could also be expected to reduce the volatility of securities prices and the risks of disorderly trading, since investors will have access to more information about a disclosing entity's performance and prospects, and this information can be more rapidly factored into the price of the entity's securities.

Any change to existing continuous disclosure obligations risks undermining confidence in the market and discouraging investment. In periods of financial turmoil, a lack of assurance to market participants that information with a negative price impact will be disclosed may actually contribute to a lack of confidence in all entities to which continuous disclosure obligations apply. This may result in participants engaging in trading and lending behaviour that may be disadvantageous to these participants, to these entities and to system stability as a whole.

This effect may arise even where the regulator is not exercising any powers affecting continuous disclosure obligations or where no regulated entities are subject to resolution activities. It should be recognised that the suspension of continuous disclosure obligations could result in some stakeholders suffering significant financial losses because market participants may continue to trade and creditors may extend further credit in ignorance of information that they have an expectation would be made public.

Another consideration is the effectiveness of any overriding of obligations of continuous disclosure. Overriding continuous disclosure may not be particularly effective where market participants are actively seeking information from an entity, possibly in response to rumours circulating in the market. In this situation, the regulator may direct the entity not to provide the information market participants are seeking. However, any inability or refusal by entities to provide answers may, rightly or wrongly be perceived as communicating information (including incorrect information) to the market.

Overriding continuous disclosure obligations would affect the obligations of three different stakeholders. These obligations could potentially conflict with attempts to resolve a failing entity.

### **Element 1: Continuous disclosure obligations of regulated entities**

Under the current regulatory framework, the continuous disclosure rules that apply to listed entities are contained in the listing rules of a listing market.

ASX Listing Rule 3.1 requires listed entities to disclose materially price-sensitive information to the ASX immediately so that it can be disseminated to investors. Information may only be withheld if it remains confidential and a reasonable person would not expect it to be disclosed, or if certain exceptions apply — for example, that the information concerns an incomplete proposal or negotiation.

The Corporations Act provides statutory backing to the continuous disclosure requirements of the listing rules of the financial markets. A contravention of the relevant listing rule is also a contravention of subsection 674(2) of the Corporations Act (subject to some conditions). A contravention of subsection 674(2) of the Corporations Act may give rise to criminal liability.

Some unlisted entities are also subject to continuous disclosure requirements under the Corporations Act, with subsection 675(2) requiring them, in summary, to lodge with ASIC information that is not generally available and that a 'reasonable person' would expect, if it were available, could have a material effect on the price or value of the company's enhanced disclosure securities.

### **Element 2: Obligation of market operators to monitor and enforce compliance with continuous disclosure rules**

Market operators have front-line responsibility for monitoring and enforcing compliance with the continuous disclosure rules contained in the listing rules. They are responsible for the receipt and dissemination of materially price-sensitive information to investors, as well as for dealing with inadequate disclosure by listed entities and remedying false markets that may have emerged as a consequence of externally generated rumours or speculation.

A market operator, such as the ASX, has an obligation under subsection 792A(a) of the Corporations Act, to the extent reasonably practicable, to do all things that are necessary to ensure that its market is fair, orderly and transparent. Monitoring and enforcing compliance by listed entities with the continuous disclosure requirements of their respective listing rules is one component of that obligation for listing market operators.

The market operator might reach the view that, in particular circumstances, the obligation in subsection 792A(a) requires it to do such things as obtaining information from the listed entity or requiring disclosure to the market from a listed entity. The ASX routinely demands information from listed entities, for example, if it becomes aware of troubling rumours or unexplained activity in the market. If the ASX considered that a false market was likely to exist in relation to a particular security, but an entity declined to disclose relevant information, this would be a breach of the listing rules. The ASX could then take further steps that could culminate in the entity being delisted or its securities suspended from quotation on the market. Simply preventing an entity from disclosing information may not be enough to ensure that the information is not made public or that the public does not become aware of an adverse development.

### **Element 3: ASIC's role in ensuring market integrity**

The Australian Securities and Investment Commission (ASIC) has two major relevant roles with regard to financial market operators under the current regulatory framework for continuous disclosure. The first is to ensure that market operators comply with their obligation under the Corporations Act to maintain fair, orderly and transparent markets, and to monitor and enforce compliance with their respective listing rules. The second is to administer the continuous disclosure provisions in the Corporations Act.

ASIC has the power to direct a market operator, such as the ASX, to suspend dealings in a product or class of products or to give another direction in relation to such dealings (section 794D) where this is necessary or in the public interest to protect investors dealing in a relevant financial product. Failure to comply is an offence, subject to 100 penalty units per day, and the Court can order compliance. ASIC also has a separate directions power (section 798J) to give directions to other entities to suspend dealings in financial products or to give some other direction in relation to those dealings.

For example, ASIC might issue a direction to a listed entity or participant of a licensed market to cease dealing.

### **Reconciling financial system stability and market integrity**

If it is accepted that materially adverse, price-sensitive information should be able to be withheld from the market for a short period (example 24 to 48 hours) in a situation where a resolution is being considered for a distressed entity, then ideally a solution would address the respective obligations on the entities, market operators and ASIC independently.

The same arguments apply in substance to general insurers and life insurers, their authorised NOHCs and subsidiaries, as they do to ADIs under the Banking Act. Accordingly, this proposal would apply to all industry Acts.

This proposal is consistent with current international principles on crisis resolution. The FSB's Key Attributes explicitly note the importance of resolution authorities having the power to prevent a regulated entity from making market/public disclosures for a short period while the resolution is being formulated, in order to avoid exacerbating the situation and such that the resolution can be announced at the same time as the adverse news.

Given the importance of having confident and informed participation by investors in securities markets, any suspension of continuous disclosure would need to be limited to very specific circumstances and would only be able to be applied for a short period — example up to 48 hours. The situation in which this power is likely to be required is when the institution is in significant financial difficulty and APRA is working closely with that institution to resolve the matter.

### **Proposal**

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.



### Discussion 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?

## 2.1.4 Directions on pre-positioning for resolution

In order to prepare properly for distress in a regulated entity, APRA needs to plan for the effective resolution of an ADI or an insurer, and the group of which it may be part. This involves some degree of 'pre-positioning', or involves putting measures in place that allow APRA to intervene smoothly if required. In most cases, APRA is likely to pre-position for resolution well in advance of any crisis as part of ongoing prudential requirements. This might take the form of prudential standards that require regulated entities to structure elements of their business in such a way as to facilitate a range of resolution options. However, not all types of prudential distress can be fully anticipated, therefore APRA cannot put all resolution pre-positioning in place ahead of a crisis. In some cases, the nature of the required pre-positioning might only be known a short period before resolution actions need to be taken. In other cases, it could be costly to impose pre-positioning structures on regulated entities in normal times, and better to do so in a period where resolution is likely to be necessary.

In recognition of this, APRA needs to have robust direction powers to require a regulated entity to implement specified pre-positioning ahead of a resolution being actioned. For example, it may be necessary for APRA to require a regulated entity to make specified changes to its IT systems, its operational structure, the nature of functionality or financial support between entities, or the location of specified business in order to facilitate a resolution, such as a restructuring or transfer of business.

It is arguable that APRA already has direction-making powers that would extend to requiring pre-positioning for resolution. However, given the specific nature of resolution pre-positioning, it is considered appropriate to put the matter beyond any doubt and confer on APRA a specific direction power relating to resolution pre-positioning.

### 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?

## 2.2 EFFECTIVE POWERS TO DIRECT A TRANSFER OF BUSINESS FROM A REGULATED ENTITY

The *Financial Sector (Business Transfer and Group Restructure) Act 1999* (Business Transfer Act) provides for transfers of business between financial institutions and internal restructures within some groups of financial institutions. In particular, Part 4 of the Business Transfer Act provides for compulsory transfers of business.

Under the compulsory transfer of business provisions, APRA may make a determination that there is to be a transfer of business between the bodies concerned. Following amendments to the Business Transfer Act in 2008 and 2010, compulsory transfer of business provisions now extend to all ADIs (and related parties of ADIs), general insurers, life insurers and friendly societies, such that regulated business (example deposit-taking and insurance policy obligations) may be transferred to another regulated entity of the same kind (including to a 'bridge entity'). Also, non-regulated business (such as assets) may be compulsorily transferred from a regulated entity to an entity that is not regulated (such as an asset management vehicle).

Compulsory business transfer is an important tool in the package of resolution options available to APRA when managing the distress or failure of a regulated entity. The Business Transfer Act enables some or all of the business of a regulated entity (including assets, liabilities, legal rights and obligations, data and systems) to be transferred to another regulated entity in the same category, and also enables assets to be transferred to an asset management vehicle. The latter enables impaired assets to be quarantined and dealt with separately while efforts are made to resolve the distress of the regulated entity where this is considered to be the most cost-effective resolution arrangement. APRA may choose to transfer all or part of a business and may transfer the business to either or both private and public sector (that is 'bridge bank') entities.

APRA may effect a compulsory transfer without the need for the approval of owners, shareholders or others, or for novation. The flexibility to break up a distressed or failed regulated entity in this way could be used to facilitate the sale of parts of the entity to one or multiple buyers, depending on the situation. Also, where the aim of a resolution strategy is to secure the continuation of financial services to depositors or policyholders, parts or all of the regulated business of a regulated entity may be transferred to another similar regulated entity in such a manner as to ensure a seamless switch of financial service provider for the depositors or policyholders concerned.

The FSB Key Attributes states that resolution authorities should have at their disposal a broad range of resolution powers, including those necessary to effect transfers of business amongst entities.

Since 2008, the Government has been reviewing and refining the Business Transfer Act to make it consistent with international principles and practice, including the principles stated in the Key Attributes. By international standards, the Business Transfer Act is now a comprehensive framework for facilitating both voluntary and compulsory business transfers. However, there are still a few areas in which the provisions of the Business Transfer Act could be enhanced to provide APRA with greater flexibility and certainty when arranging a compulsory transfer of business from a regulated entity.

This section sets out proposals for legislative amendment for this purpose and to address any gaps identified in the Business Transfer Act.

### 2.2.1 Widen the scope of application of the Business Transfer Act to related entities of general insurers and life companies

Currently, under subsection 25(1B) of the Business Transfer Act, APRA may determine that there is to be a total or partial transfer of business from a body corporate related to an ADI, and which is not an ADI, general insurer or life insurer, to another body corporate under the following circumstances:

- the ADI is itself the subject of a Business Transfer determination; and
- the business of the related body corporate will be transferred to the receiving body (example the body corporate that will receive the business of the ADI) or a body corporate that is related to the receiving body.

A related body corporate for this purpose may be:

- a holding company of the ADI;
- a subsidiary of the holding company of the ADI; or
- a subsidiary of the ADI.

This provision is particularly important in circumstances where an ADI's business is being transferred to another ADI as part of a resolution strategy but an entity related to the ADI holds a business undertaking essential to the continued operation of the business of the ADI. If it is necessary that the business undertaking also be transferred to the receiving ADI, this provision allows APRA to determine that such a transfer will occur.

By contrast, the compulsory business transfer provisions of the Business Transfer Act applicable to insurers do not include provisions corresponding to section 25(1B). A similar need for such a provision arises in the scenario described above but where an insurer's business is being transferred to another insurer. It appears that APRA should also have the ability to transfer a business undertaking essential to the operation of an insurer.

#### Proposal

That the Business Transfer Act be amended to extend the application of subsection 25(1B) to bodies corporate related to an insurer. This will remove the existing inconsistency between treatment of ADIs and insurers under the Business Transfer Act and streamline compulsory business transfer powers across the three industries. It will also enhance the effectiveness of the compulsory business transfer power as a tool in package of resolution options available to APRA and the other members of the Council of Financial Regulators (the Council) when managing the distress or failure of a regulated entity.

#### Discussion question

Is there any reason why the compulsory business transfer provisions of the Business Transfer Act, as they relate to parties related to a regulated entity, should differentiate between ADIs and insurers in this respect?

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

The Business Transfer Act currently provides for APRA to give effect to transfers of business involving ADIs, general insurers, life companies, and related bodies corporate, provided certain statutory conditions are met. Currently, one statutory condition is that APRA must be satisfied that legislation to facilitate the transfer must be in place in the State or Territory in which the transferring body and the receiving body are established.

A number of other Commonwealth statutory regimes providing for transfers are not subject to any statutory preconditions of this kind, such as those pertaining to voluntary business transfers under the Insurance Act and Life Insurance Act.

#### 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?

## 2.3 NEW DIRECTION POWERS FOR SUPERANNUATION

As part of its Stronger Super announcement of 16 December 2010, the Government committed to giving APRA the power to issue prudential standards in relation to superannuation. Legislation giving effect to this announcement was introduced to Parliament on 16 February 2012 as the Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012.

The Bill imposes a direct obligation on Registrable Superannuation Entity (RSE) licensees to comply with prudential standards as part of a condition of their licence.

APRA currently has a number of enforcement mechanisms available to it in prudential regulation of superannuation, including appointing an acting trustee and prosecution. Following the implementation of the Stronger Super reforms these will also include revoking a MySuper authorisation and issuing infringement notices.

Recognising the importance of effective enforcement powers to the successful operation of APRA's prudential standards making power and its broader supervision of the superannuation industry, it is being considered whether APRA's current enforcement powers provide sufficient flexibility for APRA to regulate the superannuation industry and supervise the Stronger Super reforms.

Directions are a flexible intermediate regulatory power and enable prudential concerns to be acted on in a timely manner. Directions facilitate early intervention by APRA. Early intervention may be necessary due to the serious consequences that can flow from actions and states of affairs that give rise to prudential risk. In addition, the availability of a flexible directions power allows APRA to respond to significant prudential concerns as they arise, and helps avoid having to cater for all possible contingencies in the prudential standards themselves, which lead to more prescriptive outcomes.

APRA has comprehensive direction powers in relation to ADIs, general insurers and life insurers but not in relation to RSE licensees, even though the superannuation sector holds approximately \$1.4 trillion in savings and a number of superannuation entities hold tens of billions of dollars in assets. APRA currently does not have a general early intervention tool, of the flexibility of the directions power in the other industries, to address a superannuation entity's deterioration or non-compliance with prudential requirements. Whilst there are certain existing direction powers in superannuation (discussed below), their specificity limits their utility and the broadest direction power (a direction to comply with a licence condition) is not pre-emptive.

Enhancing direction powers in superannuation would allow APRA to detail specifically how an entity must address an identified concern. Direction powers would enable APRA to direct the entity specifically as to what should be done to remedy the situation, without the need to appoint an acting trustee or institute lengthy criminal proceedings, for example. In this manner, directions are capable of being drafted in a way that focuses on the specific concern, thereby allowing a proportionate regulatory response.

Directions may also be used as a deterrent. The power need not be used to its full extent to be effective. For example, providing draft proposed directions to a regulated entity, accompanied by discussion and consultation, has effectively resolved regulatory issues in the other prudentially regulated sectors without APRA having to give formal directions. This approach also allows the correction of concerns with fund management without having to resort to fines or other penalties that could otherwise penalise members. The power is thus able to be a preliminary step before a formal fine is sought.

A direction power would provide APRA with the necessary tools to effectively utilise the prudential standards making power. This is discussed in further detail below.

## APRA's powers in superannuation — currently and following implementation of the Stronger Super reforms

APRA's supervisory approach is based on a cooperative and open working relationship with boards and management of superannuation funds to resolve prudential issues that may affect an institution's ability to meet its financial promises to superannuation fund members. APRA may take enforcement action where this cooperative approach does not resolve the issues in a way that appropriately protects the interests of members.

### APRA's enforcement powers

In cases where APRA deems minor enforcement action to be necessary, APRA may accept an enforceable undertaking (EU) rather than impose sanctions. EUs are particularly relevant when an institution or an individual has made particular admissions to APRA concerning their conduct and remedial steps have commenced. EUs also offer a cost effective and timely means of achieving an appropriate supervisory outcome without the time and resources that are often necessary in any formal legal action.

However, EUs need to be negotiated and agreed to by both parties before they become effective and often represent the final outcome of a lengthy investigation. They are rarely likely to be of assistance when pre-emptive action is required to address a prudential concern.

APRA's other powers include the ability to:

- remove the RSE licensee and appoint an acting trustee to the fund, which may ultimately lead to the fund being wound up;
- instigate formal investigations into the affairs of supervised institutions;
- initiate criminal proceedings;
- seek restraining orders in court; and
- seek to disqualify individuals from holding senior roles within supervised institutions.

While these powers are useful, they may be disproportionate or respond to an event only after it has occurred. For example, it will often be preferable to give a direction targeting a prudential concern instead of replacing the RSE licensee with an acting trustee. Disqualifications, investigation and criminal proceedings, while important enforcement tools, are reactive in nature, rather than suited to pre-empting a developing prudential concern.

### Existing direction powers

APRA already has direction powers in the *Superannuation Industry (Supervision) Act 1993* (SIS Act) in relation to specific matters. Under these powers, APRA may direct an RSE licensee to:

- modify its risk management strategy (RMS) under section 29HB (however, this section will be repealed together with other provisions relating to the RMS as a result of the Stronger Super reforms and the transfer of RMS requirements to the prudential standards);

- modify the risk management plan for the entity under section 29PB (also to be repealed as part of Stronger Super);
- not accept contributions from employer sponsors where there has been a contravention of the equal representation rules under section 63;
- remove an approved auditor or actuary under section 131AA;
- not acquire or dispose of assets under section 264; and
- comply with a licence condition under section 29EB (discussed below).

These powers are quite specific in their focus. By contrast, the directions powers in the Banking, Insurance and Life Insurance Acts are enlivened by a range of triggers, from actual or impending breaches of the law through to more general prudential concerns relating to the interests of depositors or policy owners. They also set out a variety of types of directions that may be given (for example, the Insurance Act lists twenty specific kinds of directions).

### **Licence conditions and directions**

In order to be a trustee of an RSE, an RSE licence needs to be obtained from APRA. Failure to have a licence is an offence. Licences are subject to certain statutory conditions under section 29E, with APRA being able to impose further conditions on an RSE licence at any time through section 29EA. APRA also has power under section 29EB to direct an RSE licensee to comply with a specified condition of its RSE licence by a specified time if APRA has reasonable grounds to believe that the RSE licensee has breached the condition.

For example, public offer RSE licensees who satisfy the existing capital requirements by holding \$5 million dollars in net tangible assets (NTA) are subject to a condition requiring the RSE licensee to arrange for a registered company auditor to audit the trustee's compliance with that requirement. That condition is imposed by APRA under section 29EA. If a trustee failed to provide the required verification of its NTA, the appropriate course (if other steps such as discussion with the trustee fail to resolve the matter) might be a direction under section 29EB.

A key statutory condition, imposed under paragraph 29E(1)(a), is that the RSE licensee comply with the 'RSE licensee law'. The RSE licensee law includes (among other things) the SIS Act, Superannuation Industry (Supervision) Regulations 1994 (SIS Regulations) and, under the Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012, will include the prudential standards.

As a result, APRA will have power to give a basic direction under section 29EB requiring compliance with a prudential standard after that standard has been breached. Breach of a direction to comply with a licence condition is an offence, punishable by 60 penalty units.

However, a limitation of this power is that the direction may only be given after the breach of the licence condition. Whilst APRA has the ability to cancel an RSE licence on the basis of an anticipated breach of a licence condition (that is, APRA's power to cancel a licence arises before the power to issue a direction to comply with a licence condition), this is a measure of last resort.

## Prudential standards

The Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012 contains provisions to give APRA the ability to make prudential standards in relation to prudential matters in superannuation. These standards encompass both RSE licensees and their connected entities.

'Prudential matter' encompasses the affairs of the RSE and an entity connected to the RSE in relation to:

- protecting beneficiaries' interests;
- meeting the reasonable expectations of beneficiaries;
- maintaining the sound financial position of the RSE;
- not promoting instability in the Australian financial system;
- the conduct of the RSE licensee of any of its affairs relevant to the RSE with integrity, prudence and professional skill;
- the appointment of auditors and actuaries; and
- the conduct of audits and actuarial investigations.

Prudential standards may further elaborate on the covenants implied into the governing rules of superannuation entities provided in sections 52-53 and the new section 54A.

## Breach of a prudential standard

Whilst the prudential standards 'must be complied with' (per subsection 34C(1)), there is currently no specific provision for the breach of a standard. A breach of a prudential standard would have to be actioned after the fact by APRA through the licence conditions direction power, or other actions including cancelling an RSE licence.

### 2.3.1 Potential new direction triggers

Given the gaps identified above, it is being considered whether APRA should have new direction powers in relation to superannuation. The purpose of the direction powers would be for the rectification of significant problems, in the nature of an enforcement power.

Possible triggers for the issue of a direction might include:

- a breach of the RSE licensee law or licence condition;
- an anticipated breach of the RSE licensee law or licence condition;
- promoting instability in the Australian financial system;
- conducting affairs in an improper or financially unsound way; and



- where the failure to issue the direction would materially prejudice the interests or reasonable expectations of beneficiaries of the superannuation entity.

### **Breach of the RSE licensee law or licence condition**

RSE licensee law encompasses the SIS Act, SIS Regulations, *Financial Sector (Collection of Data) Act 2001*, *Financial Institutions Supervisory Levies Collection Act 1998* and some provisions of the *Corporations Act 2001*. The concept will be extended to include the prudential standards, as inserted by the Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012.

As previously noted, APRA is able to issue a direction to comply with licence conditions under section 29EB, and it is a condition of all RSE licences that the RSE licensee complies with the RSE licensee law (paragraph 29E(1)(a)). It follows that APRA is also already able to direct an RSE licensee to comply with the RSE licensee law.

This provides APRA with the clear ability to police the prudential standards through the direction power. It is a natural progression to allow APRA to enforce the prudential standards through a direction power as directions may be used as a beneficial preliminary step, allowing RSE licensees the chance to comply with the law (as specified in the direction) before another action is taken, such as the revocation of a licence or the imposition of a fine.

### **Anticipated breach of the RSE licensee law or licence condition**

Currently, APRA has limited pre-emptive powers in superannuation, including cancelling an RSE licence for an anticipated breach of a licence condition, yet APRA is unable to issue a direction to comply with conditions imposed on an RSE licence until after a breach has occurred. There is, therefore, a gap for situations where a pre-emptive but preliminary approach is required in order to prevent a minor situation from escalating to further harm members.

Whilst there are benefits in providing APRA with the ability to pre-empt a breach of the law, or a licence condition, and thereby prevent harm to beneficiaries before it occurs, APRA's view of what may become a breach of the law may be different to that of the affected RSE licensee. For this reason, APRA's decision to issue a direction would need to be a reviewable decision. As such, RSE licensees that were dissatisfied with APRA's decision to issue a direction would be able to request APRA reconsider the decision. The request to review a decision would enable the RSE licensee to provide its own reasoning to APRA, after which APRA may confirm, revoke or vary the decision. If an RSE licensee was still dissatisfied with APRA's decision after it had been reviewed, then the RSE licensee would be able to apply to the Administrative Appeals Tribunal for further review of the decision.

### **Promoting instability in the Australian financial system**

The Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012, when passed into law, will provide APRA with the ability to issue prudential standards relating to prudential matters. 'Prudential matter', as defined in subsection 34C(4), will include conduct in such a manner as not to cause or promote instability in the Australian financial system.

As prudential standards themselves are unable, and should not seek, to prescribe or proscribe every form of relevant conduct or activity that may lead to instability in the Australian financial system, they are unlikely to comprehensively cover situations in which actions may lead to instability in the Australian financial system.

Given the size of the pool of superannuation savings, the portfolio decisions of superannuation funds could have important consequences both for asset prices and for sectors that depend on these investors for financing. While experience has shown that such a broad-based shift by the superannuation sector would be most unlikely to take place, APRA nevertheless has a prudential responsibility to ensure the stability of the financial system. It is therefore proposed that APRA be given power to issue a direction to address circumstances where the conduct of an entity may promote or cause instability in the financial system. This is consistent with the Banking, Insurance and Life Insurance Acts which provide APRA with such powers and where APRA has a regulatory responsibility to ensure entities meet their prudential requirements.

### **Conducting affairs in an improper or financially unsound way**

A prudential matter includes conduct by an RSE licensee or a connected entity of the RSE licensee of a registrable superannuation entity of the affairs of the RSE licensee or a connected entity in such a way as to keep itself in a sound financial position. Accordingly, APRA will have the power to make prudential standards concerning matters relating to the financial position of an RSE.

However, it is not possible, or desirable, for the prudential standards to address every variety of activity, transaction or investment that might involve improper or financially unsound conduct. Rather, it may be desirable for APRA to be able to respond flexibly to instances of improper or financially unsound conduct should they arise. Therefore it is proposed that the grounds for issuing a direction may include where the RSE licensee is conducting its own affairs or those of the RSE in an improper or financially unsound way. A direction can be given on similar grounds under the Banking, Insurance and Life Insurance Acts.

For example, APRA might ascertain that an RSE licensee is investing substantial assets of the fund in a poorly performing, opaque, offshore investment vehicle, in circumstances where little is known about the underlying assets or the identity of the managers of the vehicle. It may not be possible in this instance to establish a breach of the RSE licensee law, as it would be difficult to proscribe such circumstances in the prudential standards without being unduly restrictive. Nevertheless, such situations may be sufficiently serious to warrant intervention and the use of a direction power to allow a trustee to address the problem.

### **The failure to issue the direction would materially prejudice the interests or reasonable expectations of beneficiaries of the superannuation entity**

Once again, APRA will have power to make prudential standards relating to protecting the interests, and meeting the reasonable expectations, of beneficiaries of RSEs. However, it is neither feasible nor appropriate for the prudential standards to deal with every issue that might impact on those interests and expectations.

Providing APRA with the explicit power to issue a direction where the interests or reasonable expectations of beneficiaries would otherwise be materially prejudiced will provide APRA with the ability to act early and rectify prudential concerns. Moreover, the directions framework will enable specific steps to be required of an entity in order to rectify the concern (see the contents of a

direction section below), making a direction more malleable to addressing the interests of beneficiaries under diverse situations.

Concerns may be initially raised that the ‘interests of beneficiaries’ and ‘reasonable expectations of beneficiaries’ are broad concepts and subject to interpretation. In response, it should be noted that there must be a ‘material prejudice’ to the interests or reasonable expectations of beneficiaries if the direction were not issued in order for the direction power to be validly triggered. This reflects the wording of the corresponding ground for issuing such a direction in the Banking, Insurance and Life Insurance Acts. The ‘material prejudice’ requirement acts as a threshold consideration, acting to prevent the trigger of this direction over minor concerns. Moreover, the material prejudice would usually apply to the interests or reasonable expectations of all or a class of ‘beneficiaries’, rather than one member.

### Proposal

That the SIS Act be amended to allow APRA to issue a direction based on the following triggers:

- a breach of the RSE licensee law or licence condition;
- an anticipated breach of the RSE licensee law or licence condition;
- promoting instability in the Australian financial system;
- conducting affairs in an improper or financially unsound way; and
- where the failure to issue the direction would materially prejudice the interests or reasonable expectations of beneficiaries of the superannuation entity.

Further, that the decision to issue a direction for a breach, or anticipated breach, of the RSE licensee law or licence condition be a reviewable decision under the SIS Act.

#### Discussion questions

Should there be a limitation on the triggers for a direction?

Would any other triggers for the issue of a direction (including the additional grounds in the Banking, Insurance and Life Insurance Acts) be appropriate in the superannuation context?

### 2.3.2 Contents of a direction

As is the position under the Banking, Insurance and Life Insurance Acts, a direction would:

- identify the specific event giving rise to the trigger of the direction;
- specify positive or negative actions required of the trustee in order to rectify the event which gave rise to the issue of the direction; and
- include a time limit for compliance.

In this manner, a trustee would be informed of the specific steps required to rectify the prudential concern, and the amount of time the trustee has before the situation will be escalated, such as

through the offence for a failure to comply with a direction (see the breach of a direction section below) or one of APRA's other powers.

The content of a direction will normally depend on the ground upon which it is given. For example, if a direction is based on non-compliance with a particular prudential standard, the direction would normally include a requirement to comply with that prudential standard. However, it may be necessary to specify actions that need to be taken or desisted from in order to achieve compliance, in which case it will not be sufficient to merely have power to direct compliance with the RSE licensee law. Similarly, if the basis for the direction is one of the other grounds (example the RSE licensee is conducting its affairs in an improper or financially unsound way), then it will be necessary to specify the kinds of things that must be done or desisted from to address the issue.

Accordingly, it is proposed that APRA be given the flexibility to frame directions according to the circumstances. In this regard, as well as having power to require compliance, it is proposed that APRA be given the power to direct an RSE licensee 'to take or not take specific action in relation to the structure or organisation of the affairs, or the conduct of the affairs ' of the RSE.

It is further proposed that, consistent with the position under the Banking, Insurance and Life Insurance Acts, a direction triggered by an actual or anticipated breach of the RSE licensee law or a licence condition would be merits reviewable. Therefore, where a trustee disagreed with APRA's reasoning, for example, the trustee believed that it was not in breach of the RSE licensee law or that a current state of affairs would not lead to a breach of the RSE licensee law, then it would be able to apply for APRA to review its decision to issue the direction under the reviewable decisions framework currently set out in the SIS Act (discussed above). This framework would provide the opportunity for the RSE licensee to provide APRA with its own explanation of the state of affairs and enable APRA to reconsider its decision to issue the direction in light of that explanation. If the RSE licensee was not satisfied with APRA's decision following review, the RSE licensee would be able to seek further review through the Administrative Appeals Tribunal.

### **Contents of a direction: removal of an individual trustee, director or officer**

In some situations an individual trustee, director or officer of a superannuation entity may be the source of a prudential concern. As such, the removal of that individual trustee, officer or director may be able to resolve the prudential issue without the need to remove the entire trustee; as is the current alternative under paragraph 133(1)(e). Under this paragraph APRA has the ability to remove an RSE licensee in its entirety if the RSE licensee breaches the RSE licensee law. Following the removal, APRA would appoint an acting trustee (as per section 134).

Accordingly, it is proposed to expressly include the removal of a specific individual trustee, director or officer of the superannuation entity in the contents of what a direction may require. If this was to be included APRA would first be required to identify the specific trigger for the issue of the direction (as outlined in the list of triggers above) before being able to direct the trustee to remove the identified individual trustee, director or officer. In this manner, APRA's desire to remove an individual trustee, director or officer would not, by itself, give APRA the ability to order such removal. Rather, a breach or anticipated breach of the RSE licensee law or licence condition, or a prudential concern as listed in the triggers above would need to first be identified before APRA could require the trustee to remove the individual that gave rise to that trigger.

## Proposal

That, under the SIS Act, after identifying the relevant trigger that gave rise to the direction, APRA would be able to require, within a specified amount of time:

- specific positive or negative actions for the trustee to undertake, or not undertake, in order to rectify the event that gave rise to the direction;
- the trustee 'to take or not take specific action in relation to the structure or organisation of the affairs, or the conduct of the affairs of the RSE'; and
- the removal of an individual trustee, director or officer of the superannuation entity.

### Discussion questions

Should anything else be included in the contents of a direction? In particular, are any of the specific kinds of directions under the Banking, Insurance and Life Insurance Acts appropriate for consideration?

Should there be limitations in the scope of the contents of a direction?

Is it suitable to provide APRA with the ability to direct an RSE licensee 'to take or not take specific action in relation to the structure or organisation of the affairs, or the conduct of the affairs' of the RSE?

Is it suitable to provide APRA with the ability to direct an RSE licensee to remove an individual trustee, director or officer?

### 2.3.3 Breach of a direction

The optimal approach to apply to a failure to comply with a direction could come from any of the: SIS, Banking, Insurance or Life Insurance Acts, or a combination of those.

- Under section 29JB of the SIS Act, a failure to comply with a direction to comply with a licence condition is an offence of strict liability, punishable by 60 penalty units.
- Under section 11CG of the Banking Act, both the ADI or NOHC, and an officer of that ADI or NOHC may be found liable for failing to comply with a direction, punishable by 50 penalty units. A persistent failure to comply is also a continuing offence.
- Under section 108 of the Insurance Act, both the insurer or NOHC, and an officer of that insurer or NOHC may be found liable for failing to comply with a direction, punishable by 50 penalty units. In both cases, it is an offence of strict liability. A persistent failure to comply is also a continuing offence.
- The same approach in insurance is applied to life insurance. Under section 230F of the Life Insurance Act, both the life company or NOHC, and an officer of that life company or NOHC may be found liable for failing to comply with a direction, punishable by 50 penalty units. In both cases, it is an offence of strict liability. A persistent failure to comply may also constitute a continuing offence.

## Proposal

That the SIS Act provide for a breach of any direction given by APRA to be punished in a similar manner to the Insurance and Life Insurance Acts (as above).

### Discussion questions

Bearing in mind the approaches taken under the Banking, Insurance and Life Insurance acts, should a failure to comply with a direction:

- Be a strict liability offence?
- Be able to result in personal liability against officers of an RSE?
- Be a continuing offence?

### Example: Breach of the current RSE licensee law

Currently, under section 105 of the SIS Act, trustees are required to keep copies of member or beneficiary reports for at least ten years, and to make those reports available for inspection by APRA upon request. Noncompliance is an offence of strict liability per subsection 105(2).

As it is part of the SIS Act, section 105 also forms part of the RSE licensee law. Without using the direction power for a breach of the RSE licensee law or licence conditions, the penalty of noncompliance with section 105 is the strict liability offence under subsection 105(2).

However, using this direction power, in the case where a trustee was not making reports available to APRA, in the first instance a direction could be issued to the trustee requiring the trustee to make member or beneficiary reports available to it. The trustee would then have the chance to make the reports available once more by following the specific requirements set out in the direction. If the trustee then refused to comply with the direction, it would be in breach and liable to the attached penalty for non-compliance with a direction. Alternatively, the trustee may access the review of decisions process. This would enable the trustee to provide reasons why it did not make the reports available, after which APRA may confirm, vary or revoke its decision to issue the direction.

In this manner, a direction would be issued as a preliminary step rather than taking a first step of actioning the strict liability offence through the courts. The trustee would be issued with a formal notice, which it would be able to question, and detailed with the specific steps it should take in order to remedy its breach. Accordingly, additional time would be given to the trustee to comply with the law and the situation would not be immediately escalated through the courts.

### Example: Breach of the new requirements relating to MySuper

Section 29VA of the Superannuation Legislation Amendment (MySuper Core Provisions) Bill 2011 establishes fee rules in relation to MySuper products. Trustees must ensure that certain fees charged to MySuper members are charged as the same flat fee, or the same percentage of the MySuper account balance, or the same combination of those.

A failure to comply with the fee rules in relation to MySuper products, per paragraph 29U(2)(d), may lead to APRA cancelling authority to issue a MySuper product. Cancellation of authority to issue a MySuper product then, per section 29SAB, means that the trustee of the MySuper product must

honour its election to transfer the assets attributed to the MySuper product as required in the prudential standards.

If a direction power were instead to be used for a breach of the RSE licensee law, APRA would be able to issue a direction to the trustee and specify how the fees must be charged. The trustee would then have the opportunity to comply with this direction and amend its fees accordingly, or seek a review of the decision and provide its reasoning. In this sense, less drastic steps are taken initially, rather than cancelling, or threatening to cancel, the trustee's MySuper authorisation.

#### Example: Directions issued through the prudential standards

The prudential standards will form part of the RSE licensee law under the Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012. Draft Superannuation Prudential Standard SPS 310 on Audit and Related Matters, amongst other matters, requires audit reports to be conducted, sets out the requirements for the content of an audit report and requires the RSE licensee to provide a verified copy of the audit report to APRA.

Under the direction power for a breach of the RSE licensee law, the failure to comply with any of these matters allows APRA to issue a direction for the RSE licensee to comply with the prudential standard. APRA may also be able to reasonably anticipate a future breach of these requirements, which would allow APRA to issue a direction for the anticipated breach of the RSE licensee law. The failure to comply with the direction would then lead to the attached penalty for a failure to comply with a direction, rather than the existing alternative approaches such as the instigation of formal proceedings or the cancellation of an RSE licence.

#### Example: Making investments that conflict with the interests of members

A situation may develop where APRA has identified a serious financial concern. For example, a trustee may be making investments that appear to advantage the interests of a third party outside the jurisdiction over those of beneficiaries.

Here, the trustee may have breached its obligations in relation to listing interests on the conflicts of interest register. In such case, a direction triggered on the basis of a breach of the RSE licensee law (through a breach of the prudential standards) may be able to direct the trustee to remedy its conflicts register but would not remedy the more substantial issue regarding the transactions themselves.

On the other hand, APRA would be able to issue a direction based on the trustee conducting its affairs in an improper or financially unsound way, or because the failure to issue the direction would materially prejudice the interests of beneficiaries of the superannuation entity. These triggers, in this example, would give rise to more tailored requirements being available within the direction itself, enabling APRA to direct the trustee to stop making payments to the third party and to seek the return of monies that have already left the jurisdiction.

## 2.4 OTHER PROPOSED TECHNICAL AMENDMENTS TO DIRECTION-MAKING PROVISIONS

That the following technical amendments be made to the direction-making provisions of the industry Acts to ensure consistency within and across the industry Acts:

- replicate subsection 11CA(1B) and subsection 11CA(1C) of the Banking Act in the Insurance Act and Life Insurance Act to ensure that APRA may give a direction despite any external support

(example Government support) being in force for an insurer. This will ensure consistency in direction-making provisions between the Banking Act on one hand, and of the Insurance Act and Life Insurance Act on the other;

- amend the recapitalisation direction provisions of the industry Acts so that they are consistent with the general direction provisions of the industry Acts. For example, an inconsistency is where APRA is able to vary a general direction but not a recapitalisation provision. It is proposed that the same approach be applied across all categories of directions;
- amend section 13F of the Banking Act, section 103C of the Insurance Act and section 230AC of the Life Insurance Act to clarify that APRA may incorporate, by reference, other extraneous material (example prudential standards) in making recapitalisation directions for the purpose of specifying characteristics of capital instruments; and
- amend section 11CF, subsections 13P(9) and 29(9) of the Banking Act, subsection 103L(9) and section 107 of the Insurance Act, and subsection 230AK(9) and section 230E of the Life Insurance Act to correct a drafting error and to ensure that information relating to directions and revocation of directions is confidential unless published in the Gazette. The current reference in these provisions to the Part 6 of the *Australian Prudential Regulation Authority Act 1998* (APRA Act) is erroneous because Part 6 of the APRA Act does not operate to impose secrecy on regulated entities or their employees, officers or contractors. The policy intent is for these classes of persons to maintain confidentiality as to the fact that a direction has been made, varied or revoked and as to the contents of a direction.



### 3. AUSTRALIAN BRANCHES OF FOREIGN ENTITIES

Foreign banks are an important source of competition in the Australian banking industry and provide a valuable conduit for offshore funding to our capital-importing economy. They are also active participants in Australia's domestic financial markets and payment systems, thereby helping to provide liquidity and to enhance market depth and efficiency.

Foreign banks may be authorised under the Banking Act to do banking business in Australia either through Australian incorporated subsidiaries, which have their own separate legal identity, are therefore subject to Australian law and are treated like any other locally incorporated bank; or through branches, which do not have a separate legal identity. This choice gives flexibility in corporate structuring, allowing foreign banks to use the most efficient structure for their operations in Australia and enhances Australia's appeal as a location for cross-border expansion of banking groups.

As at December 2011, of the 48 foreign banks operating in Australia, 39 operated via branches and nine operated via subsidiaries. Foreign bank branches (referred to as 'foreign ADIs') held total assets in Australia of \$297.6 billion as at December 2011, which represented around 8.8 per cent of total assets of all banks in Australia. At the same date, foreign bank subsidiaries held total assets in Australia of \$110.6 billion, representing around 3.3 per cent of total bank assets in Australia.

The main business of foreign ADIs in Australia tends to be a combination of corporate lending, trade finance, wholesale funding (including from other ADIs), provision of risk hedging to ADIs and corporate clients (for example, through interest rate and currency swaps and options), treasury functions, and securities trading. The customers of foreign ADIs in Australia tend to be exporters and importers seeking trade finance, other ADIs (for example, for risk hedging or funding), companies seeking funding via syndicated loans in which branch banks participate as lenders, large corporate borrowers and large depositors (corporate, ADI, and some high net worth individuals). Foreign ADIs are not permitted to accept retail deposits in Australia (see below).

Cross-border expansion by banking groups through integrated branch networks can be attractive to banks, since it is often less costly and more efficient than establishing a series of legally independent subsidiaries. The use of a branch structure could, however, pose risks to the bank's creditors in Australia and to the stability of the Australian financial system if the foreign bank becomes insolvent or gets into financial difficulty.

The failure of integrated cross-border banking groups might pose particular threats. Since a branch is an integral part of the foreign bank, it is considerably harder to insulate the local operations from any instability in the bank's home country or in other jurisdictions, compared with a subsidiary. This means that the Australian branch of a foreign bank is likely to be at a higher risk from foreign instability than a locally incorporated subsidiary of a foreign bank. In recognition of this risk, APRA does not allow foreign ADIs to take retail deposits in Australia. This limits the nature of the impact that the failure or distress of a foreign bank operating via a branch in Australia can have on the Australian financial system. Nonetheless, there is still the potential for a foreign bank's Australian operations to become systemically significant. This can occur as a result of the size of its balance sheet in Australia, the extent of its participation in particular financial markets or payment systems, and the size of inter-bank exposures. This situation is not unique to Australia and there is a growing recognition internationally that foreign ADIs have the potential to transmit financial shocks to the host system in which they are operating.

In addition, since the head office bank and the branch are one entity in law, there is nothing to prevent it from moving assets (and liabilities) between countries without the normal constraints on transfers from one company to another, making it considerably easier for a branch to transfer assets offshore (or for liabilities to be transferred into a branch). This means that, at any given time, there is no assurance that deposits and other funding in the Australian branch of a foreign bank are necessarily covered by assets in Australia. APRA does not impose net asset or *de facto* capital requirements to foreign ADIs. Rather, APRA places reliance on the overall capital position of the foreign ADI in its home jurisdiction.

The prime responsibility for oversight of the Australian operations of a foreign ADI rests with its home supervisor, although a foreign ADI is nonetheless subject to APRA's supervision in respect of its Australian operations. There are, however, limits to the control APRA can exert over a foreign branch in Australia, and over cross-border groups generally.

The FSB's Key Attributes includes recommendations that authorities have the power to enable cross-border coordination of bank resolution. Specifically, the FSB standard states that authorities should have the capacity to resolve the subsidiaries and branches of globally interconnected financial institutions. In the case of foreign branches, the standard states:

The resolution authority should have resolution powers over local branches of foreign firms and the capacity to use its powers either to support a resolution carried out by a foreign home authority (for example, by ordering a transfer of property located in its jurisdiction to a bridge institution established by the foreign home authority) or, in exceptional cases, to take measures on its 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.

The FSB envisages the above arrangements as part of a much higher level of international cooperation than currently takes place. In particular, the FSB recommends that regulators should have a statutory obligation to 'consider the potential impact of its resolution actions on financial stability in other jurisdictions'. The FSB proposals suggest the need for resolution authorities to have the statutory tools to facilitate cross-border cooperation and coordination in a resolution, but also the capacity to take defensive moves to protect the domestic financial system if foreign authorities are not acting in a manner consistent with a jurisdiction's domestic financial stability.

These considerations make it appropriate to examine whether the existing statutory framework in Australia is adequate to enable APRA to respond to the distress or failure of a foreign bank operating via a branch in Australia.

## 3.1 PROVIDING APRA WITH MORE POWERS IN RELATION TO FOREIGN BRANCHES

### 3.1.1 Appointing a statutory manager to the Australian business of a foreign branch

#### Existing resolution powers

Given the prohibition on foreign ADIs to take retail deposits<sup>4</sup> in Australia via branches, APRA applies different requirements on branch operations than is the case for locally incorporated ADIs. Foreign ADIs are not required to maintain capital or hold assets in Australia to match their Australian liabilities<sup>5</sup> and are not subject to large exposure limits, but they are required to maintain a liquidity management strategy and comply with certain prudential standards governing ADIs, such as those on governance and outsourcing. The foreign ADI, as a whole, is required to be regulated by its home country in a manner consistent with the BCBS *Core Principles for Effective Banking Supervision* (BCBS Core Principles) and BCBS capital requirements.

Nevertheless, the existing law gives APRA powers over foreign branches to ensure there is some protection for domestic creditors and financial system stability. The Banking Act requires the Australian assets of an insolvent foreign ADI be available to meet the ADI's Australian liabilities in priority to its other liabilities (section 11AF of the Banking Act). APRA can issue any direction to a foreign ADI that it can make to a locally incorporated ADI, other than a direction in relation to capital or the removal or appointment of directors. In addition, APRA may direct a foreign ADI not to transfer assets out of Australia nor to move liabilities into Australia. APRA can issue directions in a wide range of circumstances, including where the ADI has breached a law or prudential standard, where APRA considers the ADI may be in distress, or where the interests of creditors or financial system stability might be at risk. This power is broad enough for APRA to issue such a direction where the foreign ADI is in distress and there is a risk to its Australian branch.

Any foreign ADI operating through a branch must nominate a senior officer outside Australia who has the delegated authority of the board and is responsible for overseeing the operation of the Australian branch. The foreign ADI must also have a senior manager ordinarily resident in Australia who is responsible for the Australian operation. These officers are responsible for making reasonable efforts to ensure the foreign ADI branch complies with a direction from APRA.

While APRA has relatively broad direction powers in relation to foreign ADIs, APRA has other crisis resolution powers in relation to locally incorporated ADIs that it lacks in relation to foreign ADIs. In particular, APRA lacks the following powers in relation to foreign ADIs operating in Australia via branches:

- APRA cannot appoint an SM to assume control of the Australian business of a foreign ADI. APRA's power to resolve a distressed foreign ADI branch is significantly constrained without this power, particularly where the parent authorities are either taking insufficient action to

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4 APRA imposes a condition on authorisation that prevents the ADI from accepting initial deposits of under \$250,000 from a person.

5 These requirements are contained in subsection 13A(4) of the Banking Act, which is in Part II Division 2 of the Act. However, Part II Division 2 does not apply to foreign ADIs (subsection 11E(1)).

address concerns in Australia or taking actions that are contrary to the interests of Australian creditors or the Australian financial system.

- In the absence of a power to appoint an SM to the Australian business of a foreign ADI, a distressed foreign ADI's Australian branch would have to be resolved in accordance with ordinary cross-border insolvency law, or in accordance with the home jurisdiction's special resolution regime for banks. A foreign jurisdiction's insolvency framework may focus on creditors (not depositors). Further, the resolution regime of a foreign jurisdiction may not operate in the interests of Australia's financial stability or Australian depositors. The absence of a statutory manager power also limits APRA's ability to prevent the transfer of assets out of Australia, for example where a foreign ADI is not complying with an APRA direction.
- In contrast, note that APRA has the power to apply to the Court to appoint a JM to assume control of the Australia business of a foreign general insurer or of a foreign life insurer.
- In the case of foreign ADIs operating via a branch in Australia, APRA cannot invoke the compulsory or voluntary transfer of business powers available in the Business Transfer Act. As a result, APRA could not readily facilitate the transfer of a branch's business in Australia to another entity (in coordination with the ADI's home supervisory authority) as part of a cross-border resolution of the ADI. It also means that APRA could not implement a business transfer of the foreign ADI's business in Australia in a separate resolution, such as where the parent authority has confined its resolution to the business of the bank in the home jurisdiction and is not adequately addressing the needs of depositors, other counterparties or the financial system in Australia.
- There is some ambiguity as to whether APRA can apply for the winding up of a foreign ADI's Australian business and, even if it could, whether the grounds upon which APRA can do so are adequate. This could impede APRA's ability to facilitate a quick and orderly recovery of creditors' funds. In contrast, APRA has specific statutory authority to apply to the Court for the winding up of the Australian business of a foreign insurer operating via a branch in Australia.

### **What are the risks of foreign bank branches operating in Australia?**

In Australia, there is a risk that, if a foreign ADI becomes financially distressed or is about to fail, its assets in Australia could be moved to another part of the ADI's global operations to the detriment of depositors and other creditors in Australia. (The risk to depositors is confined to wholesale deposits, given that branches cannot raise retail deposits.) The entities in Australia with the greatest exposure via deposits or other funding to foreign ADIs are other ADIs (including locally incorporated ADIs) and non-financial corporations.

Depending on the size and nature of a foreign ADI's participation in Australian financial markets and payment systems, the distress or failure of a foreign ADI also has the potential to cause disruption to the stability of the Australian financial system. For example, if a foreign ADI is a major participant in the Australian derivatives market (example as a counterparty to locally incorporated ADIs in the swaps and options markets), its acute distress or failure could create significant disruption to the derivatives market. This could make it difficult for locally incorporated ADIs and other corporate entities to replace hedging contracts for a period.

The distress or failure of a foreign ADI could also create significant disruption to counterparties that rely on the foreign ADI for trade finance or other credit. The extent of disruption would depend on the size of the ADI's lending business, how dominant it is in a particular niche market, and whether its borrowers can readily obtain credit from other sources. In specific circumstances, and depending on which part of the Australian economy was affected, failure of a foreign ADI could generate contagion in the Australian market and affect the funding of local banks and businesses. For example, if the foreign bank branch had borrowed a significant amount from other ADIs, the collapse of the foreign ADI could trigger contagion. This would be particularly the case if the economy and the affected lender or lenders to the branch were already under stress.

A vulnerability also arises if the foreign ADI's home authorities do not resolve the ADI's distress quickly and effectively or if they take actions that prejudice the interests of creditors in Australia or the Australian financial system. For example, a ring-fencing form of resolution by the home authorities could have an adverse impact on the ADI's creditors in Australia and, potentially, on the Australian financial system.

For the reasons set out above, there is a need to consider strengthening APRA's capacity to deal with financial distress in foreign ADIs operating in Australia via branches.

### **Addressing risks posed foreign bank branches**

Concerns surrounding the treatment of foreign branches may be best addressed by empowering APRA to appoint an SM to the Australian business of a foreign ADI. This would enable APRA to facilitate the orderly resolution of distress in a cross-border banking group in accordance with the foreign regulator's resolution actions where a coordinated resolution is agreed upon. In exceptional circumstances, empowering APRA to appoint an SM to the Australian business of a foreign ADI would also help APRA to implement a stand-alone resolution where the home authorities are not taking actions consistent with the interests of the Australian financial system and creditors in Australia.

Appointing a statutory manager to the Australian business would help to secure the branch's assets to meet the ADI's liabilities to its depositors and other creditors in Australia, and allow APRA to resolve the branch in such a way as to reduce any adverse effects on financial system stability, where necessary. Appointing an SM would assist in effecting a transfer of the assets and liabilities to another ADI or a bridge entity if that were considered an appropriate response to the situation. It would also assist in readying the Australian operations for winding up should that be the appropriate course of action.

The power to appoint an SM could be particularly useful for foreign financial groups that have both branches and subsidiaries in Australia. If the foreign parent became distressed, that distress would likely flow through to subsidiaries and branches. Enabling APRA to appoint an SM over subsidiaries and branches could substantially assist in resolving the entire Australian business of the foreign ADI in a manner consistent with the interests of non-retail depositors and financial system stability. The manager could ensure that the branch's affairs were managed in such a way as to maintain interdependent relationships with any Australian ADI or insurer that is part of the same group.

In most situations, APRA could rely on the local management of the branch to comply with a direction. However, in a crisis, conflicts of interest on the part of the branch management and uncertainty as to who is in control of the assets in Australia could increase the risk that a direction is not complied with. In contrast, an SM would have control over the assets in Australia and could be expected to act in the interests of creditors and non-retail depositors in Australia.

The existence of a power to appoint an SM could also assist APRA and the Government in any negotiations with the foreign bank's home authorities (and the foreign bank's head office), given that the ability to appoint an SM could make the home authorities and foreign bank head office more attentive to the views and concerns of the Australian authorities than would be the case in the absence of such a power.

The appointment of an SM to an ADI branch and non-ADI subsidiaries of the foreign ADI in Australia could also assist APRA to implement a wider range of resolutions than would be the case with liquidation. For example, an SM could continue to operate some of the business of the branch and relevant subsidiaries in Australia, provided that there is sufficient local functionality to enable this to be done. This may be beneficial as an interim measure, for example, in continuing to meet drawdowns under lending commitments or payments under derivatives, pending the final resolution, for instance by transfer of the business to another entity).

Empowering APRA to appoint an SM over the foreign ADI branch and non-ADI subsidiaries of the foreign ADI in Australia would, to some degree, replicate the current powers that exist over life insurance and general insurance branches. In the case of insurers, APRA can apply to the Court for a JM to be appointed over the Australian business of the foreign insurer.

### Proposal

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.

#### Discussion questions

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?

### 3.1.2 Enable APRA to apply to the Court for the winding up of the Australian business of a foreign ADI

Currently, APRA appears to have standing under the Corporations Act to apply to the Court for the winding up of the Australian business of a foreign ADI. However, there is no provision in the Banking Act to apply for the winding up of the Australian business of a foreign ADI. In contrast, APRA has authority under section 14F of the Banking Act to apply for the winding up of a locally incorporated ADI. The Corporations Act might not adequately cater for circumstances in which APRA might need to apply for the winding up of a foreign ADI, because:

- The grounds under which APRA may apply for the winding up of the Australian business of a foreign ADI under the Corporations Act are limited. In particular, the grounds do not include circumstances in which winding up orders may have been sought against other sister branches, or the head office, of the ADI overseas. Similarly, the circumstances do not include situations in which APRA is of the view that a winding up is necessary in the interests of the Australian financial system. Consequently, the Corporations Act regime does not provide a satisfactorily broad mechanism for protecting Australian creditors and financial system stability.
- the absence of a specific provision in the Banking Act to enable APRA to apply to the Court for the winding up of the Australian business of a foreign ADI is inconsistent with the Insurance Act and Life Insurance Act. Both the Insurance Act and Life Insurance Act enable APRA to apply to the Court for the winding up of a foreign insurer based on the grounds available under those Acts.

Providing APRA with the power to apply for the winding up of the Australian business of a foreign ADI under the Banking Act would ensure that APRA can apply to wind up a foreign ADI based on grounds that have regard to APRA's mandate of protecting depositors (in this case, non-retail depositors) and maintaining financial system stability. This would also align APRA's power to wind up a foreign ADI with APRA's current powers to apply for the winding up of a locally incorporated ADI under the Banking Act and to apply for the winding up of foreign general insurers and foreign life insurers under the Insurance Act and Life Insurance Act respectively.

## Proposal

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 in item 3.1.1, 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.

### Discussion questions

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

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

### 3.1.3 Enable APRA to revoke the authorisation of a foreign-regulated entity if the foreign regulated entity's authorisation is revoked by its home regulator

Currently, there are certain grounds in the industry Acts under which APRA may revoke the authorisation of a foreign-regulated entity. For example, under the Banking Act, APRA may revoke the authorisation of an ADI, including that of a foreign ADI, if the grounds under subsection 9A(2) exist. However, there is no specific ground in the industry Acts allowing APRA to revoke a foreign regulated entity's authorisation when the authorisation provided by its home country has been revoked.

A core element of APRA agreeing to authorise a foreign ADI is that it is subject to adequate home country supervision. This being the case, the question arises whether a foreign ADI should continue to be authorised in Australia if it is no longer subject to adequate prudential supervision in its home country. The same applies in respect of foreign general insurers and EFLICs.



## Proposal

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.

## 3.2 EXTENDING APRA'S DIRECTION POWERS

### 3.2.1 Harmonising the power to direct that a foreign branch not transfer assets out of Australia across the industry Acts

The *Financial Sector Legislation Amendment (Prudential Refinements and other Measures) Act 2010* (2010 Act) amended the Banking Act to clarify that APRA may issue a direction to a foreign ADI branch to prevent undesired intra-entity transactions that may undermine the financial position of a foreign ADI branch's operations in Australia. This is particularly important in a situation where the foreign ADI is in financial distress and ensures that liability holders in Australia are not disadvantaged in the winding up or other resolution of the ADI. In essence, the power explicitly enables APRA to direct a foreign ADI branch not to transfer its Australian assets to an offshore head office or sister branch, nor to transfer liabilities into the Australian branch. Specifically, subsection 11CA(2B) of the Banking Act was inserted to clarify that APRA may direct a foreign ADI:

- to act in a way that a particular asset, or a particular class of assets, of the ADI is returned to the control of the part of the ADI's banking business that is carried on in Australia, or that a particular liability, or a particular class of liabilities, of the ADI ceases to be the responsibility of the part of the ADI's banking business that is carried on in Australia; or
- not to act in a way that a particular asset, or a particular class of assets, of the ADI ceases to be under the control of the part of the ADI's banking business that is carried on in Australia, or that a particular liability, or a particular class of liabilities, of the ADI becomes the responsibility of the part of the ADI's banking business that is carried on in Australia.

Equivalent provisions were not inserted into the direction-making provisions of the Insurance Act or Life Insurance Act, even though the directions powers in the three industry Acts are harmonised in most respects. The same rationale applies to foreign insurers operating via branches in Australia as for foreign branch ADIs with regard to whether APRA should have the power to prevent undesired intra-entity transactions that may undermine the financial position of a foreign branch's operations in Australia. Again, this direction power is particularly important in a situation where the foreign branch is in financial distress and this direction power ensures that liability holders in Australia are not disadvantaged in the winding up or other resolution of the foreign branch.

## Proposal

That the directions power under the Insurance Act and Life Insurance Act be harmonised with that under the Banking Act in this regard. Specifically, that provisions equivalent to section 11CA(2B) of the Banking Act be inserted into the Insurance Act and Life Insurance Act.

### 3.2.2 Directing a compulsory transfer of business to or from a foreign branch

The Business Transfer Act makes provision for the voluntary or compulsory transfer of all or part of the business of an ADI, general insurer or life company to another ADI, general insurer or life company or to another company or body respectively.

There is ambiguity about whether the Business Transfer Act applies to foreign regulated entities (that is foreign-incorporated financial institutions operating in Australia as branches) or only to regulated entities incorporated in Australia. Given that business transfers may need to be made in respect of Australian branches of foreign regulated entities as part of a resolution process, it is desirable to eliminate this ambiguity and confirm that the Business Transfer Act applies to Australian branches of foreign regulated entities. Clarifying that the Business Transfer Act applies to branches in Australia would ensure that APRA could facilitate a voluntary or compulsory transfer of business. For voluntary transfers, this would ensure that branches are afforded the same level of flexibility in relation to the transfer of business as their locally incorporated counterparts. Compulsory transfers of business of a financial institution are an important crisis management tool for APRA. Transferring the whole or part of a regulated entity's business to another regulated entity or a bridge institution is a tool that APRA needs to have available to assist in the resolution of any distressed financial institution. It can be used either as part of a coordinated cross-border resolution agreed with the home authorities or as part of a stand-alone resolution where the home authorities are not acting in a manner consistent with the interests of the Australian financial system or counterparties in Australia.

#### 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?

## 4. ENHANCING THE STATUTORY MANAGEMENT AND JUDICIAL MANAGEMENT LEGISLATIVE FRAMEWORKS

It is important that APRA has effective powers to intervene when regulated financial institutions are at risk of experiencing financial difficulties that threaten their ongoing viability, and to ensure the effective resolution of the situation in a manner which maintains the stability of the financial system and protects depositors and policyholders.

APRA currently has the power to appoint an SM to an ADI, and apply to the Federal Court for the appointment of a JM to a general or life insurer, when one or more grounds for appointment (set out in the respective legislation) are met. The board of directors of the ADI or insurer ceases to exercise powers over the entity upon the appointment of an SM or JM, and the SM or JM is vested with powers of control of the ADI or insurer.

The SM and JM regimes provide a flexible mechanism for dealing with a financial institution in acute distress and where APRA does not have confidence that the board and management of the ADI or insurer is capable of resolving the distress satisfactorily or where the board and management are mismanaging the entity. Statutory and judicial management provides a tool through which a range of potential resolution actions may be implemented. For example, statutory or judicial management enables the implementation of a resolution that preserves the core business and functionality, and the economic value, of a regulated entity with a view to the entity's business continuing as a going concern. Equally, statutory or judicial management can be used to prepare and preposition the entity for an orderly discontinuation of business, including through the invoking of the FCS (in the case of ADIs and general insurers).

In reviewing the powers available to APRA, and to SMs and JMs, to deal with regulated entities experiencing financial distress, the Government has identified a number of potential enhancement measures. In some respects, there is a lack of clarity in relation to the powers that may be exercised by APRA and SMs or JMs in the event of financial distress and, in some situations, these powers may be insufficiently robust or too limited in scope. Also, there is a need for greater clarity that these powers can be used to continue a regulated entity's business for a period of time as a going concern where this is necessary as part of a resolution strategy.

This section of the Discussion Paper proposes enhancements to the legislative framework for the statutory management and judicial management regimes in order to ensure their effective operation in a crisis situation. These reforms are intended to simplify existing powers across the statutory and judicial management regimes or, in some cases, to strengthen the powers currently available to APRA to deal with regulated entities experiencing financial difficulties.

### 4.1 APPOINTING A STATUTORY OR JUDICIAL MANAGER

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

Section 13A of the Banking Act specifies the circumstances that must exist before APRA is able to appoint an SM to an ADI. The legislative triggers specified include where the ADI becomes unable to meet its obligations or suspends payment, or where the ADI or APRA consider that one of those two

circumstances are foreseeable. Section 13A also enables APRA to appoint an SM to an ADI if APRA considers that it is likely that the ADI will be unable to carry on banking business consistently with the interests of depositors or financial system stability in Australia.

The triggers specified in section 13A are primarily linked to situations in which the ADI is insolvent or on the brink of insolvency. It is arguable that the existing grounds do not enable APRA to appoint an SM to an ADI facing an emerging distress situation or in circumstances where an ADI's board of directors are ineffectual or obstructive. APRA's inability to appoint an SM in these circumstances has the potential to hamper APRA from intervening before a distress situation deteriorates into something that ultimately may become more difficult to manage or more expensive to resolve. Extending the triggers in section 13A would enable APRA to appoint a statutory manager in a timely and responsive manner where there is a need for early intervention before an ADI's situation becomes critical, in order to prevent detriment to depositors or the stability of the financial system, or both.

### 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?

## 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

In a situation where an external administrator (example a liquidator, receiver or other form of external administrator) is appointed to the authorised NOHC of a regulated entity, this has the potential to trigger financial distress in the regulated entity. This distress may arise through a number of channels, including cross-default clauses being triggered as a result of the external administration of the NOHC, adverse confidence impacts and the risk of an interruption to essential services provided to the regulated entity by the NOHC. In these circumstances, it may be necessary for APRA to move quickly to assume control of the ADI via statutory management or to apply to the Court for the appointment of a JM to an insurer if the authorised NOHC's external administration poses serious risks to the ADI or insurer. Therefore, it may be worth extending the grounds for appointing an SM or

JM to include the appointment of an external administrator to an authorised NOHC where this poses a significant threat to the operation or soundness of the ADI or insurer.

#### 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.

### 4.1.3 Broaden the grounds to appoint a judicial manager to an insurer

The grounds on which the Federal Court may order the appointment of a JM are set out in sections 62L and 62M of the Insurance Act and sections 158 and 159 of the Life Insurance Act.

If the insurer has been subject to an investigation, the Federal Court can appoint a JM to the insurer if it is in the interests of the policyholders that such an order be made. If an investigation cannot be carried out due to time constraints, the Federal Court can appoint a JM to an insurer if it is satisfied that:

- the insurer is unlikely to meet its liabilities as they come due;
- the insurer has failed to comply with directions or prudential standards; or
- there are reasonable grounds for believing that the financial position or management of the insurer may be unsatisfactory.

However, none of the provisions expressly enable the Court to order the appointment of a JM to an insurer on the grounds that the insurer is unable to carry on business in Australia consistently with the interests of financial system stability. The inability of the Court to appoint a JM for this reason limits APRA's flexibility in pursuing its goal of maintaining stability in the financial system, as it is required to do under the APRA Act and under the Insurance Act and Life Insurance Act.

#### Proposal

That the following amendments be made:

- Section 62L of the Insurance Act and section 158 of the Life Insurance Act be expanded to state that the Federal Court may make an order that an insurer be placed under judicial management if the Court is satisfied that the insurance business of the company has been investigated under Part V Insurance Act/Division 3 of Part 7 Life Insurance Act; and that, having regard to the results of the investigation, it is in the interests of the policyholders of the insurer or of financial system stability in Australia that the order be made.
- Section 62M of the Insurance Act and section 159 of the Life Insurance Act be expanded to provide that the Court may make an order that an insurer be placed under judicial management if the Court is satisfied of one of the circumstances outlined in the section and that the time needed to make or complete an investigation would be likely to be such as to

prejudice the interests of the policyholders of the company or *financial system stability in Australia*.

#### 4.1.4 Enable a statutory manager to be appointed to a bridge bank or bridge insurer

In the event of a crisis, the Government may wish APRA to utilise the compulsory transfer provisions in the Business Transfer Act to direct the transfer of the business of a financially distressed ADI or insurer to a Government-owned company authorised by APRA as an ADI or insurer (that is a 'bridge bank' or 'bridge insurer'). Under this option, the Government would establish a new company under Australian law and would ensure that it was adequately capitalised to run the business transferred to it. APRA would authorise the new company as an ADI or insurer before the transfer takes place.

In these circumstances, APRA may wish to appoint an SM to the bridge bank or bridge insurer, pending the completion of the transfer and the establishment of a board and management team to the company. This is because it may take the Government several days or even weeks to find suitable directors and a CEO for the bridge bank or bridge insurer. In the interim period, APRA and the Government would need to be satisfied that the institution is under effective control so that it can assume the transferred business and run it prudently. An SM would provide this assurance, given that they would assume all directorship and management powers of the entity and would be subject to the guidance and direction of APRA, as the case may be.

##### Proposal

That the Banking Act be amended to empower APRA to appoint an SM to an ADI that has been established by the Government for the purpose of assuming some or all of the business of an ADI in distress. APRA would need to be satisfied that statutory management is necessary or desirable in order to ensure the prudent management of the ADI's business or to facilitate the implementation of a resolution of financial institution distress.

Further, that the Insurance Act and Life Insurance Act be amended to empower APRA to appoint an SM to an insurer established by the Government:

- for the purpose of assuming some or all of the business of an insurer in distress; and
- where APRA is satisfied that statutory management is necessary or desirable in order to ensure the prudent management of the insurer's business or to facilitate the implementation of a resolution of financial institution distress.

To facilitate the transfer of business from a distressed entity to a bridge bank or insurer in this context, the Government will also consider whether any consequential amendment to the Business Transfer Act is necessary. Consideration will also be given to whether amendments are needed to be made to the Corporations Act or other legislation to make it clear that the Government can establish a company for this purpose without appointing a board for so long as the SM or JM is in control of the entity.

## Discussion questions

Is it appropriate for an SM or JM to be appointed to a bridge bank or bridge insurer?

Are there any risks associated with appointing an SM or JM to a bridge bank or bridge insurer?

### 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

Currently, section 15C of the Banking Act provides that the fact that an SM is in control of an ADI's business does not allow the contract, or a party to the contract, to do any of the following:

- deny any obligations under the contract;
- accelerate any debt under that contract; and
- close out any transaction relating to that contract.

Corresponding provisions exist in the Insurance Act and Life Insurance Act when a JM is in control of an insurer and in the Business Transfer Act when a compulsory transfer of business has been effected under that Act.

Without such provisions, the appointment of an SM or JM to, or a compulsory transfer of business from, a regulated entity is likely to be an 'event of default' or other 'specific event' under many commercial contracts. These 'events' may have a number of consequences that are detrimental to the continuing operations of the regulated entity. For example, they may entitle the other party to the contract to cease meeting their contractual obligations, such as performing business services. If the contract is a loan or other type of debt, such events may allow the creditor to ask for immediate payment of the amount outstanding under the loan, and may have additional penalty clauses attached. If the contract relates to other transactions or trades, such events may entitle the other party to close out these transactions and ask for immediate settlement of any outstanding accounts.

In the context of statutory/judicial management, these provisions protect the financial position of the regulated entity and the interests of depositors/policyholders until the SM or JM has had time to make an assessment as to an appropriate course of action. These provisions also ensure the SM or JM can enable the regulated entity to continue trading if that is appropriate.

If a regulated entity has lodged security or collateral with a counterparty as part of a contractual arrangement, the risk arises that the terms of the contractual arrangement may provide for a right on the part of the counterparty to take action in realising or otherwise obtaining benefit from the security or collateral. Section 15C and its equivalent provisions in other APRA-administered legislation should apply to ensure that the mere appointment of an SM or JM to, or compulsory transfer of business from, the regulated entity does not trigger these terms. The adverse consequence of these terms being triggered would be that the already fragile financial position of regulated entities in distress may be exacerbated and frustrate measures taken by the Government to stabilise them and resolve the distress they are in.

## 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.

### 4.1.6 Clarify the effect the appointment of a statutory manager or judicial manager has on a deed of company arrangement

A recent Federal Court decision<sup>6</sup> has raised a question as to the effect the appointment of an SM or JM to a regulated entity has on a deed of company arrangement (DOCA).

A DOCA is a form of external administration under the Corporations Act that applies to companies that are either insolvent or nearing insolvency. Commonly, a DOCA will provide for a composition of existing debts or for payment to be postponed while the company continues to trade and recovers or while there is an orderly sale of its assets. A deed must provide for a registered liquidator to act as administrator of the DOCA. Creditors have the responsibility to decide by a majority in number and value of their claims whether a company should execute a DOCA or should go into liquidation.

The Federal Court decision stated that the status of a DOCA to which a general insurer is subject is unclear following the appointment of a JM to the general insurer. Whilst acknowledging that section 62U of the Insurance Act would ensure that a deed administrator would be displaced upon the appointment of a JM, the Court questioned whether the deed may continue to subsist. The Court noted that Part VB of the Insurance Act attempts to create a paramount mode of corporate restructuring and that the effect of this intention may simply result in the termination of a DOCA, but the judgment indicates that this matter is not beyond doubt.

It is desirable that the effect of the appointment of an SM or JM on a DOCA is certain. This would be achieved if it was made clear that the appointment of either an SM or JM has the effect of terminating all other forms of external administration, including a deed administrator and the terms of a DOCA, to ensure that depositors' and policyholders' interests are adequately protected. This is consistent with existing provisions in the industry Acts that have the effect of terminating the appointment of any external administrator of a regulated entity where an SM or JM is appointed to

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<sup>6</sup> *Australian Prudential Regulation Authority v ACN 000 007 492 (Under Judicial Management) (Subject to Deed of Company Arrangement)* [2010] FCA 912 (25 August 2010).



the regulated entity. This would prevent any further payments being made or transactions being entered into under an existing DOCA.

### Proposal

That it be made clear in the industry Acts that any DOCA in existence at the time an SM or JM is appointed is terminated upon the appointment of an SM or JM. Further, the Court could be empowered to make orders setting aside transactions entered into or payments made under the DOCA before the appointment of the SM or JM, or altering the terms of the deed itself, having regard to the interests of depositors or policyholders. These orders could be made upon the application of an interested party.

#### Discussion question

What are the implications of this proposal for the rights of creditors under DOCAs?

## 4.2 MORATORIUM PROVISIONS

When an SM or JM is appointed to an ADI or insurer, the SM or JM will need time to assess the nature of the financial damage affecting the institution and will, along with APRA and the Government, be required to determine an appropriate resolution. The SM or JM will also need to have access to, and be able to utilise, the institution's resources for the purposes of the administration.

The moratorium provisions that are invoked upon the appointment of an SM or JM are therefore designed to create a 'breathing space' within which APRA, the Government and the SM/JM may determine and implement appropriate resolution measures. To achieve this objective, creditors and others should be temporarily prevented from taking litigious and enforcement actions that have the potential to distract from or hamper the diagnosis and resolution of financial distress. In other words, the provisions should operate as a shield that protects SMs or JMs from being subjected to a multiplicity of time-consuming and costly actions, and should ensure that all resources within reason are accessible for the purposes of the administration.

The current moratorium provisions are inconsistent across the industry Acts and could be simplified. There may be scope for some enhancements to be made to the moratorium provisions in the three Acts to ensure that they adequately protect an ADI or insurer from potential litigious and enforcement actions during a period of distress resolution. Proposals for amendment are discussed in the following sections of the Discussion Paper.

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

Section 15B of the Banking Act provides that a person cannot begin or continue a proceeding in a Court against an ADI while an SM is in control of the ADI's business, unless the Court grants leave on the ground that the person would be caused hardship if leave were not granted or APRA consents to the proceedings beginning or continuing. A person intending to apply for leave of the Court under

this section must give APRA at least 10 days notice of their intention to apply, and APRA may apply to the Court to be joined as a party to the proceedings for leave.

Section 15B does not apply to a proceeding in respect of an offence or a contravention of a provision of a law for which a pecuniary penalty may be imposed.

Section 62P of the Insurance Act and section 161 of the Life Insurance Act both provide that while a general insurer or life company is under judicial management, a proceeding in a Court against the insurer or in relation to any of its property cannot be commenced or proceeded with, except with the JM's written consent or with the leave of the Court. These sections do not apply to a proceeding in respect of an offence or a contravention of a provision of a law for which a pecuniary penalty may be imposed.

Some amendments are considered appropriate to enhance the moratorium provisions of the three industry Acts.

### **Desirable features of an enhanced and simplified moratorium provision**

The following list details the desirable features of a standardised set of provisions. In identifying these features, regard has been given to the moratorium provisions in the Corporations Act that apply during a voluntary administration, as well as provisions in legislation from New Zealand, Singapore, Canada and the United Kingdom.

- Proceedings in a Court

A proceeding in a Court against the company or in relation to any of the company's property cannot be commenced or proceeded with during statutory or judicial management. A 'Court' would include anybody whose proceedings may lead to a reduction in the company's property or cause a distraction for the SM or JM, provided that body has characteristics similar to those of a court of law. For example, industrial tribunals and forms of commercial arbitration should be considered a 'Court' for the purposes of the moratorium.

APRA, the Court or the SM or JM would be able to permit a creditor to commence or continue proceedings, provided the creditor would be caused hardship if leave were not granted.

- Enforcement of a security attached to property

All 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 any interest in. However, APRA, the Court or the SM or JM may permit creditor to enforce their security. This would not affect the arrangements in respect of covered bonds.

- Claiming or repossessing property

No person shall attempt to claim, recover, repossess or re-take any property or premises in the possession of, in use by, or occupied by the company. However, APRA, the Court or the SM or JM may grant the owner or lessor of property leave to take possession of their property.

- Judgment or orders in respect of the company

No execution or other method of enforcement of a judgment or order against the company or its assets may commence or continue.

If a sheriff or other Court officer has seized company property in execution, where the property has not yet been sold or where the sheriff or other Court officer holds proceeds of execution when notice of the appointment is received, the property or the proceeds must be handed over to the SM or JM.

- Disposal of property

Whilst an SM or JM is in control of a company, no other person may dispose of any of the company's property, unless given authority to do so by the SM, JM or APRA.

- Essential services

Suppliers of essential services (electricity, gas, water and telecommunications) cannot refuse services to an ADI or insurer under external management on the sole basis of a debt owing to them and they cannot make further supply conditional on payment of an outstanding debt.

- Annual general meeting

Whilst an SM or JM is in control of a company, APRA or the Court may waive the requirement under section 250N of the Corporations Act that a public company hold an annual general meeting.

## 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?

## 4.3 POWERS AND IMMUNITY OF STATUTORY AND JUDICIAL MANAGERS

### 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

Part II Division 2 of the Banking Act provides that an SM appointed to an ADI may do various things when in control of the ADI. An SM has the powers of the board of the ADI in question and has the capacity to govern the ADI and, through the ADI, its subsidiaries. In addition, an SM has specific powers under the Act to assist in implementing a resolution of the ADI, including the power to recapitalise the ADI. However, subsection 13A(3) of the Banking Act provides that if an ADI becomes unable to meet its obligations or suspends payment, the assets of the ADI in Australia are to be available to meet the ADI's liabilities in the following order:

1. the ADI's liabilities (if any) to APRA for payments made under the FCS;
2. the ADI's debts (if any) to APRA for costs APRA incurs in administering the FCS;
3. the ADI's deposit liabilities in Australia; and
4. the ADI's other liabilities.

Subsection 13A(3) is designed to preserve the assets of a financially distressed ADI and, once a winding up has commenced, it will apply in conjunction with sections 555 and 556 of the Corporations Act and subsection 16(2) of the Banking Act<sup>7</sup>. As noted above, the requirements set out in subsection 13A(3) are to apply 'once an ADI becomes unable to meet its obligations or suspends payment'.

The threshold of 'once an ADI becomes unable to meet its obligations or suspends payment' is also provided for in subsection 13(1) of the Banking Act as a ground that APRA may invoke to appoint an SM to an ADI. Thus, there is legal uncertainty as to whether the priority provision in subsection 13A(3) is applicable while an SM is in control of an ADI but before a winding up has commenced.

Specifically, it is unclear whether the effect of subsection 13(1) is such that it will interfere with an SM's functions and duties under the Banking Act. The wording of subsection 13A(3) arguably limits the scope of what an SM might do in these circumstances by mandating that the ADI's assets are to be available to meet the ADI's liabilities in a particular order. Without clarification, an SM may feel severely restricted as to what they may do to manage an ADI's business. This could have an adverse impact on the Government's attempts to resolve the distress or failure of an ADI.

This potential interpretation is also at odds with the policy intent that statutory management is designed to function as a tool through which APRA may ensure either the implementation of some form of resolution that preserves some or all of the ADI as a going concern or prepares the ADI for an orderly and timely liquidation.

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<sup>7</sup> Subsection 16(2) of the Banking Act provides that despite anything contained in any law relating to the winding-up of companies, but subject to subsection 13A(3), debts due to APRA by an ADI under that section have priority in a winding-up of the ADI over all other unsecured debts.

## 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).

### 4.3.2 Statutory immunity for statutory and judicial managers

Section 14C of the Banking Act provides that an SM will only be liable for a loss that is incurred because of any fraud, dishonesty, negligence or wilful failure to comply with the provisions of the Act.

Section 62ZM of the Insurance Act and section 179 of the Life Insurance Act both provide that a JM will not be subject to any liability to any person in respect of anything done, or omitted to be done, in good faith in the exercise or performance of powers, functions or duties conferred or imposed on the JM by those Acts.

In essence, section 62ZM of the Insurance Act and section 179 of the Life Insurance Act provide greater protection than subsection 14C(2) of the Banking Act in the following respects:

- Under the insurance legislation, immunity is not available where the JM fails to act 'in good faith'. By contrast, immunity is not available under the Banking Act where the ADI SM acts in a 'negligent' fashion. In most situations, it will be easier for a claimant to establish negligence than a lack of good faith.
- The insurance legislation is expressed to apply generally to 'any liability'. By contrast, subsection 14(2) of the Banking Act refers to 'a loss'.

Section 58 of the APRA Act provides APRA, its members and its employees a level of protection that is more robust than the statutory protection accorded to SMs and JMs. It states that APRA, an APRA member, an APRA staff member, or an agent of APRA is not subject to any liability to any person in respect of anything done, or omitted to be done, in the exercise or performance, *or the purported exercise or performance*, of powers, functions or duties conferred or imposed on APRA, an APRA member or an APRA staff member by or under the APRA Act or another law of the Commonwealth. There is a justifiable limit to this protection in that it is not available where there is bad faith on the part of APRA, its members, staff members or agents.

Robust immunity provisions are important components of the statutory management and judicial management legislative frameworks. SMs and JMs are charged with the responsibility to protect depositor and policyholder interests and to promote financial system stability and, in accordance with this twin purpose, may be required to take actions that have the potential to adversely affect directors, shareholders and certain classes of creditors. It is therefore conceivable that adversely affected stakeholders may subsequently seek to recover any loss suffered via legal action against the SM or JM personally. Moreover, the circumstances of an SM's or JM's appointment are such that they may be required to take actions of a higher-than-usual level of risk or in situations of considerable uncertainty, and in a potentially highly litigious situation. It is therefore necessary that an SM or JM has confidence that they can take the actions required to resolve the distress of the entity and ensure its sound management, within the limits of their powers, without fear of personal liability. If there is significant uncertainty on this matter, there is a high risk that suitable persons will not be willing to assume the appointment as SMs or JMs.

Accordingly, an appropriate level of statutory immunity should operate to ensure that:

- a potential SM or JM is not deterred from accepting the position due to concerns about their personal exposure to liability; and
- SMs or JMs are able to act confidently and decisively in the midst of a distress situation, and without concern that affected parties may commence legal action against them, or that they may suffer other liability as a result of their actions as an SM or JM.

#### 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.

## 4.4 REMOVING STATUTORY MANAGERS

### 4.4.1 Enable APRA to terminate its control of an ADI or to remove a statutory manager

Section 13C of the Banking Act empowers APRA to terminate its control of an ADI or terminate a statutory management where:

- the ADI's deposit liabilities in Australia have been repaid or APRA is satisfied that suitable provision has been made for their repayment, and APRA considers that it is no longer necessary for it or an administrator to remain in control of the ADI's business; or
- APRA considers that the ADI is insolvent and is unlikely to be returned to solvency within a reasonable time, and APRA has applied for the ADI to be wound up under the Corporations Act.

The current formulation of section 13C can be read as meaning that, in the absence of insolvency, APRA's control of an ADI or statutory management can only be terminated where depositors have been repaid or will be repaid.

The Act does not provide the flexibility for APRA to terminate its control of an ADI or to terminate statutory management in a wider range of circumstances — essentially where the resolution of the ADI's affairs has been completed and APRA's control or statutory management is no longer necessary. This lack of flexibility on termination is inconsistent with the reality that statutory management is a resolution tool that can be used to implement a range of resolutions. In some cases, statutory management will be used to assume temporary control of an ADI in acute distress for the purpose of facilitating its restructuring or recapitalisation, where this will result in it continuing to conduct banking business. In such a situation, depositors will not be repaid, other than under the normal contractual terms of their deposits if they wish to be repaid in due course. In such a situation, APRA would terminate statutory management once it is satisfied that the ADI has been restored to financial soundness and has an effective governance structure to ensure that it manages its risks prudently.

The current provisions also do not explicitly provide for termination in circumstances where an SM has initiated a voluntary winding up of the company (as opposed to APRA having commenced proceedings for a Court ordered winding up).

#### Proposal

That section 13C be expanded to enable APRA to terminate its control or to remove an SM where APRA is satisfied that the ADI has been restored to a sound financial condition and that APRA's control or statutory management are no longer required; or where voluntary winding-up proceedings have been commenced.

### 4.4.2 Replacement of a statutory manager

Section 14E of the Banking Act enables APRA to terminate the appointment of an SM in certain circumstances, subject to the need not to terminate statutory management until the conditions in section 13C of the Act have been satisfied. In particular, section 14E empowers APRA to terminate the appointment of an SM if the SM contravenes a requirement of the Act. Section 14E also states that the terms and conditions of the SM's appointment may provide for the termination of an SM's appointment.

The wording of section 14E may be ambiguous as to the circumstances in which an SM's appointment may be terminated and as to APRA's ability to replace the SM with another SM. It is important that the SM maintain the confidence of APRA. If that confidence is lost, it is arguable that the Banking Act should provide APRA with the flexibility to terminate the appointment of an SM and replace that person with another SM if APRA believes that such action is necessary in order to resolve the ADI's affairs, protect depositors or maintain the stability of the financial system. A similar mechanism exists in the Insurance Act and Life Insurance Act for a JM to be replaced with another JM for an insurer under judicial management.

#### Proposal

That section 14E of the Banking Act be amended to make clear that APRA can terminate the appointment of an SM and replace that person with another SM where APRA believes this would be desirable for the purpose of satisfactorily resolving the business of the ADI in statutory management, maintaining confidence in the resolution process, protecting the interests of depositors or maintaining the stability of the financial system.

## 4.5 OBTAINING INFORMATION FROM ENTITIES UNDER STATUTORY OR JUDICIAL MANAGEMENT

### 4.5.1 Require directors to submit a report to statutory or judicial managers

Under the Corporations Act, in a compulsory winding up, the directors and secretary of the company must prepare and submit to the liquidator a report as to the affairs of the company (subsection 475(1) Corporations Act; ASIC Form 507). The report is a detailed statement of the assets and liabilities of the company. Also, directors can be required by the liquidator to provide further information by way of report (subsection 475(2) Corporations Act), which is to be given within 14 days of the service of a notice requiring the information by the liquidator on the director

(subsection 475(5) Corporations Act). Failure to comply with any requirement in section 475 without a reasonable excuse is an offence.

### Proposal

That similar provisions be inserted into the industry Acts to provide that directors and the secretary of an ADI or insurer must submit to the SM or JM a report as to the affairs of the institution upon the appointment of an SM or JM unless the SM or JM, with APRA's approval, waives the obligation. This proposed amendment would place a positive obligation on the secretary and directors of the financially distressed institution at the time of appointment of an SM or JM and, in doing so, would facilitate diagnosis of the financial condition of the institution. Relevant information from the former directors and secretary would be particularly helpful if there is a possibility that the FCS would be declared or if any form of public support is used in resolving the distress or failure of the institution.

Further, that the directors and secretary of an ADI or an insurer at the time an SM or JM is appointed be required to prepare and submit to the SM or JM a report as to the affairs of the regulated entities, unless the SM or JM, with APRA's approval, waives the obligation to prepare the report. Failure to comply with this requirement without reasonable excuse would be an offence.

### Discussion questions

The proposal under item 4.5.2 relates to requiring any person to provide information relating to a regulated entity's business upon requests by a JM appointed to the regulated entity. Is that proposal and section 14AD of the Banking Act sufficient to address this issue?

## 4.5.2 Power to obtain information under judicial management

Section 14AD of the Banking Act empowers APRA to require a person, by written notice, to provide APRA with information, or documents containing information, relating to the business of an ADI that is under statutory management. A person that fails to comply with APRA's requirement to give information or documents commits an offence.

The purpose of this section is to equip APRA with the ability to readily obtain information that may assist an SM to promptly and accurately assess the financial position of an ADI. It recognises that information about the financial condition of the ADI is most likely to be within the knowledge of key personnel within the ADI or with whom the ADI deals, and enables APRA to require such information in a timely manner so as to maximise the chances of rehabilitation or crisis resolution. For example, an SM may require information that relates to the liquidity and risk exposure of the ADI, or that reveals the location and value of collateral recovered or provided by the ADI. Any information obtained may be used to inform and aid the SM's decision-making in order to facilitate an effective resolution of distress in the ADI.

For insurers under judicial management, the Insurance Act and Life Insurance Act set out the powers of a JM. However, these Acts do not include provisions that are analogous to section 14AD. Accordingly, JMs and APRA must rely on the voluntary cooperation of third parties when attempting to obtain relevant information and, as a result, the ability to assess the financial position of an insurer is comparatively weak.



## Proposal

That the Insurance Act and Life Insurance Act be amended so that these Acts are consistent with the Banking Act in respect of section 14AD of the Banking Act. This would equip APRA and a JM with the ability to access information pertinent to their functions via the following mechanism:

- Empower APRA to require, by notice, a person to provide APRA with information relating to the business of an insurer that is under judicial management.
  - The notice must specify the period within which the information or documents must be given to APRA, and may specify the form and manner in which the information or documents must be given.
- APRA may issue the notice if:
  - the JM requests, in writing, that APRA require such information or documents from the person;
  - APRA reasonably believes that the person has the information or documents; and
  - APRA is satisfied that the JM requires the information for the purposes of the performance of their duties and functions under the Insurance Act or Life Insurance Act.

## 4.6 MINOR AND TECHNICAL AMENDMENTS

That the following minor and technical amendments be made to the statutory and judicial management regimes:

- Repeal subsection 14C(4) of the Banking Act so that an SM is not considered to be a director for any purpose. This provision would no longer be necessary if the proposal in item 4.3.2 is implemented, which proposes a provision for comprehensive statutory immunity for SMs and JMs.
- Amend the Banking Act to clarify that the *Commonwealth Authorities and Companies Act 1997* does not apply to an ADI under the control of an SM. This would avoid the unintended outcome that might otherwise arise where an ADI is placed into statutory management, whereby it would be consolidated into the Commonwealth financial accounts.
- Amend section 62R of the Insurance Act and section 163 of the Life Insurance Act to provide APRA with standing to apply for the replacement of a JM with another. Currently, the Court may make an order for replacement of a JM. This will clarify that APRA may apply for such an order.
- Amend section 14A of the Banking Act to clarify that, upon the appointment of an SM to an ADI, any person vested with management of the ADI at that time is divested of that management, and that management of the ADI vests in the SM. This will align the Banking Act with the Insurance Act and Life Insurance Act in respect of the effect of the appointment of a JM.
- Repeal section 62Q of the Insurance Act and section 162 of the Life Insurance Act on the basis that these sections are unnecessary.

- Amend section 62S of the Insurance Act and section 164 of the Life Insurance Act to provide for a form for the claim for remuneration and expenses by a JM.
- Amend the Insurance Act and Life Insurance Act by inserting a provision corresponding to section 15 of the Banking Act to clarify that directors of a regulated entity cease to hold office when an SM or JM is appointed to the regulated entity.

## 5. POWERS IN RELATION TO WINDING UP AND EXTERNAL ADMINISTRATION OF REGULATED ENTITIES

The principal objective of prudential regulation is to promote the prudent management of regulated financial institutions to reduce the risk that institutions are unable to meet their commitments and to maintain the stability of the Australian financial system. However, prudential regulation cannot entirely remove the risk of an institution failing. Where the failure of a particular institution becomes inevitable, prudential supervision has an important role to play in maintaining public confidence in the financial system while the institution is either resolved or exited from the market.

It is therefore important that APRA has effective powers to:

- intervene when regulated financial institutions are at risk of experiencing financial difficulties that may threaten their ongoing viability;
- ensure the effective resolution of distress or failure of a regulated entity in a manner which protects depositors and policyholders, and maintains the stability of the financial system; and
- ensure the timely and orderly exit of the regulated entity from the financial sector if necessary.

These powers are needed to ensure that APRA is well placed to intervene in situations of financial distress to maintain a high level of confidence in the financial sector. In particular, it is important that APRA is able to support confidence by providing appropriate protection to beneficiaries and to ensure that the distress or failure of a financial institution does not undermine the stability of the financial system.

APRA currently has powers in relation to the winding up of regulated entities under the industry Acts. Some enhancements to these powers were made in 2008 and 2010. However, with the release of revised standards and other guidance by international agencies such as the FSB, BCBS and International Association of Insurance Supervisors (IAIS), along with experience in the application of some of these powers in the general insurance sector, the Government and APRA have identified further areas where enhancement may be warranted. These proposed enhancements are intended to simplify existing powers, where appropriate, or in some cases strengthen the powers currently available to APRA to ensure the orderly exit or management of a distressed regulated entity.

Winding up powers enable APRA to act in situations where an entity is insolvent or about to become insolvent. The ability to initiate the winding up of an entity in a timely manner assists to prevent the deterioration of assets that may be available to depositors or policyholders, and other creditors. The ability to exercise this power in a range of circumstances may assist to improve potential outcomes for depositors or policyholders of a failing institution or for the financial system more broadly. As a result, these powers should contribute to confidence in the industry and the financial system.

### 5.1 CLARIFYING THE WINDING UP REGIME UNDER THE INDUSTRY ACTS AND CORPORATIONS ACT

A recent decision by the Federal Court, *Australian Prudential Regulation Authority v ACN 000 007 492 (in Liq)* [2011] FCA 353 (*Rural & General*), has highlighted some issues in the operation of the winding up regime. The decision exposed some technical issues in the operation of the winding up provisions between the industry Acts and Corporations Act. These proposals are aimed at resolving the issues in

the operation of the winding up provisions and at making the legislative framework clear so that it operates as intended.

### 5.1.1 Clarifying provisions in the industry Acts regarding the winding up of regulated entities

For each of the prudentially regulated industries, APRA has the power to apply to the Court to initiate winding up proceedings under the respective industry Acts or the Corporations Act or both. The triggers for the exercise of this power vary across each of the prudentially regulated industries.

The industry Acts provide that if certain preconditions are met, APRA (or a JM, in the case of the Insurance Act and Life Insurance Act) may apply to the Federal Court for an order that a regulated entity be wound up. The relevant provisions are summarised below:

- **Banking Act** — Section 14F of the Banking Act provides that APRA may apply to the Federal Court for an order that an ADI be wound up if an SM is in control of the ADI's business and APRA considers that the ADI is insolvent and cannot be restored to solvency within a reasonable period. Upon APRA's application under the Banking Act for a winding up order, the winding up of the ADI is conducted in accordance with the provisions of the Corporations Act, including the Corporations Act provisions enabling the Court to make the winding up order and to appoint a liquidator to the ADI. The Banking Act differs from the Insurance Act and Life Insurance Act in this regard in that, where APRA applies for a winding up order under insurance legislation, the Court makes the order under the provisions of the insurance legislation rather than under the Corporations Act.
- **Insurance Act** — Section 62ZU of the Insurance Act enables APRA to apply to the Federal Court for an order that a general insurer be wound up once an investigation of the insurer has been made. The Federal Court may then make the order if satisfied that it is in the interests of the insurer's policyholders. In addition, where a JM is appointed to the general insurer, the JM may recommend to the Federal Court that a general insurer be wound up. If so, the JM may apply to the Court to make an order giving effect to its recommended course of action. The Court may make the order if it considers, in the circumstances that winding up is most advantageous to the general interest of the policyholders of the general insurer concerned, while promoting financial system stability in Australia.
- **Life Insurance Act** — Section 181 of the Life Insurance Act provides that APRA may apply for an order that a life company be wound up. APRA may do so if, having regard to the conclusions reached by APRA as a result of an investigation of the life company, APRA is satisfied that it is necessary or proper that the application be made. The Court may make an order following an application from APRA if the Court is satisfied that it is in the interests of the owners of policies issued by the company that such an order be made. In addition, where a JM is appointed to the life company, the JM may recommend to the Court that the life company be wound up. Similar to the Insurance Act in this aspect, the Court may, on the JM's application, make the order if it considers that, in the circumstances, winding up is most advantageous to the general interest of the policyholders of the insurer concerned, while promoting financial system stability in Australia. However, unlike under the Banking Act or Insurance Act, a life company is not wound up except by a Court order made on an application under the Life Insurance Act.

The above provisions afford specific grounds for the winding up of APRA-regulated entities upon application by APRA. Accordingly, if APRA holds a justifiable belief that a regulated entity should be

wound up, APRA is not confined to the Corporations Act's customary triggers for the winding up of companies generally. This separate framework under the industry Acts reflects the fact that ADIs and insurers are different from other corporations on the basis that their business affects particular beneficiaries protected under prudential regulation. It also recognises APRA's distinct mandate in regulating these corporations for the purpose of ensuring that they act in the best interests of depositors and policyholders, and to promote financial system stability.

In the event that a Court does order the winding up of a regulated entity under the Insurance Act or Life Insurance Act, these Acts provide that the winding up of the regulated entity is to be conducted in accordance with the Corporations Act. This enables the Court, for example, to appoint a liquidator under the Corporations Act to the insurer being wound up.

The Federal Court decision in *Rural & General* has cast doubt on the ability of a JM appointed to an insurer to have the entity wound up under the Insurance Act or Life Insurance Act. Justice Perram held that an insurer could not be wound up 'in accordance with the *Corporations Act 2001*' unless the winding up order was first made under the Corporations Act. Justice Perram characterised the JM's application under the Insurance Act as an application that the general insurer be wound up in insolvency under section 459A of the Corporations Act. As a JM does not have standing to apply for the winding up of a company under the Corporations Act, the standing provision of the Corporations Act was read to include a JM by relying on the principle of implied amendment.

The decision in *Rural & General* raises doubts as to whether a future Court will consider the grounds under the Insurance Act (that is policyholder protection and the promotion of financial system stability) when determining whether to make a winding up order, or will be bound to only consider the more general grounds under the Corporations Act. A similar concern arises where APRA (rather than a JM) applies to the Court for an order to wind up a general insurer.

The uncertainty arising from *Rural & General* extends equally to an application by APRA for the winding up of a life insurer under the Life Insurance Act. This is because the relevant provisions of the Life Insurance Act and Insurance Act are largely harmonised in this regard. However, this uncertainty does not extend to the Banking Act, as the winding up order in respect of an ADI upon an application by APRA under the Banking Act is made under the Corporations Act, as noted above.

## Proposal

To remove any uncertainty in respect of the above matter, it is proposed that the Insurance Act and Life Insurance Act be amended to make it clear that:

- the Federal Court is able to make a winding up order in respect of a general insurer and life company under the Insurance Act and Life Insurance Act respectively;
- such an order should be able to be made whether upon application by APRA or by a JM under the Insurance Act and Life Insurance Act;
- an application by APRA or a JM for winding up a general insurer or life insurer under insurance legislation should not be characterised as an application under the Corporations Act; and
- subsequent to such an order being made under the Insurance Act or Life Insurance Act, winding up of the general insurer or life company is to proceed in accordance with the relevant provisions in the Corporations Act. This includes the Court being able to appoint a liquidator to the regulated entity under the Corporations Act.

### 5.1.2 Clarifying that voidable transactions are applicable where a winding up order has been made under an industry Act

The Court also found in the *Rural & General* decision that the voidable transaction provisions in Part 5.7B of the Corporations Act would not apply if a Court makes an order to wind up a regulated entity under the Insurance Act.

A voidable transaction includes an ‘uncommercial transaction’ or an ‘unfair preference’ that was entered into within a specified time before the ‘relation-back day’. Section 9 of the Corporations Act defines ‘relation-back day’ as the day upon which a winding up is taken to have begun ‘because of Division 1A of Part 5.6’ of the Corporations Act. Therefore, if a Court orders that an insurer be wound up under the Insurance Act, for example, the voidable transaction provisions will not apply.

From a policy perspective, there is no reason why uncommercial transactions and unfair preferences should not be voidable merely because a Court decides to make an order for the winding up of an ADI, general or life insurer under one of the industry Acts as opposed to under the Corporations Act. It is important that creditors and other stakeholders in an insurer in winding up derive the protections provided by the rules on voidable transactions if the insurer is wound up under the Insurance Act or Life Insurance Act.

#### Proposal

That the relevant legislation be amended to ensure that the Corporations Act provisions concerning voidable transactions (in particular, the definition of ‘relation-back day’) are applicable in a situation in which a Court has made a winding up order under the Insurance Act or Life Insurance Act.

### 5.1.3 Specifying the relation-back day

Under the Corporations Act, certain transactions that a company entered into before a winding up has commenced may be voidable upon an application to the Court by the liquidator. Voidable transactions include unfair preferences, uncommercial transactions, insolvent transactions, unreasonable director-related transactions and unfair loans. If a Court is satisfied that a transaction falls into one of these categories, the types of orders that it may make include an order directing a person to pay to the company an amount equal to that which has been paid under the voidable transaction, an order directing the transfer of property, and an order directing a person to indemnify the company.

These orders may not, however, be made until a company proceeds into liquidation and the liquidator makes an application to the Court. Section 588FE of the Corporations Act provides that a transaction is not ‘voidable’ unless it occurred during a period of time ending on the ‘relation-back day’. Section 9 of the Corporations Act provides that the ‘relation-back day’ will be either:

- the day on which a winding up order has been made; or
- the day on which a voluntary administration began (together, the ‘relation-back day’).

Thus, a transaction will not be voidable unless it occurred during a specified period of time before a winding up order is made or a voluntary administration commences. That period of time can be up to three years, but varies depending on the type of voidable transaction that the liquidator seeks to challenge. For instance, unfair preferences can only be entered into within 6 months before the relation-back day.

The appointment of an SM or JM to an ADI, general insurer or life insurer in itself does not trigger the voidable transaction provisions of the Corporations Act. However, these voidable transaction provisions will be triggered if the ADI, general insurer or life insurer proceeds to liquidation or another form of external administration after statutory or judicial management (as long as issues raised in item 5.1.2 are resolved). If statutory or judicial management continues for an extended period, any liquidator subsequently appointed may lose the opportunity to challenge, under the voidable transaction provisions, certain transactions entered into before the commencement of statutory or judicial management. For instance, if judicial management continued for a six-month period and the entity was then placed into liquidation, the liquidator would lose the opportunity to pursue unfair preferences. This would be to the detriment of creditors of the institution.

On 19 January 2010, the then Minister for Financial Services, Superannuation and Corporate Law, the Hon Chris Bowen MP, announced that the Government would amend the law to address the above anomalies that exist in the Corporations Act definitions of ‘relation-back date’ and ‘commencement date’ where there are successive or overlapping external administrations. Statutory and judicial management are analogous to voluntary administration under the Corporations Act. Therefore, the commencement of the relation-back day, when liquidation is preceded by judicial management, should be analogous to the commencement of the relation-back day in a voluntary administration under the Corporations Act.

### Proposal

Where an SM or JM is appointed to an ADI, general insurer or life insurer before it proceeds to liquidation, the relation-back day should be:

- in the case where an SM is appointed, the date on which APRA appoints the SM; or
- in the case where a JM is appointed, the date on which the Federal Court appoints the JM.

Consideration would need to be given to whether an earlier date should apply where the company was under external administration at the time that the SM or JM was appointed, as well as whether any consequential amendment needs to be made as a result of this proposal.

## 5.2 EXPANDING THE SCOPE OF THE WINDING UP AND EXTERNAL ADMINISTRATION PROVISIONS IN THE INDUSTRY ACTS

Although the winding up and external administration provisions in the industry Acts generally operate satisfactorily, the regime would benefit from certain enhancements, such as widening the scope of some of the provisions and clarifying other provisions. In particular, there is a lack of uniformity in APRA’s powers over administrators and in the circumstances in which a person applying for the appointment of an external administrator must provide APRA with notice. An expansion in the scope of these provisions would create a more consistent and effective legislative framework for the winding up and external administration of regulated entities.

### 5.2.1 Ensuring that APRA's existing powers in the winding up of a regulated entity extend to where a provisional liquidator is appointed to the regulated entity

Generally, a provisional liquidator can be appointed when an application has been made to the Court for an order that the institution be wound up. A provisional liquidator is appointed to safeguard the institution's business and property, pending the outcome of an application for a winding up order. In effect, the provisional liquidator's primary duty is to preserve the status quo with the least possible harm to all concerned. This enables the Court to decide, after a proper and final hearing, whether to wind up the institution.

Currently, APRA has the power to apply for a winding up order in respect of APRA-regulated entities. In making such an application, APRA may seek to recommend that the Court appoint a provisional liquidator pending the hearing of the winding up application. APRA may choose to do this where there is a need to protect an institution's assets from dissipation during this period and the assets of the institution cannot be preserved by appropriate undertakings — example where there is not already an SM or JM in place. In other cases, where persons other than APRA have applied for the winding up of a regulated entity and APRA has not objected, a provisional liquidator may be appointed to prevent dissipation of assets pending the hearing of the winding up application.

Subsection 472(2) of the Corporations Act currently enables the Court to appoint a provisional liquidator at any time after the filing of a winding up application and before the making of a winding up order. Subsection 472(6) further provides that the exercise of a provisional liquidator's powers is subject to the control of the Court, and a creditor or contributory or ASIC may apply to the Court in relation to the exercise or proposed exercise of any of those powers. APRA is not included among the persons with standing to apply to the Court in relation to the exercise of a provisional liquidator's powers.

There is an apparent inconsistency between APRA's inability to apply to the Court to appoint a provisional liquidator and existing provisions in APRA-administered Acts. APRA may apply to the Court for directions regarding any matter arising under the winding up of a regulated entity, for example under section 62ZS of the Insurance Act. APRA-administered Acts also currently require a liquidator of a regulated entity to notify APRA in writing before they propose to make an application to the Court in relation to a matter arising under the winding up of a regulated entity. In addition, APRA currently has the power to request, from a liquidator of a regulated entity, information in writing about the winding up of the regulated entity.

#### Proposal

That APRA be given standing to apply to the Court to give directions in relation to the powers of a provisional liquidator appointed to an APR-regulated entity.

### 5.2.2 APRA to apply for the winding up of an ADI without the ADI having first been placed in statutory management

Section 14F of the Banking Act currently empowers APRA to apply to the Court for an ADI to be wound up where APRA considers that the ADI is insolvent, where the ADI cannot be restored to solvency within a reasonable period, and where an SM is in control of the ADI. The effect of



section 14F of the Banking Act is that APRA does not have the power to apply to the Court for the winding up of an ADI unless an SM is in control of the ADI.

In most situations, it would be desirable for APRA to first appoint an SM before proceeding to a winding up, given that an SM may assist APRA to assess the ADI's solvency or to take actions required to facilitate an effective resolution of the ADI's affairs. However, where APRA has already formed the view that the ADI is insolvent (after having investigated the ADI, for example), there should be the flexibility to apply to the Court to wind up the ADI without having to first appoint an SM to the ADI. Having to appoint an SM as an interim step is only likely to be necessary if there are particular tasks that APRA needs an SM to perform that a liquidator cannot perform — example to investigate the ADI to assess solvency or to pre-position the ADI to be wound up and for the FCS to be implemented. However, having to appoint an SM before applying for a winding up order does not make sense where, for example, there is no scope to attempt an open resolution of the an ADI or where APRA forms the view that the implementation of the FCS could proceed without the appointment of an SM. This proposal is intended to provide flexibility to APRA within the legislative framework and enhance the options available to APRA in managing the distress or failure of an ADI.

#### Proposal

That section 14F of the Banking Act be amended to empower APRA to apply to the Court for the winding up of an ADI where APRA considers that the ADI is insolvent and could not be restored to solvency within a reasonable period, regardless of whether an SM has been first appointed to the ADI.

### 5.2.3 Providing APRA with notice of proposed applications for external administration

Sections 62ZQ of the Insurance Act and 179C of the Life Insurance Act were amended by the 2010 Act to compel a person applying to a Court for the appointment of an external administrator to a general insurer or life insurer to provide APRA with copies of the application and documentation filed in support of the application. This must be done before the person makes the application. APRA is then entitled to be heard in Court on the application. This amendment aligned the Insurance Act and the Life Insurance Act with an existing provision in the Banking Act to the same effect.

However, there are certain circumstances in which an external administrator may be appointed without an application to the Court (example by the appointment of receivers or through a voluntary administration).

#### Proposal

That the 2010 legislative amendments be extended so that the notification requirement is applicable to all forms of external administration, including those that are Court appointed.

Under this proposal, persons seeking to appoint a liquidator to a regulated entity would be required to inform APRA that they wish to do so and to provide APRA with documentation in support of such appointment. It is envisaged that this requirement would be complied with if the information is provided to APRA before the external administrator is appointed. It is not intended that a failure to comply with this requirement will prevent or delay any proposed external administration of a regulated entity.

This amendment enables APRA to receive information about any prospective appointment of an external administrator to a regulated entity, or to a regulated entity's property, before the external administrator is appointed. This is intended to allow APRA to understand the circumstances giving rise to the proposed appointment and for APRA to take appropriate and timely action if necessary. This proposed amendment would apply to relevant provisions of the industry Acts.

#### Discussion question

Will the proposed amendment impose any material compliance costs on regulated entities or insolvency professionals appointed to administer a regulated entity?

### 5.2.4 Harmonising the industry Acts on APRA's involvement in the external administration of regulated entities

Currently, under the Insurance Act and Life Insurance Act, the following provisions apply in respect of the external administration of a regulated entity:

- A liquidator has to notify APRA of any application to the Court by the liquidator on the winding up of the regulated entity and APRA has the right to be heard in such an application;
- APRA has the right to apply to the Court for directions on any matter arising under the winding up of the regulated entity; and
- APRA has the right to request information from the liquidator about the winding up of the regulated entity.

These provisions are intended to enhance APRA's ability to monitor the conduct of the liquidation of a regulated entity, given the potential impact on the interests of depositors or policyholders. Specifically, they enable APRA to participate in legal proceedings, including providing an opportunity for APRA to submit its views to a Court on any aspect of the liquidation process where depositor or policyholder interests or financial system stability may be affected.

While the Banking Act includes a provision on the first point, it does not include provisions corresponding to those in the Insurance Act and Life Insurance Act on the second and third points.

#### Proposal

That the industry Acts be harmonised by inserting provisions on the second and third points above into the Banking Act.

Moreover, it is proposed that the provisions above be applied in the case of liquidations not just of ADIs, general insurers and life insurers, but also of authorised NOHCs and of subsidiaries of ADIs, general insurers, life insurers and authorised NOHCs.

### Discussion question

Will the proposed amendment impose any material compliance costs on regulated entities or insolvency professionals appointed to administer a regulated entity?

## 5.2.5 Ensuring that a judicial manager may be appointed to an insolvent insurer

Under the Insurance Act and Life Insurance Act, APRA may apply to the Federal Court for an order that an insurer be placed under judicial management. Upon such an application, the Federal Court may make the order if it is satisfied of certain things.

A recent judgment of the Federal Court<sup>8</sup> suggests that, where an application to appoint a JM is made under Part VB of the Insurance Act, the Court may decline to appoint a JM where the insurer is 'plainly insolvent'. At paragraph 42 of the judgment, it was stated that '(i)t would be inappropriate to place a plainly insolvent insurer under judicial management because there would be no hope of it being successfully restructured' and 'in the case of a plainly insolvent insurer the Court is unlikely to appoint a JM at all'.

In the event a general insurer or life company is plainly insolvent, the parts of the Insurance Act and Life Insurance Act concerning judicial management should serve to enable the appointment of a JM.

Judicial management is a key mechanism through which financially distressed insurers can be resolved. It is designed as a means by which the interests of policyholders of the institution and the stability of the Australian financial system may be protected. To achieve these objectives, JMs are vested with the management of the insurer and are equipped with the powers and functions of its board of directors. As soon as possible after assuming these powers, JMs are required to recommend to the Court a course of action that is most appropriate in the circumstances. The possible courses of action that a JM may recommend include that the business be transferred to another insurer, the insurer be recapitalised, or the insurer be wound up.

Any doubt about the ability of the Federal Court to appoint a JM in circumstances where the entity is not plainly insolvent has the potential to constrain both APRA and the Government's ability to manage a financial crisis.

### Proposal

That Part VB, Division 1 of the Insurance Act and Part 8, Division 1 of the Life Insurance Act be amended to ensure that the Federal Court may appoint a JM to an insolvent insurer.

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<sup>8</sup> *Australian Prudential Regulation Authority v ACN 000 007 492 (Under Judicial Management) (Subject to Deed of Company Arrangement)* [2010] FCA 912.

### 5.3 CLARIFYING CIRCUMSTANCES SURROUNDING ‘COURSES OF ACTION’ FOR INSURERS UNDER JUDICIAL MANAGEMENT

Sections 62ZI and 62ZJ of the Insurance Act and sections 175 and 176 of the Life Insurance Act provide for JMs to recommend certain courses of action in relation to insurers under management and for Courts to make orders giving effect to such recommendations.

Currently, JMs and Courts are required to choose the course of action that they consider in the circumstances ‘to be most advantageous to the general interest of the policyholders of the general insurer concerned, while promoting financial system stability in Australia’.

On the current wording, there may be some ambiguity as to whether a Court under section 62ZJ for example, could make an order giving effect to a particular course of action that it considered to be most advantageous to the general interest of policyholders but where that course could not necessarily be said to ‘promote financial system stability’.

#### Proposal

That the above mentioned sections of the Insurance Act and Life Insurance Act be amended to clarify that Courts and JMs, in seeking to give effect to courses of action that are considered to be most advantageous to policyholders, are not unduly constrained by the requirement to promote financial stability in cases where broader financial system stability is not relevant.

Other provisions in the industry Acts that enable powers to be exercised on grounds of policyholders’ interests and financial system stability will also be examined in a similar vein — to ensure that the absence of one of the two criteria does not unduly impede the exercise of the power in appropriate circumstances. These include subsection 14A(5A)(b) and subsection 14AB(8) of the Banking Act, subsection 62ZA(8) of the Insurance Act and subsection 168B(8) of the Life Insurance Act.

## 6. THE FINANCIAL CLAIMS SCHEME

The Financial Claims Scheme (FCS) was established by the Government in 2008. The FCS is administered by APRA. There are two separate FCS arrangements; one is applicable to Australian-incorporated ADIs; the other is applicable to general insurers. The FCS applicable to Australian-incorporated ADIs provides depositors with a guarantee of their deposits to a threshold prescribed by regulations. The threshold is currently set at \$250,000 per account-holder per ADI. In the case of general insurers, the FCS provides compensation to eligible persons with insurance claims against a failed general insurer. Under both FCS arrangements, the FCS applies to an ADI or general insurer at the discretion of the Treasurer when APRA has formed the view that the ADI or general insurer is insolvent and, in the case of an ADI, has applied to the Federal Court for an ADI to be wound up, or in the case of a general insurer, has applied to the Federal Court for the general insurer to be wound up or for a JM to be appointed.

While the legislative framework for the FCS provides it with the capacity to achieve its objectives, particularly with refinements made in 2010, some of the legislative provisions would benefit from further enhancements. Some changes to the ADI FCS framework have already been the subject of a Government consultation paper released in May 2011 based on a review of the framework. The enhancements proposed here are in addition to and build upon those changes and relate to both an FCS for ADIs and general insurers. To date, the FCS has been declared once in respect of a small general insurer and APRA's experience in administering the FCS for that general insurer also serves as a basis for some of the enhancements proposed here.

### 6.1 PROPOSED ENHANCEMENTS TO THE FCS FRAMEWORK FOR BOTH ADIS AND GENERAL INSURERS

#### Existing framework

The legislative framework for the FCS for ADIs resides in the Part II Division 2AA of the Banking Act. There are also provisions relevant to the FCS in the APRA Act and the *Financial Claims Scheme Levy (ADIs) Act 2008*. In addition, provisions relevant to the administration of the FCS are included in the *Banking Regulations 1966*.

The legislative framework for the FCS for general insurers resides in Part VC of the Insurance Act. There are also provisions relevant to the FCS in the APRA Act and the *Financial Claims Scheme Levy (General Insurers) Act 2008*. In addition, provisions relevant to the administration of the FCS are included in the *Insurance Regulations 2002*.

#### Changes proposed under the 2011 review of ADI FCS

The Government consulted on proposed changes to the legislative framework for the ADI FCS in May 2011. In September 2011, the Deputy Prime Minister and Treasurer announced that the Government will make legislative changes to the existing framework to improve the effectiveness of the FCS. These changes will be progressed through amendments to legislation and include:

- removing coverage of foreign branches of Australian-incorporated credit unions, building societies and banks;

- enabling an additional payment option that allows APRA to transfer deposits to a new institution, utilising the funding available under the FCS;
- establishing a ‘look-through’ mechanism for pooled trust accounts;
- requiring the Treasurer to activate the FCS upon the recommendation of APRA once APRA has applied to the Federal Court for an insolvent ADI to be wound up and where the ADI has deposits that are eligible for protection under the FCS and have not been transferred to another entity; and
- enabling the Treasurer to activate the FCS earlier than the point of winding up, once APRA has appointed an SM to an insolvent ADI and to enable the FCS to be administered while the ADI remains in statutory management.

The legislative changes being progressed are limited to the ADI FCS framework. To the extent that some of these changes are also relevant to the general insurance FCS framework, corresponding changes to the Insurance Act are proposed in this paper below.

### 6.1.1 Automatic declaration of the FCS

Currently, under the Insurance Act, the Minister has discretion as to whether the FCS should be declared for a general insurer. In the May 2011 consultation on the review of the ADI FCS framework, it was recommended that the FCS be activated automatically either:

- at the time that APRA applies to the Court for the winding up of an insolvent ADI; or
- at the time that the Court issues a winding-up order

where at the time the application is made or the order is issued the ADI has deposits that are eligible for protection under the FCS and have not been transferred to another entity. This recommendation is intended to provide depositors with certainty that the FCS will be invoked in the case of an insolvent ADI. It also brings the FCS into greater alignment with international principles on deposit insurance and with international practice.

It would be appropriate for the general insurance FCS arrangements to be aligned with the ADI FCS arrangements, such that the FCS must be declared when an application for winding up of a general insurer has been made to the Court. This would provide eligible policyholders and other eligible claimants with certainty that they are protected by the FCS in a winding up of the general insurer.

#### Proposal

That the FCS for general insurers be activated automatically at the time that APRA applies to the Court for the winding up of an insolvent general insurer where, at the time the application is made, the general insurer may be subject to claims that are eligible for protection under the FCS.

As with the proposed change to the FCS for ADIs, the Minister would retain the discretion to declare the FCS for a general insurer before the application for winding up, such as when a JM is appointed, upon the recommendation of APRA.

## 6.1.2 Enabling the FCS to be used to facilitate a transfer of insurance business from a failed general insurer where this is more cost-efficient than effecting a payout to claimants

Currently, the Insurance Act provides APRA with various methods to meet a claimant's entitlement under the FCS. These consist of paying the amount to the claimant or applying the amount for the person's benefit, or a combination of both. The Insurance Act does not contemplate other methods by which the interests of a claimant could be protected in the event of the failure of a general insurer, such as transferring an insurance policy to another general insurer.

Under the May 2011 consultation on the review of the ADI FCS framework, it was recommended that APRA be able to use another payment mechanism in addition to those provided for under the Banking Act. This payment mechanism would enable the transfer of protected deposit accounts from the failed ADI to an ADI that has agreed to assume the deposit liabilities. APRA would determine whether the transfer option would provide a cost-effective and efficient option based on the circumstances in each case. It was noted in the consultation paper that APRA already has extensive business transfer powers under legislation to effect the necessary transfer of business from one ADI to another. This is also the case with the transfer of business from a general insurer to another.

In the context of general insurers, a transfer of business relating to long-tail insurance claims may be either the only practical or the most cost-effective means of maintaining an insured's protection. The situation may arise that an insured event occurs before the date of the FCS declaration, and the loss may not manifest itself until a long time after the FCS has been declared. There is therefore the potential for long-tail claims to arise long after the FCS has been declared or has even closed in respect of the failed general insurer. Such long-tail policy liabilities are excluded from coverage under the current FCS arrangements unless a particular claim has arisen in the period during which FCS claims are permitted. Even where the claimant knows that they are affected by the insured event, it may be that it is difficult to quantify the loss that the claimant may suffer until long after the FCS has been declared. The Insurance Act currently provides that APRA may agree with a claimant an amount that is to be paid out under the FCS. However, this may not be effective in every case, such as where, for whatever reason, APRA and the claimant fail to agree upon a settlement of a claim.

Policy liabilities and associated contractual rights and obligations may be transferred to another general insurer with funding provided for under section 131A of the Insurance Act. However, it is not clear that this funding source would be available in an FCS situation. Therefore, it would be desirable to enable such policies to be transferred to another general insurer as part of the FCS process, using FCS funds.

Incorporating this option into the FCS provides a number of potential benefits. It provides greater capacity to protect policyholders and potential claimants under long-tail policies in circumstances where a claim may arise several years after the FCS has been declared, and where the policyholder is not able to secure replacement cover on similar terms from another general insurer via a new policy. It also facilitates bringing the FCS to a close earlier than might otherwise be the case by enabling potential claims to be made on another general insurer willing to accept the policy obligations.

### Proposal

That the Insurance Act be amended to enable funds appropriated under an FCS declaration to be used to facilitate the transfer of policy liabilities from the failed general insurer to another general insurer willing to assume those liabilities in circumstances where APRA determines this to be

feasible, cost-effective and efficient. This will provide another option for APRA to enable claims against the failed general insurer to be met (or continue to be met) and is consistent with the objective of ensuring the protection of policyholders' interests, particularly in resolving the issue arising from meeting long-tail claims against the failed general insurer. It is analogous to the recommendation in the May 2011 consultation in respect of the FCS for ADIs in that both involve applying the FCS to facilitate the transfer of business from a failed regulated entity to another similar regulated entity to ensure that liabilities to affected beneficiaries continue to be met.

#### Discussion questions

Is it appropriate to allow FCS funds to be used to facilitate the transfer of policy liabilities from a general insurer subject to an FCS declaration to another general insurer willing to accept the policy obligations where APRA assesses this to be feasible, cost-effective and efficient?

Are there legal or practical impediments to enabling the FCS to be applied to facilitate the transfer of policy liabilities from a failed general insurer to another general insurer?

### 6.1.3 Enabling APRA to obtain information from third parties in relation to the FCS

Currently, APRA may, under the Banking Act or the Insurance Act, require certain persons to give either reasonable assistance or specified information in relation to the FCS. This is to facilitate APRA's administration of the FCS and to ensure that correct amounts of entitlement are paid out in an efficient manner under the FCS.

However, these provisions of the Banking Act and Insurance Act enable assistance and information to be sought only from:

- an ADI or general insurer;
- an SM or liquidator appointed to the ADI; or
- a JM or liquidator appointed to a general insurer.

in respect of which the FCS is declared. There is also provision under the Insurance Act to enable APRA to require information from an insurance claimant. However, these provisions do not enable APRA to require information to be sought from other persons who may hold information that facilitates the administration of the FCS in the case of ADIs or general insurers.

In the ADI context, these persons may include third party service providers to whom APRA may delegate FCS functions under section 16AN of the Banking Act. Examples might include providers of data warehouse facilities, data processing facilities and IT services.

In the general insurance context, one issue that has emerged from experience in administering the FCS is that third parties may hold the relevant information, such as claims files. These third parties may include a co-insurer, insurance broker, claims manager or another general insurer to whom liabilities may have been purportedly transferred by the failed general insurer without complete novation. In other words, circumstances may be such that the failed general insurer might not necessarily hold the relevant claims files.



## Proposal

That the Banking Act and Insurance Act be amended to enable APRA to require information from a third party where such information will facilitate FCS administration.

### Discussion question

Are there practical/legal considerations or other impediments to enabling APRA to require information relating to the FCS from third parties?

## 6.1.4 Ensuring certainty of payment of FCS entitlements made by APRA

Currently, under the Banking Act and Insurance Act, APRA has responsibility for making payments to persons entitled to payment under the FCS. The purpose of the FCS is to ensure that depositors in a failed ADI have timely access to their deposit funds and that general insurance claimants have timely access to funds owing as a result of a claim against a failed general insurer. To this end, APRA seeks to ensure prompt payouts under the FCS. Amounts paid out as entitlements under the FCS are then recoverable by APRA on behalf of the Government in the liquidation of the ADI or general insurer, as the case may be.

APRA is subject to various requirements under the Banking Act or Insurance Act in making payment of FCS entitlements. In the winding up of the ADI or general insurer, APRA may also enter into arrangements with the liquidator of the ADI to facilitate the FCS payout process and the proper recovery of monies paid out under the FCS from the assets of the ADI or the general insurer in liquidation. In seeking to recover monies paid out under the FCS, APRA is doing so on behalf of the Government to ensure that, to the extent possible, the cost to the Government and, therefore, to taxpayers, of funding FCS payouts is minimised.

To this end, where APRA has complied with the statutory requirements and responsibilities under the Banking Act or Insurance Act, and with any contractual arrangements entered into with a liquidator in the winding up of the ADI or general insurer, perhaps the amounts paid out by APRA under the FCS should be required to be accepted by the liquidator as final and certain under the legislation. To achieve this, the legislation could be amended to provide that the liquidator is bound by payments properly made under the FCS, provided that APRA has complied with the FCS provisions in the Banking Act and Insurance Act, and with any agreement between APRA and the liquidator.

While current legislative provisions imply that APRA does not have to comply with proof-of-debt provisions in respect of amounts paid out under the FCS, it may be worthwhile having an express provision inserted into the relevant legislation to remove any uncertainty in this regard. The consequence of amounts paid out under the FCS not being final and certain is that all parties involved during the payout process may incur additional cost, time and effort in ensuring that FCS payouts may indeed be recovered in liquidation before they are paid out. The requirement for APRA to have complied with all relevant statutory requirements and any agreement entered into with the liquidator before a payout is made binding is a safeguard to ensure that other creditors of the ADI or general insurer are not placed at a disadvantage in the liquidation process.

## Proposal

That the Banking Act and Insurance Act be amended to require a liquidator of an ADI or general insurer that is declared to be subject to the FCS to accept as proof-of-debt the amounts paid under

the FCS by APRA provided that APRA has complied with the requirements of the Banking Act and Insurance Act (as the case may be), and with any applicable contractual arrangements entered into with the liquidator.

#### Discussion questions

Are there practical/legal considerations or other impediments to making amounts relating to FCS payouts binding upon liquidators in the winding up of an ADI or general insurer in respect of which the FCS has been declared?

Are other creditors of a failed ADI or general insurer adequately protected by the proposed safeguard? Are there other safeguards that should be considered in this proposal?

## 6.2 PROPOSED ENHANCEMENTS SPECIFIC TO THE ADI FCS FRAMEWORK

### 6.2.1 Enabling regulations to be prescribed for refining the definition of ‘net credit balance’ to suit particular circumstances

Subsection 5(1) of the Banking Act defines the term ‘net credit balance’ in a protected account to be the excess of the balance of the account in credit in favour of the account-holder at that time over the amount (if any) of fees, charges and duties that are identified under the agreement under which the account is kept and are payable by the account-holder to the ADI at that time.

In some situations, depending on the terms of the agreement between the ADI and the account-holder under which the account is kept, it may not be clear what the agreement provides for in terms of fees and charges imposed on an account-holder. Where this is the case, determination of the net credit balance may require APRA to make a judgement on the amount of the net credit balance — for example to determine which fees and charges are to be allocated to the applicable account.

#### Proposal

That subsection 5(1) of the Banking Act be amended to enable regulations to be made to vary the definition of ‘net credit balance’. The regulations could provide that APRA may, in circumstances where it is not clear from the relevant contractual documentation relating to the account in question, determine the nature and amount of the deductions for fees and charges when calculating the net credit balance for the purposes of administering FCS payouts.

### Discussion question

Is it appropriate that regulations to be made to allow APRA to determine what fees and charges are to be applied where this is not clear under the agreement under which an account is kept?

## 6.2.2 Enabling the suspension of FCS payments in respect of accounts that are the subject of a suspension, injunction or freezing order pending a determination that payment is appropriate

Account-holder access to an account may be 'frozen' (that is subject to a suspension, injunction or freezing order) for a number of reasons, including where action has been taken by an enforcement or government agency in relation to the proceeds of crime or in the event of a legal dispute over the quantum of the balance. An ADI may freeze access to accounts prior to the declaration of the FCS, or a liquidator or SM may wish to do so after the declaration of the FCS.

Currently, the Banking Act does not expressly provide for differential treatment of accounts that have been frozen. Section 16AF of the Banking Act operates to protect all account-holders who have a protected account with a net credit balance with a declared ADI, regardless of the status of the account.

### Proposal

That the Banking Act be amended to enable the suspension of FCS payments in respect of particular frozen accounts. The proposal could consist of the following:

- A definition of 'frozen accounts' could be introduced into the Banking Act (or in regulations made under the Act) to clearly identify the particular category of account that necessitates differential treatment. For example, the suspension of FCS payments will probably be required where access to the account has been frozen as a result of an enforcement action in relation to the proceeds of crime or breaches of tax laws. A suspension may be unwarranted, however, if the freeze has been imposed because an account-holder has defaulted on amounts owing to the ADI. This is because FCS payouts are made on a gross basis, with no netting of amounts payable by an account-holder to the ADI.
- APRA could be empowered to determine whether an account meets the definition of a frozen account.
- The liquidator (or SM, if one has been appointed) could be responsible for resolving the status of frozen accounts as soon as practicable.
- The liquidator or SM could be required to report their findings to APRA.
  - APRA could then make a decision as to whether payments should be made to the account-holder or whether the suspension should be maintained.
- Where an account-holder has more than one protected account, where one is frozen and the other(s) not frozen, APRA could make payouts in respect of any account that is not frozen.

## 6.3 PROPOSED ENHANCEMENTS SPECIFIC TO THE GENERAL INSURANCE FCS FRAMEWORK

### 6.3.1 Ensuring that the liquidator of a general insurer in respect of which the FCS is declared provides reasonable assistance to APRA in administering the FCS

Section 62ZZO of the Insurance Act currently enables APRA to require a liquidator of a general insurer to provide APRA with reasonable assistance when it is administering the FCS. However, in addition to this requirement, a liquidator also has various other obligations under the Corporations Act. The situation may arise where a liquidator may be placed in a position of uncertainty as to whether its obligation to assist APRA in administering the FCS in respect of a general insurer overrides its obligations under the Corporations Act in respect of the winding up of the general insurer generally. This could be resolved if the Insurance Act were amended to make it clear that complying with the requirement under section 62ZZO of the Insurance Act takes precedence over the Corporations Act.

The same issue arose in the context of the FCS for ADIs. However, the 2010 Act inserted a provision in the Banking Act to address the issue. Under the Banking Act, similar to the Insurance Act, APRA may also require a liquidator to assist APRA in the performance of its functions under the FCS. The 2010 Act amended the Banking Act to provide that this requirement to assist APRA takes precedence over the other aspects of the winding up of an ADI, including any requirements under the Corporations Act. In addition, the 2010 Act made it clear that a liquidator has the powers that are necessary or convenient to comply with a requirement to assist APRA. The 2010 Act also ensured there are sufficient safeguards to protect a liquidator in seeking to comply with a requirement to assist APRA. These include:

- ensuring that the liquidator's costs in assisting APRA will be met by APRA under the FCS funding arrangement; and
- not requiring a liquidator to comply with a notice issued by APRA unless there is sufficient property available to meet the costs that are likely to be incurred by the liquidator in complying with the requirement, or APRA indemnifies the liquidator for those costs.

#### Proposal

That the same amendments as those mentioned above made to the Banking Act by the 2010 Act be made to the Insurance Act in respect of liquidators of general insurers for which the FCS has been declared.

### 6.3.2 Ensuring the effective payout of FCS entitlements to third party claimants of a policyholder of a failed general insurer where the policyholder is in liquidation

Currently, the Insurance Act provides for different types of claimants under the FCS framework for general insurers. Persons who may claim under the FCS are those entitled to claim under insurance cover provided under a protected policy, and those permitted to recover an amount from a general insurer under other provisions of other legislation such as the *Insurance Contracts Act 1984* and the Corporations Act. Given the scope of persons who may claim under the FCS, it is possible that a

claimant may not be a policyholder of a failed general insurer but, rather, a person claiming against such a policyholder. An example of this would be where a company has taken out an insurance policy against the risk of compensation to its employees and the company is in liquidation with outstanding claims for compensation by its employees at the time that the FCS is declared.

Section 562 of the Corporations Act provides that, where a company in liquidation had a policy covering liability to third parties, and the company or its liquidator has received from the insurer amounts in respect of that liability, such amounts must be paid by the liquidator to the third parties in priority to all payments under section 556 of the Corporations Act. This provision is intended to ensure that insurance claimants against an insolvent policyholder receive the amounts due to them arising from payments made by the insurer to the policyholder. However, it is unlikely that payments made under the FCS will fall within the scope of section 562 as currently worded. As such, a risk arises that any amounts paid out under the FCS to the policyholder company in liquidation will go into the pool of funds available for distribution to general creditors of the policyholder company by its liquidator, rather than be available to compensate third party claimants against the policyholder company. This is inconsistent with the policy objective of the FCS, which is to compensate eligible persons with insurance claims against a failed general insurer, and is inconsistent with the approach taken under the Corporations Act

#### Proposal

That the relevant legislation be amended to provide that amounts paid out under the FCS to an insolvent policyholder must be paid by the liquidator of the policyholder to whom they are due in priority to all payments under section 556 of the Corporations Act.

### 6.3.3 Enabling APRA to make interim payments to claimants under the FCS

Currently, under the FCS, where APRA becomes aware that a person has made a claim under a protected policy, section 62ZZI of the Insurance Act places an obligation upon APRA to determine whether a general insurer is liable to the person in respect of the claim and the amount of that liability. Once a determination is made, APRA may make payments to the person, subject to the person meeting the eligibility requirements for claims of \$5,000 or more. Subsection 62ZZK(1) of the Insurance Act permits APRA to pay the amount to the person in instalments.

APRA has encountered difficulties in administering these provisions where personal injury claims have been litigated. While the general insurer may have admitted liability in respect of a claim, the exact quantum of the claim may not be known for many years — example where the person who has suffered the injuries is a minor and it will take many years before the full impact of the injuries becomes apparent. While the legal obligation to pay out under a claim may not arise until the quantum of the claim is determined, payments to injured minors are often made by general insurers to meet medical and legal costs arising in the interim. This is understood to be industry practice. Under section 62ZZF as currently worded, APRA arguably does not have the ability to make such interim payments under the FCS as payments cannot be made until an amount has been determined.

This could be addressed by enabling APRA to determine that the amount of a claim will be ‘at least’ a specified amount, with the capacity to determine further amounts when the need arises. This is intended to ensure that FCS claimants in the situation outlined above are not disadvantaged merely because of the amount of time it might take for the full impact of the event insured against to be known in a particular case or class of cases.

## Proposal

That the Insurance Act be amended to provide APRA with the discretion to make interim payments under the FCS.

### 6.3.4 Extending the interim period of notional insurance coverage to 90 days

In the event the Minister declares that the FCS is to apply to a failed general insurer, section 62ZZH of the Insurance Act provides that all relevant policies will continue in effect for a period of 28 days. This provision acknowledges the practical difficulty of policyholders of the failed general insurer to obtain replacement insurance cover following the failure of the general insurer.

The 28-day period of continued coverage is provided on the same terms as the coverage provided by the policy that preceded it, with the same limits, exclusions, and deductible or excess amounts. The coverage is deemed to be extended, even if the policy is cancelled within the 28-day grace period or where the period of cover would otherwise have ended during the 28-day grace period.

The current interim period may pose difficulties if, in a particular case, a policyholder of the failed general insurer is not aware that the FCS has been declared in respect of the insurer, such as where they may be overseas. Difficulties may also arise where it may potentially take many weeks to secure replacement insurance cover (such as with more complex or unusual policies, or where the failed insurer was the dominant general insurer in a particular insurance product niche).

In recognition of these considerations, it may be worth extending the 28-day period of interim notional insurance cover to 90 days.

It is acknowledged that this could result in the Government undertaking a higher level of insurance risk than is the case under the existing 28-day limit, subject to the capacity to recover any costs from the failed general insurer and any shortfall via an industry levy. However, the benefits, in terms of reduced disruption to markets (example where the failed general insurer has market dominance in a particular product niche) and the greater effectiveness of protecting policyholders with complex or unusual policies, are considered to justify any increased risks this proposal entails.

## Proposal

That the Insurance Act be amended to extend the interim period of notional insurance coverage to 90 days after the FCS has been activated.

### Discussion question

Would the extension of the 28-day period of notional insurance coverage under the FCS to 90 days have any consequences other than those outlined above?

### 6.3.5 Clarifying that APRA need not make separate decisions in relation to claim validity/quantum and claimant eligibility in every case of a claim made under the FCS

The current provisions of the Insurance Act suggest that determinations as to the validity and quantum of FCS claims must be made at the same time as determinations as to claimant eligibility.

This was not intended as a matter of policy and the effect of this requirement is to increase the costs of FCS administration.

#### Proposal

That the Insurance Act be amended so that APRA has a single obligation to make a decision as to whether a person is entitled to be paid under the FCS, rather than having obligations to make separate decisions as to validity/quantum and eligibility.

### 6.3.6 Clarifying that APRA may do various things in determining a claim under the FCS

The Insurance Act provides for APRA to recover, on behalf of the Government, monies paid out and costs incurred under the FCS in the liquidation of the general insurer. There appears to be some uncertainty as to what it is that APRA may do to determine a claim, based on the current wording of the Insurance Act. Uncertainty as to what APRA may do to determine a claim may compromise APRA's ability to recover FCS monies and costs from the liquidator in the winding up of the general insurer.

#### Proposal

That the Insurance Act be amended to clarify the kind of actions that APRA may take in the course of determining a claim under the FCS. This could include actions ordinarily done in the course of determining a general insurance claim, such as engaging claims assessors, legal advisors, actuarial advisors and medical experts.

## 6.4 MINOR DRAFTING AMENDMENTS TO THE BANKING ACT AND INSURANCE ACT IN RESPECT OF THE FCS

The following minor drafting amendments to the Banking Act and Insurance Act are also proposed to enhance the administration of the FCS:

- Correct a drafting oversight by adding references to paragraphs (ea) and (eb) of subsection 16AK(4) in paragraph (g) of subsection 16AK(4).
- Correct a drafting oversight by adding references to paragraphs (da) and (db) of subsection 62ZZP(4) in paragraph (e) of subsection 62ZZP(4).
- Clarify the scope of directions that APRA may give to delegates under section 16AN of the Banking Act and section 62ZZT of the Insurance Act. The directions APRA may give should include those pertaining to:
  - the integrity of and processes relating to decisions made by a delegate in performing or exercising delegated powers or functions;
  - the disclosure of conflicts of interest;
  - the maintenance of records relating to decisions;

- privacy; and
  - confidentiality.
- Clarify that FCS payouts under the Banking Act are to be made on a gross basis rather than a net basis — that is payouts would be made on a gross basis and not be netted for any amounts owed to the ADI by the account-holder other than fees and charges on the protected accounts.
  - Remove any doubt that a delegate appointed by APRA under section 16AN of the Banking Act and section 62ZZT of the Insurance Act is not a delegate appointed under section 48 of the APRA Act.
  - clarify the wording of subsection 62ZZF(1) of the Insurance Act such that it does not have the unintended effect of requiring a claimant to re-lodge a claim with APRA in the approved form in order to receive an entitlement under the FCS where the claimant has already lodged a claim with the general insurer before the FCS was declared.
  - Amend section 62ZZF and section 62ZZG of the Insurance Act to enable regulations to be made to prescribe the amount of a claim below which APRA does not have to assess eligibility of a person making the claim. This amount is currently \$5,000, with no mechanism available in the legislation to change it from time to time. This proposed change will afford flexibility in making changes to the amount from time to time, taking into account inflation and other relevant factors.
  - Amend subparagraphs 62ZZF(1)(b)(ii) and 62ZZG(1)(aa)(ii) of the Insurance Act to add a reference to the Minister. This will enable both the Minister and APRA to extend the period within which a claim has to be made for a claimant to be entitled to FCS payout.
  - amend Note 1 under subsection 62ZZG(3) of the Insurance Act to include a reference to section 601AG of the Corporations Act. This is to update Note 1 with the amendment to section 62ZZJ in 2010, which added a reference to section 601AGF of the Corporations Act.



## 7. FINANCIAL MARKET INFRASTRUCTURE

On 8 April 2011, the Deputy Prime Minister and Treasurer, the Hon Wayne Swan MP, referred a number of issues relating to financial market infrastructure ('FMI') regulation to the Council. The Treasurer asked the Council for advice on measures that could be introduced to ensure that Australia's regulatory system for financial market infrastructure continues to protect the interests of Australian issuers, investors and market participants, including under a scenario where ASX is part of a foreign-domiciled group. In this context, FMI refers to critical FMI in the form of market operators and clearing and settlement facilities.

The issues examined included, but were not limited to, the adequacy of oversight, powers of direction and crisis management arrangements for market operators and clearing and settlement facilities.

The Working Group released a Consultation Paper seeking stakeholder views on 21 October 2011. Submissions closed on 2 December 2011. 22 submissions were received, of which 18 were public and four were confidential. On 30 March 2012, the Deputy Prime Minister and Treasurer released the Council's letter of advice in relation to the review.

The Treasurer's referral, the public submissions and the Council's advice are available on the Treasury website at [www.treasury.gov.au](http://www.treasury.gov.au).

Treasury is seeking further engagement with stakeholders to inform the development of a final policy framework based on the Council recommendations.

The Council's recommendations included recommendations in relation to directions powers and the introduction of a statutory management regime for FMIs. The Government has yet to make any decisions regarding the Council's recommendations.

On 31 July 2012, the Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO) published for public comment the report, *Recovery and resolution of financial market infrastructures, consultative report issued by CPSS-IOSCO*<sup>9</sup>.

That paper seeks comments on the application of the Financial Stability Board's (FSB) *Key Attributes of Effective Resolution Regimes for Financial Institutions* to financial market infrastructure entities.

The proposals for reform proposed in this chapter should be read in light of the ongoing work by CPSS-IOSCO in relation to the resolution and recovery of FMIs, in particular the elements of effective regimes discussed in that recently released paper. In particular, that paper sets out a range of issues that may arise in relation to FMIs in relation to specific resolution and recovery mechanisms.

While this paper deals with possible reforms in relation to these issues for insurers and ADIs, this is also an appropriate opportunity to inform the consideration of any FMI related reforms. Comment is therefore also sought in relation to FMIs.

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9 [www.bis.org/press/p120731.htm](http://www.bis.org/press/p120731.htm).

## 7.1 STATUTORY MANAGEMENT REGIME, EXTERNAL ADMINISTRATION AND INSOLVENCY

### 7.1.1 Establishing a statutory management regime and extending related direction powers for FMIs

Similar issues to those detailed in Chapter 1 arise in relation to FMIs that comprise part of a corporate group, where other non-licensed group members provide essential services to the licensed entities.

Australian financial markets and clearing and settlement facilities are regulated by ASIC under the Corporations Act, to ensure that facilities provide their services in a fair and effective manner. ASIC has responsibility for monitoring compliance with obligations imposed on licensed clearing and settlement facilities, and for taking action such as issuing directions to enforce compliance with all obligations imposed upon such facilities. The Reserve Bank of Australia (RBA) has specific responsibilities for establishing and monitoring compliance with financial stability standards (FSS) including conducting an assessment at least once a year, and for ensuring that clearing and settlement facilities do all things reasonably practicable to reduce systemic risk. Separately the RBA also has responsibility for oversight of payment systems.

While no statutory management regime currently exists for FMIs, the Council has recommended to Government that such a regime, based on the Banking Act regime, should be adopted. The Government is currently considering the Council's recommendations. The issue therefore arises as to whether the proposals in this paper relating to the enhancement of crisis management powers under the Banking Act, in respect of ADIs, should also apply to FMIs under the Corporations Act and other applicable legislation.

#### Discussion questions

Should any reforms raised in Chapter 1 in relation to the scope of APRA's directions powers also be provided for in relation to ASIC's directions powers in relation to an Australian market licence, and ASIC's and the RBA's powers in relation to clearing and settlement facilities?

If a statutory management regime is introduced for FMIs, should any reforms raised in this Chapter in relation to statutory management of ADIs and their related entities also be provided for in relation to FMIs?

Should any reforms raised in this Chapter in relation to the duties of external administrators be extended to external administrators of FMIs or their related entities?

### 7.1.2 Extending the proposals relating to foreign branches to FMIs

Similar issues may exist to those detailed in Chapter 3 in relation to the appointment of SMs over FMIs holding Australian overseas licences rather than domestic licences. Such entities are primarily based in an overseas jurisdiction, but may have a domestic presence within Australia. Key elements of their businesses may be located in foreign jurisdictions.

The initial proposals for the introduction of a statutory management regime for FMIs, publicly canvassed by the Council, did not contemplate any regime extending to the Australian based operations of a foreign clearinghouse.

Consideration of whether to adopt a similar proposal in relation to FMIs must account for the lack of any concept of a 'branch' in the regulatory regime for overseas licence holders. Any domestic presence is likely to be very limited and be highly dependent upon home country operations to carry on its functions.

If any such extension of the proposed FMI regime occurred, it may therefore be queried whether the role of an SM over domestic operations should necessarily have a focus on supporting an external administrator (including the equivalent of an SM) appointed over the licence holder in their home jurisdiction; rather than being directed at running domestic operations independently. Statutory management of the domestic operations of an overseas licence holder other than in support of a foreign administrator is, in practice, unlikely to be feasible and may in any event run counter to the goal of maintaining stable and effective FMI service provision.

#### Discussion questions

Should any reforms raised in Chapter 3 in relation to the appointment of SMs over local branches of foreign ADIs also be adopted in any possible statutory management regime for FMIs?

- Should the possible application of any statutory management regime to the domestic operations of an overseas licence holder be restricted to where an external administrator (including the equivalent of an SM) has been appointed over the licence holder in their home jurisdiction?
- What should the role of an SM be, where they are appointed only over the domestic operations of an overseas licence holder? In particular, how should their relationship with a 'primary' external administrator in the licensee's home jurisdiction be defined?

Is such an extension necessary, if cross-border insolvency mechanisms are reformed to enable foreign external administrators of FMIs to obtain Court ordered remedies in relation to the licensee's domestic operations?

- Should the appointment of an SM over the domestic operations of an overseas licensee come to an end when a foreign external administrator obtains recognition and domestic relief under the *Cross-Border Insolvency Act 2008* (Cross-Border Insolvency Act)?

### 7.1.3 Cross-border Insolvency

The United Nations Committee on International Trade Law Model Law on Cross-Border Insolvency (Model Law) was drafted by the United Nations Committee on International Trade Law's Working Group on Insolvency Law, approved and adopted by the Commission on 30 May 1997 and endorsed by the United Nations General Assembly in December 1997.<sup>10</sup> Australia adopted the Model Law by passage of the *Cross-Border Insolvency Act 2008* (Cross-Border Insolvency Act).

The introduction of the Model Law is part of the broader shift in international cross-border insolvency arrangements away from territorialism towards universalism.

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<sup>10</sup> Official Records of the General Assembly, Fifty-second Session, Supplement No. 17 (A/52/17), paras. 12-225.

The Model Law:

- provides a procedure by which foreign proceedings can be recognised;
- provides foreign insolvency representatives with rights necessary to administer the foreign proceeding locally;
- imposes positive obligations upon domestic courts and insolvency practitioners to cooperate with their foreign counterparts; and
- provides limited mechanisms to coordinate concurrent foreign insolvency proceedings.

The *Cross-Border Insolvency Regulations 2008* excludes ADIs, general insurers and life companies from the operation of the law.

It is intended that the application of the Model Law to Australia should not disturb local special insolvency arrangements for such entities — statutory and judicial management procedures.

The Act operates in parallel to existing provisions in domestic companies and insolvency law that facilitate trans-national insolvency administration. However, the Model Law prevails in the event of any conflict between the new and old regimes.

Any possible introduction of statutory management for FMIs gives rise to the same policy considerations that underlie the exclusion of ADIs, general insurers and life companies from the operation of the Model Law (see chapter 3), as implemented in Australia.

- The Model Law may result in a foreign insolvency proceeding being given effect, which may interfere with the proper conduct of specialised domestic resolution regimes.
  - In this context, the domestic regime should be seen as extending beyond the statutory management processes to those mechanisms put in place to facilitate pre-administration intervention (for example support of informal workouts, influencing company behaviour) — such as the operation of the licensing regime and directions powers.
  - Domestic and foreign insolvency processes may operate inconsistently.
- Multiple concurrent administrations may delay quick and efficient resolution, and may therefore contribute to uncertainty for market participants and increased system instability.
- Foreign insolvency administrations may be directed to purposes that do not align with the objects of the domestic specialised regime. Foreign administrations may put creditor protection above system stability, or may focus on the needs of foreign systems or participants in preference to domestic systems or participants.
  - Foreign insolvency laws may afford preferences to foreign stakeholders.
- Foreign insolvency administrations may be subject to control by foreign regulators or Courts.

One option is for the current carve-out from the operation of the Cross-Border Insolvency Act (which applies to ADIs and insurers) to be extended to FMIs, in the event that a statutory management regime is introduced for such entities.

However, it should be recognised that there may be circumstances in which FMI (or bank or insurance company) resolution may be assisted by giving effect to foreign insolvency administrations. Indeed, it may be expected that it would be desirable to give domestic effect to home country FMI resolution activities in relation to foreign operators operating under an overseas operators' licence.

For example, an FMI operates in Australia but is based and primarily operates in the UK. It experiences financial difficulty and becomes subject to a reorganisation proceeding in the UK. The UK proceeding results in a scheme that restores the entity to solvency. The establishment process and the resulting scheme do not discriminate between foreign and domestic stakeholders. It may be advantageous to enable the effects of the foreign scheme to be recognised domestically through the operation of the Model Law.

The ability for the cross-border regime to be allowed to apply may also be of particular benefit given that some foreign cross-border insolvency regimes require comity.

That is, a resolution of an Australian FMI insolvency may only be capable of being given effect under a foreign country's laws, if an equivalent resolution under their laws could be given effect to within Australia. The US implementation of the Model Law (Chapter 15 of their Code) requires comity.

One option is to modify the current exceptions so that applications for recognition or remedies under the Cross-Border Insolvency Act may be made with the consent of the relevant regulator (ASIC and RBA for FMIs, APRA for ADIs and insurers).

This would enable recognition of foreign resolution proceedings and granting of domestic relief where appropriate, while giving regulators an effective veto, when required, to protect the interests of domestic participants and system stability.

There is a current anomaly in the law that would enable recognition of foreign insolvencies in relation to ADIs, general insurers and life companies under the provisions that operated prior to the adoption of the Cross-Border Insolvency Act. The Corporations Act legacy provisions continue to operate in parallel to the new regime<sup>11</sup>, but are not subject to any carve-out for these entities. This anomaly could be addressed both in respect of any possible proposed changes to FMIs and in relation to ADIs, general insurers and life companies.

#### Discussion questions

Should FMIs be carved out from the scope of the Cross-border Insolvency Act?

Should any carve out be modified to give the relevant regulators the option of allowing recognitions and remedies with their consent?

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11 Sections 580 and 581 of the Corporations Act.

### 7.1.4 Enhancing the statutory management regime

In the event that a statutory management regime for FMI is introduced, similar issues would apply for FMI to those detailed in Chapter 4 in relation to:

- broadening of the grounds for appointing SMs (item 4.1.1);
- acceleration or termination ('ipso facto') clauses (item 4.1.5);
- effect of appointment of an SM on a deed of company arrangement (item 4.1.6);
- widening moratorium provisions (item 4.2.1);
- immunities for SMs (item 4.3.2);
- termination of statutory management (item 4.4.1);
- replacement of SMs (item 4.4.2);
- reporting requirements for directors (item 4.5.1); and
- the minor and technical amendments identified in item 4.6.

Issues relating to broadening the grounds for appointing an SM in relation to appointments to bridging entities would only arise if the Business Transfer Act were extended to apply to FMI.

#### Discussion question

In the event that a statutory management regime was introduced for FMI, should any reforms raised in Chapter 4 in relation to those issues also apply to such a regime?

### 7.1.5 External administration and harmonisation

Similar issues may apply for FMI to those detailed in Chapter 5 in relation to notice of external administration (item 5.2.3) and harmonisation (item 5.2.4).

In the event that a statutory management regime for FMI was introduced, similar issues may apply for FMI to those detailed in chapter 5 in relation to the relation-back day (item 5.1.3).

### Discussion question

Should any reforms in relation to these issues raised in Chapter 5 also be applied in relation to FMIs (with relation-back day related reforms only arising if a statutory management regime was introduced)?

## 7.2 DIRECTIONS POWERS

### 7.2.1 Extending the proposed direction powers to FMIs

Similar issues to those detailed in Chapter 2 in relation to directions powers, director liability, continuous disclosure and the relevance of system stability considerations to the exercise of ASIC or RBA powers arise in relation to relevant FMIs.

### Discussion question

Should any reforms raised in Chapter 2 in relation to directions powers, director liability, continuous disclosure and the relevance of system stability considerations to the exercise of APRA's powers also be provided for in relation to ASIC's and RBA's regulation of FMIs?

### 7.2.2 Extend the application of the Business Transfer Act to FMIs

The Business Transfer Act, as discussed in Chapter 2 does not apply to FMIs. As stated, in relation to banks and insurers, the Act provides an important tool in the package of resolution options available to regulators. This tool is not available in relation to clearing and settlement facilities or market operators.

A specialised power to impose binding compromises on creditors is not provided to SMs under the Banking Act or JMs under the Insurance Act or the Life Insurance Act. However, the use of SM powers together with the business transfer regime can provide for equivalent effects.

If a statutory management regime were adopted for FMIs then, in the absence of the application of the Business Transfer Act to FMIs, binding collective compromises that override dissenting stakeholders could only currently be put in place in relation to FMIs via use of Schemes of Arrangement.

It may be questioned whether Part 5.1 of the Corporations Act is a suitable mechanism for putting in place compromises in relation to systemically important entities. The requirement for creditors to approve a creditors scheme may both:

- fail to reflect the priority that should be given to the interests of financial system stability over the interests of creditors; and
- result in delays that may not be consistent with the need to expeditiously resolve concerns regarding the financial distress of key FMI.

### Discussion questions

Should the Business Transfer Act apply to FMIs?

If so, what, if any, modifications should be provided for in how it applies to these entities?

Alternatively (or additionally) should a modified Scheme of Arrangement regime apply to FMIs, upon the application of an FMI SM (if adopted)?

If so, what modifications might be made to ensure the timely putting in place of binding arrangements in relation to FMIs?

- Should creditors' or members' approvals be required in addition to Court approval under such a regime (as is currently the case)?
- Should the Court's powers to make interim orders or make interim arrangements be enhanced to address any delays in putting in place a final binding arrangement?



## PART B — SIMPLIFICATION AND STREAMLINING

### 8. SIMPLIFICATION AND STREAMLINING OF ACTS ADMINISTERED BY APRA

APRA has responsibility for the prudential supervision of banks, credit unions, building societies, general insurers, life insurers, friendly societies, and superannuation entities. APRA was established as the sole prudential regulator in Australia in part to achieve greater consistency and neutrality in the prudential regulation of financial institutions.

The supervisory framework should be broadly consistent across legislation where sensible, while allowing for appropriate differences between the industries that APRA supervises. Currently, APRA's legislative framework for prudential supervision is set out in various Acts of Parliament. These include the following Acts (collectively referred to in this section as 'the industry Acts'):

- Banking Act 1959;
- Insurance Act 1973; and
- Life Insurance Act 1995.

There is also other legislation administered by APRA, including the *Superannuation Industry (Supervision) Act 1993* (SIS Act), *Financial Sector (Collection of Data) Act 2001* (FSCODA), *Financial Sector (Business Transfer and Group Restructure) Act 1999* (Business Transfer Act) and *Financial Sector (Shareholdings) Act 1998* (FSSA).

The industry Acts have largely achieved their objectives, assisted by amendments made in recent years to strengthen and harmonise provisions across the industry Acts. However, despite progressive efforts, there are still areas that could be further simplified and streamlined.

A harmonised framework would enhance both clarity and transparency in the application of the industry Acts and SIS Act and, as a result, should reduce costs both of doing business and administering the legislative framework.

In some areas of the industry Acts and SIS Act, the pursuit of a more consistent set of powers also entails a strengthening of some of APRA's supervisory powers. These enhancements mostly deal with APRA's ability to monitor, investigate and enforce prudential requirements, ensuring that APRA is well-equipped to identify and respond effectively to prudential risk. This is appropriate to promote safety and stability within the regulated financial sectors.

In addition, this section of the paper also sets out proposed enhancements to legislative provisions that already apply in a simplified manner across the regulated industries — example certain provisions of the FSCODA and the APRA Act and other legislative provisions relating to finance and levy matters affecting APRA.

## 8.1 STREAMLINING OF AUTHORISATION PROVISIONS OF THE INDUSTRY ACTS

A key aspect of the prudential regulation framework is the capacity to control entry into the market to ensure that entities undertaking regulated activities and the individuals responsible for ensuring the financial soundness of those entities, meet certain minimum standards. Minimum standards for entry and participation in regulated financial markets provide an important foundation for promoting sound management of regulated entities, the safety and stability of the financial system, and the protection of depositors and policyholders.

Authorisation serves to control access to prudentially regulated segments of the financial services market, which would otherwise be open to unrestricted entry. It ensures that entities meet minimum standards while operating in the market. Authorisation also makes it easy for consumers and APRA to identify which entities are subject to prudential regulation and operate in the regulated market.

The authorisation power is primarily concerned with the entity that will be undertaking the regulated activity. However, it is also important that APRA has the power to compel authorisation of a NOHC of an entity, particularly where that NOHC exerts significant control over the regulated entity or the group of which the regulated entity is a part.

### 8.1.1 Enabling APRA to require a NOHC of a regulated entity to be authorised

A NOHC in the context of APRA's prudential framework, is a company that holds subsidiaries that carry on regulated business. Accordingly, a NOHC is defined in the industry Acts as a holding company that is incorporated in Australia that does not carry on a business other than a business consisting of the ownership or control of other bodies corporate.

The establishment of a NOHC may offer some key benefits to a financial services group. These benefits may include enhancements to operational flexibility and risk management capacity. However, the establishment of a NOHC may also create prudential risks. The NOHC will typically be the controlling shareholder of the entities under its corporate umbrella. It is therefore in a position to exert a substantial degree of control over the business decisions made in its subsidiaries and throughout the wider group. As a result, subsidiaries that are ADIs or insurers may end up bearing risks beyond those that they would normally assume if they were operating as independent entities. Moreover, ADIs or insurers that are members of an unregulated group of companies may be exposed to financial inter-relationships that span across the group, and may be vulnerable to contagion risks from the financial weaknesses of other entities within the group.

The risk of intra-group contagion can only be effectively monitored and supervised through effective supervision of the NOHC. Thus, effective oversight of NOHCs is crucial for the protection of depositors and policyholders and for the maintenance of financial system stability.

### Current position of NOHC authorisation under the industry Acts

In recognition of the important role that NOHCs assume in respect of ADIs and insurers, APRA publishes authorisation guidelines for NOHCs, which set out APRA's expectations on what activities a NOHC should and should not conduct. When a NOHC is authorised, APRA is able to ensure that the group of which an ADI, general insurer or life insurer is a part is effectively supervised and regulated via the following mechanisms:

- APRA may impose conditions on a NOHC authorisation.

- APRA may make prudential standards requiring an authorised NOHC to ensure that it and its subsidiaries satisfy prudential requirements.
- APRA may require information from an authorised NOHC.
- APRA may investigate an authorised NOHC.
- APRA may give directions to an authorised NOHC.

The above powers are only applicable to NOHCs authorised by APRA. However, APRA authorisation of a NOHC is contingent on the NOHC applying for an authorisation. The current regime is effective in relation to financial groups that include a subsidiary applying for an authorisation as an ADI, general insurer or life insurance company. In this situation, APRA may refuse to authorise the subsidiary unless the NOHC is authorised (subsection 9(3A) of the Banking Act, subsection 13(3) of the Insurance Act and subsection 22(1A) of the Life Insurance Act).

Where a financial group includes subsidiaries that are already authorised, however, the current regime is less satisfactory. APRA may impose a condition on authorised subsidiaries that their holding company be authorised, but a subsidiary is not legally capable of directing its holding company to seek authorisation. APRA could then revoke the authorisation of the subsidiary for failing to comply with the condition, but revoking an authorisation is an extreme response, which could have various undesirable repercussions.

If APRA were able to require NOHCs to become authorised, the following measures could be implemented:

- the authorised NOHC would be required to comply with prudential standards concerning governance, capital and risk management;
- the authorised NOHC would be required to continually provide APRA with assurance that it maintains prudent policies addressing the nature of intra-group transactions and the adequacy of information and accounting systems;
- the operations of the authorised NOHCs would be limited by conditions imposed by APRA, and an authorised NOHC would not be permitted to conduct any business that was not ancillary to its core role of holding company for investments in the regulated group companies; and
- APRA would be able to give directions to an authorised NOHC for various purposes, including to enforce compliance with prudential requirements and to facilitate the resolution of a distressed financial group.

The consequence of APRA not being able to require a NOHC to be authorised is that APRA is not able to effectively exercise these powers under the prudential framework it operates.

## Proposal

Two options have been identified to address this issue:

- Empower APRA to issue a notice to a holding company of an APRA-regulated entity that requires the holding company to take steps to ensure that the regulated entities it controls in the group are owned by an authorised NOHC.

- Require all holding companies of APRA-regulated entities to become authorised NOHCs unless exempted by APRA.

Either option would achieve the desired objective of enabling APRA to require a holding company to be authorised, and thereby bring the holding company within the prudential regime to facilitate effective group supervision. The first option is considered to be preferable to the second, given that it avoids the need for all holding companies to be considered for authorisation and enables APRA to approve a group structure in connection with authorising a NOHC.

In addition to these options, consideration is being given to empowering APRA to authorise a NOHC under any one of the three industry Acts and deem it to be automatically authorised under the other industry Acts where a NOHC is a holding company for more than one type of regulated entity. On this basis, a group could have a multiple-authorised NOHC. Consequently, where a group headed by a NOHC has banking, general insurance and life insurance arms, APRA could apply prudential standards to each set of industry grouping as if they were headed by independently authorised NOHCs. APRA would also be empowered to vary or revoke the multiple authorisation status of the NOHC.

### **Option A — Empower APRA to issue a notice to a holding company**

Under this approach, APRA would be empowered to impose an obligation on the holding company to ensure that regulated entities within its group come under the control of an entity that is an authorised NOHC, within a group structure approved by APRA.

The merit of this option is that it affords flexibility to both APRA and the holding company to agree upon an arrangement that strikes an appropriate balance between minimising regulatory costs and ensuring prudential soundness. For example, rather than the holding company itself becoming an authorised NOHC, APRA may be amenable to the holding company establishing a new company to head up a part of the group that includes the regulated entity or regulated entities.

### **Option B — Require all holding companies of APRA-regulated entities become authorised NOHCs**

This approach would impose a legislative requirement on all non-authorised holding companies of APRA-regulated entities to apply to APRA to become authorised NOHCs unless APRA waives the requirement. APRA would determine whether to waive the requirement depending on APRA's views as to whether the holding company in question needed to be authorised for the purposes of prudential supervision of the group as a whole.

#### **Discussion questions**

Are there practical difficulties for industry in the event that certain NOHCs are required to be authorised as proposed?

Would the proposals lead to added costs on industry?

Which of the two options set out in this paper is preferable?

## **8.1.2 Application process for authorisation**

Currently, section 20 of the Life Insurance Act sets out requirements regarding applications for registration as a life company, including the following:

- Application must be in a form (if any) approved by APRA.
- Application must be accompanied by any information requested by APRA.
- If an applicant does not provide information requested by APRA before the end of a period of time specified by APRA, the application is taken to be withdrawn.

These requirements are useful in facilitating the processing and assessment by APRA of applications for authorisation generally, whether an entity is seeking to be authorised as an ADI, a general insurer or life company. There are no parallel provisions in the Banking Act or Insurance Act. The SIS Act contains its own requirements regarding applications for registration but this proposal will not affect these.

#### Proposal

That similar application provisions to those in the Life Insurance Act be added to the Banking Act and Insurance Act.

### 8.1.3 Provisions to impose, vary and revoke conditions of authorisation

Currently, there are provisions in the industry Acts for APRA to impose, vary and revoke conditions of authorisation. However, the provisions differ between the industry Acts. For example:

- It is not an offence if a condition of registration is breached under the Life Insurance Act, but it is if a condition of authorisation is breached under the Banking Act and Insurance Act.
- The penalty provisions for breach of authorisation differ significantly between the Acts.

Sections 13 and 14 of the Insurance Act provide a comprehensive and clear model for imposing, varying and revoking conditions of authorisation. These provisions allow APRA, at any time and by written notice, to impose conditions, or additional conditions, on an insurer's authorisation. They also enable APRA to vary or revoke conditions imposed on an insurer's authorisation. Section 14 further provides that an insurer commits an offence if it does, or fails to do, an act that results in a contravention of a condition of the insurer's authorisation.

The authorisation provisions in the Banking Act and Life Insurance Act are not as comprehensive as those in the Insurance Act.

#### Proposal

That the provisions on conditions of authorisation in the Insurance Act be replicated in the Banking Act and Life Insurance Act.

### Discussion question

Is there any reason why the model in the Insurance Act should not be preferred?

## 8.1.4 Revoking an authorisation

Currently, the Banking Act and Insurance Act include provisions that allow APRA to revoke authorisations granted to regulated entities in certain circumstances. These provisions vary between the Banking Act and Insurance Act and do not appear in the Life Insurance Act. This means APRA does not have a consistent approach toward revocation of authorisation under the industry Acts.

Currently, APRA may only cancel a life company's registration if a life company has ceased to carry on a life insurance business in Australia under section 26 of the Life Insurance Act. There is no power in the Life Insurance Act corresponding to section 9A of the Banking Act and section 15 of the Insurance Act, where APRA may revoke an authorisation for various reasons, including where the authorised entity has failed to comply with the requirements of the respective Acts.

There are also differences between APRA's ability under the Life Insurance Act to revoke the registration of a life insurer and to revoke the registration of a NOHC. Under the Life Insurance Act, APRA may revoke a NOHC registration in circumstances similar to those in the Banking Act and Insurance Act revocation provisions. This is because the NOHC provisions under the Life Insurance Act were aligned with the NOHC provisions under the other Acts, whereas the life company registration provisions were not reviewed when legislation to introduce NOHCs into the Life Insurance Act was passed.

These anomalies could be corrected in order to establish a simplified and effective set of powers between the Acts and to enable APRA to revoke an authorisation or registration on a wider range of grounds than currently exist under the Life Insurance Act.

### Proposal

That the industry Acts be amended to ensure consistency in the legislative framework among the industry Acts in respect of provisions on revocation of authorisation. In particular, it is proposed that the industry Acts be amended to enable APRA to revoke a regulated entity's authority in the following circumstances:

- the entity has failed to comply with a requirement of the Act or of an instrument made for the purposes of this Act (including prudential standards);
- the entity has failed to comply with a requirement of the FSCODA or of an instrument made for the purposes of this Act (including reporting standards);
- the entity has failed to comply with a requirement of Commonwealth law that is prescribed in the regulations;
- the entity has failed to comply with a direction from APRA under the Act;
- the entity has failed to comply with a condition of authorisation;

- it would be contrary to financial system stability in Australia for the authorisation to remain in force;
- it would be contrary to the interests of depositors/policyholders of the entity for its authorisation to remain in force;
- the entity has failed to pay:
  - an amount of levy or late penalty to which the *Financial Institutions Supervisory Levies Collection Act 1998* applies; or
  - an amount of charge fixed under section 51 of the APRA Act;
- the entity is insolvent and is unlikely to return to solvency within a reasonable period of time;
- the entity has inadequate capital by reference to APRA’s regulatory requirements and is unlikely to have adequate capital within a reasonable period of time;
- the entity has ceased to carry on the regulated business in Australia for which it was authorised to do so;
- the entity has, in connection with its application for authority, provided APRA with information that was false or misleading in a material particular;
- the entity has, in connection with a prudential matter, knowingly or recklessly provided APRA with information that was false or misleading; or
- where the entity is authorised as a foreign branch, its authorisation to carry on the relevant regulated business has been revoked by its home regulatory authority.

Due to the inconsistency between the industry Acts regarding APRA’s requirement to publish the revocation of an authorisation, it is further proposed that subsection 9A(6) of the Banking Act, subsection 15(5) of the Insurance Act and section 240 of the Life Insurance Act be harmonised.

If this proposal is implemented, consideration will be given to consequential amendment to the industry Acts to ensure that any revocation of the authorisation of a regulated entity does not compromise the interests of depositors and policyholders.

#### Discussion questions

Should any of the proposed revocation conditions not be included in the harmonised list?

Are there any other instances where APAPRA should have the right to revoke an authorisation?

### 8.1.5 Enabling APRA to keep and publish a register of authorised entities

It is desirable for APRA to be able to keep and publish a register of institutions that APRA authorises under its legislation. This provides a means of accurately tracking the population of all the different authorised entities. It also provides an accurate reference point for depositors and policyholders, among others, as to which institutions are authorised by APRA to carry on specified types of regulated business under the various industry Acts.

It is important that stakeholders can easily identify which financial institutions are authorised by APRA to conduct the different types of business regulated by APRA. Most domestic and international regulators that carry out authorisation functions keep and publish lists of the institutions permitted to carry out regulated activities. These include ASIC, the UK Financial Services Authority, the MAS and the Reserve Bank of New Zealand.

Currently, the industry Acts include provisions for keeping and/or publishing registers of authorised persons. However, these provisions are inconsistent between the Acts. Given that APRA is the sole prudential regulator of various industries in Australia, it is desirable that APRA take a consistent approach in keeping and publishing registers of authorised persons for all the industries it regulates.

### Proposal

That the current provisions in the Industry Acts and SIS Act be amended to introduce a harmonised provision on the keeping and publishing of registers of authorised persons. These amendments would be based on the existing provision in section 9C of the Banking Act, which provides that APRA may, from time to time, publish a list of ADIs in the *Gazette* or in such other manner as APRA determines.

The harmonised provision would also enable APRA to keep and publish a list of persons authorised as NOHCs under the industry Acts.

This harmonised provision would enable APRA to keep and publish such registers and afford the necessary flexibility in doing so, including publishing such registers on its website if APRA considers this to be the best approach. This proposal would enhance clarity and transparency as to the identity of persons authorised by APRA.

### Discussion question

Are there any other measures that might be helpful in allowing the public to easily determine whether financial institutions are authorised by APRA?

## 8.1.6 Documents to be supplied to APRA in application for authorisation and changes to such documents after authorisation

Currently, section 10 of the Banking Act provides that an application for authorisation as an ADI is accompanied by a copy of the act, charter, deed of settlement, memorandum of association and articles of association of the applicant, or other document by which the applicant is constituted. Under subsection 10(3), after the applicant is authorised as an ADI, it must notify APRA if its constitutional documents are altered. This must be done within 3 months of the alteration.

Directors must exercise their powers and discharge their duties in good faith in the best interests of the corporation and for a proper purpose (section 181 of the Corporations Act). However, a director of a wholly owned subsidiary may instead act in the best interests of the holding company where the subsidiary's constitution authorises this (section 187 of the Corporations Act). If an ADI that is a subsidiary alters its constitution so that it expressly authorises the ADI's directors to act in the best interests of its holding company, this would allow the ADI's directors to act in the best interests of the group/holding company instead of the ADI. Where the interests of the holding company and ADI



are inconsistent, the ADI's directors may act to the detriment of the interests of the ADI and/or the depositors of the ADI.

The prudential regulation framework places responsibility on the board of directors of an ADI to ensure that the ADI carries on its business in accordance with prudential requirements and in the interests of depositors. As such, it is essential that the board of directors of an ADI serves the interest of the ADI (including its depositors) rather than the interests of its holding company and the rest of the group.

The Insurance Act and Life Insurance Act currently lack an equivalent provision to section 10 of the Banking Act.

### Proposal

That section 10 of the Banking Act be amended to provide that, unless APRA has given prior written approval, the constitution of an ADI may not be altered to provide that the directors of the ADI are authorised to act in the interests of the ADI's holding company.

That the Insurance Act and Life Insurance Act be amended to include a provision corresponding to section 10 of the Banking Act (incorporating the amendment proposed in the paragraph above).

### Discussion question

Are there practical difficulties involved for regulated entities and their NOHCs in complying with the requirement proposed above?

## 8.1.7 Scope of business requiring authorisation in Australia

Currently, the industry Acts include provisions specifying the types of activities that amount to carrying on a business that requires authorisation. This proposal is intended to modify the provisions that specify when a regulated business is taken to be carried on in Australia.

In the Insurance Act, there are two tests to determine whether an insurance business is carrying on business in Australia.

- Subsection 3(6) of the Insurance Act states that if an overseas insurance business uses an agent in Australia to act in relation to their business, the overseas insurer will be taken to be carrying on an insurance business in Australia.
- Subsections 3(1) and 3(5) of the Insurance Act specify that carrying on an insurance business includes inducing others into contracts of insurance, publishing or distributing a statement related to the insurer's willingness to enter into a contract of insurance, or procuring the publication or distribution of such a statement. Whether these actions have, or are likely to have, their effect in Australia determines whether an insurance business is deemed to have been carried on in Australia (subsection 3(7) of the Insurance Act).

The Banking Act does not include similar provisions. The Life Insurance Act does not include provisions dealing with the last aspect. This complication has given rise to some practical difficulties in preventing foreign banks, without authorisation, from soliciting deposits from Australian residents via the internet. In addressing this situation, APRA became aware that it is unclear under the Banking

Act whether it has the legal authority to prevent the foreign bank from offering deposit accounts to Australian citizens and residents over the internet from a foreign country.

If such a situation was to arise in the general insurance context, APRA could order a foreign insurer based outside Australia to cease their activities targeted at persons resident in Australia on the basis that the relevant provisions of the Insurance Act would be contravened by such activities. APRA should have clear authority in such situations to assert that there is, or will be, a breach of Australian law and that such activity should cease. Such a power is consistent with APRA'S statutory mandate to protect the interests of depositors and policyholders, including prospective depositors and prospective policyholders.

Other Australian Acts and foreign legislation contain similar provisions to the Insurance Act. Whether a financial services business is taken to be carried on in Australia, and therefore whether the business must apply for a licence from ASIC, is determined in a test similar to the second aspect of the Insurance Act provisions (section 911D Corporations Act). Moreover, many other jurisdictions have provisions in their financial services legislation similar in effect to those of the Insurance Act. These include the UK, Hong Kong and Singapore. Many foreign regulators have taken the approach that the offer of financial services/products to the residents of their country from a foreign country through the internet or other means does not avoid the application of relevant laws and regulations of that country.

There is another possible consequence of this gap in the industry Acts. APRA enters into Memoranda of Understanding with other regulators overseas on reciprocal arrangements for assistance in supervisory/enforcement action. In some jurisdictions, the relevant laws governing the overseas regulator require that the laws of the host jurisdiction (example Australia) are contravened or are likely to be contravened before the home regulator (example the overseas regulator) may extend assistance to the host regulator (example APRA). The inability of APRA to cite what Australian law has been contravened or is likely to be contravened in the circumstances described above mean that, even if APRA were to seek the assistance of the overseas regulator concerned, the overseas regulator could be unable to take steps to end the behaviour originating from within its jurisdiction. The proposed amendments would ensure that this consequence is avoided.

This proposal is not intended to and will not prevent an Australian citizen or resident from seeking, on their own initiative, to establish a banking or an insurance relationship with a foreign bank or insurer not authorised in Australia. Rather, it seeks to prevent a foreign bank or insurer not authorised by APRA from soliciting such a relationship with Australian residents and citizens.

### Proposal

That the Banking Act and the Life Insurance Act be amended to bring them into line with the Insurance Act in this regard. Specifically, that the relevant provisions of the Insurance Act referred to above should be adapted for inclusion in the Banking Act and Life Insurance Act.

### 8.1.8 Consequences of carrying on a regulated business without authorisation

There are currently provisions in the Banking Act, Insurance Act and SIS Act that provide penalties for carrying on regulated business without proper authorisation granted by APRA. However, the Life Insurance Act does not currently specify a penalty for carrying on an unlicensed life business. A penalty in the Life Insurance Act would help to ensure that all life businesses in Australia are registered.

## Proposal

That section 17 of the Life Insurance Act be amended to make it an offence for any person to carry on a life insurance business without being registered by APRA. The nature and quantum of a penalty for committing such an offence would be commensurate with the penalty for carrying on an unauthorised insurance business under the Insurance Act.

### 8.1.9 Registration of life companies

Section 21 of the Life Insurance Act provides that APRA must register a company that has applied for registration under the Act unless APRA is satisfied that one or more of five specified grounds for refusal exists. The relevant grounds are:

- that the company is not able, or is unlikely to be able, to meet its obligations, including obligations in respect of business other than life insurance business;
- that the company is not able, or is unlikely to be able, to comply with the provisions of the Life Insurance Act or the FSCODA;
- that the name of the company so closely resembles the name of a company already registered under the Act as to be likely to deceive;
- in the case of a company that carries on, or proposes to carry on, some other form of business in addition to life insurance business, that the carrying on of that other form of business in addition to insurance business would be contrary to the public interest; and
- that the company is a subsidiary of a NOHC that is not a registered NOHC.

By contrast, the provisions in the Insurance Act and Banking Act regarding the authorisation of general insurers and ADIs provide APRA with broad discretion as to whether to authorise those entities. Under those Acts, APRA is under no obligation to authorise an entity. Subsection 12(2) of the Insurance Act simply states that APRA may authorise an applicant to carry on insurance business in Australia. Subsection 9(3) of the Banking Act states that, if an application has been made, APRA may grant the body corporate an authority to carry on banking business in Australia.

The provisions relating to the registration of life companies in the Life Insurance Act are also inconsistent with other provisions in that Act relating to the registration of life company NOHCs. In the case of life company NOHCs, APRA may register a NOHC applicant if it considers it appropriate to do so. This is a broad discretion.

## Proposal

That the provisions regarding the registration of life companies be simplified by reference to the provisions on the authorisation of general insurers and ADIs.

### Discussion question

Is there any reason that APRA should not have the same discretion in authorisation under the Life Insurance Act as it has under the Banking Act and Insurance Act?

## 8.2 SIMPLIFICATION OF PROVISIONS RELATING TO OBTAINING INFORMATION AND INVESTIGATION

A fundamental element of prudential supervision is the ability for a supervisory authority to obtain information from and investigate regulated entities. Obtaining information from a regulated entity is essential to effective monitoring of the financial condition of the entity and its compliance with prudential and reporting requirements. Although APRA primarily monitors regulated entities on the basis of regular data provided to it pursuant to reporting standards made under the FSCODA, APRA also regularly obtains information from regulated entities on an *ad hoc* basis under the information-gathering powers available under the industry Acts.

In addition to powers to obtain information from a regulated entity, APRA also needs powers to investigate regulated entities. APRA may need to investigate an entity to ascertain whether an entity has breached a statutory or prudential requirement, to evaluate the financial condition of a regulated entity, and to establish whether corrective action should be taken. A supervisor needs to have clear legal powers to be able to conduct an investigation comprehensively and in a timely manner.

The relevant international principles highlight the need for robust legal powers for obtaining information from and investigating regulated entities promptly and effectively. The BCBS Core Principles and the IAIS Core Principles include a number of principles relating to the need for the supervisory authority to have clear and robust powers to obtain information off-site and on-site and to conduct inspections or investigations as part of the core supervisory framework. This recognises the need for a supervisor to be able to obtain information quickly and reliably and to have the means of verifying information, including through the engagement of expert investigators. The FSB's Key Attributes stress the importance of effective resolution powers and for these to be exercisable at a relatively early stage of distress. This recognises the need for a resolution authority and/or supervisory authority to have early and unfettered access to information relevant to the exercise of such powers. The BCBS made a similar point in the *Report and Recommendations of the Cross-border Bank Resolution Group* on Banking Supervision, issued in March 2010.

It is in this context that the Government and APRA have reviewed the powers available to APRA under the industry Acts to obtain information and to investigate or appoint an investigator. The review included consideration of:

- the adequacy of the powers allowing APRA to obtain information from a regulated entity and its group, which included consideration of the grounds for exercising the powers, the type of information APRA may obtain and the entities APRA may obtain information from;
- the adequacy of the grounds under which investigation powers may be exercised, such that APRA can initiate an investigation or appoint an investigator in a wide range of circumstances, including where APRA believes it has cause to obtain additional information for the purpose of

assessing a regulated entity's financial condition, or establishing whether an entity is complying with prudential requirements;

- the adequacy of the statutory purposes for which investigation powers may be exercised;
- the ability for APRA to itself conduct an investigation or to appoint another person to do so;
- the scope of the investigation powers, including the power to obtain documents and information, to search premises and to interview staff and other relevant parties; and
- the ability to initiate an investigation quickly and in a manner that facilitates thorough and effective investigation.

In most respects, APRA's powers to obtain information and its investigation powers are satisfactory by reference to the above considerations and relevant international benchmarks. However, there are deficiencies or gaps in several parts of the industry Acts, particularly with respect to the investigation powers. There are also a number of unnecessary differences between the industry Acts. The proposals in this section seek to address these issues.

Effective monitoring and investigative powers form the basis of a responsive, targeted and efficient enforcement regime for APRA. This is fundamental to maintaining the integrity and credibility of the prudential regime and protecting the interests of beneficiaries and financial system stability.

### 8.2.1 Removal of 'show cause' notice in the Insurance Act and Life Insurance Act

Subsection 52(1) of the Insurance Act requires APRA to issue a 'show cause' notice to an insurer in order to investigate it. The insurer has 14 days to respond to this notice with the reasons why it believes APRA should not investigate it. The Act empowers APRA to give a shorter notice period if APRA considers that a shorter period is necessary and the period given is reasonable.

Similar show cause requirements apply under subsections 52(1C) and 79(1) of the Insurance Act and section 135 of the Life Insurance Act.

The requirement to give notice of an investigation and to provide the insurer in question with the opportunity to provide reasons why the investigation should not take place arguably creates a risk of unreasonable delay in certain circumstances. The risk is that, upon giving notice to show cause, information relevant to the investigation might be concealed, removed, modified or destroyed, thereby reducing the potential effectiveness of the investigation. This risk is high where the investigation relates to suspected breaches of prudential requirements or fraud.

The investigation powers in the Banking Act do not contain an equivalent requirement to the 'show cause' notice. Instead, APRA can commence an investigation of an ADI without such notice, as long as the grounds for conducting an investigation have been met.

#### Proposal

That the 'show cause' notice obligations in the Insurance Act and Life Insurance Act be repealed and that these Acts be amended to empower APRA to conduct an investigation or appoint an investigator on the grounds set out in the Acts, without the need to issue a notice to show cause.

As a consequence of the removal of the ‘show cause’ notice requirement, it is also proposed that the entry and search powers under the Insurance Act and Life Insurance Act be simplified by reference to the Banking Act to meet the Commonwealth standards set out in the *Guide to Frame Commonwealth Offences, Infringement Notices and Enforcement Powers*.

Under sections 54 and 80 of the Insurance Act and section 140 of the Life Insurance Act, APRA can enter the premises of an insurer (or in the case of section 80, the non-residential premises of a present or former trustee, custodian or investment manager in investigating the affairs of a designated security trust fund in the context of Lloyd’s underwriters) without consent or warrant for the purposes of an investigation. It is proposed that these sections be amended to only authorise entry to premises by consent or under a warrant.

#### Discussion questions

Is the removal of the ‘show cause’ requirement reasonable, having regard to the risks associated with the requirement, as outlined above?

Are there any other safeguards that should be imposed on the power to investigate in lieu of the ‘show cause’ notice?

## 8.2.2 Modification to grounds for conducting an investigation

The industry Acts and the SIS Act each set out the grounds under which APRA may conduct an investigation or appoint an investigator. As the grounds differ between these Acts, there is scope to consider whether any benefits can be gained from streamlining the various provisions.

### Modifying the ground for investigation relating to the contravention of an Act or requirement

Section 52 of the Insurance Act sets out the grounds under which APRA may conduct an investigation or appoint an investigator to a general insurer, its authorised NOHC or subsidiary.

Some grounds for investigation under the Insurance Act occur ‘where it appears to APRA that a body corporate that is a general insurer or authorised NOHC has contravened or failed to comply with a provision of this Act or the *Financial Sector (Collection of Data) Act 2001* or a condition or direction applicable to it under this Act or that Act’ (paragraph 52(1)(aa)).

In contrast, the equivalent provision in the Life Insurance Act (paragraph 136(b)) is expressed in less definitive terms — that is that ‘the [relevant] body may have contravened’ the relevant Act or requirement. Also, the equivalent provision in the SIS Act (paragraph 263(1)(a)) requires that a contravention ‘may have occurred or be occurring.’

An investigation is generally conducted for the purpose of ascertaining certain facts or obtaining information and, prior to an investigation, it may not be clear whether a regulated entity, an authorised NOHC or a subsidiary of a regulated entity or authorised NOHC *has* contravened an Act or prudential requirement.

## Proposal

That subparagraph 52(1)(aa)(ii) and subsection 52(1B) of the Insurance Act be amended to align the Insurance Act with the Life Insurance Act and SIS Act. APRA would be allowed to give notice to investigate a general insurer where the insurer *may* have contravened the FSCODA or the Insurance Act.

## Modifying the ground for investigation relating to the deterioration in the financial condition of a regulated entity or authorised NOHC

Paragraph 52(1)(a) of the Insurance Act empowers APRA to conduct an investigation or appoint an investigator if 'it appears to APRA that there is, or there may be, a sudden deterioration in a general insurer's or authorised NOHC's financial condition'. This provision is relatively restrictive compared to other equivalent provisions in the Insurance Act (example the grounds for giving directions) because it confines the deterioration in the affairs of the insurer to 'sudden' deterioration. The *speed* of deterioration is not a relevant consideration in determining whether an investigation should take place. Rather, the *extent* of deterioration is the relevant consideration. This was recognised when, in 2010, subparagraph 104(1A)(a)(iii) of the Insurance Act was amended to replace 'sudden deterioration' with 'material deterioration'. One should also note the broad nature of paragraph 263(1)(b) of the SIS Act, which requires that it appears to APRA that 'the financial position of a superannuation entity may be unsatisfactory'.

There is no equivalent to paragraph 52(1)(a) of the Insurance Act in the Life Insurance Act.

## Proposal

That paragraph 52(1)(a) of the Insurance Act be amended, such that it would be worded thus: 'it appears to APRA that there is, or there may be, a **material** deterioration in a general insurer's or authorised NOHC's financial condition'.

That a new provision be included in section 136 of the Life Insurance Act to empower APRA to conduct an investigation or appoint an investigator if 'it appears to APRA that there is, or there may be, a material deterioration in a life insurer's or authorised NOHC's financial condition'.

## Widening the grounds for investigation to include subsidiaries

Paragraph 52(1)(b) of the Insurance Act empowers APRA to conduct an investigation or to appoint an investigator if 'it appears to APRA that information in its possession calls for the investigation of the whole or any part of the business of a general insurer or authorised NOHC'. Similarly, subsection 136(g) of the Life Insurance Act empowers APRA to conduct an investigation or appoint an investigator (in the case where the entity is a life company) where 'information in the possession of the Regulator calls for the investigation of the whole or any part of the life insurance business of the life company'.

Paragraph 136(h) of the Life Insurance Act empowers APRA to conduct an investigation or appoint an investigator (in the case where the entity is a registered NOHC) where 'information in the possession of the Regulator calls for the investigation of the business of the NOHC.'

These grounds for investigation should be widened to include reference to the subsidiaries of a life insurer, general insurer and authorised or registered NOHC. This reflects that the Insurance Act and Life Insurance Act confer powers of investigation over subsidiaries. However, at present, the Insurance Act and Life Insurance Act do not provide for grounds similar to the above to apply in the

case of subsidiaries. The effect of this is that APRA has only limited capacity to investigate subsidiaries — essentially only where contravention of an Act or requirement has occurred by the subsidiary or where the grounds for investigating a general or life insurer, or an authorised or registered NOHC, already exist. This creates a risk that APRA may not be able to initiate an investigation sufficiently quickly to be effective.

#### Proposal

That section 52 of the Insurance Act and section 136 of the Life Insurance Act be amended to empower APRA to commence an investigation or appoint an investigator where it appears to APRA that information in its possession calls for an investigation of the whole or any part of the business of a subsidiary of a general or life insurer, or a subsidiary of an authorised or registered NOHC.

### 8.2.3 Rationalise duplication of investigation and information-obtaining powers under the Banking Act

#### Power to obtain information under the Banking Act

There is a duplication of powers to obtain information from an ADI in the Banking Act. The principal power to obtain information from an ADI is in section 62 of the Act. This applies to all ADIs (both ADIs incorporated in Australia and those incorporated in another jurisdiction and operating in Australia via a branch — that is a foreign ADI). Section 62 also empowers APRA to obtain information from an authorised NOHC and a subsidiary of an ADI or an authorised NOHC. The power can be exercised in any circumstances and includes a requirement to supply APRA with books, accounts or documents. It is the statutory power on which APRA relies to obtain information from ADIs and their groups.

Section 13 of the Banking Act empowers APRA to issue a notice to an ADI to require it to supply information relating to an ADI's financial stability, and may include a requirement to supply books, accounts or documents. It does not enable APRA to require the supply of information from an authorised NOHC or subsidiary. Moreover, section 13 applies only to an ADI incorporated in Australia. It does not apply to a foreign ADI.

It is arguable that the presence of section 13 could preclude APRA from using the power in section 62 in circumstances where APRA has concerns over an ADI and is acting to protect depositors and to promote the stability of the financial system — that is in the territory to which Division 2 Subdivision A applies. It could be argued that APRA may be unable to use section 62 powers in these circumstances, given that the Banking Act is structured in such a way that it presumes that section 13 would be relied on for obtaining information from an ADI. If this argument has force, then APRA may be constrained in obtaining information from an authorised NOHC or subsidiaries. Moreover, section 13 requires the issuance of a notice, and is constrained to obtaining information on financial stability matters, whereas section 62 requires no notice and is not constrained by financial stability information. Therefore, it would be preferable for APRA to be able to rely on section 62 for obtaining information, rather than section 13.

#### Proposal

That the provisions in section 13 relating to the power to obtain information be repealed, such that the wider powers contain in section 62 provide the mechanism for requiring an ADI to provide APRA with information.



Further, that subsection 13(2) be incorporated into section 62, such that APRA can require a statutory declaration to be made in relation to information provided by an ADI, authorised NOHC or subsidiary. Subsection 13(3) should be retained.

### Power to investigate under the Banking Act

There is also duplication of powers under the Banking Act in relation to investigations. APRA can investigate an ADI under section 13A of the Act, and also under section 61. Section 13A is limited to a narrow set of circumstances, as set out in subsection 13A(1), such as the likelihood of an ADI's inability to meet obligations or suspension of payment, inability to carry on business in the interests of its depositors, or inability to carry on business consistently with the stability of the financial system in Australia. These are inappropriately narrow grounds for conducting an investigation, given that an investigation is likely to be needed well before any of these circumstances arise.

Moreover, the purpose of an investigation is to obtain information and assess the nature and extent of an entity's financial situation for the purpose of taking proactive action to ensure compliance with prudential requirements and to maintain the soundness of an entity. The grounds set out in subsection 13A(1) are pertinent to the other matters to which section 13A relates — that is the power for APRA to take control of an ADI or appoint an administrator to take control of an ADI's business. In contrast, section 61 empowers APRA to conduct an investigation of an ADI in a much broader set of circumstances. This is appropriate, given that the purpose of an investigation is to obtain information and assess the nature and extent of difficulties of an entity, and should therefore be exercisable in a wide range of circumstances.

Section 13A is also constraining in terms of the scope of the investigation power. Under section 13A, APRA is empowered to investigate only a locally incorporated ADI. It does not empower the investigation of a foreign ADI, an authorised NOHC or a subsidiary. In contrast, section 61 appropriately applies the investigation power widely to include any ADI (including foreign ADIs), authorised NOHCs and subsidiaries. This is appropriate, given that an investigation is an information-gathering and verification process. For it to be effective, it needs to be able to be applied across any entity in the relevant group and not just to an ADI.

For the above reasons, APRA regards section 61 as the primary investigation power in the Banking Act. APRA would rely on this power to conduct an investigation of an ADI and any member of its group, including in the circumstances to which Division 2 Subdivision A applies. However, there is concern that the presence of the investigation power in section 13A may prevent APRA from using the investigation power in section 61 in circumstances where APRA may be considering the possibility of taking remedial or resolution measures, including potentially the appointment of an SM under section 13A. It can be argued that the presence of investigation powers in section 13A may require APRA to rely on those powers, rather than the powers in section 61 in the circumstances to which Division 2 Subdivision A applies.

### Proposal

That the investigation power in section 13A of the Banking Act be repealed and that the sole investigation power be that contained in section 61. Consideration will also need to be given to consolidating subsection 13(4) into section 61 of the Banking Act and to consequential amendment of section 13B of the Banking Act.

## 8.2.4 Enabling APRA itself to investigate an ADI, an authorised NOHC and a subsidiary

Under the general power of investigation in section 61 of the Banking Act, APRA is empowered to appoint a person to investigate an ADI, an authorised NOHC or a subsidiary of an ADI or authorised NOHC where APRA is satisfied that such a report is necessary. However, unlike the Insurance Act and Life Insurance Act, under which APRA itself can conduct the investigation, section 61 of the Banking Act only empowers APRA to appoint an investigator; it is silent on the issue of whether APRA can itself conduct the investigation. In contrast, under the more limited investigation power in section 13A(1) of the Banking Act, when an ADI fails to meet its obligations, APRA may itself conduct an investigation of an ADI, as well as appoint a person to conduct an investigation.

### Proposal

That section 61 of the Banking Act be amended to empower APRA to conduct an investigation of an ADI, authorised NOHC or subsidiary of an ADI or authorised NOHC. APRA would retain the capacity to appoint a person to conduct an investigation.

If this proposal is implemented, consequential amendments would be required to section 61 to require cooperation with APRA as an investigator and to provide APRA with access to documents, systems etc on the same basis as current obligations apply to an ADI, authorised NOHC or subsidiary in respect of a person appointed by APRA.

## 8.2.5 Extending the ability for APRA to appoint a person to investigate a life insurance company, its registered NOHC or a subsidiary

Sections 135 to 137 of the Life Insurance Act empower APRA to conduct an investigation of a life insurance company, its registered NOHC and a subsidiary of the insurer or NOHC. However, the Life Insurance Act does not empower APRA to appoint a person to conduct investigations. The inference to be drawn is that the Life Insurance Act only allows APRA itself to conduct the investigation, rather than appointing a person to perform the investigation on its behalf.

This contrasts with the equivalent provisions in the Insurance Act and Banking Act. Under section 52 of the Insurance Act, APRA can conduct an investigation itself, but can also appoint a person to conduct the investigation. Similarly, sections 13A and 61 of the Banking Act empower APRA to appoint a person to conduct an investigation.

Some kinds of investigation are best performed by persons with specific expertise and experience in a particular field relevant to the investigation — such as a technical expert on IT matters, accounting, or some specific area of financial or prudential risk. APRA will not necessarily have staff with the requisite skills and experience to perform the role effectively. It may therefore be necessary to engage a specialist for the task. The proposed amendment would also align the Life Insurance Act in alignment with the other industry Acts.

### Proposal

That the Life Insurance Act be amended to empower APRA to appoint a person to conduct an investigation on APRA's behalf.

## 8.2.6 Provide an appointed investigator with the power to conduct an examination of persons relevant to its investigation

Section 61 of the Banking Act allows APRA to appoint a person to investigate and report on prudential matters in relation to the relevant ADI or NOHC. Subsection 61(2) of the Act imposes an obligation on the entity being investigated to give the investigator access to its books and documents and to supply the investigator with the information needed to conduct the investigation.

Section 62 enables APRA to require certain persons to provide information. However, it does not:

- include all persons who might be able to provide relevant information about the entity that is under investigation; or
- expressly provide the appointed investigator with the power to conduct an examination of persons relevant to its investigation.

### Proposal

That the Banking Act be simplified by reference to the other industry Acts and the SIS Act — that is section 55 of the Insurance Act, section 142 of the Life Insurance Act and section 270 of the SIS Act. These sections provide APRA with an express power to conduct examinations of persons in relation to matters that are relevant to its investigations.

## 8.2.7 Persons not to disclose information obtained during an investigation

Currently, APRA does not have the power to direct an individual and their legal representatives not to divulge information revealed to them as part of an investigation. For example, individuals and their representatives are currently permitted to disclose information revealed to them as part of an investigation under section 13B or 61 of the Banking Act.

Such a power would be particularly important where APRA's investigation concerns an ongoing or functioning entity and APRA has concerns that the revelation of an investigation by APRA could result in adverse consequences, including a 'run' on the entity.

### Proposal

That APRA be given the power to direct a person or entity being investigated (and their legal representatives) not to disclose the content of the investigation. This should be included in all the industry Acts and the SIS Act.

### Discussion questions

Are there any concerns as to the impact of this proposal on the rights of individuals and regulated entities?

Are there any safeguards necessary or desirable in conjunction with the use of the power?

## 8.2.8 Persons APRA may seek assistance from during investigations

Once an investigation is under way, section 55 of the Insurance Act allows APRA to issue various notices to certain prescribed persons. Section 50 of the Insurance Act defines the meaning of 'prescribed persons' for the purposes of section 55. The definition excludes the following persons:

- a receiver, or a receiver and manager, of property of the relevant entity;
- an administrator within the meaning of the Corporations Act;
- an administrator of deed of company arrangement executed by the relevant entity under Part 5.3A of the Corporations Act; and
- a liquidator or provisional liquidator for the relevant entity.

The exclusion of these persons from the definition of prescribed persons may curtail the ability of APRA to carry out an investigation into the affairs of the relevant entity.

Under subsection 62(3) of the Banking Act, APRA may require externally-administered bodies corporate to provide it with information, including books accounts or documents. Under the equivalent sections in the Insurance Act (section 115) and Life Insurance Act (section 141), it is not clear whether APRA may obtain information from externally-administered bodies corporate. Section 115A of the Insurance Act and section 140 of the Life Insurance Act also do not make it clear whether they extend to externally-administered bodies corporate.

### Proposal

That section 50 of the Insurance Act be amended so that either:

- these persons are included in the definition of prescribed persons; or
- a provision is inserted that allows APRA to seek the reasonable assistance of these persons in the conduct of its investigations.

It is further proposed that sections 115 and 115A of the Insurance Act, and section 140 and 141 of the Life Insurance Act, are extended so that these provisions apply to a body corporate that is, or becomes, an externally-administered body corporate within the meaning of the Corporations Act.

### Discussion questions

Is there any reason APRA should not be able to seek assistance from external administrators during investigations?

Are there other people APRA should be able to seek assistance from during investigations?

## 8.2.9 APRA may investigate and obtain information in respect of group matters

APRA supervises individual regulated entities as well as groups that contain regulated entities. On a practical level, APRA's supervision of groups takes account of the fact that many prudentially regulated entities that are members of a group do not actually operate as fully stand-alone entities and, consequently, their risks and operations need to be considered in the context of the group as a whole. The purpose of group supervision is therefore primarily aimed at addressing contagion risk across a group — to ensure that a group is financially sound and that group activities, intra-group relationships and intra-group transactions do not jeopardise the financial soundness of APRA regulated entities within the group.

The global financial crisis highlighted the need for enhanced group supervision. Financial groups with activities in more than one financial industry and with a mix of activities across financial and non-financial industries and across regulated and unregulated entities create challenges and risks. Non-traditional activities can make up a sizeable proportion of earnings and can make a material contribution to a group's risk profile. Further, financial institutions are increasingly expanding beyond their traditional industry boundaries and using holding company structures to improve operational efficiency. This increases the potential for non-traditional activities to impact on the financial health of APRA-regulated entities within a group. Therefore, APRA needs to be able to obtain an overall view of the financial and operational soundness of a group to be confident that group risks are being:

- measured within and across a group in its entirety; and
- managed such that they are unlikely to materially affect the financial health of any APRA-regulated entities in that group.

APRA has powers under the industry Acts to obtain information from, and to investigate individual members of, a group of companies, including a regulated entity. However, while APRA is able to obtain information and investigate on prudential matters relating to a regulated entity, an authorised NOHC or other individual member of a group, it is not clear under the current legislation that APRA is able to do so in respect of prudential matters relating to the group as a whole. For APRA to effectively conduct both prudential supervision and crisis resolution on a group basis, it is essential that the scope of APRA's information-obtaining and investigation powers extend to group matters.

Further, APRA's ability to make prudential standards for subsidiaries currently only extends to subsidiaries that are corporations. Whether an entity can be classified as a 'subsidiary', and hence whether it is able to be regulated via relevant prudential standards, is determined by the current definitions in section 5 of the Banking Act and sections 4 of the Insurance Act and the Life Insurance Act. These definitions are not broad enough to allow APRA to supervise groups effectively insofar as they include entities that are not corporations.

Effective prudential regulation and crisis management requires APRA to have robust investigation and information-obtaining powers in order to detect incipient stresses and distress or breaches of prudential requirements promptly. Given that APRA conducts both prudential supervision and crisis resolution on a group basis where necessary, it is essential that the scope of APRA's information-obtaining and investigation powers extend to group matters, including matters concerning members of the group that do not fall within the meaning of 'subsidiary'.

### Proposal

That the relevant investigation and information-obtaining powers in the industry Acts be amended so that they extend to group matters, rather than being restricted to matters relating to individual members of the group.

Further, that APRA be empowered to request information about non-subsidiary entities, including funds, partnerships and trusts, that are controlled by groups containing authorised businesses.

## 8.2.10 Simplify information-obtaining powers

APRA's powers to obtain information from a life company and its group are limited; the provisions of the Life Insurance Act related to APRA's information-obtaining and investigation powers are different to those in the Banking Act and Insurance Act.

Currently, APRA cannot obtain information from subsidiaries of a life company and subsidiaries of a registered NOHC. Section 131 of the Life Insurance Act restricts this power to the obtaining of information from life companies and registered NOHCs, although the Life Insurance Act does empower APRA to require a life company or registered NOHC to provide APRA with information in relation to a subsidiary.

The information APRA may ask for under subsection 131(1) of the Life Insurance Act is more limited than that available under subsection 62(1) of the Banking Act and subsection 115(1) of the Insurance Act. Further, subsection 131(1) of the Life Insurance Act allows APRA to require the production of information but not the production of books, accounts or documents. Section 132 of the Life Insurance Act allows APRA to obtain records but the scope is more limited and does not allow APRA to collect information from subsidiaries.

Subsection 131(2) of the Life Insurance Act requires APRA to specify in the notice requiring information a period within which information must be provided to APRA. The subsection states that the period specified must not end earlier than 7 days after the day on which the notice is given to the body. There is no equivalent provision in the Banking Act or Insurance Act.

To be consistent with general Commonwealth policy, it is important to give due notice to persons required to produce information or documents. Given the time it may take an entity to find the information, and to allow for contingencies such as ill-health, allowing a minimum of 14 days in general is more appropriate. However, where there is a justifiable need for urgency, it may be appropriate that this time is reduced. This might be necessary, for example, where there is an urgent need to obtain information for the purpose of ascertaining the financial condition of the entity and to determine whether to take particular remedial or resolution measures. A significant delay in obtaining information risks seriously impeding APRA's ability to perform its functions effectively, to the potential detriment of policy owners and the stability of the financial system.

Subsection 131(4) of the Life Insurance Act entitles a body to be paid reasonable compensation for making copies for the purpose of complying with a notice requiring that a copy of a document be given to the regulator. Neither the Banking Act nor the Insurance Act provide for such compensation.

### Proposals

That subsection 131(1) of the Life Insurance Act be amended to empower APRA to require a subsidiary of a life company or registered NOHC to provide APRA with information of the kind specified in subsection 131(1).

That subsection 131(1) of the Life Insurance Act be amended to allow APRA to obtain a similar scope of information to that available under the Banking Act and Insurance Act. It is also proposed that section 131 be amended to allow APRA to obtain books, accounts or documents like in the other industry Acts. Should these amendments proceed, consideration will be given to whether there is a need to retain section 132 of the Life Insurance Act.

That subsection 131(2) be amended so that, in general, the period specified must not end earlier than 14 days after the day on which the notice is given to the body. However, where, in APRA's view, there is a justifiable need for urgency, it is proposed that this period may be reduced. An equivalent of these changes would be made to the Banking Act and Insurance Act.

That subsection 131(4) be repealed, given that the Banking Act and Insurance Act do not provide for compensation for the cost of making copies of documents.

## 8.2.11 Investigate the unauthorised carrying on of regulated business

APRA does not presently have any investigation powers in relation to unauthorised conduct of banking business — that is a breach of section 7 or section 8 of the Banking Act. Such unauthorised activity could be conducted by a representative office of an overseas bank, or by other persons, whether individual or corporate.

This is in contrast to the position under the Insurance Act, where APRA has comprehensive powers to investigate the unauthorised carrying on of insurance business under Part VA of the Insurance Act.

It is anomalous that APRA is able to investigate the unauthorised carrying on of general insurance business, but not the unauthorised carrying on of banking business or life insurance business. APRA is the prudential regulator of all three sectors of the financial industry, and should have consistent powers of investigation in this regard, particularly where the unauthorised carrying on of regulated business can cause harm in Australia.

### Proposal

That the Banking Act and Life Insurance Act be amended to align with the Insurance Act in this regard, that is an equivalent of Part VA of the Insurance Act be replicated in the Banking Act and Life Insurance Act.

## 8.2.12 Requirements regarding investigation reports

The industry Acts and the SIS Act provide for reporting obligations at the conclusion of investigations conducted by APRA across the Acts it administers. At present, each of the industry Acts has separate and different reporting requirements once investigations have been completed or, in some cases, discontinued. Some Acts also have additional mandatory reporting requirements in relation to the content of the report and to the sending of reports to third parties.

These requirements are not consistent between the industry Acts and the SIS Act. These differences are not deliberate but appear stem from the fact that these Acts were developed at different times and were administered by different agencies before the Wallis reforms.

### Proposal

That obligations relating to investigation reports be simplified across the industry Acts and the SIS Act. These simplified obligations would provide that a report be sent at the conclusion of an investigation to the persons who have been subject to the investigation. The industry Acts and the SIS Act would be amended to achieve the following:

- The industry Acts and SIS Act would provide for a report to be prepared on completion of an investigation, but this should not extend to requiring transcripts to be attached to the report as is currently the case under the SIS Act.
- Upon discontinuation of an investigation, all industry Acts and the SIS Act would allow APRA to decide whether a report needs to be prepared.
- Once a report is prepared, all industry Acts and the SIS Act would provide a copy to be made available to the entity being investigated.
- All industry Acts would not require APRA to consult with the Attorney-General before giving a copy of an investigation report to the body investigated. This would be achieved by removing subsection 60(6) of the Insurance Act.
- All industry Acts would not allow APRA to release investigation reports to the public. This would be achieved by removing subsection 60(7) of the Insurance Act.

## 8.2.13 Strengthening of actuarial investigation powers

Section 49E of the Insurance Act empowers APRA to require a general insurer to appoint, at the insurer's expense, an actuary who is not an officer of the insurer and not the actuary appointed in accordance with section 39 of the Insurance Act. APRA can require the insurer to engage the actuary to investigate all or a specified part of the insurer's liabilities and produce a written report.

This is an important provision in the Insurance Act. It complements the other investigation powers in the Act, but is specific to actuarial investigation. The section provides APRA with a formal means of obtaining an independent actuarial assessment of a general insurer and therefore an important means of assessing the financial condition of an insurer.

A number of features of section 49E reduce the effectiveness of the section as an investigative tool. In particular, the section does not facilitate the quick initiation of an actuarial investigation. This is because it provides for several periods before an investigation may commence:



- It allows up to 7 days following the serving of a notice by APRA on the insurer for the insurer to appoint the actuary.
- If the actuary is not acceptable to APRA, the Act allows a further 7 days for APRA to notify the insurer as such. The insurer then has a further 7 days to appoint another actuary.
- The section allows up to 30 days from the time the initial notice is served on the insurer for the insurer to deliver the actuary's report to APRA or such longer time as APRA allows.

In addition, the section does not empower APRA to appoint an actuary to conduct the investigation and it does not permit APRA to specify the terms of reference for the investigation.

The time delays allowed for in section 49E, the inability of APRA to specify an actuary of its choosing, and the inability for APRA to specify the terms of reference for the investigation in the actuary's terms of appointment, limits the effectiveness of the section. In particular, it creates a risk of substantial delays in the appointment of an actuarial investigator, such that a quick investigation may be impeded. In turn, this has the potential to constrain APRA's ability to obtain the information it requires in order to determine the financial condition of the insurer and take appropriate remedial and/or enforcement action. The section falls short of what is required for an effective investigation power, impeding APRA's supervisory capacity. It also falls short of relevant international benchmarks, such as the IAIS Core Principles, which stress the importance of robust investigation powers that allow for quick and thorough investigation.

There is no parallel section in the Life Insurance Act. However, APRA has a similar power in the SIS Act. Part 25 Division 3 of the SIS Act allows APRA to require the appointment of a number of people of specified qualifications. Similar limitations are placed on the power in the SIS Act as those outlined above regarding the Insurance Act.

### Proposal

That section 49E of the Insurance Act be amended to address these deficiencies. Specifically, it is proposed that section 49E be amended to:

- enable APRA to specify the actuary to conduct the investigation (while retaining the option of APRA allowing the insurer to select the actuary);
- require the insurer to appoint the actuary on terms of reference specified or approved by APRA;
- require the insurer to appoint the actuary within a time frame specified by APRA; and
- require the insurer to provide the actuary's report to APRA within a time frame specified by APRA.

It is also proposed that similar amendments be made to remove similar limitations on the power in Part 25 Division 3 of the SIS Act.

In recognition of the importance of broad consistency of supervisory powers between the Insurance Act and Life Insurance Act, and the importance of having robust investigation powers, it is proposed that the Life Insurance Act be amended to include the same provisions in that Act.

## 8.2.14 Requirement to notify APRA where prudential requirements are breached

The industry Acts require regulated entities and members of the corporate group to which they belong to report to APRA certain breaches of prudential requirements and certain changes in financial position. The requirements ensure that Australia's regulatory regime accords with international best practice and enable APRA to ensure the sound financial position of regulated entities and the financial system as a whole.

Section 62A of the Banking Act and section 38AA of the Insurance Act compel a member of a corporate group to notify APRA if it becomes aware of certain circumstances (involving financial soundness or compliance with prudential standards). If a member of the corporate group fails to notify APRA in those circumstances, criminal liability may be imposed. There are, however, unnecessary inconsistencies among the provisions under the industry Acts. For example, under the Banking Act, the requirement extends to one member of a corporate group reporting on the breach by another member of the corporate group. This is not the case under the Insurance Act or Life Insurance Act. There is no reason why these Acts should be different in this regard, particularly in the context of effective prudential supervision of groups.

### Proposal

That a simplified provision replace the existing sections in all three industry Acts relevant in this regard. The simplified provision should provide that a member of a relevant corporate group commits an offence if it fails to immediately inform APRA, where it becomes aware of certain matters, including that it, or another member of the group:

- has breached a prudential standard;
- may not be in sound financial position;
- has breached a provision of the relevant Act or regulations made under the Act; and
- has breached a condition of authority where applicable.

## 8.2.15 Enhance the application of the whistleblower protection provisions

The Banking Act (paragraph 52A(2)(c)), Insurance Act (paragraph 38A(2)(c)), Life Insurance Act (paragraph 156A(2)(c)) and SIS Act (paragraph 336A(2)(c)) provide that:

*The disclosure of information by the discloser qualifies for protection under this Division if... the information concerns misconduct, or an improper state of affairs or circumstances, in relation to the body corporate...*

Based on the current legislation, for protection to apply, there must be misconduct or an improper state of affairs or circumstances. This has no regard to a prospective whistleblower's opinion or belief. This may deter a whistleblower who believes, on reasonable grounds, that the misconduct or improper state of affairs/circumstances exists, but is not certain of this.

Proposed amendments to these provisions could consider the wording of the auditor/actuary whistleblower obligations in sections 129 and 130 of the SIS Act. These refer to opinions that a

contravention 'may have occurred, may be occurring, or may occur' and to formation of the opinion that the financial position of an entity 'may be, or may be about to become, unsatisfactory'.

#### Proposal

To amend the whistleblower provisions in the industry Acts to bring them into line with the equivalent provisions in the SIS Act.

### 8.2.16 Ensure that the whistleblower protection provisions apply to former employees, directors, etc

The Banking Act (subsection 52A(1)), Insurance Act (subsection 38A(1)), Life Insurance Act (subsection 156A(1)) and SIS Act (subsection 336A(1)) provide that 'this section applies to a disclosure of information by a person (the discloser) who **is**, in relation to an ADI/insurer/superannuation entity, any of the following: (a) an officer...; (b) an employee'. A person who has **ceased to be** an employee may still be subject to punitive action — example civil proceedings relating to the disclosure of confidential information.

#### Proposal

That an amendment be undertaken to provide protection of a person who is **or was** any of the persons listed in the Banking Act (subsection 52A(1)), Insurance Act (subsection 38A(1)), Life Insurance Act (subsection 156A(1)) and SIS Act (subsection 336A(1)).

## 8.3 ENHANCEMENT OF DATA COLLECTION AND PUBLICATION PROVISIONS

APRA is a central repository of statistical information for the Australian financial sector and collects financial statistics from a wide range of financial institutions, including institutions that are regulated by APRA and certain classes of institution that are not. Almost all of APRA's data collections are made under the FSCODA and its subordinate reporting standards. The object of the FSCODA is to enable APRA to collect information in order to assist:

- (i) APRA in the prudential regulation or monitoring of bodies in the financial sector;
- (ii) another financial sector agency to perform its functions or exercise its powers; and
- (iii) the Minister to formulate financial policy.

APRA collects data on behalf of other government bodies, including the RBA, the Australian Bureau of Statistics and ASIC. About 80 per cent of the data collected is shared with other agencies. In addition, APRA performs various other data collection and publication activities, such as the production and release of statistical information through publications and the provision of customised statistics (subject to confidentiality restrictions).

The statistics APRA publishes inform many decision-makers in the Australian financial system, including APRA, government policy-makers, other regulators, market analysts, researchers and senior management of financial institutions. APRA follows international standards so that users can have confidence in the integrity of the data and so that statistics are made available on an impartial basis.

### 8.3.1 Broaden the definition of ‘regulated entity’ under the FSCODA to include subsidiaries of registered life companies and NOHCs

Section 13 of the FSCODA provides that the Act applies to, and APRA may make reporting standards that impose reporting obligations on, ‘financial sector entities’. The term ‘financial sector entity’ is defined in section 5 of the FSCODA as including, amongst other things, a ‘regulated entity’ and a ‘registered entity’.

Subsection 5(4)(a) of the FSCODA states that a ‘regulated entity’ — a class of ‘financial sector entity’ — includes a body regulated by APRA within the meaning of subsection 3(2) of the APRA Act. Subsection 3(2) of the APRA Act, in turn, lists the bodies regulated by APRA as including ADIs, ADI authorised NOHCs, general insurers, general insurer authorised NOHCs, subsidiaries of general insurers and subsidiaries of general insurance authorised NOHCs, and life companies and registered NOHCs of life companies. Paragraph 5(4)(c) of the FSCODA further provides that a ‘regulated entity’ includes a subsidiary of an ADI, or a subsidiary of an ADI authorised NOHC.

The definition of ‘regulated entity’ does not include subsidiaries of life companies and subsidiaries of NOHCs registered under the Life Insurance Act.

#### Proposal

That the legislation be amended to ensure that APRA may make reporting standards in respect of subsidiaries of life companies and subsidiaries of registered NOHCs of life companies.

#### Discussion questions

Are there practical difficulties or costs implications in requiring subsidiaries of life companies and subsidiaries of life company NOHCs to provide data?

Would the proposal increase costs to industry?

### 8.3.2 Provide that a NOHC is not a registrable corporation under the FSCODA

As noted above, section 5 of the FSCODA provides that a ‘financial sector entity’ includes a ‘regulated entity’ and a ‘registered entity’. Subsection 7(1) of the FSCODA outlines the characteristics of corporations that may qualify as a ‘registrable corporation’ and hence a ‘registered entity’. Importantly, subsection 7(2) then excludes, among others, any corporation whose total assets do not exceed \$5 million in value from qualifying as a ‘registrable corporation’ under subsection 7(1).

In general, a ‘registrable corporation’ is any foreign corporation or trading or financial corporation formed within Australia, whose total assets exceed \$5 million, and:

- whose sole or principal business activities in Australia are the borrowing of money or the provision of finance;
- whose assets arising from the provision of finance exceed 50 per cent of its total assets in Australia; or
- that engages in the provision of finance in the course of carrying on in Australia a business of selling goods by retail, and whose total assets exceed \$25 million.

If a corporation falls into the criteria outlined in subsection 7(1), it will be responsible for seeking to be registered in accordance with the FSCODA. Once the corporation is registered and has been categorised, it may be required to submit reporting forms on either a monthly or quarterly basis.

Subsection 7(2) of the FSCODA provides that, notwithstanding the criteria outlined in subsection 7(1), a corporation will not be a registrable corporation if it falls into any of the categories listed in paragraphs 7(2)(a) to (j). For example, ADIs and general insurers are listed as not being registrable corporations for the purposes of subsection 7(1).

### Proposal

That the list in subsection 7(2) of the FSCODA be amended to provide that authorised NOHCs of ADIs, general insurers and life companies are not registrable corporations pursuant to subsection 7(1).

#### Discussion question

Is there any reason why section 7 of the FSCODA should not be amended to provide that NOHCs of ADIs, general insurers and life insurers are not registrable corporations?

### 8.3.3 Redefine the term ‘registrable corporations’ under the FSCODA

Both APRA and the financial services industry have faced difficulties in applying the current formulation in subsection 7(1). Operation of this subsection captures entities that should arguably be outside its purview, and in some instances does not capture entities that should ideally fall within the subsection.

As noted above, in general, a ‘registrable corporation’ is any foreign corporation or trading or financial corporation formed within Australia, whose total assets exceed \$5 million, and:

- whose sole or principal business activities in Australia are the borrowing of money or the provision of finance;
- whose assets arising from the provision of finance exceed 50 per cent of its total assets in Australia; or
- that engages in the provision of finance in the course of carrying on in Australia a business of selling goods by retail and whose total assets exceed \$25 million.

The problem with this formulation is that borrowing, lending and the provision of finance can represent a small part of an entity that is a major participant in Australian financial markets. As such, subsection 7(1) is currently not capturing a range of entities in relation to which data would be valuable. Important information regarding the conduct of Australian financial markets and associated systemic risk is therefore unavailable to APRA, the Government and the market.

Equally, paragraph 7(1)(b) — regarding foreign corporations — may be capturing a broader range of entities than is desired. Paragraph 7(1)(b) provides that a corporation will be a registrable corporation for the purposes of the FSCODA if it is a foreign corporation or an Australian trading or financial corporation, and:

(b) the sum of the value of such of the assets in Australia of the corporation as consist of debts due to the corporation, being debts resulting from transactions entered into in the course of the provision of finance by the corporation, exceeds:

(i) **50 per cent**; or

(ii) if a greater or lesser percentage is prescribed by the regulations — the percentage so prescribed;

of the **sum of the values of all the assets in Australia** of the corporation.

This formulation is problematic because it is ambiguous as to what the term ‘debts’ is intended to capture, and what the policy intention is behind the 50 per cent threshold. This means that some foreign corporations that have engaged in relatively minor financing activities and nevertheless represent 100 per cent of ‘debts due’ to those corporations, are undesirably captured as ‘registrable’ corporations for the purposes of the FSCODA. As a result, APRA receives applications from these foreign corporations requesting an exemption from being registered as a registrable corporation. These foreign corporations invariably have a negligible effect on the Australian financial system.

#### Proposal

That the criteria set out in subsection 7(1) of the FSCODA be repealed.

That the definition of ‘registrable corporations’ be amended to include reference to engagement in ‘financial services’. In turn, the term ‘financial services’ would be defined by way of regulation.

#### Discussion question

Does the current formulation in subsection 7(1) of the FSCODA provide an appropriate scope for the collection of data? Is there any other aspect of the definition of ‘registrable corporation’ that should be reviewed?

### 8.3.4 Consequences of late, incorrect, incomplete or misleading data submissions

Section 13 of the FSCODA provides that it is an offence of strict liability for a financial sector entity to fail to submit data to APRA within the time-frames specified in the reporting standards. However, if a financial sector entity submits data that is incorrect, incomplete or misleading, section 17 of the FSCODA provides that APRA may issue a notice to the entity requiring it to submit data to APRA within a period it specifies, which is not less than 14 days. If an entity does not comply with the notice, APRA may then give the entity directions that require it to provide APRA with adequate information. The entity commits an offence if it fails to comply with the direction within the period specified in the direction. Subsection 17(5) provides that the period that APRA may give the entity to comply with the direction must not be less than 14 days.

The effect of these provisions is that an entity commits an offence if it fails to submit data in accordance with the time-frames set out in a reporting standard. However, if an entity complies with the time-frame stipulated in the reporting standard, but does so incorrectly, improperly, evasively or untruthfully, it will have a minimum of 28 days to correct the form before an offence is deemed to

have occurred. This de facto extension presents a considerable obstacle for APRA, as timeliness and accuracy are vitally important for the performance of its functions.

#### Proposal

That the FSCODA be amended such that the total period in which an entity has to correct inadequate information should be reduced from 28 days to 4 business days. Accordingly:

- APRA would retain the power to give a non-compliant entity a notice requiring further information and specifying the period within which an explanation or further information is to be given. Currently, the period must not be less than 14 days beginning on the day on which the notice is given. It is proposed that this period of notice be reduced to no more than two business days.
- APRA would retain the ability to issue a subsequent direction to the entity to rectify the reporting document and supply adequate information. Subsection 17(5) currently provides that directions must specify a period within which they are to be complied with. Currently, the period specified must not be less than 14 days beginning on the day in which the directions are given. It is proposed that this period of notice be reduced to not less than 2 business days.
- The FSCODA would be amended to remove the extension period provided in section 17 and to make it an offence for an entity to submit data that is incorrect, incomplete, misleading, or non-compliant, at the time of the submission of the document. Thus, if an entity is required to correct information after it has been submitted, the entity will be deemed to have committed an offence on the date it submitted the original data.

### 8.3.5 Clarify that the FSCODA does not apply to a discretionary mutual fund established or controlled under state legislation

APRA may require discretionary mutual funds (DMFs) to provide data under the FSCODA (see paragraph 5(2)(d)). However, section 6A of the FSCODA states that the FSCODA 'does not apply, in relation to a DMF, to State insurance not extending beyond the limits of the State concerned'. However, this section, as currently worded, does not operate to exclude State established or controlled DMFs from the ambit of the FSCODA because DMF business is not technically 'insurance' business.

#### Proposal

That section 6A be amended to provide that the FSCODA does not apply to DMFs established or controlled under state legislation.

### 8.3.6 Harmonise which auditors and actuaries APRA may provide protected documents to

Section 56 of the APRA Act has an impact on APRA's data publication responsibilities. Section 56 requires that APRA, and others with access to protected information or documents, keep that information and those documents secret. The secrecy does not apply to an employee of the body to which the information or document relates. There is a policy objective of affording adequate protection to confidentiality of information and documents relating to regulated entities and their

NOHCs. However, there is a need to balance this against the policy objective of publishing or disclosing certain information (subject to appropriate restrictions) in line with APRA's statutory responsibilities in statistical publication and the benefit of this information. There is therefore a comprehensive regime for exemption from confidentiality under section 56 of the APRA Act.

Subsection 56(6A) of the APRA Act provides that protected information may be provided to certain auditors and actuaries. However, the subsection contains the following anomalies:

- It only allows for documents to be provided to auditors and actuaries of general insurers and their NOHCs. However, auditors are also appointed to ADIs and their NOHCs and auditors and actuaries are appointed to life insurers and their NOHCs.
- It includes a proviso that disclosure must be for the purposes of the performance of APRA's functions, or the exercise of APRA's powers, under Commonwealth law or State/Territory law. However, subsection 56(3) permits disclosure for the purposes of a prudential regulation framework law. It is not clear whether the exemption provided by subsection 56(6A) is any wider than subsection 56(3) or how the exemptions are different.

#### Proposal

That subsection 56(6A) of the APRA Act be reviewed and amended, so as to ensure that protected information and protected documents may be shared, for the purposes of prudential supervision, with auditors, actuaries and other independent experts providing professional services to regulated entities and where relevant, authorised NOHCs and subsidiaries.

### 8.3.7 Broaden the public disclosure of information by the institutions themselves or by APRA

Over the last decade, international standard-setting bodies and prudential supervisors have been placing greater emphasis on the role that effective public disclosure can play in reinforcing market disciplines on financial institutions and strengthening the incentives for the prudent management of risks. The Basel II Pillar 3 requirements are an example of this. More recently, the BCBS's proposals for bank liquidity requirements include proposals for banks to publicly disclose their liquidity position as a means of further enhancing market discipline.

The IAIS has also advocated public disclosure as an important adjunct to the prudential supervision of insurers, issuing standards and guidance that seek to promote effective disclosure by insurers of information on their risk positions and on key performance metrics. The FSB has also issued various reports and guidance to promote public disclosure to strengthen the incentives for sound risk management practices by financial institutions and to assist in the maintenance of financial system stability.

APRA, like many prudential supervisors, has incorporated public disclosure requirements into some prudential standards. This was done in respect of *Prudential Standard APS 330 Capital Adequacy: Public Disclosure of Prudential Information*, which implements the Pillar 3 disclosure requirements of Basel II.

#### Proposal

The following amendments to the APRA Act and the industry Acts are proposed.



That the prudential standard-making provisions in the industry Acts be amended to make it clear that APRA may require regulated entities to publicly disclose information of a nature, and in a manner, prescribed by APRA by way of prudential standards.

That subsection 56(5C) of the APRA Act be amended to provide APRA with the power to publish information that relates to identified regulated entities and is obtained under the FSCODA or the industry Acts. Currently, APRA may only publish information obtained under section 13 of the FSCODA. Under this proposal, APRA could not publish the information if it relates to individual customers or counterparties or is of a confidential or commercially sensitive nature, as determined by APRA through the process specified in section 57 of the APRA Act.

That section 57 of the APRA Act be amended so that APRA may:

- make a determination in relation to specific information contained in a reporting document, as opposed to being able to make a determination only in respect of the information in the entire reporting document, which is presently the case;
- make a determination that a reporting document, or specific information contained in a reporting document, is not confidential in specific circumstances; and
- make a determination in relation to classes or types of specific information contained in a reporting document, as opposed to being restricted to making a determination only in respect of a document that is actually given to APRA, as is currently the case.

## 8.4 INTRODUCING INDEPENDENT EXPERTS AND STREAMLINING PROVISIONS ON AUDITORS AND ACTUARIES

Under the industry Acts and the SIS Act, APRA may require ADIs, general insurers, life companies and superannuation entities to appoint auditors and may require general insurers and life companies to appoint actuaries. The roles and responsibilities of appointed auditors and actuaries, and the requirements imposed on regulated entities to make arrangements to enable them to fulfil their responsibilities, are set out in prudential standards issued under these Acts. The function of auditors and actuaries is to provide APRA with an assurance that the information provided to it is accurate and complete. This may involve providing APRA with an assurance that a regulated entity's financial systems and controls are adequate. A number of auditor and actuary reviews are conducted annually.

In addition to performing the regular functions set out in the prudential standards, APRA may request that auditors and actuaries, on an *ad hoc* basis, conduct a targeted prudential review concerning a specific area of a licensed institution's operations. For example, APRA may request an auditor to examine an ADI's collateral systems to ensure that this function is being managed prudently.

Both regular reviews and *ad hoc* assessments serve to supplement APRA's in-house prudential supervision. They form a key element of the regulated entity's reporting framework as the information that they provide enhances APRA's ability to monitor the entities which it regulates.

This section of the discussion paper describes a number of proposals to streamline provisions in the industry Acts and the SIS Act regarding auditors and actuaries. It also describes a proposal to allow

APRA to appoint independent experts much in the same way as auditors and actuaries are appointed.

### 8.4.1 Make it an offence to mislead actuaries

Appointed actuaries are responsible for assessing the overall financial condition of an insurer and for advising on the valuation of its policy liabilities on an annual basis. In particular, appointed actuaries are responsible for preparing a Financial Condition Report and for providing this report to the company.

Actuaries undertake their assessments based on the data, reports and other relevant information provided to them by the insurer. It is therefore crucial that all relevant information supplied to an actuary is authentic. However, despite the vital importance of accurate information, the Insurance Act, Life Insurance Act and the SIS Act do not specifically prohibit the provision of misleading information to an actuary.

The absence of this prohibition is inconsistent with the treatment of auditors under the industry Acts. Section 16E of the Banking Act, section 49DA of the Insurance Act, section 91 of the Life Insurance Act and section 130BB of the SIS Act state that it is an offence to mislead an auditor, with the penalty being 5 years imprisonment or 200 penalty units, or both.

Section 16D Banking Act, section 49D Insurance Act, section 90 Life Insurance Act and section 130BA SIS Act require an auditor to notify APRA if they are aware of any attempt to mislead or otherwise unduly coerce them. A failure to notify APRA is an offence with the penalty being 12 months imprisonment or 50 penalty units, or both. As with the requirement not to mislead an auditor, the Insurance Act, Life Insurance Act and SIS Act do not contain provisions requiring an actuary to notify APRA if they are aware of any attempt to mislead or otherwise unduly coerce them.

As both auditors and actuaries are appointed to regulated entities to undertake impartial assessments, there is no reason why they should be treated differently in this regard. Both auditors and actuaries are reliant on the accuracy of the information that is provided to them. Furthermore, the potential consequences of actuaries undertaking analysis based on misleading or incorrect information is just as significant as it is for auditors. An inaccurate evaluation of an insurer's policy liabilities — which form the largest class of liabilities on its balance sheet — could result in both APRA and the board of the insurer forming a fundamentally erroneous view of the overall financial condition of the insurer.

#### Proposal

That the industry Acts and the SIS Act be amended to make it an offence for a person to mislead an actuary, modelling new provisions and associated penalty provisions on those already applicable in the case of auditors. It is further proposed that these Acts be amended to require an actuary to notify APRA if they are aware of any attempt to mislead or unduly coerce them. The penalty associated with a contravention of either one of these requirements would be the same as that for an auditor.

## 8.4.2 Auditors and actuaries providing information to APRA and regulated entities to treat this information as confidential

Auditors and actuaries are, by virtue of their role, privy to information that may be commercially sensitive and which, if disclosed, may adversely affect regulated entities and/or the stability of the Australian financial system.

### Proposal

That the auditor and actuary regimes in the industry Acts and the SIS Act be amended to ensure that all auditors and actuaries providing information to APRA and regulated entities in accordance with these Acts and associated prudential standards are to treat this information as confidential.

A failure to abide by these confidentiality obligations would be a criminal offence.

## 8.4.3 Streamline provisions on roles, duties and functions of auditors and actuaries

The roles, duties and functions of auditors and actuaries are defined inconsistently between the Banking Act, Insurance Act, Life Insurance Act and prudential standards. Whilst subsection 16AV(2) of the Banking Act provides that the appointed auditor must perform the functions and duties of an auditor that are set out in the prudential standards, subsection 83(3) and section 97 of the Life Insurance Act provide that auditors and actuaries must perform the functions set out in the prudential standards and the reporting standards, which are determined by APRA. Section 49J of the Insurance Act, on the other hand, states that auditors must perform the functions set out in the prudential standards, and must audit yearly statutory accounts and prepare other reports.

### Proposal

That these provisions of the industry Acts be streamlined by using the Life Insurance Act provisions as a model. Specifically, subsection 16AV(2) of the Banking Act and section 49J of the Insurance Act should be amended to provide that auditors (and, in the case of the Insurance Act, actuaries) must perform their functions and duties as set out in the prudential standards and the reporting standards.<sup>12</sup> Specific functions and duties currently set out in the industry Acts (such as the duty to audit yearly statutory accounts and prepare other reports) will be moved to the standards.

## 8.4.4 APRA to determine the appointment, termination and functions and duties of auditors and actuaries in its standards

Subsection 11AF(1AB) of the Banking Act provides:

Without limiting the prudential matters in relation to which APRA may determine a standard, a standard may provide for matters relating to:

- (a) the appointment of auditors; and

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<sup>12</sup> Note that provision for similar amendment of the SIS Act is intended be made as part of the Stronger Super reforms.

- (b) the conduct of audits.

This subsection should be read in conjunction with section 16AV of the Banking Act, which currently provides:

- (1) This section applies if the prudential standards require an auditor to be appointed.
- (2) The appointed auditor must perform the functions and duties of an auditor that are set out in the prudential standards.
- (3) The appointed auditor must comply with the prudential standards in performing the functions and duties.
- (4) The ADI or authorised NOHC to whom the prudential standards apply must make any arrangements that are necessary to enable the appointed auditor to perform the functions and duties.

These sections, when read together, enable APRA to ensure that auditors it requires an entity to appoint under the Banking Act will comply with *any* requirements prescribed in the prudential standards relating to auditors. As a result, specific requirements in relation to the appointment of auditors and the conduct of audits are determined in prudential standards.

The Insurance Act and the Life Insurance Act both contain prudential standard-making powers in relation to auditors and actuaries. Sections 49J and 49K of the Insurance Act and subsection 83(3) and section 97 of the Life Insurance Act require that auditors and actuaries of insurers comply with the auditor and actuary prudential standards relating to the functions of auditors and actuaries. However, there is no equivalent of section 16AV of the Banking Act in either the Insurance Act or Life Insurance Act. Therefore, it is not clear that APRA can ensure that auditors and actuaries that APRA requires entities to appoint under the Insurance Act and Life Insurance Act will comply with *all* prudential standards relating to auditors and actuaries. Further, some of the provisions relating to auditors and actuaries in the insurance legislation are particularly prescriptive, which means APRA cannot determine these matters in prudential standards.

### Proposal

That an equivalent of section 16AV of the Banking Act (as modified in item 8.4.3, above) be inserted into the Insurance Act and Life Insurance Act. This provision would not only apply to ADIs, insurers, authorised NOHCs and their auditors and actuaries, but also to the subsidiaries of ADIs, insurers, authorised NOHCs and their auditors and actuaries.

That, where appropriate, some of the Insurance Act and Life Insurance Act provisions regarding auditors and actuaries be repealed and that the substance of the provisions be inserted into prudential standards. These changes would facilitate a consistent approach between the industries and give APRA the flexibility to change provisions regarding the appointment, termination and functions and duties of auditors and actuaries. These changes include moving the following provisions to the prudential standards (and possibly amending them to ensure consistency):

- subsection 39(3) of the Insurance Act and sections 84 and 93(3) of the Life Insurance Act;
  - These sections prohibit a regulated entity from appointing a person as an auditor or actuary if that person does not satisfy fit and proper criteria or is otherwise disqualified

from holding that appointment. For ADIs, however, this prohibition exists in *Prudential Standard APS 310 Audit and Related Matters*.<sup>13</sup>

- section 40 of the Insurance Act and section 83A of the Life Insurance Act;
  - These sections allow APRA to require an insurer to appoint an auditor to be an auditor for a particular purpose. The auditor may be the principal auditor or an additional auditor. For ADIs, *Prudential Standard APS 310 Audit and Related Matters* allows APRA to require an ADI or NOHC to appoint additional auditors, other than the appointed auditor.
- section 46 of the Insurance Act and sections 87 and 95 of the Life Insurance Act;
  - These sections require general insurers and life companies to provide APRA with written details of appointed auditors and actuaries, within 14 days after the day of the appointment. For ADIs, *Prudential Standard APS 520 Fit and Proper* imposes a similar requirement in respect of the appointment of auditors.
- section 43 of the Insurance Act and sections 85 and 94 of the Life Insurance Act; and
  - Section 43 of the Insurance Act prescribes when a person will stop holding an appointment as a general insurer's auditor or actuary, while the Life Insurance Act is silent in this regard. The Life Insurance Act enables the directors of a life company to appoint an interim auditor or actuary while the Insurance Act contains no analogous provision. The Banking Act has no provisions dealing with the end of an auditor's appointment. These inconsistencies would be resolved in the prudential standards.
- subsections 39(1), 39(2) and 39(4) of the Insurance Act and sections 83 and 83A and subsection 93(1) of the Life Insurance Act.
  - These sections impose requirements on general insurers and life companies to appoint auditors and actuaries, and state, among other things, that only one principal auditor and one principal actuary may be appointed at any one time. They also prevent APRA from appointing group wide auditors and actuaries. There are no equivalent provisions in the Banking Act.

#### Discussion questions

Is there any reason the Government should continue to determine the appointment, termination and functions and duties of auditors and actuaries in the Insurance Act and Life Insurance Act?

Is there any reason this proposal should not extend to the auditors and actuaries appointed to subsidiaries of ADIs, insurers and authorised NOHCs?

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<sup>13</sup> Alternatively, the Industry Acts and the SIS Act could be amended to include a provision modelled on section 16AV of the Banking Act together with a provision confirming, for the avoidance of doubt, that a person appointed must satisfy the fit and proper criteria and not be a disqualified person.

#### 8.4.5 Auditors and actuaries to notify APRA or regulated entity (or its related entities) of certain matters

Section 16BA of the Banking Act and section 49A of the Insurance Act place certain notification requirements on past and present auditors and actuaries of a regulated entity, an authorised NOHC, or a subsidiary of a regulated entity or authorised NOHC. These auditors and actuaries must notify APRA if they have reasonable grounds for believing that one of the entities has significantly failed or will significantly fail to comply with applicable prudential standards, their authorisation conditions, the relevant legislation, or a direction given by APRA. Determining whether a failure is significant involves having regard to the financial loss arising or the financial loss that will arise from the failure to one of the entities or the depositors/policyholders of the ADI or insurer. These auditors and actuaries referred to above must also notify APRA if they have reasonable grounds for believing that one of the entities is at risk of insolvency or the existing or proposed state of affairs of an ADI or insurer may materially prejudice the interests of depositors/policyholders of the regulated entity.

The Life Insurance Act contains auditor and actuary notification provisions that are different in some respects (see sections 88 and 98). Subsection 88(1) of the Life Insurance Act places notification requirements on an auditor of a life company, registered NOHC or subsidiary of a life company or registered NOHC. The auditor must notify the entity it is appointed to or the entity's directors of any matter that may contravene the Life Insurance Act or the FSCODA or the interests of the policyholders of the body.

Subsection 88(3) requires the auditor to notify APRA if the entity it is appointed to does not deal with these matters within a reasonable time. Subsections 98(1) and 98(3) extend these provisions to actuaries of life companies but not to actuaries of registered NOHCs or subsidiaries.

#### Proposal

That a consistent approach be taken across the industry Acts regarding the duty of auditors and actuaries to notify APRA and the entities they are appointed to of certain matters. As part of this, section 49A of the Insurance Act may be replicated in the Life Insurance Act. Subsections 98(1) and 98(3) of the Life Insurance Act could also apply to actuaries of registered NOHCs and subsidiaries. Further, the provisions corresponding to subsections 88(1) and 88(3) and the reworked 98(1) and 98(3) of the Life Insurance Act could be inserted into the Banking Act and Insurance Act. This will create greater consistency between the industry Acts and better protect the interests of depositors and policyholders.

#### 8.4.6 Auditor and actuary provisions to apply to authorised NOHCs and subsidiaries

Divisions 2A and 2B of Part II of the Banking Act set out the legislative framework for auditors of ADIs and authorised NOHCs and their subsidiaries. The provisions impose various requirements on both auditors and the entities they are appointed to in relation to, amongst other things, responsibilities to APRA, the treatment of information and the prohibition of fraudulent conduct. In recognition that an auditor may be appointed to an ADI, an authorised NOHC, or a subsidiary of an ADI or authorised NOHC, some of the provisions apply in relation to auditors that have been appointed to all of these entities. However, there are other provisions that apply solely in relation to the auditors of ADIs.

Similarly, the Insurance Act and Life Insurance Act do not comprehensively extend the application of the auditor and actuary regimes to the authorised NOHCs of insurers, and to the subsidiaries of authorised NOHCs and insurers. That is, whilst some sections do apply to these entities, many provisions are only applicable in relation to the auditors and actuaries of life and general insurers.

### Proposal

That the auditor and actuary provisions applying to insurers extend to their NOHCs and subsidiaries and to ensure consistency of treatment between the banking and insurance industries, the following amendments are proposed:

- Enable APRA to refer an auditor or actuary of an authorised NOHC or a subsidiary of an authorised NOHC or insurer to a professional association under section 48 of the Insurance Act and section 125 of the Life Insurance Act. Currently, these sections provide that, if APRA is of the opinion that an auditor or actuary of a general insurer or life company has failed to perform their duties adequately, or is otherwise not a fit and proper person to be an auditor or actuary, APRA may refer these particulars to a professional association that may take disciplinary or other action against the auditor or actuary.
- Allow APRA to direct an authorised NOHC, or the subsidiary of an ADI or authorised NOHC, to end the appointment of an auditor under section 17 of the Banking Act. Currently, the Banking Act only empowers APRA to direct an ADI to remove an auditor from their position in certain circumstances. It is also proposed that section 49R of the Insurance Act and section 125A of the Life Insurance Act be extended to enable APRA to direct a subsidiary of an insurer or authorised NOHC to remove an auditor or actuary.
- Make it an offence to provide false or misleading information to auditors and actuaries of authorised NOHCs and subsidiaries of authorised NOHCs and regulated entities under section 16E of the Banking Act, section 49DA of the Insurance Act and section 91 of the Life Insurance Act. Currently, these sections only make it an offence to provide false or misleading information to auditors of ADIs and insurers. Item 8.4.1 above proposes to make it an offence to provide false or misleading information to actuaries of insurers. This proposal extends this change to auditors and actuaries of authorised NOHCs and subsidiaries of authorised NOHCs and regulated entities.

### Discussion questions

Is it appropriate that these provisions also apply to NOHCs and subsidiaries?

Are there other provisions that do not currently apply to NOHCs and subsidiaries that should?

## 8.4.7 Streamline the protection from liability provisions in the industry Acts

The industry Acts and the SIS Act currently provide protection from liability for certain persons when they act in exercising powers or discharging functions under the Acts. However, the provisions differ among the Acts in terms of scope and level of protection.

For example, section 70A of the Banking Act provides that a person is not subject to any liability to any person in respect of anything done, or omitted to be done, in good faith and without negligence in the exercise or performance, or purported exercise or performance, of powers, functions or duties

under the Banking Act. These protections cover auditors who are under an obligation to provide information to APRA about the ADIs to which they have been appointed. Section 49C of the Insurance Act does offer some protection for auditors and actuaries, but it is limited to the provision of information to APRA. Similarly, the Life Insurance Act protects auditors and actuaries in circumstances limited to the voluntary provision of information to APRA. Sections 89 and 99 of the Life Insurance Act also protect auditors and actuaries by specifically providing for the conferral of qualified privilege in respect of statements made by them in certain circumstances.

### Proposal

That the different provisions for protection from liability in the industry Acts be reviewed and streamline. This will ensure an adequate scope and level of protection for persons when they act in exercise or performance, or purported exercise or performance, of powers, functions or duties under the industry Acts. In particular, the industry Acts will be amended to ensure that protection from liability is consistent for persons such as auditors and actuaries, and on other independent experts as proposed in Item 8.4.8 below, including protection in relation to qualified privilege. Protection from liability will also apply to both voluntary and mandatory provision of information under the industry Acts.

#### Discussion question

Is there any reason why section 70A Banking Act should not be replicated in the Insurance Act and Life Insurance Act?

### 8.4.8 Appointment of independent experts

The categories of risk faced by regulated entities have become increasingly complex and multi-faceted, in line with technological developments, financial innovation and new lines of business. This is the case for banking and insurance, among other financial industries. Risk modelling, IT systems, payments systems infrastructure, operational risk and some forms of asset valuations all pose considerable risks to financial institutions. APRA, like other supervisors, cannot sensibly maintain in-house expertise to sufficiently assess all these forms of risk. Similarly, auditors and actuaries do not have expertise in all forms of risk. In order that APRA may effectively monitor regulated entities, there are occasions when APRA needs the power to require a regulated entity, an authorised NOHC or a subsidiary of a regulated entity or authorised NOHC to engage a specialist to review and report on the adequacy of risk management matters.

Other than the legislative regime pertaining to auditors and actuaries in the industry Acts, there is currently no legislative provision for APRA to require regulated entities to appoint independent experts to review certain specialist risk areas. In contrast, many foreign supervisors have this power. Further, part 25 division 3 of the SIS Act gives APRA the power to require the appointment of an individual or a committee of individuals to investigate the financial position of a superannuation entity and to specify the qualification of the individual or the qualifications members of the committee must hold.

Giving APRA this power over all APRA-regulated entities would have the following benefits:

- *Flexibility.* The framework would enable APRA to require the appointment of an independent expert to both a specific regulated entity or, if appropriate, a particular class of institutions.



- *Efficiency.* The framework would facilitate the engagement of specialists, with in-depth expertise in particular fields, as needed. This would be considerably more efficient than APRA maintaining staff with such expertise.

The power would have similar aspects to the auditor and actuary regime. Auditors and actuaries are types of independent expert. As with auditors and actuaries, the regulated entity, authorised NOHC or subsidiary of the regulated entity or authorised NOHC would be required to engage an independent expert on terms specified by APRA or agreed with APRA. Independent experts would be required to perform the functions set out in prudential standards and comply with prudential standards in performing their functions. Likewise, the cost of engaging an independent expert would be borne by the regulated entity, authorised NOHC or subsidiary of the regulated entity or authorised NOHC. However, APRA would be required to consult with entities prior to appointing an independent expert. The proposal would enable APRA to require independent reports from such experts on prudential matters pertaining to these entities. The proposed amendments would also enable APRA to obtain independent reports about the activities of entities APRA is not very familiar with.

### Proposal

That the industry Acts be amended to enable APRA to require regulated entities, authorised NOHCs and subsidiaries of regulated entities and authorised NOHCs to engage independent experts to review and report on specified risk management matters.

That APRA be given the power to require regulated entities, authorised NOHCs and subsidiaries of regulated entities and authorised NOHCs (or a class of regulated entities, authorised NOHCs and subsidiaries of regulated entities and authorised NOHCs) to appoint an independent expert via two methods:

- making prudential standards that require regulated entities, authorised NOHCs and their subsidiaries to appoint independent experts in areas and circumstances specified in the standards; and
- issuing a notice to an ADI, insurer, authorised NOHC or subsidiary to require the entity in question to appoint independent experts on an *ad hoc* basis to provide a report in accordance with the terms of reference specified in the notice.

The first method would enable APRA to require the appointment of independent experts in the same way it requires the appointment of auditors or actuaries, for matters that require independent expert review on an ongoing basis. The second method would enable APRA to require independent experts to produce reports on a one-off or irregular basis.

### Discussion question

Do businesses expect this power to have a significant impact on them, administratively or financially?

## 8.5 REFINEMENT OF THE SCOPE OF THE PRUDENTIAL STANDARDS

Prudential standards are a type of legislative instrument that assist the Government and APRA in the regulation of financial system entities. They allow APRA to determine the detail of the law relating to financial systems, subject to parliamentary scrutiny. APRA's ability to determine the law using prudential standards is particularly useful where the law needs to be detailed and where the law involves technical issues. The industry Acts determine the scope of the prudential standard-making powers of APRA.

The scope of the prudential standard making powers would benefit from simplification and clarification. Although the prudential standards vary considerably between the industries, reflecting the different risk profiles and business functions of different types of financial institution, there is a need for a broadly consistent approach across the industry Acts to the statutory powers governing the making of prudential standards.

Further, it would be desirable to clarify, and in some cases increase, the scope of matters the standards can cover. Changes would improve APRA's capacity to regulate effectively.

### 8.5.1 Refinement and simplification of the definition of 'prudential matters'

The definition of 'prudential matters' is a key provision in the Banking Act and Insurance Act, given that it determines the scope of the prudential standard-making powers of APRA and the matters for which regulations may be made. It also has relevance for some other powers exercisable by APRA, including in relation to investigations. However, the definition of prudential matters differs between the Banking Act and the Insurance Act and the definition excludes certain matters that it should include.

'Prudential matters' is defined differently across the industry Acts and the Life Insurance Act does not contain a definition. There are slight differences in wording between the Banking Act (subsection 5(1)) and the Insurance Act (subsection 3(1)). Although the Life Insurance Act refers to 'prudential matters', it does not define it. It would be desirable for prudential matters to be consistently defined in the industry Acts. This recognises that the concept of prudential matters is much the same across the banking, general insurance and life insurance industries, even though the specifics of particular prudential standards varies considerably across the industries. A consistently applied definition would simplify prudential regulation across the industries in areas where this is desirable, such as governance, risk management and some elements of capital adequacy. It would also assist in the move to a 'level 3' approach to prudential supervision, where APRA seeks to apply supervisory requirements across financial groups on a consistent basis.

In this context, it is noted that the definition of prudential matters in the Banking Act refers to a 'relevant group of bodies corporate' (as well as to an ADI, an authorised NOHC and subsidiaries), whereas the definition in the Insurance Act does not include the reference to a group. Given that prudential matters relate to groups of bodies corporate, as well as to the regulated entity, its authorised NOHC and subsidiaries; in the case of insurance as well as banking, it is important that the definition in all three industry Acts applies to 'relevant group(s) of bodies corporate'. If 'relevant groups of bodies corporate' were referred to in the Insurance Act and Life Insurance Act, it would be defined in these Acts, as it is in the Banking Act.

Currently, under the Life Insurance Act, it is not completely clear which matters APRA may make prudential standards on or matters the Government may make regulations on. Due to the absence of a definition of 'prudential matters' in the Life Insurance Act, the scope of APRA's prudential making powers is ambiguous. This creates uncertainty for APRA and the life insurance industry.

The current definitions of 'prudential matters' in the Banking Act and Insurance Act make no reference to protecting the interests of depositors or policyholders. Depositor and policyholder protection is a fundamental reason for the prudential regulation and supervision of ADIs and insurers. APRA's purposes under the APRA Act, the objects of the Insurance Act and Life Insurance Act and numerous sections in the Banking Act demonstrate that a fundamental reason for prudential regulation is the protection of the interests of depositors and policyholders. As APRA is the Australian prudential regulator, its powers to make prudential standards should include the protection of the interests of depositors and policyholders.

The current definitions of prudential matters indirectly capture the concept of depositor and policyholder protection by referring to the conduct of a regulated entity to keep it in a 'sound financial position' and to conduct its affairs with 'integrity, prudence and professional skill'. However, the absence of explicit reference to depositor or policyholder protection reduces the clarity of the definition and creates uncertainty over whether prudential standards can be made on the grounds of protecting depositors or policyholders. This might be the case, for example, if the standard in question does not necessarily relate to the 'conduct' of a regulated entity or where a standard might relate to matters not necessarily anchored to the concept of 'sound financial position'.

Another area where clarity would be desirable is in relation to whether standards can be made for matters beyond the 'conduct' of a regulated entity (and its group). The current definitions refer to conduct, but no reference is made to the 'structure' or 'organisation' of a regulated entity (and its group). In practice, this has not been a problem to date, but greater clarity is desirable as to the capacity to make standards or regulations in relation to the structure and organisation of a regulated entity and its group. This is particularly important given the increasing international emphasis on recovery and resolution planning, among other matters, which not only relate to the conduct of an entity, but also to its structure and organisation.

A further issue that warrants clarification in the definition of 'prudential matters' is whether it includes issues relevant to the resolution of a regulated entity and its group (example measures to facilitate recapitalisation, transfers of business undertaking, payout of depositors/policyholders, or some other form of resolution in a distress situation). Although it can be argued that the current definition does embrace such matters, there is some uncertainty on the scope of the current definition and therefore the scope of APRA's prudential standard-making power.

Given the increasing international and domestic emphasis on recovery and resolution planning and facilitating cost-effective resolution of distressed financial institutions, it is appropriate for 'prudential matters' to refer to the ability to ensure that a regulated entity may be resolved effectively. This would be consistent with the recommendations of the BCBS and FSB.

## 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.

### 8.5.2 Simplify which entities must comply with the prudential standards

Section 32 of the Insurance Act and section 230A of the Life Insurance Act state that APRA may determine standards relating to prudential matters, which must be complied with by insurers, authorised NOHCs and subsidiaries of insurers or authorised NOHCs (and particular classes within those groups). Section 11AF of the Banking Act is similar but does not apply to subsidiaries of ADIs, or subsidiaries of authorised NOHCs.

## Proposal

That section 11AF of the Banking Act be amended to enable APRA to determine prudential standards in relation to the subsidiaries of ADIs, and subsidiaries of authorised NOHCs (and particular classes of these subsidiaries).

## 8.6 ENHANCE APRA'S ABILITY TO DISQUALIFY INDIVIDUALS FROM ACTING AS RESPONSIBLE PERSONS

The fit and proper criteria set out in APRA's prudential standards seek to ensure that individuals holding important positions in APRA-regulated entities or authorised NOHCs have the appropriate expertise and experience and are of good character. The Federal Court-based disqualification regime

in turn plays a critical role in ensuring that individuals who fail to meet these standards are prevented from operating a financial sector entity. Hence, it is important that the disqualification regime is robust and consistent across industries where appropriate.

Under the current regime, there are provisions on when an individual is deemed to be a disqualified person without the need for a Federal Court order, and separate provisions on when the Federal Court may make an order for an individual to be disqualified. For the former, the criteria determining when individuals are automatically disqualified differ between the industry Acts.

For the latter, the Federal Court may, on application by APRA, disqualify an individual from being or acting as:

- a director, senior manager or auditor for an ADI or an authorised NOHC under the Banking Act;
- a director, senior manager, auditor or actuary for a general insurer or a senior manager or agent in Australia for a foreign general insurer, or a director or senior manager of an authorised NOHC under the Insurance Act;
- a director, principal executive officer, appointed actuary or auditor for a registered life insurance company under the Life Insurance Act;
- an approved auditor of a retirement savings account provider under the *Retirement Savings Accounts Act 1997*; or
- an individual trustee of a superannuation entity (other than a self-managed superannuation fund (SMSF)), a director, secretary or executive officer of a body corporate that is a trustee, investment manager or custodian of a superannuation entity (other than an SMSF), or an auditor or actuary of a superannuation entity (other than an SMSF) under the SIS Act.

The criteria determining which individuals are automatically disqualified differ between the industry Acts. The criteria the Court considers in deciding whether an individual should be disqualified would benefit from strengthening.

### 8.6.1 Streamlining the definition of ‘disqualified person’

APRA’s legal framework operates to prevent an inappropriate person from holding a position of significant responsibility in a regulated entity or authorised NOHC via:

- legislation that prohibits disqualified persons from acting as responsible persons in a financial sector company; and
- prudential standards that require an entity to make an initial and ongoing assessment as to whether responsible persons are fit and proper.

Under the industry Acts, a ‘disqualified person’ must not act as a director, senior manager or auditor of an ADI, insurer or authorised NOHC; nor may they act as the senior manager of the Australian operations of an ADI or insurer. An individual commits a criminal offence if they are in breach of these provisions. Similarly, a body corporate must not employ a disqualified person in one of the positions described above.

The definitions of 'disqualified person' are located in section 20 of the Banking Act, section 25 of the Insurance Act, section 245 of the Life Insurance Act and section 120 of the SIS Act, and all four Acts diverge. For example, a person who has been convicted of an offence under the FSCODA or the Corporations Act will be a 'disqualified person' under the Banking Act and Insurance Act, but not under the Life Insurance Act or the SIS Act. Under the SIS Act, a person will also be a 'disqualified person' if a civil penalty order has been made against the person. There does not appear to be a reason why the threshold for disqualification should be any different for those working in banking, general insurance or life insurance or working in positions of influence in these sectors.

#### Proposal

That section 20 of the Banking Act be used as a model and replicated in the Insurance Act, Life Insurance Act and SIS Act. However, the SIS Act provision should retain the reference to a civil penalty order.

### 8.6.2 Court to consider prudential standards in disqualification proceedings

Section 21 of the Banking Act, section 25A of the Insurance Act, and section 245A of the Life Insurance Act determine when the Federal Court may disqualify a person from being or acting in a stipulated position of responsibility for a specified company. The Court may disqualify if it is satisfied that the person is not a fit and proper person to be or act as such a person and the disqualification is justified.

The Court has several matters it may take into account in deciding whether a person is fit and proper or not. One of these matters is any criteria for fitness and propriety set out in the prudential standards.<sup>14</sup>

Prudential standards are a fundamental mechanism through which APRA is able to assess the aptitude of persons who assume responsible positions within regulated entities. APRA's fit and proper prudential standards, for example, require companies to develop a fit and proper policy, to periodically assess and evaluate their responsible persons as being fit and proper, and to take steps (including to inform APRA) when it is demonstrated that a person is not fit and proper to hold their position. The standards are necessarily tailored for the banking and insurance industries and are a fundamental component of prudential supervision. It is a key duty of responsible persons to adhere to the standards.

#### Proposal

That the federal court be required to consider the criteria for fitness and propriety set out in the prudential standards when determining whether a disqualification is justified.<sup>15</sup>

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<sup>14</sup> The same approach is also intended to be adopted as part of the Stronger Super reforms.

<sup>15</sup> This proposal is intended to extend to the SIS Act as part of the Stronger Super reforms.

### 8.6.3 Extend disqualification in one regulated industry to disqualification in other regulated industries

Under the current legislative framework, APRA must apply to the Federal Court separately under each industry Act and the SIS Act to ensure that an individual is disqualified from holding a stipulated position of responsibility in a regulated entity. This framework is unnecessarily burdensome. It would be more effective if APRA could seek to have a person disqualified from all regulated industries in one order, if that approach were warranted in respect of that person.

#### Proposal

That the industry Acts and the SIS Act be amended so that APRA is only required to deal once with a person it seeks to be disqualified, rather than having to apply for disqualification under different Acts covering the same issues, should a disqualified person seek to move from one regulated industry to another.

To facilitate this policy position, two options are proposed:

#### Option A

This option would involve an automatic disqualification across all APRA-regulated industries (banking, general insurance, life insurance and superannuation) where an individual has been disqualified in one APRA-regulated industry. As a safeguard, it is proposed that the Court could exercise its discretion to limit the scope of the disqualification upon application by the disqualified individual. This application could be made to the Court either at the time of disqualification or at some later time when the applicant seeks to act as a responsible person at a regulated entity or authorised NOHC in another industry. The legislation could set out criteria upon which the Court would exercise the discretion, including criteria pertaining to the nature of the disqualification. This is the favoured option.

#### Option B

This option would involve APRA having the power, where an individual has been disqualified in one regulated industry, to apply to the Court for an order to extend the disqualification across to other industries. This application may be made to the Court either during or immediately following the substantive disqualification hearing. The Court would have discretion as to whether to grant the order, based on criteria set out in the legislation, including criteria pertaining to the nature of the disqualification.

## 8.7 OTHER PROPOSALS

### 8.7.1 Enhance and simplify the record-keeping provisions

The industry Acts and SIS Act were all recently amended with respect to the keeping of records by regulated entities. These amendments were intended to simplify the record-keeping provisions for APRA-regulated entities with respect to their accessibility by APRA. In particular, the amendments require that:

- the records are kept in Australia (or overseas only with APRA's approval);

- APRA is notified, in the approved form, of their location and any change to that location within 28 days; and
- the records are kept in English or in a form in which they are readily convertible into English.

## Proposal

That the record-keeping provisions be further enhanced in three ways:

1. That section 60 of the Banking Act be amended so that its requirements are clear in that they apply to foreign ADIs. The proposal is not intended to extend the scope of section 60 to keeping records pertaining to the overseas operation of a foreign ADI. It is intended that the proposal cover only the records of a foreign ADI pertaining to its business in Australia.
  - 1.1. Section 60 of the Banking Act currently provides for how an ADI should keep financial records. Section 286 of the Corporations Act requires certain ADIs to keep financial records. However, due to the manner in which section 60 is currently worded, it does not apply to foreign ADIs. Section 286 of the Corporations Act applies to a 'company', 'registered scheme' or 'disclosing entity' as defined by that Act. This means that if the entity is registered as a foreign company under section 601CE of the Corporations Act and section 286 of the Corporations Act does not apply to the entity, the entity is not required to complete the approved form.
  - 1.2. Most foreign ADIs appear to fall into this category and therefore are not required to complete the approved form. This is in contrast to the position under the Insurance Act where foreign general insurers fall within the scope of the record-keeping provision in section 49Q of the Insurance Act.
2. That the record-keeping requirements in the Life Insurance Act be strengthened by ensuring that they apply to all accounting records that a life company keeps for the purposes of the Life Insurance Act and prudential standards.
  - 2.1. Sections 75 and 76 of the Life Insurance Act are limited in comparison with the requirements imposed under section 49Q of the Insurance Act (the equivalent to sections 75 and 76 of the Life Insurance Act), which applies to all accounting records that a general insurer keeps for the purposes of the Insurance Act and prudential standards.
3. That the Life Insurance Act and the Insurance Act be amended to clarify that records should be kept for a period of seven years.
  - 3.1. These Acts do not clearly specify the length of time which life companies and general insurers must retain records.

## 8.7.2 Harmonise provisions enabling APRA to apply for a judicial direction to comply

Currently, there are disparate provisions in the industry Acts on seeking judicial directions to comply with provisions of these Acts. Under the Banking Act, subsection 65(1) provides that the Attorney-General may apply to the Federal Court, by motion, to seek a judicial direction of compliance where an ADI or NOHC is convicted of an offence against the Banking Act or the



regulations. The Attorney-General has the power to seek a direction of compliance while APRA cannot; this is due to historical reasons that are no longer applicable. APRA is the agency responsible for ensuring compliance with the provisions of the Banking Act and therefore it initiates enforcement actions in the first instance. This makes it appropriate that APRA should also be able to seek a direction of compliance.

Under the Insurance Act, once an investigation is underway, section 55 enables APRA to issue various notices to certain prescribed persons that require them to produce books, to give reasonable assistance to APRA in connection with the investigation or to attend an examination to be conducted by APRA concerning matters relevant to the investigation. Section 56 of the Act creates an offence for non-compliance with any requirement that has been imposed on a person under section 55. The penalty may be imprisonment for 3 months.

In some circumstances, this penalty may be disproportionate. Therefore there is concern that the Courts may be reluctant to impose such a penalty, and as a result, APRA may not be able to secure compliance with its notices. Further, an order for compliance may be more appropriate in some circumstances than a civil or criminal penalty.

In comparison, section 289 of the SIS Act enables APRA to 'certify' a failure to comply with a requirement made under the SIS Act to the Court. APRA may do this if it is satisfied that a person has, without reasonable excuse, failed to comply with a requirement made under the SIS Act. When APRA has made such a certification, the Court may inquire into the case and order the person to comply with the requirement as specified in its order.

The Life Insurance Act does not contain an equivalent provision.

### Proposal

That the industry Acts be harmonised such that they all include a provision to enable APRA to apply to the Court for a direction for compliance with a requirement under an industry Act if APRA is satisfied that a person has failed to comply with a requirement under the industry Act. This would provide APRA with an appropriate tool to ensure compliance in certain circumstances.

### 8.7.3 Insurance Act and Life Insurance Act to have effect despite the Corporations Act

Section 70B of the Banking Act states that in the event of an inconsistency between the Banking Act and the Corporations Act, the provisions in the Banking Act will prevail to the extent of the inconsistency.

The Banking Act sets out various powers that may be exercised by APRA, and requirements with which ADIs and their officers must comply. On occasion, the application of these provisions may be inconsistent with certain requirements under the Corporations Act that are applicable to companies and their officers generally. When section 70B, a general provision, is read together with these specific Banking Act provisions, it is clear to affected persons that the Banking Act provisions take precedence to the extent that they are inconsistent with any Corporations Act provisions.

Potential for conflict between the two Acts may arise in many instances. The need for section 70B is particularly pronounced where APRA is managing the distress or failure of a regulated entity in a crisis. Examples of these instances include:

- direction-making powers; and
  - If APRA makes a direction to a regulated entity, both the regulated entity and its officers have to ensure compliance with the direction. A regulated entity, as a corporation incorporated or otherwise registered under the Corporations Act, may be subject to other requirements under the Corporations Act applicable to companies in general. A director of a regulated entity may also be subject to directors' duties under the Corporations Act. If ensuring compliance with an APRA direction made under the Banking Act is inconsistent with Corporations Act requirements, section 70B of the Banking Act applies to make it clear that the Banking Act prevails.
- shareholders' rights.
  - Actions taken by APRA in the event of a crisis need to prevail over owners' or shareholders' rights, under the Corporations Act, to participate in the direction, management and operation of the company.

These two examples demonstrate the vital role that section 70B plays in a crisis resolution situation. For APRA's crisis resolution powers to be effective, directors and senior management need to have confidence that their compliance with APRA's requirements take precedence over anything in the Corporations Act. Lack of certainty in this regard creates a serious risk that directors and senior management may delay acting on APRA's instruction, or even resign if they consider that compliance with APRA's instructions will expose them to liability under the Corporations Act. Such consequences would potentially jeopardise the effectiveness of a resolution.

In essence, section 70B affirms that, where APRA's duty to protect depositors and financial system stability is inconsistent with rights or obligations that apply in relation to companies generally under the Corporations Act, the Banking Act provisions apply. Other jurisdictions' resolution regimes equip the resolution authority with the ability to suspend owners', shareholders' and others' rights in relation to a financially distressed institution, but APRA does not have this power. Section 70B is therefore essential.

However, an equivalent provision to section 70B is not present in the Insurance Act or Life Insurance Act. There is therefore no certainty that, where an inconsistency arises in the application of provisions under insurance legislation as against provisions under the Corporations Act, the insurance legislation will prevail. This ambiguity may result in unintended consequences in the application of provisions in the insurance legislation, particularly in the area of crisis management powers.

#### Proposal

That an equivalent of section 70B of the Banking Act be inserted into the Insurance Act and Life Insurance Act.

### 8.7.4 Provide APRA with the right to intervene in Court proceedings

APRA may, based on common law principles, seek leave to join certain Court proceedings as a non-party intervener or as *amicus curiae*. However, it does not have a statutory right to intervene in Court proceedings under every Act it administers. Statutorily, APRA may intervene in Court proceedings under section 320 of the SIS Act, but only in proceedings relating to matters arising

under the SIS Act. However, APRA does not have a statutory power to intervene in Court proceedings under the industry Acts.

In various situations, it may be appropriate for APRA to seek the leave of the Court to intervene in Court proceedings. An example of where APRA may wish to intervene in a Court proceeding, but does not at present have the legislative power to do so, is in the demutualisation of a life insurer. This is governed by the provisions of Part 5.1 of the Corporations Act and is consequently administered by ASIC. ASIC is under no obligation to consult with APRA about the information to be provided to members in an Information Memorandum required by the Corporations Act. However, a demutualisation is a very significant structural change for an entity often involving new capital calculations and requirements.

In comparison, other Australian regulators have express legislative powers to intervene in Court proceedings. ASIC may, with the leave of the Court and subject to any conditions imposed by the Court, intervene in any Court proceeding instituted under Division 2 of the *Australian Securities and Investments Commission Act 2001* (ASIC Act) (section 12GO). Likewise, the Australian Competition and Consumer Commission may, with the leave of the Court and subject to any conditions imposed by the Court, intervene in a proceeding instituted under the *Competition and Consumer Act 2010* (section 87CA).

#### Proposal

That APRA be given the right to intervene in Court proceedings instituted under the industry Acts. A provision such as section 87CA of the *Competition and Consumer Act 2010* could form the basis of this power. It is appropriate that the Court retains discretion on whether to include APRA in Court proceedings.

### 8.7.5 Service of documents

Currently, section 121 of the Insurance Act provides for how documents and notices may be served on or given to persons for the purposes of the Act. Some deficiencies have been identified with this section.

The Insurance Act currently requires service of notices 'in the case of a body corporate incorporated in Australia, by leaving it at or sending it by registered post to the registered office of the body corporate'. Where a JM has been appointed to an insurer, it is not clear whether a notice should be served on the JM or the registered office of the insurer in order to be valid.

Section 121 has not been reviewed since the Corporations Act was enacted in 2001. Subsection 121(1) refers bodies corporate incorporated in Australia. The section is now unclear as it was not updated with the introduction of the Corporations Act.

While section 121 of the Insurance Act provides for the service of documents on regulated entities amongst others, no equivalent provisions exist under the Banking Act or Life Insurance Act.

#### Proposal

That subsection 121(1) of the Insurance Act be amended to ensure that service of a notice on the JM, rather than on the registered office of the insurer, does not invalidate the service.

That subsection 121(2) of the Insurance Act be amended to take account of the introduction of the Corporations Act. It is further proposed that an equivalent of section 121 of the Insurance Act be inserted into the Banking Act and Life Insurance Act.

### 8.7.6 Facilitating cooperation by APRA with foreign regulators on on-site reviews and information collection

In the course of conducting prudential supervision, there are many instances where APRA may seek to facilitate on-site reviews of APRA-regulated entities by a foreign regulator where these entities have a presence in and are subject to supervision by regulators of that foreign jurisdiction. Similarly, foreign regulators regularly enable APRA to conduct on-site reviews of the foreign operations of Australian-regulated entities operating in a foreign jurisdiction. Such cross-border cooperation is an essential requirement for effective global supervision of financial institutions and is becoming increasingly so as financial institutions become more multinational.

Currently, there are no provisions in the APRA Act or the industry Acts to enable APRA to facilitate cooperation with foreign regulators in the areas of on-site reviews and information exchange in respect of regulated entities having a presence in more than one jurisdiction. The only exception to this is in paragraph 56(5)(a) of the APRA Act, which permits the transmission of certain information and documents to foreign regulators. In addition, the general framework under Commonwealth law relating to cooperation with foreign regulators, the *Mutual Assistance in Business Regulation Act 1998* (MABRA) is only of limited assistance, for reasons expanded on below.

As a result, whenever the need arises to cooperate with foreign regulators, APRA has resorted to informal arrangements, such as through memoranda of understanding, which are not legally binding. This may be problematic where issues arise as to the legal rights and obligations of the parties involved. A more defined legislative framework for cooperation between APRA and foreign regulators, in areas such as the collection of information from and on-site reviews of regulated entities, has increasingly become more important in light of various international standards and guidance on cooperation between regulators.

Currently, financial sector legislation in Australia does not explicitly facilitate<sup>16</sup>:

- responses to requests by foreign regulators for information on activities of entities (for instance foreign banks authorised as ADIs in Australia) for which the foreign regulators have consolidated group supervisory responsibilities;
- foreign regulators undertaking on-site and reviews in Australia for the purpose of assessing the operations of such entities in Australia, and obtaining access to information of such entities; and
- APRA seeking the cooperation of a foreign regulator in conducting on-site reviews of and obtaining information from a regulated entity located in that foreign jurisdiction.

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<sup>16</sup> Section 10A of the APRA Act merely states the Parliament intends that APRA should, in performing and exercising its functions and powers, have regard to the desirability of APRA cooperating with other financial sector supervisory agencies, including foreign agencies having the function of regulating or supervising financial institutions.

APRA's supervisory powers are defined in relation to prudential matters. These do not include collecting information for foreign regulators. Currently, APRA is permitted, under section 56 of the APRA Act to pass on information that it has obtained for its own purposes to a foreign regulator, but no provision exists in the APRA Act or industry Acts for APRA to collect information primarily or solely for the purpose of a foreign regulator. For this reason, the current regime under the APRA Act does not present a firm framework for the sharing of information with foreign regulators.

MABRA enables certain Commonwealth business-regulating authorities to provide assistance to certain foreign business-regulating authorities or agencies. However, MABRA is expressed to be of general application and is not specifically targeted at the financial services sector. Therefore, the processes required under MABRA do not make it suitable in the context of extending cooperation with foreign regulators in the areas of on-site reviews of and collection of information from regulated entities. This is due to MABRA's focus on taking evidence from persons with a view to ascertaining whether an offence has been committed. MABRA's framework is also not streamlined for regular information requests from foreign regulators and allowing foreign regulators to undertake on-site reviews. Therefore, the framework under MABRA does not meet APRA's needs in seeking to cooperate with foreign regulators in the prudential supervision of financial institutions, in accordance with international best practice.

The absence of the proposed legislative provisions may also hinder APRA's ability to fulfil its statutory responsibilities by limiting APRA's ability to oversee the operations of its regulated entities overseas. Many Australian APRA-regulated entities have overseas operations. Foreign regulators may apply reciprocity tests (whether formally or informally) in determining whether to assist APRA in its collection of information or to permit APRA to visit or undertake on-site reviews of the overseas operations of APRA-regulated entities. If APRA is unable to assist a foreign regulator due to a perceived gap in the domestic legislative framework, the foreign regulator may in turn be unable to assist APRA when APRA requires its assistance.

As with APRA's collection of information and on-site review of APRA-regulated entities in overseas jurisdictions, the collection of information and on-site review by foreign regulators of their regulated entities in Australia is primarily for the purpose of understanding the business conducted by these entities, their risk management practices and their levels of risk exposure. Information collection and on-site reviews are not directed in the first instance at identifying breaches of the law or as a prelude to prosecution for offences as a result of breach of the law.

## **International precedent**

International standards and guidance issued by various international agencies generally provide that supervisory authorities have certain powers under their enabling legislation, such as the inclusion of powers to cooperate with foreign regulators in the sharing of information and facilitation of on-site reviews of regulated entities. In addition, some international standards include statements that:

- the decision on whether or not to share information in any particular case should rest with the supervisory authority;
- laws or procedures that unnecessarily impede the exchange of supervisory information should be amended;
- formal requirements should not be a pre-requisite to information-sharing; and

- confidentiality should be imposed on information shared between regulators.

The international agencies issuing these standards and guidance include the BCBS, the CBRG, the FSB and the IAIS.

In recognition of these standards and guidance, APRA's fellow regulators around the world have adopted specific provisions in their enabling legislation to make it clear that the financial service regulator may cooperate with foreign regulators in the sharing of information and/or on-site inspections of regulated entities. Some expressly allow on-site reviews by foreign regulators in their jurisdictions while others enable the host regulator to conduct the on-site review on behalf of the home regulator, and vice versa. It is a common feature of such arrangements that foreign regulators are enabled to obtain, through some means, access to the information of regulated entities in the host jurisdiction, after following due process. These jurisdictions include the European Union, the UK, the US, Singapore, Hong Kong and New Zealand.

It appears that there are some common elements within international practice, such as:

- certain types of information may be supplied to a home supervisor upon request to a host supervisor;
- home supervisors may be able to have access to the overseas operations of entities they regulate in a host supervisor's country via on-site reviews or examinations, and to obtain information from them; and
- statutory confidentiality is conferred on information shared with or obtained by foreign regulators.

### Proposal

That the relevant legislation be amended to facilitate APRA's cooperation with, and rendering of assistance to, foreign regulators. Relevant legislation in the foreign jurisdictions mentioned above could serve as useful models for the proposed provisions. These provisions could include:

- enabling APRA to collect information and conduct on-site reviews of regulated entities in Australia at the request of, and for the purpose of assisting, foreign regulators;
- enabling foreign regulators to collect information directly or enable APRA to conduct on-site reviews of regulated entities in Australia that are members of groups the foreign regulator supervises. Such information collection may be permitted on a continuing basis, subject to APRA's ability to withdraw such permission at any time;
- providing for the collection of information by foreign regulators to be subject to confidentiality obligations;
- enabling the activities of foreign regulators to be controlled via the application of various conditions and through the withdrawal of permission if necessary;
- clarifying the rights and obligations of foreign regulators permitted to conduct on-site reviews of or obtain information from a regulated entity in Australia and make it clear that a foreign regulator may not impose penalties under Australian law under any circumstances; and

- enabling APRA to seek the cooperation of foreign regulators in enabling APRA to conduct on-site reviews of and to collect information from APRA-regulated entities that have a presence in and are supervised by the relevant foreign regulator in a foreign jurisdiction, subject to the rights and obligations applicable in that jurisdiction.

This proposal will bring the legislative framework in Australia in line with international standards and the law in other jurisdictions. This proposal will ensure that a clear legal framework exists for APRA to cooperate with foreign regulators in the sharing of information and facilitation of on-site reviews of regulated entities.

### 8.7.7 Minor drafting amendments to the industry Acts

The following minor drafting amendments are proposed to simplify and streamline APRA's prudential supervision:

- Insert in provisions corresponding to section 35 of the Insurance Act (obligation to comply with prudential standards) in the Banking Act and Life Insurance Act. This clarifies that authorised bodies must comply with prudential standards applying to them.
- Streamline the definitions of 'director' across the industry Acts. The definition of 'director' would be aligned with the existing definition under the Corporations Act.
- Ensuring that, under all industry Acts, proceedings for the judicial management (under the Insurance Act and Life Insurance Act) or the winding-up of a company may be instituted even where proceedings relating to the same matter have already been instituted against a company for an offence against the relevant Act. This is provided for in subsection 248(2) of the Life Insurance Act, but similar provisions do not appear in the Banking Act or Insurance Act.
- Amending the *Superannuation (Financial Assistance Funding) Levy Act 1993* to use the terminology 'levy base' rather than 'value of assets' in the relevant sections, and to provide that the relevant Minister is to determine the methodology under which 'levy base' is calculated. This will streamline the terminology and calculation across the relevant industry Acts.
- Amending the SIS Act to allow APRA to prescribe by legislative instrument, rather than through regulation, the application fee for Registrable Superannuation Entity (RSE) licenses. This will align the treatment of license application fees across the industry Acts.
- Considering whether any of the proposed SIS amendments throughout this part will lead to consequential amendments to the *First Home Saver Accounts Act 2008* and *Retirement Savings Accounts Act 1997*.

## PART C — MISCELLANEOUS AND TECHNICAL AMENDMENTS

### 9. PROPOSALS SPECIFIC TO ACTS SUPERVISED BY APRA

APRA has responsibility for prudentially overseeing banks, credit unions, building societies, general insurers, life insurers, friendly societies, and most superannuation entities. APRA was established as the sole prudential regulator in Australia, in part to achieve greater consistency and neutrality in the prudential regulation of financial institutions.

It is important that the legislation APRA administers provides a comprehensive and robust framework for the prudential regulation and supervision of the financial sector. The framework must also remain relevant in light of developments in financial markets, and balance prudential objectives with the need to promote the efficiency of the financial sector. International developments are also important in reviewing Australia's financial sector legislation; amendments to legislation are needed from time to time to ensure that Australia's regulatory arrangements are in line with international principles and best practice, while ensuring that they are tailored to the particular needs and circumstances of the Australian financial system. The framework should be consistent across legislation where that is sensible, given that differences remain in the characteristics of particular lines of financial sector businesses. A well developed and coherent framework will enable APRA to operate in a more transparent, consistent and efficient manner.

Chapter 8 discusses proposals aimed at ensuring consistency among the different Acts administered by APRA pertaining to each industry. This chapter discusses proposals that are specific to different Acts supervised by APRA.

Currently, APRA's legislative framework for prudential supervision consists of various Acts of Parliament. This framework includes the following Acts:

- Banking Act — covering ADIs, including banks, credit unions and building societies;
- Insurance Act — covering general insurers and Lloyd's underwriters;
- Life Insurance Act — covering life companies and friendly societies;
- SIS Act — covering superannuation entities; and
- FSSA — governing the stake held in ADIs and insurers.

These proposals are intended to address certain regulatory gaps that have been identified in applying the legislation and/or to enhance APRA's ability to discharge its statutory mandates as they pertain to each Act.

The Government seeks comment on these proposals. For ease of reference, the proposals have been organised according to the Act they fall under.



## 9.1 BANKING ACT

### 9.1.1 Enabling APRA to obtain information from, and investigate representative offices of, overseas banks

Under section 61 of the Banking Act, APRA may investigate only prudential matters in relation to an ADI, authorised NOHC or their subsidiaries. There is no power in the Banking Act to investigate a breach of section 67 of the Banking Act relating to representative offices of overseas banks. APRA presently does not have any investigation powers if it suspects that:

- a person is operating a representative office in Australia without APRA's consent; or
- a representative office with consent given under section 67 is in breach of a condition of its consent.

APRA is also unable to exercise any formal powers, including its information-gathering power under section 62 of the Banking Act, in respect of a representative office, because these powers are limited in scope to an ADI, an authorised NOHC or their subsidiaries. In those circumstances, any enquiry by APRA in relation to a potential breach would need to be undertaken without the use of any formal information-gathering powers, such as by relying on material produced voluntarily or the gathering of information by way of a complaint or informal APRA surveillance in visiting office premises and making observations. As a breach of section 67 is a criminal offence, APRA could refer the matter to the Australian Federal Police who could then execute criminal search warrants if considered appropriate. However, this could take considerable time to implement and would be considerably less efficient than APRA undertaking the assessment. While APRA could seek an injunction under section 65A to stop a representative office from acting in breach of the Banking Act, it would be helpful for APRA to have in its possession relevant information or evidence in support of such an application. An information-obtaining and investigation power in respect of representative officers of overseas banks would assist in this regard.

#### Proposal

That the Banking Act be amended to confer upon APRA powers to obtain information from, and to investigate a breach of, section 67. If this is implemented, then APRA could either appoint an APRA officer or an external party to carry out investigations, depending upon the circumstances.

Sections 13A, 61 and 62 of the Banking Act could be used as a model for this power (as modified by the proposals elsewhere in this Discussion Paper)

### Discussion question

Do representative offices of overseas banks have any concerns with the introduction of a power on the part of APRA to obtain information from and investigate representative offices in Australia?

## 9.2 INSURANCE ACT

### 9.2.1 Clarifying the role and responsibilities of an agent in Australia of a foreign general insurer

Currently, under the Insurance Act, a foreign general insurer carrying on business in Australia ('foreign branch') must at all times be represented by an agent for the purposes of the Insurance Act. The agent may either be an individual resident in Australia or a body corporate incorporated in Australia. Under the prudential standards made by APRA that are applicable to general insurers, the agent in Australia is required to undertake certain roles and responsibilities.

Agents in Australia of foreign branches serve an important purpose in the framework for prudential regulation of foreign branches. Like locally incorporated general insurers, foreign branches may carry on general insurance business in Australia, including retail general insurance business. However, they do not maintain a capital base, but are required to maintain assets in Australia greater than their liabilities in Australia to the level of their minimum capital requirement to ensure policyholder protection. The assets of a foreign branch are deemed to be assets in Australia only if they are either held by the agent on trust for the foreign branch or held by a custodian and the agent (or his delegate) is involved in the directions to the custodian on disposal of assets. As such, the agent in Australia plays a vital role in ensuring that the foreign branch maintains appropriate assets in Australia, a key component of the regulation of a general insurer.

Although the Insurance Act mandates the appointment of an agent in Australia, it does not make provision for any of the duties of an agent, or provide for any consequences if an agent fails in its duties. This makes it difficult for APRA to take action to deter any wrongdoing on the part of agents in Australia or to take remedial action in response to any such wrongdoing. Unlike locally incorporated general insurers, foreign branches do not have a board of directors and senior managers in Australia to whom APRA may look for responsibility for any wrongdoing on the part of the foreign branch. It is essential that the role and responsibilities of an agent in Australia be made clear in the legislative framework to ensure the effective prudential supervision of foreign branches by APRA.

#### Proposal

That the Insurance Act be amended to outline the role and responsibilities of agents in Australia at a high level, and the consequences of failing to discharge these responsibilities. Amendments could include:

- expressly providing that prudential standards made by APRA be made applicable to agents in Australia;

- imposing an obligation on agents in Australia to comply with requirements in prudential standards applicable to them;
- clarifying the role and responsibilities of an agent in Australia in providing certain information to APRA under the Insurance Act; and
- providing for protection from liability for an agent in Australia acting in good faith and according to the provisions of the Insurance Act.

### 9.2.2 Amending the definition of ‘subsidiary’ under the Insurance Act to align with the corresponding definition under the Banking Act and Life Insurance Act

Currently, under the Insurance Act, a company is defined as a subsidiary if its holding company (that is a general insurer or authorised NOHC) is in a position to cast, or control the casting of, more than 25 per cent (the threshold percentage) of the maximum number of votes that might be cast at a general meeting of the company, or holds more than 25 per cent of the issued share capital of the company. In contrast, under the Banking Act and Life Insurance Act, the threshold percentage is 50 per cent. The definition in the Banking and Life Insurance Act uses the same definition for ‘subsidiary’ that applies under the Corporations Act.

The reason for the different definition of ‘subsidiary’ in the Insurance Act appears to be historical. The 25 per cent threshold percentage was employed for the definition of ‘subsidiary’ in the Insurance Act for the purpose of certain provisions of the Insurance Act that were repealed some time ago and no longer exist. However, despite the repeal of those provisions, the definition of ‘subsidiary’ remained unchanged and continues to apply to newer provisions of the Insurance Act, although the definition is not intended to apply as a matter of policy. For example, under prudential standards made by APRA applicable to general insurers, ‘subsidiary’ is defined according to the 50 per cent percentage threshold, in harmony with the definition of ‘subsidiary’ in the Banking Act, Life Insurance Act and the prudential standards applicable to ADIs and life companies.

The 25 per cent percentage threshold is of particular concern in the context of the whistleblower protection provisions of the Insurance Act. The consequence of its application is that the scope of certain whistleblower protection requirements is broadened to include certain companies in a group, such that a regulated entity may not be in a position to control these companies and therefore possibly fail to comply with the requirements. APRA has received submissions from certain general insurers proposing that the definition of ‘subsidiary’ under the Insurance Act be amended so that they would not inadvertently breach these requirements. The Government consulted on this aspect of the impact of the definition of ‘subsidiary’ in its October 2009 Options Paper on *Improving Protections for Corporate Whistleblowers* and did not receive any submissions objecting to a proposed amendment to the definition of ‘subsidiary’.

#### Proposal

That the definition of ‘subsidiary’ under the Insurance Act be amended so that it aligns with the current definition of the term under the Banking Act, Life Insurance Act and prudential standards applicable to ADIs, general insurers and life companies.

### Discussion question

Is there any reason why the current definition of 'subsidiary' under the Insurance Act should not be changed to align with that under the Banking Act and Life Insurance Act (that is the same definition that applies under the Corporations Act)?

### 9.2.3 Amending the definition of 'pre-authorisation liability' to ensure it extends to liabilities assumed by a general insurer under certain circumstances

The current definition of 'pre-authorisation liabilities' in section 3 of the Insurance Act is a liability assumed by a body corporate that, after assuming the liability, becomes authorised under section 12 of the Insurance Act to carry on insurance business. Accordingly, whether a liability is a pre-authorisation liability hinges on the date of an insurer's authorisation under section 12.

In 2002, the Insurance Act was amended by the *General Insurance Reform Act 2001* (GIRA) as part of the reforms following the collapse of HIH Insurance. The Insurance Act was amended so that, effective 1 July 2002, insurers were granted authorisation under section 12 of the Act. Prior to this date, insurers were authorised under either section 23 or, if they carried on insurance business before 9 December 1971, under section 24 of the Insurance Act (collectively, 'previous authorisation provisions').

Whilst most existing general insurers were re-authorised under section 12 in 2002, some were deemed authorised under the transitional provisions of the GIRA and, accordingly, they continue to be authorised under the previous authorisation provisions.

Thus, there are three categories of insurers to consider for the purpose of this proposal:

- Insurers who were authorised under previous authorisation provisions and subsequently re-authorised under section 12 in 2002 (Category 1 insurers) — Any business written before section 12 re-authorisation is included in the definition of pre-authorisation liabilities and, therefore, is excluded from their liabilities in Australia based on the current provisions of the Insurance Act.
- Insurers who have been authorised under section 12 since 2002 (including direct offshore foreign insurers ('DOFIs') operating in the Australian market that were authorised under section 12 in 2007) (Category 2 insurers) — Since 2007, DOFIs are required to be authorised under section 12 to operate in the Australian insurance market. Business written by a DOFI prior to being authorised in Australia is a pre-authorisation liability.
- Insurers who were authorised under previous authorisation provisions and were deemed authorised in 2002 by the transitional provisions of the GIRA (Category 3 insurers) — As these insurers were never authorised under section 12 of the Insurance Act, under the current definition of pre-authorisation liability, none of their liabilities are pre-authorisation liabilities. This is the appropriate outcome given policyholders elected to insure with an authorised insurer and, therefore, should have access to the various protections under the Insurance Act. However, the legislation is not entirely clear on the application of these protections.

The classification of a liability as a 'pre-authorisation liability' will have significant consequences for the purposes of the Insurance Act. This is because, to the extent that liabilities are considered 'pre-authorisation liabilities', such liabilities (including policy liabilities in Australia) will not have the protection of the following provisions of the Insurance Act:

- under section 28, insurers are not required to hold assets in Australia against liabilities in Australia that are pre-authorisation liabilities;
- under subsection 116(3), liabilities in Australia that are pre-authorisation liabilities do not have priority claim over assets in Australia in a winding-up;
- under section 62M, pre-authorisation liabilities are not included in an assessment of whether a foreign insurer can meet its liabilities in Australia from its assets in Australia, for the purpose of appointing a JM;
- under paragraphs 62ZZC(1)(b) and 62ZZE(1)(b), pre-authorisation liabilities are not included in an assessment of whether a foreign insurer can meet its liabilities in Australia out of its assets in Australia, for the purpose of declaring that the FCS applies to a specified insurer; and
- under Regulation 7B(b) of the *Insurance Regulations 2002*, a policy that is a pre-authorisation liability of a foreign general insurer is not protected under the FCS.

### **Category 1 insurers**

Currently, for Category 1 insurers, liabilities assumed before July 2002 are defined as pre-authorisation liabilities. The classification of an insurer's pre-2002 liabilities as pre-authorisation liabilities is inappropriate because these liabilities form part of the business written while the insurer was authorised under the Insurance Act to carry on insurance business in Australia. If such an insurer were to have pre-2002 policyholder liabilities and went into liquidation, issues would arise because the various statutory protections referred to above would not be available to safeguard the interests of those policyholders. The policy intent is that, since these policyholders elected to insure with an authorised insurer, the various protections should be available to them. This proposal would reflect this intent by ensuring that liabilities assumed at a time when an insurer was authorised under the previous authorisation provisions are not pre-authorisation liabilities. As such, the proposal aims to give effect to APRA's mandate under the Insurance Act of protecting policyholders' interests.

### **Category 2 insurers**

Business written by a DOFI prior to being authorised in Australia is a pre-authorisation liability. Accordingly, insurers are not required to hold assets in Australia against them pursuant to section 28. Also, holders of policies written by the DOFI before it became authorised under section 12 do not receive priority in respect of the DOFI's assets in Australia under subsection 116(3), even if the claim was incurred after authorisation. These outcomes are appropriate given policyholders elected to insure with an unauthorised insurer and assumed the associated risks of doing so.

### **Category 3 insurers**

The current definition of 'pre-authorisation liabilities' does not adequately deal with category 3 insurers. Although the ultimate outcome is appropriate as indicated above, it would be prudent to make explicit in the legislation that their pre-2002 liabilities are not pre-authorisation liabilities.

## Proposal

That the class of liabilities considered to be pre-authorisation liabilities under the Insurance Act be narrowed to address the issues that exist because of how the different classes of insurers were authorised. This will ensure that protection is afforded by various provisions of the Insurance Act to liabilities that will no longer be considered pre-authorisation liabilities under this proposal.

Under the proposal, section 3 of the Insurance Act would be amended so that:

- the definition of pre-authorisation liability covers liabilities assumed at a time when a general insurer was not authorised under the previous authorisation provisions [section 24 (before 9 December 1971), the previous section 23 (before the GIRA came into effect on 1 July 2002)] or section 12 (after 1 July 2002); and
- pre-2002 liabilities of insurers who were deemed to be authorised under the transitional provisions of the GIRA (that is Category 3 insurers) are not pre-authorisation liabilities.

The Government notes that, if these amendments are effected, consequential amendment to the *Insurance Regulations 2002* may also need to be considered where they refer to pre-authorisation liabilities.

### Discussion question

The Government welcomes comment on this proposal, particularly from general insurers who fall within one of the categories identified above.

## 9.2.4 Clarify the meaning of assets in Australia as regards foreign reinsurance recoverables

Currently, section 28 of the Insurance Act requires an insurer to hold assets in Australia (excluding goodwill and other assets specified by APRA in a prudential standard) of a value greater than the total amount of its liabilities in Australia. This requirement aims to ensure that, in accordance with subsection 116(3) of the Insurance Act, in the winding-up of a general insurer, the insurer's assets in Australia must not be applied in the discharge of its liabilities other than its liabilities in Australia. This requirement is best understood in light of APRA's core objective of protecting policyholders. APRA protects policyholders through prudential supervision backed by a robust prudential framework. However, prudential supervision does not and is not intended to guarantee a zero failure rate among the entities so supervised. In the event of an insurer's failure, the Insurance Act includes provisions aimed at minimising losses to policyholders and other creditors in Australia.

Whether an asset is an 'asset in Australia' is determined according to private international law principles established under common law. However, there are provisions in the Insurance Act that affect the common law position. Subsection 116A(1) has the effect of overriding the application of these common law principles through specifying that an amount is taken to be an asset in Australia in certain circumstances. When determining which of its assets may be considered an asset in Australia in complying with section 28, concession is given under subsection 116A(1) to APRA-authorized insurers that allows them to count reinsurance recoverables expected from foreign reinsurers as an asset in Australia, provided the relevant reinsurance arrangements meet the criteria in subsection 116A(1). This concession recognises the important role that reinsurance plays in an insurer's risk management and that, in some cases, reinsurance needs to be sourced from overseas.

Subsection 116A(1) sets out three criteria that must be satisfied for an amount to be considered an asset in Australia:

- (a) the insurer expects to recover the amount under a contract of reinsurance entered into with a person who is outside Australia;
- (b) the amount must relate to claims in respect of liabilities in Australia of the insurer, whether or not the claims have been paid by the insurer; and
- (c) under the terms of the contract, payments by way of reinsurance are to be made in Australia.

While the requirements in subsection 116A(1) appear unambiguous, they do not contemplate or address certain characteristics of the international reinsurance market, such as:

- the manner in which reinsurance recoverables are managed by foreign reinsurers within their commercial operations;
- the structure of the Lloyd's market and the associated claims management and payment mechanisms;
- the dominant use of reinsurance brokers when placing business with foreign reinsurers;
- the increasing role of group reinsurance within internationally active insurance groups that is managed outside Australia (usually by the parent); and
- the legal nature of the reinsured (a local branch or subsidiary).

Different outcomes can result from applying subsection 116A(1), particularly depending on whether an intermediary is used, the type of foreign reinsurer (example Lloyd's underwriters), the terms of the reinsurance contract, the reinsurer's business processes and the characteristics of the reinsured. Indeed, where subsection 116A(1) is construed narrowly, a reinsurance recoverable will, in many cases, no longer be considered an asset in Australia.

In particular, for reinsurance contracts with Lloyd's underwriters, amounts payable under the Lloyd's rules is to the broker in the London market and therefore the reinsurance recoverable would not meet the requirements of subsection 116A(1). However, the policy intent is that reinsurance recoverables from Lloyd's underwriters should be counted as an asset in Australia.

Ultimately, there are different views as to how subsection 116A(1) should be applied. This uncertainty creates difficulties for supervisors, reinsurance brokers, foreign reinsurers and reinsurers based in Australia. It is important that the policy and legislation be clear on where and why a concession should apply, and that the Insurance Act be amended accordingly. Clearly articulating the policy position and addressing the impact of subsection 116A(1) on the common law will ensure that insurers are clear on their obligations.

## Proposal

That subsection 116A(1) of the Insurance Act be amended to clarify the criteria in paragraphs (a), (b) and (c), and to address the impact of the application of subsection 116A(1) on the common law. This will be done in such a way as to clearly reflect the policy intent behind this provision and to address the issues that could arise from its application.

In particular, it is proposed that subsection 116A(1) be amended to:

- clarify that, with the exception of reinsurance contracts with Lloyd’s underwriters, only contracts that expressly provide for payments to be made in Australia should satisfy the criterion in subsection 116A(1)(c). Under the current wording, the Court may take into account whether there is a customary practice of payments being made in Australia. This proposal would ensure that payments are, indeed, required to be made in Australia. This will make it more certain that the assets would be accessible in the event of a winding-up; and
- introduce a provision within the Insurance Act that confers on APRA the ability to specify criteria in a prudential standard such that APRA may exclude a foreign reinsurance recoverable that meets the subsection 116A(1) criteria from being an asset in Australia. APRA would be able to exercise this power where it does not consider it prudent for the foreign reinsurance recoverable to be counted as an asset in Australia, such as where there is a risk that amounts due to be paid in Australia might otherwise be paid outside Australia. In particular, this would address the issue of where a foreign reinsurance recoverable is, in fact, paid to a broker outside Australia and does not subsequently reach the general insurer in Australia.

If this proposal is implemented, any prudential standard excluding certain assets from the scope of subsection 116A(1) will also be consulted upon with the industry before being brought into effect by APRA.

#### Discussion question

The Government welcomes comment on issues that may arise from the current application of s116A(1) and on the implications of the proposed amendments to s116A(1) in regard to the treatment of foreign reinsurance recoverables.

## 9.3 LIFE INSURANCE ACT

### 9.3.1 Streamlining prudential regulation by moving technical material from the Life Insurance Act and its regulations to prudential standards

In 2007, the Government commenced a review of various legislation administered by APRA with a view to simplifying and streamlining these Acts. This review was intended to improve the flexibility, consistency and transparency of these Acts and reduce the compliance burden for the financial sector, consistent with the Government commitments relating to prudential regulation in response to *Rethinking Regulation: The Report of the Taskforce on Reducing Regulatory Burdens on Business*. It was acknowledged as part of the review that the industry Acts administered by APRA and related legislation tended to evolve separately and in response to industry developments, leading to undesirable inconsistencies over time. It was noted that there was scope to refine and update the four industry Acts to make them more consistent. *Rethinking Regulation: The Report of the Taskforce on Reducing Regulatory Burdens on Business* stated that Government should ensure that APRA has sufficient flexibility to tailor requirements to accommodate differing circumstances. The legislative framework should also cater for the diverse range of entities operating within the financial sector. The process of simplifying and streamlining APRA-administered legislation began with the *Financial*



*Sector Legislation Amendment (Simplifying Regulation and Review) Act 2007* by amending the industry Acts with the aims stated above.

Prudential standards issued by APRA assist to improve the clarity and certainty of prudential requirements by providing additional detail on prudential matters set out in the enabling legislation. Standards complement and reinforce the prudential requirements set out in the industry Acts by specifying how the regulatory framework is intended to operate in practice and APRA's expectations in overseeing that framework. Standards enable key minimum requirements to be specified at a level of detail that would not be appropriate within principles-based, enabling legislation.

Standards introduce greater flexibility into the prudential framework as they can be more readily adjusted over time to respond to developments in both domestic and international conditions, industry best practice and broader structural changes in the market. This enhances the effectiveness of prudential regulation by ensuring that regulation remains relevant over time and can reduce the burden on industry associated with out-dated statutory requirements.

The Life Insurance Act was an example of an industry Act that included a significant amount of technical detail, compared to the Banking Act and the Insurance Act. Since 2007, various matters set out in the Life Insurance Act have been relocated into and refined within prudential standards made by APRA. This has been done in consultation with the industry. Despite this, there are still parts of the Life Insurance Act that either prescribe technical detail or enable technical detail to be prescribed in regulations. Regulations are made by the Government and reflect Government policy. Prudential standards are made by APRA and reflect the policy of the prudential regulator.

The Government has identified certain matters currently prescribed in the Life Insurance Act or able to be prescribed in regulations that could properly be considered prudential matters that could potentially be specified by APRA in prudential standards. These matters do not pertain to the policy regarding the wider architectural framework of life insurance regulation, but to operational matters in prudentially supervising life companies. It is proposed that such matters are best dealt with via prudential standards, rather than being set out in the Act or regulations. This provides for greater flexibility in changing the requirements to meet changing circumstances. It is also consistent with international principles, which emphasise the importance of prudential regulations being made by an operationally independent regulatory agency, but subject to appropriate transparency and accountability arrangements.

Moving prudential details into standards, rather than locating them in the Act or in regulations, does not detract from robust standards of transparency or accountability. In terms of Parliamentary scrutiny, there is no difference between regulations and prudential standards; both are subject to scrutiny by Parliamentary processes. As mentioned above, APRA consults extensively with the industry before making new standards or amending existing standards. Accordingly, there is a strong degree of accountability to standards-setting processes.

## Proposal

Therefore, the following amendments to the Life Insurance Act are being proposed:

- Enabling certain matters in Division 4 of Part 10 relating to surrender values and paid-up policies to be specified in prudential standards — this will enable all requirements relating to surrender values and paid-up policies to be specified in a single location.

- Replacing the reference to regulations in paragraph 9(1)(d) with ‘prudential standard’ in relation to the term beyond which a contract for payment of an annuity constitutes a life policy.
- Replacing the references to regulations in the definition of ‘superannuation policy’ in the Schedule with ‘prudential standards’.
- Enabling certain matters in Part 9, relating to transfers and amalgamations of life insurance business, to be specified in prudential standards rather than prescribed in regulations. This will also facilitate alignment the Life Insurance Act with the Insurance Act in respect of documents to be lodged in transfers and amalgamations of insurance business.
- Enabling certain matters currently prescribed in sections 33, 38, 39, 40, 42, 43, 45, 47, and 75 to 81, and Divisions 3, 4, 5 and 6 of Part 4, to be specified in prudential standards.

This proposal is not expected to impose additional compliance costs on the industry. It may potentially reduce administrative costs by simplifying the regulatory framework, such that detailed requirements are all set out in prudential standards, rather than being variously located in the Act, regulations and standards.

The proposed amendments would be structured so that existing provisions contained in the Act or in regulations would continue to apply in those forms until such time as they are replaced by the relevant prudential standards.

#### Discussion question

Are there any reasons why APRA should not be able to specify the matters identified above in prudential standards?

### 9.3.2 Amending the Life Insurance Act to facilitate the implementation of changes arising from the LAGIC project

APRA has been consulting the industry on a project to review the life and general insurance capital standards (LAGIC). As part of that project, APRA has identified proposed amendments to the Life Insurance Act that are essential to facilitate LAGIC implementation.

The Government has been working closely with APRA on the LAGIC project and proposes that the Life Insurance Act be amended to facilitate LAGIC implementation. The proposed changes include:

- enabling a single capital requirement to be imposed under the Life Insurance Act (including amendments to sections 3, 52, 62, 63 and 159, as well as inserting a new definition specifying that ‘capital adequacy’ is as set out in the prudential standards); and
- allowing APRA to specify in prudential standards additional situations in which a life company must establish a separate statutory fund under section 31.

With respect to changes enabling the imposition of a single capital requirement, LAGIC involves removing the dual solvency and capital adequacy capital requirements under the Life Insurance Act and replacing them with a single capital requirement.

The Life Insurance Act, when enacted in 1995, included specific provisions on solvency and capital adequacy. In 2007, the majority of the solvency and capital adequacy provisions were removed, including their definitions. However, some provisions still rely on solvency and capital adequacy as trigger points for certain APRA powers.

This proposed removal of provisions relating to a dual solvency and capital adequacy regime from the Life Insurance Act will continue the process of removal of technical content from the Life Insurance Act commenced by the *Financial Sector Legislation (Simplifying Regulation and Review) Act 2007*, and will afford APRA flexibility in determining the most appropriate capital requirements under prudential standards, as is the current practice for capital requirements for ADIs and general insurers.

### Proposal

That the references in the Life Insurance Act to solvency and capital adequacy be updated so that there is only one trigger point in the Life Insurance Act for the exercise of certain powers (linked to capital adequacy). The definition of capital adequacy will be severed from the existing definition by making it clear under the Life Insurance Act that capital adequacy is as defined in the prudential standards. Provisions of the Life Insurance Act that are proposed to be amended include sections 3, 52, 62, 63 and 159. These amendments will facilitate the introduction of APRA's proposed approach to LAGIC.

Section 31 of the Life Insurance Act currently requires life companies to have statutory funds, including separate statutory funds in respect of certain types of business. The proposal will enable APRA to specify, by way of prudential standards, other types of business in respect of which a separate statutory fund must be maintained. This can enhance the protection of policy owners of life companies in respect of certain types of business, and other policy owners, by ensuring the business is appropriately ring-fenced in a separate statutory fund. APRA has, as a matter of supervisory practice, requested this in respect of certain types of business. This proposal would formalise that existing supervisory practice.

This proposal is not expected to impose additional compliance costs on the industry. Industry has been formally consulted by APRA on several occasions regarding the LAGIC proposal to move to a single capital requirement and abolish the current dual solvency and capital adequacy requirements.

### 9.3.3 Amending paragraphs 16B(2)(a) and 16B(2)(b) of the Life Insurance Act in regard to the benefit fund rules of a friendly society

Part 2A of the Life Insurance Act sets out special provisions relating to life companies that are friendly societies. Paragraphs 16B(2)(a) and 16B(2)(b) of the Life Insurance Act currently tie adequate adoption of an amendment to the benefit fund rules for the purposes of the Life Insurance Act to the interests of members of the society.

Several friendly societies have now demutualised, generally in conjunction with a restructure under a scheme of arrangement pursuant to Part 5.1 of the Corporations Act. Often these arrangements involve cancelling membership in the friendly society as a result of the demutualisation and issuing shares in a holding company in exchange for membership rights. While such persons continue to have a contractual relationship with the friendly society through their interests in the benefit fund or funds of the friendly society, they are no longer members of the society. Their equity interest becomes a formalised shareholding interest in the new company.

In a mutually-owned friendly society, the members and the policy owners are the same people; the interests of members are coexistent with the interest of policy owners. Following demutualisation, the members and the policy owners are no longer combined as one. In recognition of this, an amendment to the Life Insurance Act is needed to ensure that the interests of policy owners (rather than the members) are taken into account in determining whether benefit fund rules have been adequately adopted.

#### Proposal

That the Life Insurance Act be amended in order to protect the rights of policy owners of a demutualised friendly society so that they may continue to be able to vote on proposed benefit fund rule amendments, following a demutualisation of the friendly society and restructure. This could be done by expanding the categories of person who may 'adequately adopt' benefit fund rules of a company or an amendment of benefit fund rules of a company, to include those persons who because of section 16F are taken to be the owner of a policy referable to the benefit fund.

### 9.3.4 Rationalising the use of Part 9 of the Life Insurance Act relating to transfers and amalgamations of life insurance business with Part 3 of the Business Transfer Act as it relates to voluntary transfers of life insurance business

Part 9 of the Life Insurance Act currently provides for transfers and amalgamations of life insurance business to be effected by a scheme confirmed by a Court. A voluntary transfer of life insurance business may also be effected under Part 3 of the Business Transfer Act if APRA approves such a transfer. There is an overlap between these two regimes that offers entities regulated under the Life Insurance Act an option of different transfer routes whenever a transfer of life insurance business is contemplated.

As a matter of supervisory practice, APRA has discouraged the use of the Business Transfer Act for voluntary transfers of business by life companies that are not friendly societies. The Business Transfer Act, and the associated transfer rules, are written on the basis that the transfer to be approved is between mutually-owned companies, where the policy owners and the members are the same people and can therefore reasonably vote to protect their own interests.

The use of the Business Transfer Act by life companies does not adequately protect the interests of policy owners and does not appear to be consistent with the legislative intent behind the Business Transfer Act. The Business Transfer Act and the transfer rules require a vote by the members of the entity. In the case of a non-mutually owned life company, that would mean that the shareholders would vote and the policy owners would not. Unlike under Part 9 of the Life Insurance Act, where the Federal Court approves the transfer, there is no Court approval process under the Business Transfer Act. Accordingly, a transfer of business involving a non-mutual life insurer provides greater scope for protecting policy owners' interests if the transfer is effected under the Life Insurance Act than if it is done under the Business Transfer Act.

#### Proposal

That the Business Transfer Act be amended to prevent life companies that are not friendly societies from undertaking voluntary transfers of business under the Business Transfer Act unless APRA has made a determination that it is appropriate in that particular case.

#### Discussion question

Do members of the industry, both friendly societies and other life companies, have views on whether they prefer to effect a transfer of life business under one regime over another and why?

### 9.3.5 Enabling APRA to vary and revoke a declaration made under section 12A and 12B of the Life Insurance Act that certain business is to be treated as life insurance business

Currently, APRA may, under section 12A of the Life Insurance Act, declare that insurance or annuity business is life insurance business. APRA may also, under section 12B of the Act, declare that other financial business is life insurance business. Declarations under sections 12A and 12B are intended to permit the offering of products that would otherwise fall within the prohibition under section 234 against carrying on mixed business.

APRA has in the past provided such declarations to life companies. In some cases, these declarations are no longer appropriate in the current legislative and regulatory environment. APRA therefore may wish to revoke or vary declarations that should no longer be maintained in the current environment. However, APRA does not intend to retrospectively revoke or vary declarations in respect of existing business. APRA would take into account existing business to ensure that such business continues to benefit from the protection afforded by the declaration until the natural expiry of that business (example expiry of the life insurance policy or policies concerned).

The Life Insurance Act does not currently provide for APRA to vary or revoke a declaration made under sections 12A or 12B. This being the case, there is no mechanism to ensure that life companies cease to treat new insurance or annuity business as life business under previously granted declarations.

#### Proposal

That sections 12A and 12B of the Life Insurance Act be amended to enable APRA to vary or revoke declarations made under those sections. These sections could also be amended to enable further conditions to be imposed on existing declarations.

### 9.3.6 Amending section 234 of the Life Insurance Act to provide that a life company may in certain circumstances be prohibited from carrying on general insurance business

Section 234 of the Life Insurance Act prohibits a life company from carrying on any insurance business other than life insurance business. However, under subsection 234(2), a life company may carry on mixed insurance business if the company were carrying on general insurance business immediately before the commencement of the Life Insurance Act.

In certain circumstances, it is not appropriate for life companies to be carrying on general insurance business merely because they did so prior to the commencement of the Act. In particular, some life companies have ceased and then recommenced carrying on general insurance business on the basis that the company had carried on such business prior to the commencement of the Life Insurance Act. Some of these companies now offer changes in benefits and conditions (example varying premium

rates), while others have changed the way in which they are carrying on mixed business. In such cases, the insurer is no longer carrying on general insurance business in the same manner as it was before the introduction of the Life Insurance Act. This was not the legislative intention behind section 234, which was to avoid adversely affecting companies that were writing both life and general insurance business at the commencement of the Life Insurance Act.

### Proposal

That subsection 234(2) of the Life Insurance Act be amended to clarify the circumstances under which the exemption from the prohibition on carrying on mixed insurance business applies.

#### Discussion question

What are the practical implications of the existing exemption from the prohibition in section 234 being limited in the manner proposed? Are there additional compliance costs involved?

### 9.3.7 Establish a custodian requirement and clarify other requirements for eligible foreign life insurance companies

The Life Insurance Act allows foreign corporations that are authorised to conduct life insurance business in an overseas jurisdiction to apply for registration to operate in Australia as a branch. Such a corporation is known as an eligible foreign life insurance company (EFLIC). At present, the *Life Insurance Regulations 1995* make access to the Australian market conditional on the applicant being incorporated and authorised to conduct life insurance business in the US.

Once registered, an EFLIC is subject to the same legislative and prudential requirements as locally-incorporated life companies.

A key concept in the regulation of life companies under the Life Insurance Act is the statutory fund. All life insurance policies issued by the life company must be referable to a specific statutory fund. A life company is required to separately account for the assets and liabilities of the statutory fund and can only distribute assets in accordance with the Life Insurance Act. Importantly, a statutory fund does not have separate legal existence from the company of which it forms a part. The Life Insurance Act also expressly provides that a statutory fund does not involve a trust relationship.

Under the Life Insurance Act, an EFLIC is required to establish a Compliance Committee. The Compliance Committee must meet requirements specified by APRA in prudential standards and must have sufficient powers of management over the branch to enable it to ensure that the EFLIC complies with the Life Insurance Act. The members of the Compliance Committee are defined as directors for the purposes of the Life Insurance Act.

However, in the case of an EFLIC, while the Australian branch is required to operate a statutory fund in respect of its life insurance business, the recognition of the statutory fund in jurisdictions outside Australia is far from certain. As an EFLIC is subject to regulation in its home jurisdiction, the Courts and regulators in that jurisdiction may not, unlike an Australian Court, regard the assets of a statutory fund as being reserved to meet the liabilities of policy owners ahead of liabilities owed to other creditors of the EFLIC. This could lead to attempts, where the EFLIC is in financial difficulty, to seize or deal with the assets of a statutory fund outside Australia as belonging to an EFLIC's creditors as a whole and not just the Australian policy owners. This is a key distinction in the operations of an

EFLIC when compared to a locally incorporated life company. It is a legal risk which could be material for the policy owners of an EFLIC compared to the policy owners of a locally incorporated life company.

A statutory fund is designed to 'ring-fence' certain assets to ensure they are available to satisfy the liabilities to which they relate. In the case of an EFLIC, these protections are not as robust due to the lack of a legal entity in Australia to hold the assets. Statutory funds are not a widely used legal concept internationally. As a result, Australia's statutory fund structure may not be recognised by overseas Courts in the winding-up of an EFLIC in another jurisdiction. There is a significant risk that the assets referable to the Australian statutory fund could be used to satisfy liabilities of the EFLIC in another jurisdiction in a wind-up. This could go as far as policy owners sharing in losses incurred by the company outside Australia.

The foreign head office of the Australian branch is not subject to Australian regulation and could be authorised in countries with a wide range of legal, accounting, corporate, prudential and supervisory environments. A failure could happen in a disorderly way, and APRA may not have the opportunity to intervene to protect Australian policy owners.

### **How are these problems addressed in other industries?**

#### ***General insurance***

Australian branches of foreign general insurers are required to hold assets in Australia sufficient to meet liabilities in Australia and capital requirements. Assets must be held either by a custodian or by the insurer's agent in Australia on trust for the branch. As a result, the issues raised in relation to life companies are largely mitigated.

#### ***Superannuation***

Although superannuation funds are not exposed to the same issues in relation to branches due to their different legal structures, custodian arrangements are widely used. Public offer trustees are able to meet the capital requirement applicable to them by holding assets through a custodian in certain circumstances, although this is to be replaced by the operational risk financial requirements under the Stronger Super reforms.

#### **Proposal**

That high-level provisions be inserted into the Life Insurance Act establishing the requirements for custodian arrangements and granting APRA the power to specify the detailed requirements through prudential standards.

Under the proposed approach, the burden of ensuring that assets are only dealt with in accordance with the Life Insurance Act would be placed on the Compliance Committee. This would be appropriate as they have the key responsibility for ensuring compliance with all applicable requirements. The combination of the roles of the custodian and the Compliance Committee, together with the restrictions imposed through the custodian agreement, would provide an appropriately strong level of protection for the policy owners in Australia.

Further, that the Life Insurance Act be amended in a number of areas to clarify the intended operation of the Act as it relates to EFLICs. Specifically:

- Amend the objects clause in section 3 of the Life Insurance Act to ensure that it appropriately takes into account the structure of EFLICs.
- Clarify Part 9 of the Life Insurance Act to require the Court to consider the interests of owners of policies referable to the statutory funds of each life company affected by the scheme. The current wording could be read as requiring the Court to have regard to the interests of the policy owners of the company outside Australia that have no connection with the Australian operations. This would not preclude a Court from considering the interests of owners of policies issued by an EFLIC outside Australia, but would not require it to do so.
- Clarify the responsibilities of the Compliance Committee for breaches of the Life Insurance Act. The Act treats Compliance Committee members as directors of the life company but the relative responsibility of each for any breaches of the Act is not specified. It is proposed that the Life Insurance Act be amended so that the Compliance Committee members who are resident in Australia are made responsible for breaches.
- Amend Parts 8 and 9 of the Act to clarify how the Act applies to an EFLIC's business outside of Australia. In particular, to clarify:
  - the extent of the control by a judicial manager in Australia of an EFLIC's business outside Australia;
  - that references to 'the interests of owners of policies' and 'policies issued by the company' in respect of an EFLIC are intended to relate only to policies referable to statutory funds of the EFLIC, and not policies more broadly;
  - the power of the Court under section 176 or section 181 to order that an EFLIC be wound up is limited to winding up the affairs of the EFLIC in Australia; and
  - that an EFLIC cannot be wound up in Australia except by order of the Court on an application under subsection 175(6) or section 181 of the Act.
- That EFLICs should not be permitted to write business outside Australia through a statutory fund of the Australian branch. That is, only Australian business will be permitted to be written through a branch in Australia.

## 9.4 SUPERANNUATION INDUSTRY (SUPERVISION) ACT

### Stronger Super

The superannuation industry is currently undergoing a period of significant change following the Government's response to the Super System Review. The Government's Stronger Super reforms provide APRA with new powers and an expanded role within the superannuation industry. These reforms include providing APRA with the ability to make prudential standards, to have a greater role in data collection and publication, and to authorise trustees who apply to offer MySuper products.

Outside the Stronger Super process, several areas have been identified where APRA's regulation of superannuation entities could be improved. Part B of this paper covers broader proposed changes to



APRA's regulatory powers that generally apply to either most or all regulated sectors. The following proposals are specific to the superannuation entities APRA regulates.

#### 9.4.1 For APRA to be given discretionary power to appoint an acting trustee in circumstances where APRA has taken all reasonable steps to identify or locate a trustee

Section 134 of the SIS Act allows APRA to appoint an acting trustee in the case of suspension or removal of the trustee.

This proposal would give APRA the ability to be able to appoint an acting trustee where APRA has taken all reasonable steps to identify or locate a trustee but has not succeeded in doing so for the purposes of winding up a fund. For example, the corporate trustee of the fund may have been deregistered.

This will help address the current regulatory gap where a fund has fewer than five members but does not qualify to be an SMSF. Currently, neither the Australian Tax Office nor APRA have grounds on which they can wind up these funds. In circumstances where APRA exercises this new power to appoint an acting trustee, it would be required to first make all reasonable efforts to locate and determine the identity of the existing trustee. Where the existing trustee cannot be located and identified, APRA would have the ability to appoint an acting trustee. The appointment of an acting trustee under these circumstances would revoke the appointment of any previous trustee. APRA's decision to appoint a trustee would be subject to a merits review, however, which trustee APRA chose to appoint would not be reviewable.

##### Discussion question

What are the potential advantages or the potential problems with providing APRA a discretionary power to appoint an acting trustee where the existing trustee cannot be located and identified?

#### 9.4.2 To treat Limited Liability Partnerships consistently with body corporates in relation to investment managers

Currently, section 125 of the SIS Act prevents a person who is not body corporate from being an investment manager of a superannuation fund. This proposal is for limited liability partnerships to be treated consistently with bodies corporate.

Limited liability partnerships are a common structure for obtaining exposure to private equity investments, particularly international private equity. Limited liability partnerships are partnerships with:

- one or more general partners, who may or may not be bodies corporate themselves, who undertake management functions for the partnership and who are liable for the debts and other obligations of the partnership; and
- one or more limited partners who, as passive investors, do not participate in the management of the partnership and are not liable for the debts and other obligations of the partnership. The liability of limited partners is limited to their investment commitment to the partnership.

The rights and obligations of the general and limited partners are set out in the partnership agreement, which is subject to the partnership legislation in the jurisdiction where the partnership was formed or registered.

In some jurisdictions, limited liability partnerships have some of the characteristics of a body corporate, while in others they may not.

If the limited liability partnership is taken to be a body corporate under Australian law, the monies invested by a limited partner would be an investment in that body corporate. Under the SIS Act, a trustee investing in a body corporate does not appoint the management of the body corporate as an investment manager or as a custodian of the assets of the superannuation fund. A trustee's participation in a limited liability partnership, as a limited partner, is akin to the trustee investing in a collective investment or a managed investment scheme.

If, however, a limited liability partnership is not a body corporate under Australian law, and therefore not an entity separate from the individual partners, and the general partner undertaking the investment management function is not a body corporate, the participation of a superannuation trustee in the partnership will give rise to issues such as the SIS Act requirement that an investment manager be a body corporate.

Treatment of limited liability partnerships on a basis consistent with bodies corporate, for the purposes of section 125 of the SIS Act, would remove any doubt about the ability of trustees of regulated superannuation funds to participate in private equity investments structured as a limited liability partnership and would also increase transparency by removing a need for an interposed structure (such as a special purpose trust) to hold the limited liability partnership interests.

#### Discussion question

Is consistent treatment between limited liability partnerships and body corporates desirable for the purposes of section 125 of the SIS Act?

### 9.4.3 To extend APRA's powers so that it can investigate any contravention as far as it relates to a superannuation interest, superannuation entity or an RSE licensee

This proposal would amend the SIS Act to allow APRA to investigate any contravention of relevant legislation, for example, under the *Criminal Code Act 1995* (Criminal Code) or the Corporations Act, so far as it relates to a superannuation interest within the meaning of the SIS Act.

This would be consistent with ASIC's powers under section 13 of the ASIC Act, which allows ASIC to investigate contraventions of a law of the Commonwealth, State or Territory if it concerns the management of the entity, or fraud or dishonesty, and relates to a body corporate, managed investment scheme or financial product.

The primary investigation powers under the SIS Act currently only allow APRA to investigate the affairs of a superannuation entity, including its financial position, or a contravention of the SIS Act or FSCODA.

These investigation powers do not allow APRA to exercise any relevant compulsory powers to formally investigate fraudulent conduct in relation to a 'superannuation interest' (as defined under

the SIS Act) or ‘superannuation entity’ (also as defined under the SIS Act) more broadly. This is because, while other contraventions may have been committed, the fraudulent conduct may not constitute a contravention of the SIS Act or otherwise fall within section 257 or section 263.

This situation is due to the repeal of the various fraud provisions that were previously in the SIS Act, namely:

- (a) Section 304: recklessly making false or misleading statements — repealed under the *Criminal Code Amendment (Theft, Fraud, Bribery and Related Offences) Act 2000*;
- (b) Section 305: intentionally making false or misleading statements — repealed under the *Criminal Code Amendment (Theft, Fraud, Bribery and Related Offences) Act 2000*; and
- (c) Section 145: fraudulently inducing a person to engage in a regulated act — repealed under the *Financial Services Reform (Consequential Provisions) Act 2001*.

While some of these provisions have now been replicated in other legislation, example Criminal Code and Corporations Act, APRA’s current investigation powers only allow APRA to commence an investigation if it appears that there are contraventions of the SIS Act and SIS Regulations, FSCODA or that a fund’s financial position may be unsatisfactory, as noted above. Upon commencing an investigation, APRA is then able only to conduct an investigation of the whole or part of the affairs of an entity. While other agencies such as ASIC will still be empowered to investigate broader fraudulent conduct or other contraventions in relation to superannuation interests or superannuation entities, APRA’s investigations powers will be more limited.

It is also proposed that APRA’s investigation powers under the SIS Act be clarified to specifically enable investigation of any breach of a licence condition of an RSE licensee, as well as any failure by an employer to remit superannuation contributions to the trustee of a superannuation fund.

Implementation of this proposal would also mean that when an investigation is commenced by APRA, the extent of APRA’s investigation powers would be clearer, forestalling the raising of issues about the potential limitation of those powers.

It is proposed to extend APRA’s powers under the SIS Act so that APRA has adequate powers to address the matters likely to fall within its remit. Such an outcome could be achieved by broadening the powers of investigation under section 263 to enable APRA to investigate any suspected contravention of the SIS Act, a law of the Commonwealth or of a State of Territory that concerns the management or affairs of a superannuation entity or that relates to a superannuation interest.

Alternatively, or in addition, a definition of the ‘affairs’ of a superannuation entity (a term which is not specifically defined under the SIS Act) could be inserted into the SIS Act (modelled as applicable on section 53 of the Corporations Act) and could include the following:

- management or affairs of the superannuation entity’s trustee, including compliance by the trustee with the trustee’s RSE licence conditions and the superannuation entity’s governing rules; and
- relates, directly or indirectly, to a superannuation interest of the superannuation entity, including the remission by an employer of superannuation contributions to the trustee of a superannuation fund.

#### Discussion question

Are APRA's primary investigation powers under the SIS Act appropriate and sufficient? Should APRA be able to investigate any contravention as far as it relates to a superannuation entity or superannuation interest?

#### 9.4.4 To expand APRA's disqualification powers under section 126H of the SIS Act

This proposal would extend the scope of APRA's disqualification power under section 126H of the SIS Act to include a ban on an individual from holding office in any body corporate that holds an interest in the relevant body corporate that is trustee, investment manager or custodian.

Currently, the scope of section 126H of the SIS Act may not be wide enough. Persons disqualified pursuant to this power may nonetheless be able to hold office in entities that own or control a body corporate that is a trustee, investment manager or custodian.

As a result, a person may be removed from having direct involvement in the operations of a trustee, investment manager or custodian, but may still have influence over it and generally still operate within the superannuation industry.

APRA can apply to the Federal Court to disqualify an individual from acting as trustee of a superannuation fund or as a responsible officer of an RSE licensee, an investment manager or a custodian of a superannuation entity. The Court may disqualify an individual if satisfied that:

- the individual contravened the SIS Act or the FSCODA on one or more occasions and the nature or seriousness, or the numbers, of the contravention/s provide grounds for disqualifying the individual;
- the individual who is or was a responsible officer of a trustee, investment manager or custodian entity when the entity contravened the SIS Act or FSCODA on one or more occasion and the nature or seriousness, or the numbers, of the contravention/s provide grounds for disqualifying the individual; or
- the individual is otherwise not a fit and proper person to be a trustee of a superannuation fund or a responsible officer of a licensed trustee entity, an investment manager or a custodian of a superannuation entity.

Application of the powers is confined to individuals holding certain positions in a regulated superannuation entity or in an entity (limited to an investment manager or custodian) that provides services to a fund under the SIS Act. The powers available to APRA under the SIS Act do not otherwise extend to officeholders or holders of equity in entities upstream to the trustee, investment manager or custodian entity. This leads to the situation where APRA may apply to the Federal Court for an order to disqualify a person from acting as trustee of a superannuation fund or as director or responsible officer of a trustee entity of a superannuation fund, approved deposit fund or pooled superannuation trust, or of an investment manager or custodian — but has no power to prevent that person from holding office in an entity that owns or controls the trustee/investment manager/custodian entity. As a result, a person may be removed from direct involvement in the operations of a superannuation entity/investment manager/custodian but may still operate within the industry, including in a position of influence over the superannuation entity.

The scope of amendment of section 126H would also extend to cover a manager employed by an RSE licensee that is a group of individual trustees. Currently, section 126H provides that a Court may disqualify an individual from being a ‘responsible officer’ (which includes a person involved in management) of an RSE licensee that is a body corporate, but not where the person has managerial responsibilities in relation to an RSE licensee that is a group of individual trustees. Similarly, section 126K provides that a person commits an offence if they act as a ‘responsible officer’ (including in a managerial position) of an RSE licensee that is a body corporate, but does not cover the situation where they exercise similar responsibilities in relation to an RSE licensee that comprises a group of individuals.

#### Discussion question

Would expanded disqualification powers for APRA maintain or enhance the integrity of the superannuation system?

## 9.5 FINANCIAL SECTOR (SHAREHOLDINGS) ACT 1998 (FSSA)

The FSSA is the instrument by which the Government seeks to ensure that ownership of financial sector companies is not so concentrated as to give rise to prudential risks. The Financial System Inquiry (Wallis) considered that:

Spread of ownership protects institutions against undue influence by a major shareholder and creates a broad interest group in the shareholder base. A dispersed ownership base also protects against a form of contagion risk that may otherwise occur if a financial institution is associated with adverse changes in the fortunes of a major shareholder.<sup>17</sup>

The Wallis Inquiry recommended that ownership restrictions apply across ADIs and insurers and that a limit of 15 per cent ownership (without approval being required) apply. This recommendation was implemented in the FSSA.

In enforcing an ownership limit of this nature, it is necessary to ensure that the requirement cannot be avoided simply by a spread of ownership amongst parties who all take an individual share below the limit but who are in substance acting collectively so that ownership is concentrated in their group. A key measure in the effort to prevent such collusion is the deeming of a person’s ‘stake’ in a financial sector company to include not only their own holding but the aggregation of that holding with those of the person’s ‘associates’.

### 9.5.1 Narrowing the requirement for approval under the FSSA

#### Definition of ‘associates’

The definition of ‘associates’ under the FSSA was cast wide so as to encompass relatives, partners, related companies and other parties with whom it might be imagined that a person could join in an

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<sup>17</sup> Financial System Inquiry, Final Report, March 1997, p. 338.

effort to avoid the 15 per cent ownership limit. The width of the definition of associates is considered to be justified as it helps to prevent collusion amongst a broad range of potential actors to undermine the ownership limit. However, when combined with the current definition of a 'stake' in a financial sector company, unintended consequences have arisen.

### **Definition of 'stake'**

The current definition of 'stake' in the FSSA relates to a person's 'direct control interest' in a company. A person's direct control interest is equal to the percentage of voting power in the company that the person is able to control at a given time.

A person's 'stake' in a company is the aggregate of their own stake and that of their associates. The effect is that, even where a person has no direct control interest of their own, they are deemed to hold a stake equivalent to that of their associates. An example may better illustrate the anomaly this creates.

Jill buys a share of 14 per cent in a financial sector company and organises for her spouse — Jack — to purchase a further 10 per cent simultaneously. Jill and Jack will be caught by the FSSA and will both need approval to hold a stake of 24 per cent in the company because they both are deemed to hold a stake including their own and that of their associates. This is consistent with the intent of the FSSA. However, if Jill acquires 24 per cent of the shares in a financial sector company on her own account, either with or without approval, and Jack acquires no interest on his own account, Jack must nevertheless apply for approval as, on the current definition, he holds a stake of 24 per cent as a result of Jill being his associate. In practice, because of the wide definition of associate under the FSSA, the effect is that numerous parties who hold no direct interest in a company are caught in a technical trap that requires them to hold approval under the FSSA. This result is not required to give effect to the policy intent behind the FSSA, and arguably creates an undue regulatory burden on business and administrative burden on regulators.

There is one situation in which it is necessary to extend the scope of the FSSA to parties that do not hold any direct control interest in a company in order to prevent a concentration of ownership undermining the limit in the FSSA. This is where the party is in a position to exercise control over a financial sector company despite not having any direct interest, for example, by reason of some informal agreement being in place. This situation is, however, already adequately dealt with in Part 2, Division 4 of the FSSA, which relates to practical control over financial sector companies.

This anomaly might be addressed by a simple refinement of the definition of 'stake' in the FSSA. The new definition would provide that a person who held no direct control interest in the financial sector company would be deemed to hold no stake in that company. Where a person held a direct control interest of any size, then, and only then, would their interest be aggregated with that of their associates to determine their total stake.

### Discussion question

Would a refinement to the definition of 'stake' in the FSSA help to reduce uncertainty in the application of the Act and streamline the application process?

### Definition of 'financial sector company'

The ownership restriction provisions of the FSSA apply to 'financial sector companies'. A 'financial sector company' is defined as:

- (a) an authorised deposit-taking institution;
- (b) an authorised insurance company; or
- (c) a holding company of a company covered by paragraph (a) or (b).

The extension of the definition to holding companies of authorised ADIs and insurers adds considerably to the complexity of the ownership provisions especially in the case of complex corporate groups. Where an authorised ADI or insurer is held by an ultimate holding company many levels up in a corporate chain, the effect is that every holding company in the chain is a 'financial sector company' for the purposes of the FSSA, and hence the ownership and control provisions of the FSSA apply to each of those companies.

Arguably, this goes further than what is required to achieve the objectives of the FSSA. The policy behind the FSSA is directed at preventing undue concentration of ownership in ADIs and insurers. Each holding company in a chain of ownership of an ADI or insurer will, by reason of the definition of 'direct control interest' in clause 11(2) of Schedule 1 to the FSSA, be caught by the requirement to seek approval to hold a stake of above fifteen per cent in the ADI or insurer. Also, holding companies and their subsidiaries are 'associates' of each other by virtue of clause 4 of Schedule 1, so that, attempts to avoid the ownership provisions by a spread of ownership amongst holding companies and subsidiaries would be caught by the FSSA.

Against that background, there seems little to be gained by classifying holding companies as financial sector companies. Such classification does, however, add considerably to the cost of compliance and to the burden for administrators.

It may be that the objectives of the FSSA and improved regulatory efficiency are best served in this regard by confining the definition of 'financial sector company' to authorised ADIs and insurers.<sup>18</sup>

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<sup>18</sup> Note that if this approach were adopted, section 19 of the FSSA (flow on approvals) would become redundant.

## Discussion questions

Would excluding holding companies from the definition of 'financial sector company' reduce the regulatory burden on industry? Is there any reason why the current definition should be retained?

## 9.6 MINOR DRAFTING AMENDMENTS TO THE INDUSTRY ACTS AND OTHER APRA-ADMINISTERED ACTS

The following minor drafting amendments are proposed:

### Banking Act 1959

- to extend the ability of APRA to set criteria in legislative instruments for granting ADI authorisation under the Banking Act and to set criteria in legislative instruments for granting consent under section 66 (use of certain words/expressions) and section 67 (restriction on establishing/maintaining representative offices of overseas banks) of the Banking Act; and
- to amend subsection 63(1) of the Banking Act to provide clarity and avoid potential ambiguities as to what constitutes an ADI's 'business'. This subsection provides that an ADI must seek prior approval in relation to, amongst other things, the sale or disposal of its business.

### Insurance Act 1973

- to delete superfluous words in subsection 62Z1(2) of the Insurance Act that relate to addition of bonuses that attach to policies. These words were transposed in error from corresponding provisions of the Life Insurance Act and make sense only in the context of life policies; and
- to amend section 17B of the Insurance Act to make clear that subsection 17B(1) does not apply to novation of contracts of insurance. Subsection 17B(1) prohibits the transfer of insurance business of a general insurer other than under a scheme confirmed by the Federal Court.

### Life Insurance Act 1985

- to replace references in the Life Insurance Act to registration of life companies and NOHCs with references to authorisation of life companies and NOHCs to align with the Banking Act and Insurance Act; and
- to amend subsection 194(2) of the Life Insurance Act to correct a drafting error. The correct reference in that subsection should be to interests of 'affected policy owners' as defined under s191(2).

### Superannuation (Financial Assistance Funding) Levy Act 1993

- To use the terminology 'levy base' rather than 'value of assets' in the relevant sections. This will harmonise the terminology and calculation across the relevant industry Acts.

### Superannuation Industry (Supervision) Act 1993



- to allow APRA to prescribe by legislative instrument, rather than through regulation, the application fee for RSE licenses. This will align the treatment of license application fees across the industry Acts; and
- to reinstate a definition of ‘involved’, formally in section 17 of the Act, for the purposes of section 194 of the Act.
  - That section provided:
 

For the purposes of this Act, a person is involved in a contravention if, and only if, the person

    - (a) has aided, abetted, counselled or procured the contravention;
    - (b) has induced, whether by threats or promises or otherwise, the contravention;
    - (c) has been in any way, by act or omission, directly or indirectly, knowingly concerned in, or party to, the contravention; or
    - (d) has conspired with others to effect the contravention.
  - The section was repealed by the *Treasury Legislation Amendment (Application of Criminal Code) Act (No. 1) 2001* consequential upon the introduction of general provisions relating to accessorial liability for Commonwealth offences under the Criminal Code. While this repeal was appropriate for criminal law purposes, it appears to have occurred without appreciation of the fact that the SIS Act definition was needed for the purposes of defining when a person is involved in a breach of a civil penalty provision under the SIS Act. Accordingly, it is proposed that the definition, or a definition in similar terms applying to civil penalty proceedings, be reinstated.

#### First Home Saver Accounts Act 2008 and Retirement Savings Accounts Act 1997

- To consider whether any of the proposed SIS amendments throughout this part will lead to consequential amendments to the *First Home Saver Accounts Act 2008* and *Retirement Savings Accounts Act 1997*.

#### Financial Institutions Supervisory Levies Collection Act 1998

- To amend section 10 of the *Financial Institutions Supervisory Levies Collection Act 1998* to improve administrative efficiency in the collection of any late payment penalties that an entity may incur, by enabling APRA to calculate the amount of the late payment penalty an entity may be liable to pay as the late payment penalty accrues, which commences after the end of the due day for payment. Currently, section 10 indicates that the late payment penalty is calculated after the original levy payment is paid by an entity. This proposal will not affect the total amount of levy payment and any late payment penalties an entity is liable to pay.

#### Financial Sector (Business Transfer and Group Restructure) Act 1999 (Business Transfer Act)

- to remove the reference to the Banking Act in subsection 8(6) of the Business Transfer Act;

- to incorporate a reference to time, in addition to the date, into paragraph 18(2)(d) of the Business Transfer Act for approvals by APRA of voluntary transfers; and
- to clarify to what extent, if any, contracts for employment or services may be transferred as part of a voluntary transfer of business under the Business Transfer Act.

#### Financial Sector (Shareholdings) Act 1998 (FSSA)

- to remove the requirement for the Treasurer to arrange for a copy of a notice of approval to be gazetted under the FSSA, as per paragraph 14(4)(a) of the FSSA, with approvals instead to be published on APRA's website; and
- to incorporate a provision in the FSSA providing an exemption from the need for sovereign states to hold an approval under the FSSA. The exemption would only apply in instances when an application to hold an approval under the FSSA had been made by a wholly or partially owned enterprise of a sovereign state.

## 10. REQUEST FOR COST-BENEFIT ANALYSIS INFORMATION

To improve the quality of regulation, the Government requires all proposals to undergo a preliminary assessment to establish whether it is likely that there will be business compliance costs associated with the proposals. In order to perform a cost-benefit analysis, the Government would welcome information from interested parties.

As part of the consultation process, respondents may wish to consider providing an assessment of the impact of the proposed changes and, specifically, any marginal compliance costs that regulated entities are likely to face. The Government will also be undertaking an impact study of its proposals.

As some of the proposed requirements may impose some compliance costs, respondents may also indicate whether there are any other relevant regulations that should be improved or removed to reduce compliance costs. In doing so, please explain what they are and why they need to be improved or removed.

Respondents are requested to use the Business Cost Calculator (BCC) to estimate costs to ensure that the data supplied to the Government can be aggregated and used in an industry-wide assessment. The Government would appreciate being provided with the input parameters to the BCC as well as the final result. The BCC can be accessed at: [www.finance.gov.au/obpr/bcc/index.html](http://www.finance.gov.au/obpr/bcc/index.html).