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18 December 2012

General Manager
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The Treasury
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Dear Sir/Madam

Response to Treasury Consultation: Strengthening APRA's Crisis Management Powers

We refer to our letter of 14 December 2012 foreshadowing comments on Treasury's proposals set out in *Strengthening APRA's Crisis Management Powers: Consultation Paper* issued in September 2012 (**Consultation Paper**).

We welcome the opportunity to comment on the Consultation Paper as the issues raised in the Consultation Paper are of great importance to the safety and stability of our financial system. We support modernising Australia's legislation so it will be effective in the event of a crisis affecting a regulated institution.

We have specific comments on the following proposals:

- Proposal 1.1.1: Control over non-regulated entities in a group
- Proposal 2.1.1: Clarifying directions powers
- Proposal 2.1.2 : Protection from liability when complying with an APRA direction
- Proposal 2.1.4: Directions on pre-positioning for resolution
- Proposal 2.2.2: Remove the requirement in the Business Transfer Act that complementary State or Territory legislation be in place
- Proposal 3.2.2: Directing a compulsory transfer of business to or from a foreign branch
- Proposal 4.1.1: Broaden the grounds for appointing a statutory manager to enable earlier appointment
- Proposal 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
- Proposal 4.1.3: Broaden the grounds to appoint a judicial manager to an insurer

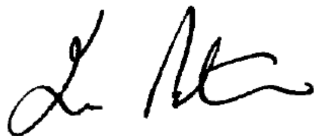
- Proposal 4.1.5: Clarify that the appointment of a statutory / judicial manager (or a compulsory transfer of business) does not enable a party to a contract with a regulated entity to access security/collateral lodged under the contract
- Proposal 4.2.1: Widen the moratorium provisions applicable where a statutory and judicial manager is appointed
- Proposal 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
- Proposal 4.3.2: Statutory immunity for statutory and judicial managers
- Proposal 8.5.1: Refinement and simplification of the definition of 'prudential matters'

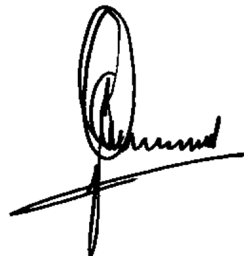
Our comments on these proposals are set out in the schedule.

We are making these responses on behalf of our firm because the proposals raise matters on which we may be called upon to advise. The views expressed are our own and not those of any of our clients.

We would welcome the opportunity to discuss this further with you.

Yours faithfully,





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SCHEDULE

Capitalised terms used in this Schedule have the same meanings as in the Consultation Paper unless otherwise defined.

1 Effective Resolution of Groups

Proposal 1.1.1: Control over non-regulated entities in a group

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 (**Option A**).*
- *Amend the Corporations Act to provide that any liquidator or receiver appointed over a subsidiary or NOHC must cooperate with APRA (**Option B**).*
- *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 (**Option C**).*
- *A combination of the above options (**Option D**).*

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?

Comments on Proposal 1.1

Any proposal to extend resolution powers to otherwise non-regulated related entities of an ADI or insurer has serious implications.

Government policy since the Wallis Inquiry[1] has promoted the formation of NOHC structures. The structure is thought both prudent and efficient on the basis that it allows for financial conglomerates (or non-financial conglomerates containing a regulated entity) to develop while protecting depositors and policy holders by legally separating regulated from non-regulated businesses.[2] A number of institutions have adopted a NOHC structure on the basis of that policy. Conglomerate groups have arisen where the regulated entity (whether an ADI or insurer) forms only a small part of the overall group.

A policy which maintains that in order to resolve a regulated entity it is necessary for a prudential regulator to have resolution powers with respect to related entities not conducting a regulated business is to deny that the NOHC structure has effectively separated risk from the regulated entity. That is a conclusion which should be taken only on the basis of evidence that the findings of the Wallis Inquiry in this regard were incorrect.

Secondly, such measures have a potentially very serious impact on the rights of persons who have dealings with those non-regulated entities, in particular, creditors, contractual counterparties, minority shareholders and employees. Persons will have dealt with those companies on the basis that they are not regulated and are not subject to the kinds of regulatory intervention that are now proposed - for example, a non-regulated entity is free to grant effective security over its assets, free to pay dividends as determined by their directors, free to pay salaries and bonuses regardless of the capitalisation of the non-regulated entity and the management of a non-regulated entity is not liable to be removed, or given directions, by a prudential regulator.

This is particularly the case if, at the same time as implementing the measure, the grounds for appointment of an SM or JM are being broadened and the consequences of the appointment (for example, the breadth of moratorium provisions) are proposed to be broadened.[3]

In relation to Option A (enabling an SM or JM to be appointed an authorised NOHC and subsidiaries of an authorised NOHC of a regulated entity), it is proposed to limit the grounds for appointing an SM or JM to an authorised NOHC or other related entity to circumstances where:

(a) the entity to be placed in 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

(b) where their inclusion in statutory or judicial management is necessary to effectively resolve the regulated entity and relevant parts of the group's affairs.

However, these grounds are not satisfactory, since:

- the assessment of what are a regulated entity's "core" or "essential" functions or what is "necessary" to resolve the regulated entity are likely to be a subjective; and
- the judgments will not be apparent to third parties dealing with non-regulated subsidiaries.

It is noted that to the extent there are concerns that regulated entities are exposed to the performance of other group entities, for example through dependence upon them for services, the extent and terms of those

[1] Financial System Inquiry, Final Report (March 1997) (**Wallis Committee Report**).

[2] See Wallis Committee Report, Chapter 8, in particular Recommendation 49.

[3] See below Proposals 4.1.1 and 4.2.1.

arrangements are already regulated through the prudential standard regulating outsourcing.[4] That standard should be administered so that risk is avoided in the first place.

At the very least, consideration of fairness to persons dealing with non-regulated entities dictates that, if these powers are to be extended, the prudential regulator should periodically assess which subsidiaries are liable to be the subject of regulatory intervention and that assessment should be made be made public so that persons dealing or proposing to deal with those entities have an opportunity to reorganise their affairs.

Option B (requirement for a liquidator or receiver to cooperate with APRA) is the least intrusive of the three options. However, consistent with our comments in relation to Option A above, this proposal also has the potential to unduly affect creditors' rights.

The requirement that a liquidator or receiver "co-operate" with APRA could entail a broad range of measures. It is conceivable that "co-operation" could extend to requiring a liquidator or receiver to expend the assets of the entity or interfere with the enforcement of a security. Alternatively, it could be limited to actions such as complying with reasonable requests for provision of information or reporting to APRA. In our view, if Option B is adopted, it should be appropriately limited to ensure that the concept of 'co-operation' is clearly defined and does not unduly affect the interests of creditors of unregulated entities.

Option C (enhanced directions powers) has the potential to be overly intrusive as regards non-regulated entities for the same reasons as those given above in relation to Option A above.

Finally, we note that the Consultation Paper raises concerns as to the efficacy of APRA's existing directions-giving powers. In our view, these concerns may be overstated, given that section 11CG of the Banking Act specifies that an ADI or authorised NOHC may be subject to criminal penalties for doing or failing to do an act, where doing or failing to do that act results in a contravention of a direction given to it by APRA. Moreover, we are not aware of any circumstances where a regulated entity has failed to give effect to a direction given by APRA.

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2 Enhancing APRA's Direction Powers – Scope and Efficacy

Proposal 2.1.1: Clarifying directions powers

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?

[4] See Prudential Standard CPS 231 (current and as taking effect on 1 January 2013).

Are there likely to be any unintended consequences?

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

Comments on Proposal 2.1.1

We do not object to the proposal to strengthen the catch all power in section 11CA(2)(p) so long as any extension is necessary and appropriate.

However we note the following:

(a) we would not read the existing catch all power as being limited to general directions as to systemic matters. It allows specific as well as general directions, so long as they can be characterised as relating to "the way in which the affairs of the body corporate are to be conducted or not conducted". The power may not extend to directions to change what constitutes the affairs of the body corporate, for example that it cease one business or enter another. Nor in our view should it. For clarity it should be sufficient to add into the section words such as "including any specific action" after "else" in the existing paragraph.

(b) there are some other provisions in section 11CA which are a cause of difficulty and which should be reviewed in conjunction with any review of the directions powers:

(i) section 11CA(2)(m) allows APRA to order not to repay any money on deposit or advance; and

(ii) section 11CA(2)(n) allows APRA to order not to pay or transfer any amount or asset to any person, or to create an obligation (contingent or otherwise to do so).

The relationship between sections 11CA(2)(m) and (n)is unclear. The repayment of money on deposit or advance in paragraph (m) is a subset of the payment of an amount in paragraph (n). However, different consequences flow according to the classification of the payment obligation as within paragraph (m) or (n): thus the concluding words of section 11CA(2) provide that a direction under (n) does not apply to a payment pursuant to an order of court or a process of execution. Suppose then that APRA orders a payment not to be made on a bond. The bond creditor brings proceedings to enforce payment of the bond. The direction does not give the bank a defence to any proceeding. The bondholder gets judgement. So far as the direction is taken to be under paragraph (n), the bondholder will be paid. If the bondholder is treated as having advanced money (and the direction is under paragraph (m)), the position is less clear: does the direction stop the payment or can this judgement be enforced?

Further, in section 11CD(2) it is provided that if a subsidy is "prevented from fulfilling its obligations under a contract" because of a direction under section 11CA, the other party is relieved from obligations owed to the ADI under the contract. This does not apply to a direction not to repay money on deposit or advance, and is subject to orders made by the Federal Court on the application of a party to the contract and the effect of the direction on the contract. There are a number of technical difficulties and uncertainties with the application of the provision, including:

- Does it only apply if the ADI is prevented by the direction from fulfilling all its obligations under the contract, or only some of them?

- What is the effect of relieving a party from its obligations under the contract? Is it relieved only from future obligations, or is it entitled to recover benefits already provided?

- Why carve out directions not to repay a deposit or advance? For example, if a creditor has promised to make periodic advances to an ADI and APRA has ordered that the ADI not repay any such advances, why should the creditor still be obliged to lend?

In the context of revising the directions powers and considering moratorium arrangements, it would be useful to reconsider how these provisions are intended to work.

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Proposal 2.1.2: Protection from liability when complying with an APRA direction

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?

Comments on Proposal 2.1.2

This proposal has particular implications for entities which conduct business in multiple jurisdictions. Compliance with a direction from APRA may not only raise questions of the incurring of civil or criminal liability, or breach of statutory obligations or common law duties, under the federal and State / Territory laws in force in Australia, but also similar questions in relation to the incurring of liability, or the breach of obligations / duties under foreign law.

Consideration should be given to, among other possibilities:

- restricting APRA's power to give a direction which may require a regulated entity, or the directors and other officers of a regulated entity, authorised NOHC or subsidiary (if the direction power is extended to subsidiaries) to take action in a place outside Australia if to do is likely to result in the incurring of civil or criminal liability, or breach of statutory obligations or other duties, under the laws in force in that place;

- APRA being required to provide an indemnity to a regulated entity, or the directors and other officers of a regulated entity, authorised NOHC or subsidiary (if the direction power is extended to subsidiaries) acting in good faith and without negligence in complying with a direction (or a direction requiring action to be taken in a place outside Australia), prior to giving such a direction; and/or

- restricting the enforcement of foreign judgements predicated on the judgment debtor (i.e. the regulated entity, or the directors and other officers of a regulated entity, authorised NOHC or subsidiary (if the direction power is extended to subsidiaries)) having incurred civil or criminal

liability, or breached statutory obligations or other duties, under the laws in force in a place outside Australia as result of compliance with an APRA direction in good faith and without negligence.

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Proposal 2.1.4: Directions on pre-positioning for resolution

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?

Comments on Proposal 2.1.4

In our view, Proposal 2.1.4 has the potential to be overly intrusive and to extend APRA's powers beyond what is reasonably necessary to ensure effective resolution of a regulated entity in distress. The proposal raises particular concerns in the context of non-regulated subsidiaries (although our comments in respect of this proposal also apply in respect of regulated entities).

Pre-positioning for resolution will impose substantial compliance costs on affected business units. In a complex group structure where essential functions are spread across a range of different entities, pre-positioning may impose a substantial burden and require significant changes to operating procedures. Whilst we accept that a higher level of compliance costs associated with prudential requirements is inevitable as regards regulated entities, it is questionable whether there is sufficient justification to impose such costs on non-regulated entities within a broader corporate group.

Issues of compliance costs are, of course, matters of policy. However, in the event that Proposal 2.1.4 is implemented, we note that this proposal does not make clear what criteria (if any) would trigger APRA's power to give a direction as to pre-positioning. Given the potentially wide-ranging consequences of this extension to APRA's direction-giving powers, such powers should be subject to appropriate criteria limiting the circumstances in which they may be exercised. In particular, such criteria should ensure that APRA does not have the power to give such a pre-positioning direction whilst an institution remains financially sound.

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

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?

Comments on Proposal 2.2.2

The removal of this statutory precondition may provide opportunities for disgruntled customers of a transferor entity under the Business Transfer Act to challenge the validity and effectiveness of the transfer on the grounds that it is ineffective under the laws of a particular State or Territory.

The business of banking involves the entry into of contracts governed by the laws of, and the taking of security over tangible and intangible property located in, a particular State or Territory including, in some cases, property created under the laws of the particular State or Territory (for example, mining licences) and the registration of interests with State or Territory authorities or agencies.

Our concern is not whether or not such a challenge would be ultimately successful, whether on constitutional or other grounds, but rather that the removal of this statutory precondition raises, in our opinion, the mere possibility of such a challenge. The costs and uncertainty which would result from such a challenge should be avoided.

In order to ensure the stability of the financial system, and provide maximum certainty in relation to the power of APRA to direct a transfer to occur, there should be no doubt as to the validity and effectiveness of a transfer under the Business Transfer Act. The requirement for complementary legislation to facilitate the transfer to be in place in the State or Territory in which each of the transferring body and the receiving body are established assists in providing this certainty. In our opinion, there is a case for requiring complementary legislation to facilitate the transfer to be in place in each State or Territory in which the transferring body carries on business or holds assets.

If the only justification for removing this statutory precondition is to avoid any need for APRA to be satisfied that the relevant State or Territory legislation is in place, then in our opinion this is an insufficient reason to risk the increased uncertainty which would flow from the removal of the statutory precondition. Surely it is not too much to ask that APRA maintain an up to date register of such legislation.

3 Australian Branches of Foreign Entities

Proposal 3.2.2
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?

Comments on Proposal 3.2.2

In our experience, if it had been clear that the voluntary and compulsory transfer provisions in the Business Transfer Act applied to the Australian business of foreign ADIs, general insurers and life insurers, then the resolution of a number of issues resulting from foreign re-organisations of financial conglomerates would have been able to have been addressed in a more effective manner than proved to be the case over recent years. Subject to our comments in relation to Proposal 2.2.2 above, we also see a benefit in APRA having the power to facilitate a voluntary or compulsory transfer of business of the Australian business of foreign ADIs, general insurers and life insurers in the event of the implementation of a recovery or resolution plan for the foreign regulated entity.

In order to ensure that such a transfer was effective:

- it may be necessary or desirable to restrict the transfer to assets and liabilities located in Australia or governed by the laws of a State or Territory; and
- in relation to assets and liabilities located outside Australia or governed by the laws of a place outside Australia, for complementary legislation (or other authorisation) to facilitate the transfer to be in place in the relevant place outside Australia.

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4 Enhancing the Statutory Management and Judicial Management Legislative Frameworks

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

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?

Comments on Proposal 4.1.1

In our view, the proposed grounds for appointment of an SM set out in Proposal 4.1.1 are overly broad.

The first ground requires only that there be reasonable grounds to believe that there will be a material deterioration in the ADI's financial position that could pose a risk to the ADI's depositors or to the stability of the financial system in Australia. Pursuant to this proposal, the deterioration need not have occurred and it need only have the potential to pose a risk (and the nature of that risk is not defined).

The second ground requires only that there be a failure to comply with a direction given by APRA to an ADI. Since the appointment of a SM is a most serious step this ground should be subject to appropriate qualifications, including requiring that:

- the non-compliance was material in nature;
- the direction with which the ADI has failed to comply was lawful and proper; and
- the non-compliance extended in duration beyond an appropriate 'grace period' in respect of non-compliance.

The appointment of an SM to an ADI represents a very substantial interference in the affairs of the ADI and is likely to have severe flow-on effects a range of stakeholders and the stability of the broader financial system. As is noted in the Consultation Paper,[5] it is a power reserved for extreme situations, such as severe

[5] Refer to Consultation Paper section 2.1.1, page 24.

financial distress. The power is an administrative, not a court order, and its exercise is currently not a reviewable decision under the Banking Act.

Notwithstanding provisions such as section 15C, the practical effect of an appointment may be that counterparties cease to deal with the ADI. If the power to appoint an SM is exercised prematurely, it has the potential to undermine confidence in the ADI and result in further deterioration in its financial position. As such, appropriate safeguards must be in place to ensure that the appointment of an SM is a measure which is reserved for situations where the ADI is in severe distress.

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Proposal 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

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.

Comments on Proposal 4.1.2

In our view the appointment of a SM to an ADI is something which requires the ADI to be the subject of severe distress. Assuming for the purposes of the discussion that APRA is given a power in certain circumstances to appoint a SM to a NOHC, it would not seem appropriate that this by itself should be a ground to appoint a SM to an ADI which is otherwise in a sound condition.

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Proposal 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

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.

Comments on Proposal 4.1.5

An extension of section 15C(2) to prevent the appointment of a SM being a ground for enforcing security is reasonable provided that proper consideration is given to the relevant exceptions.

The proposal notes that it is not to have effect on covered bonds, or close-out netting contracts under the Payment Systems and Netting Act 1998 (Cth). This is welcome, however, care will need to be taken if the legislation were to refer to security interests as defined in the Personal Property Securities Act 2009 (Cth) (**PPSA**). This legislation includes within the scope of security interest certain transactions which are not by way of security, but in some cases by way of outright assignment.[6] These include assignments of receivables which are fundamental to securitisation transactions in which banks commonly engage and, so long as they are conducted within relevant prudential standards, their operation should not be affected by section 15C (or the moratorium provisions).

The perfection of assignment in these circumstances should not be treated as the enforcement of a security interest as the transactions are in substance sales of the relevant property, not security interests over it.

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

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?

Comments on Proposal 4.2.1

In our view, it is correct that the existing moratorium provisions in relation to statutory management are in need of harmonisation and improvement.

However, any amendments need to be considered in the light of the overall purpose, circumstances and duration of statutory management and must produce results that fairly balance the interests of the ADI and counterparties. It will also be necessary to consider the interrelationship of Proposal 4.2.1 and other

[6] Section 12(3) of PPSA.

proposals raised in the Consultation Paper (in particular, the proposal to extend the statutory management regime beyond the ADI or insurer to NOHCs and subsidiaries or related entities, as outlined in Proposal 1.1.1 above).

In particular, we note:

- the breadth of the stay on proceedings;
- the duration of statutory management; and
- the impact on the enforcement of security.

Defining a court broadly to include tribunal or other body with power to effect a reduction in the company's assets or otherwise thwart or frustrate the SM / JM is sensible, and is consistent with the scope of the equivalent stay provisions in the Corporations Act.[7]

In respect of the impact on the enforcement of security, the proposal contemplates that 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 an interest in. While the administration provisions in the Corporations Act contain a stay on enforcement of securities, it should be noted that:

- there are exceptions for security interests over all (or substantially all) of the company's property (while an ADI or insurer would not be expected to have created comprehensive security, if the power to appoint a SM is extended to subsidiaries of such entities, it is quite possible that subsidiaries will enter into financing arrangements of that kind);
- administration is not an indeterminate proceeding: it leads to a creditors' meeting (generally after 20 business days) and the result of that will be either the entry into a DOCA or winding up. A DOCA does not bind a secured creditor unless the creditor agrees;[8]
- in a winding up, the creditor is generally free to exercise its rights as a secured creditor; and
- administration and liquidation are subject to the oversight of the court under the Corporations Act.

In contrast, statutory management may last for an indefinite time. There is no judicial oversight, and it is proposed that the immunities of the SM be further extended (see below).

Further, the concept of what is a security interest has been greatly expanded following the introduction of the PPSA. Staying the enforcement of a quasi-security interest (eg, flawed asset arrangements) or as mentioned above in relation to our comments on section 15C of the Banking Act, may result in considerable interference with contractual rights. Certainly, any security arrangements which are not affected by section 15C (including security arrangements and securitisation as mentioned above in our in relation to Proposal 4.1.5) should be excluded from the stay.

Similar concerns to those relating to security interests apply to the stay on claiming or repossessing property.

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[7] Section 471B of the Corporations Act provides that while a company is being wound up, a person cannot bring or proceed with a proceeding in a "court" in relation to the property of the company or the enforcement process in relation to such property. For the purposes of section 471B, a "court" has been held to include the Australian Industrial Relations Commission: see *Australian Liquor, Hospitality and Miscellaneous Workers Union v Home Care Transport Pty Ltd* (2002) 20 ACLC 820.

[8] In relation to length of the convening period, refer to section 439A of the Corporations Act. In relation to the effect of a deed of company arrangement on secured creditors, refer to section 444D of the Corporations Act.

Supply of essential services: it is proposed that suppliers of essential services cannot refuse services to an ADI or insurer under external management on the sole basis of a debt owing to them and cannot refuse to make further supply conditional on payment of an outstanding debt. We anticipate that the provisions contemplated would follow the form of section 600F of the Corporations Act.

We note that the provision applies to prevent a supplier of an essential service from refusing a request for supply or making it a condition of further supply that a debt owing before the appointment of the insolvency official is paid. It does not prevent the supplier from refusing to supply for non-payment of post-appointment debts. A power to require supply in terms broader than the terms of section 600F if the Corporations Act would be unfair to suppliers as their sole right is to be paid for what they supply and they should not be a source of finance to an ADI.

Dispensing with AGM: it is proposed that provision be made to permit the AGM to be dispensed with by an SM. Relief from the Corporations Act requirements for annual general meetings and related reporting is available from ASIC for administrators in certain circumstances.[9] However, if this is to apply to SMs, what reporting will the SM undertake to shareholders and creditors? Reports to members and creditors are a feature of other insolvency procedures[10] Further, whatever justification there might be for this in relation to the ADI or insurer itself, it is an extraordinary degree of interference with creditors' rights of a non-regulated entity in the same group as a ADI or insurer.

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Proposal 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
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).

Comments on Proposals 4.3.1

In our view, these proposals need to be reconsidered. Where an SM has been appointed despite the fact that the ADI is not actually unable to meet its obligations or has not actually suspended payment, section 13A(3) of the Banking Act does not operate and the SM should be free to carry on business. Once, however, the point has been reached where the entity is actually unable to meet its obligations or has suspended payment, then section 13A(3) should apply.

If there is concern that there may be some dispute or uncertainty as to when that point is reached, this could be addressed by providing that:

- section 13A(3) only applies where the ADI has been ordered to be wound up; and

9 In respect of exemptions from requirements relating to AGMs, see sections 250PAA-250PAB of the Corporations Act. In respect of exemptions from reporting requirements, see Part 2M.6 of the Corporations Act.

10 An externally administered company is obliged to comply with such requirements, subject to the provisions of the Corporations Act cited in above fn 9: see ASIC Regulatory Guide 174.

- the SM's determination of that inability is conclusive, subject only to review by the Federal Court of Australia.

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Proposal 4.3.2: Statutory immunity for statutory and judicial managers

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.

- **Comments on Proposal 4.3.2**

The question of this immunity for SM is an important matter if it is proposed that the SM can carry on the business of the ADI for some time, as seems to be contemplated, from proposals such as Proposal 4.3.1.

In other insolvency regimes, where an insolvency official runs the business it incurs liabilities for goods and services provided after its appointment.

For instance, where a receiver takes control of a corporation's property the receiver is liable for debts incurred for services rendered, goods purchased or hired.[11] The receiver may also agree by contract to be liable for certain payments.[12] Similarly, an administrator is liable for certain debts incurred in the course of the administration.[13]

In return, the insolvency official usually enjoys an indemnity and a priority claim over the assets of the business. In a receivership, this is usually a function of the terms of the charge. In an administration, it is a function of section 443D and 443E of the Corporations Act. This reflects the commercial reality that counterparties will be reluctant to deal with an entity that is the subject of regulatory intervention without some assurance that they will be paid for their services and supplies.

As with many businesses, regulated institutions will have many contractual arrangements which are not long term supply contracts but are uncommitted commercial relationships in the course of which contracts for particular services or supplies are formed. Examples include most derivatives and foreign exchange dealings, money-market operations, legal services etc. A combination of an indeterminate moratorium and comprehensive immunity for the SM is liable to cause suppliers and service providers to be reluctant to deal with the SM and the ADI. This will defeat one of the purposes of the appointment, in particular in the case of an institution that was otherwise capable of being resolved. Consideration should be given as to whether some provisions of the kind shall be reflected in the statutory management provisions for ADI.

Without it any with a concept for immunity for the SM, and when combined with other (expanded) moratorium provisions, how will the ADI continue to trade?

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[11] Section 419 of the Corporations Act

[12] See e.g. in *Sheahan v Carrier Air Conditioning* (1997) 71 ALJR 1223.

[13] See sections 443A-443E of the Corporations Act.

5 Refinement of the Scope of Prudential Standards

Proposal 8.5.1: Refinement and simplification of the definition of 'prudential matters'

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.

Comments on Proposal 8.5.1

We welcome the proposal to simplify the meaning of *prudential matters*, but are of the opinion that in doing so the current anomalies in the Banking Act regarding the expression *depositors* should also be addressed and resolved.

As a result of the introduction of the FCS, some of the provisions of the Banking Act relating to the protection of *depositors* (in particular sections 13A(3) and (4)) have become increasingly difficult to explain to investors. The provisions are complex and lack certainty and clarity.

The concept of a *deposit* is central to many provisions of the Banking Act (but undefined) including:

(a) in the definition of *banking business* and the use of the term A*uthorised Deposit-taking Institution* itself;

(b) the ability of APRA to take a range of actions by reference to the interests or protection of *depositors* or not do so if the action would have a specified impact on *depositors*;

(c) the power of APRA to direct an ADI not to accept or repay a *deposit* in prescribed circumstances;

(d) the provisions for the protection of *depositors* in Division 2 of Part II of the Banking Act (and the obligations of a foreign ADI to notify *depositors* that it is not subject to the provisions for the protection of depositors in Division 2 of Part II); and

(e) the requirements of section 13A(4) (but no longer the requirements of section 13A(3) – see below).

However, following the changes to section 13A(3) introduced in 2010 by the Financial Sector Legislation Amendment (Prudential Refinements and Other Measures) Act 2010 (Cth), the concept of a *deposit* is no longer relevant to those liabilities which have priority if an ADI becomes unable to meet its obligations or suspends payment.

The Banking Act currently refers to *deposits*, *deposit liabilities*, *accounts, protected accounts*, *depositors* and *account-holders*. It is unclear as to whether these terms are intended to be synonymous and, if not, the extent of the overlap between them. For example, a negotiable or transferable certificate of deposit may be a *deposit* and *deposit liability*, but may not be an *account or protected account*.

Accordingly, we recommend that, consistent with the 2010 changes to section 13A(3), consideration be given to:

- all references to *depositor* be replaced by the existing defined term *account-holder* or, alternatively, both the terms *depositor* and *account-holder* be replaced by a new term *protected depositor* to be defined in similar terms to the existing definition of *account-holder*;

- all references to *deposit* be replaced by a new term *protected deposit* (and hence *protected depositor*) which could be defined by reference to the concept of a basic deposit product as used in section 761A of the Corporations Act, rather than the concept of an *account*; and

- the term *deposit liabilities* be replaced by a new defined term, *protected liabilities* to be defined by reference to the liabilities owed to *account-holder* or the new term *protected depositor*.

In addition, some or all the references to a *deposit* could be replaced by references to an *account* or *protected account*, but we do not regard such a change as being essential as the majority of these references are of a generic nature.

These changes would provide greater clarity to the proposed definition of *prudential matters* (and APRA's powers and duties under the Banking Act) – under our recommendation the expression *depositor* in that definition would be replaced by *account-holder* or the new term *protected depositor*.

There are a number of other uncertainties and ambiguities in sections 13A(3) and (4) which could be addressed at the same time, but as these do not relate to the definition of *prudential matters*, we have not outlined them in this response to the Consultation Paper, but we would be more than happy to discuss them with Treasury.

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