



# AUSTRALIA

## FINANCIAL SECTOR ASSESSMENT PROGRAM

### TECHNICAL NOTE—BANK RESOLUTION AND CRISIS MANAGEMENT

February 2019

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FINANCIAL SECTOR ASSESSMENT PROGRAM

January 22, 2019

## TECHNICAL NOTE

BANK RESOLUTION AND CRISIS MANAGEMENT

Prepared By  
**Monetary and Capital Markets  
Department**

This Technical Note was prepared by IMF staff in the context of the Financial Sector Assessment Program in Australia. It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations. Further information on the FSAP can be found at

<http://www.imf.org/external/np/fsap/fssa.aspx>

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## Glossary

|       |                                                  |
|-------|--------------------------------------------------|
| ADI   | Authorized Deposit-taking Institution            |
| APRA  | Australian Prudential Regulation Authority       |
| ASIC  | Australian Securities and Investments Commission |
| AT1   | Additional Tier 1 Equity                         |
| AQR   | Asset Quality Review                             |
| CEO   | Chief Executive Officer                          |
| CET1  | Common Equity Tier 1                             |
| CLF   | Committed Liquidity Facility                     |
| CMA   | Crisis Management Act                            |
| CRF   | Council of Financial Regulators                  |
| D-SIB | Domestic Systemically Important Bank             |
| ELA   | Emergency Liquidity Assistance                   |
| FCS   | Financial Claims Scheme                          |
| FSAP  | Financial Sector Assessment Program              |
| FSSSA | Financial System Stability Special Account       |
| GDP   | Gross Domestic Product                           |
| G-SIB | Global Systemically Important banks              |
| ICAAP | Internal Capital Adequacy Process                |
| ILAAP | Internal Liquidity Adequacy Assessment Process   |
| LAC   | Loss Absorbing Capacity                          |
| MOF   | Ministry of Finance                              |
| MOU   | Memorandum of Understanding                      |
| MPE   | Multiple Point of Entry                          |
| NOHC  | Non-operational Holding Company                  |
| NPV   | Net Present Value                                |
| OMO   | Open Market Operations                           |
| P&A   | Purchase and Assumption (transaction)            |
| PAIRS | Probability and Impact Rating System             |
| RBNZ  | Reserve Bank of New Zealand                      |
| RBA   | Reserve Bank of Australia                        |
| R&E   | Resolution and Enforcement Unit                  |
| SIFI  | Systemically Important Financial Institution     |
| SOARS | Supervisory Oversight and Response System        |
| SPE   | Single Point of Entry                            |
| TN    | Technical Note                                   |
| TTBC  | Trans-Tasman Council on Banking Supervision      |
| T2    | Tier-2 Capital                                   |

## EXECUTIVE SUMMARY

**The Australian banking sector continues to be highly concentrated and dominated by four large banks, which together hold approximately 77 percent of total banking assets.** The financial sector in Australia is dominated by 83 commercial banks (59 percent of financial assets) and pension funds (27 percent), with total financial sectors assets of about 400 percent of GDP. The four largest banks, with largely similar business models, have been designated as domestic systemically important banks (D-SIBs) in Australia. While their pricing power has helped to sustain strong profitability, their size implies that, in the event of their failure, the impact on the financial system and the economy as a whole would be potentially enormous.

**Australia has a well-established framework for financial stability, surveillance and policy formulation and the resolution regime for financial institutions has been significantly enhanced since the financial crisis.** The recently enacted Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Act 2018 (CMA) confers new powers on the Australian Prudential Regulation Authority (APRA) to resolve financial institutions (banks and insurance companies) in distress. It strengthens APRA powers regarding conglomerate groups, statutory management, directions powers, transfer powers, conversion and write-off of capital instruments, stays, foreign branches, the Financial Claims Scheme, wind-up, and resolution planning. APRA has started to translate the new powers into prudential standards and internal work processes.

**APRA has made progress in developing recovery planning requirements for the banking industry, extending these from large to medium sized and smaller banks.** Guidance on recovery planning has been provided by APRA, including advising banks to conduct regular tests focusing on internal escalation processes, functioning of crisis management teams, and determination of communication plans. In recent years, APRA has concluded a thematic review and benchmarking exercise of recovery plans submitted by the larger banks. APRA provided entity-specific feedback on the plans, which outlined the key areas assessed as requiring improvement. APRA has asked for revised submissions which it plans to update on an annual cycle. Regular tests of recovery plans should be undertaken. APRA plans to extend its recovery planning work to include foreign-owned subsidiaries and branches.

**There is a need to better integrate the recovery planning within the risk management framework and operational testing exercises and to significantly enhance APRA's work on resolution planning, particularly for the largest banks.** Recovery plans should become an integral part of the bank's risk management framework and should thus be consistent and integrated with the bank's stress testing and capital and liquidity planning exercises. A guiding framework for a set of triggers and early warning indicators should be developed by APRA to highlight when recovery options might need to be activated. APRA's work on a pilot resolution planning project, along with a resolvability assessment, should be fed into the development of a framework for establishing credible resolution plans, which it would use as a basis for resolving a failed or failing institution. The recovery and resolution planning for financial conglomerates should also be applied on a group basis.

**Notwithstanding the recent progress in strengthening the resolution framework, steps to operationalize these tools remain to be completed.** While the mechanics of the bridge bank and asset

separation tools are established, the modalities to finance the relevant operations remain to be established. Since the resolution tools are untested in Australia, efforts should be maintained to conduct intra- and cross-institutional crisis simulation tests. Also, given the significant interconnectedness and potential spill-over effects, the Australian authorities should enhance the cooperation with the New Zealand financial regulators within the Trans-Tasman Council on Banking Supervision in the context of bank resolution by advancing the focus from generic resolution issues to the formulation of development of specific resolution plans. The authorities should also consider introducing a statutory recognition of action taken by foreign regulators.

**More needs to be done to ensure that the authorities are well-positioned to resolve a systemically important bank or to address a systemic banking crisis.** The ongoing work to build into the system features that will ensure that banks bear the costs of their own failures through an increase in the loss absorbing capacity (in the form of contractual bail-in instruments) is important. However, the resolution authority should also be able, upon entry into resolution to convert or write-down any contingent convertible or contractual bail-in instruments whose terms had not been triggered prior to entry into resolution (Key Attributes 3.5.). In this regard the resolution regime would be significantly enhanced through the introduction of statutory bail-in powers in the legislation.

**The authorities should introduce an ex-ante funded deposit insurance scheme, based on best international practice.** They should also clarify the goals and operational modalities of the Financial System Stability Special Account, the standing budgetary authorization for financial crisis management purposes. In this regard, the recently introduced bank levy could be closer tied to the resolution framework by converting it to support an ex-ante funded resolution fund.

**The Reserve Bank of Australia (RBA) is encouraged to formalize the Emergency Liquidity Assistance framework and draw up clearly defined conditions for it.** The RBA could also provide liquidity support on an uncollateralized basis to a solvent entity with a government indemnity. Nevertheless, as crises tend to escalate at a rapid speed, the RBA would benefit from a more predefined emergency liquidity assistance framework. This should include, inter alia, modalities for conducting solvency assessments and assurance from APRA (moving from point-in-time assessment to a forward-looking assessment of viability), getting a government indemnity, and for decisions whether the RBA can lend to an undercapitalized bank in recovery, or possibly in a resolution mode. The framework should require all ELA to be collateralized and consider applicable risk control measures for lending to banks beyond the CLF.

**This Technical Note (TN) builds upon the findings in the 2012 FSAP TN,<sup>1</sup> which concluded that much had been achieved to address the vulnerabilities manifested during the 2008–09 global financial crisis in numerous countries.** Since then, the authorities have made further progress in crisis management work, including via legislative initiatives and internal crisis preparedness, albeit not all recommendations have been adopted.<sup>2</sup>

<sup>1</sup> Australia: Financial Safety Net and Crisis Management Framework—Technical Note, 2012 (<https://www.imf.org/external/pubs/ft/scr/2012/cr12310.pdf>).

<sup>2</sup> See Annex I: “Status of Recommendations from the 2012 FSAP.”

**Table 1. Australia: Recommendations on Bank Resolution and Crisis Management**

| <b>Recommendations</b>                                                                                                                                                                                                                                                                          | <b>Time<sup>1</sup></b> | <b>Priority<sup>2</sup></b> |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------|-----------------------------|
| Continue work on resolution plans and resolvability assessments for systemic and mid-sized banks. Within 1 to 2 years complete first draft resolution plans for the major banks. Update and review annually.                                                                                    | C                       | H                           |
| Strengthen the independence of the resolution authority.                                                                                                                                                                                                                                        | MT                      | H                           |
| Require annual testing of recovery plans from D-SIBs and medium-sized banks.                                                                                                                                                                                                                    | C                       | H                           |
| Extend recovery planning requirements to conglomerates.                                                                                                                                                                                                                                         | ST                      | M                           |
| Operationalize the new legislated payment modalities provided for the FCS for transferring covered deposits under a P&A transaction (either with a commercial bank or with a bridge bank), including arrangements for competitive bidding process.                                              | ST                      | H                           |
| Continue working on contingency planning for systemic crisis, including via broad and severe simulations exercises and assessing specific resolution options for D-SIBs with a goal to minimize potential losses for taxpayers.                                                                 | C                       | H                           |
| Ensure adequate loss absorbency and recapitalization capacity of D-SIBs and introduce statutory powers.                                                                                                                                                                                         | ST                      | H                           |
| Retail investors' exposure to complex LAC instruments should be subject to robust safeguards                                                                                                                                                                                                    | ST                      | H                           |
| As part of resolution planning, APRA to develop a detailed set of data requirements for banks' assets based on which it could undertake appropriate asset valuations for solvency and viability assessment purposes in a resolution.                                                            | ST                      | H                           |
| Clarify the role and the operational modalities of the FSSSA, including the details for recovering the funds spent on bank resolution.                                                                                                                                                          | ST                      | M                           |
| RBA to formalize its ELA framework with clearly defined preconditions for ELA and drawn up terms and conditionalities.                                                                                                                                                                          | ST                      | H                           |
| Move to pre-funded deposit insurance scheme, to comply with best international practice.                                                                                                                                                                                                        | MT                      | M                           |
| Exclude insider deposits from FCS coverage.                                                                                                                                                                                                                                                     | MT                      | M                           |
| Advance mutual understanding between the Australia and New Zealand resolution authorities on specific cross-border bank resolution modalities.                                                                                                                                                  | ST                      | H                           |
| Introduce statutory recognition of action taken by foreign regulators, including the recognition and enforcement of out-of-court resolution decisions taken by foreign authorities; take steps to enhance cross-border coordination arrangements and recovery actions with other jurisdictions. | MT                      | M                           |
| Introduce "no creditor worse off" concept into bank resolution framework. Methodology for calculating compensation, who provides compensation, and what mechanisms exist for challenging any determination as to the amount of compensation payable should be also introduced.                  | MT                      | M                           |
| Remove the national depositor preference provision (in which depositors in the home jurisdiction have priority over depositors in a foreign branch of a failed bank).                                                                                                                           | MT                      | H                           |

<sup>1</sup> C = Continuous; I (immediate) = within one year; ST (short term) = 1–2 years; MT (medium term) = 3–5 years  
<sup>2</sup> H = high; M = medium; L = low

## INTRODUCTION<sup>3</sup>

**1. Banks and pension (“superannuation”) funds dominate the large financial sector with total assets of about 400 percent of GDP.** As of end-2017, the financial sector in Australia comprises 141 authorized deposit-taking institutions (59 percent of financial assets); pension (“superannuation”) funds (27 percent); investment funds (5 percent); insurance (5 percent); finance companies (2 percent) and the remainder, mainly comprised of specialized credit institutions. The banking system is highly concentrated—the 4 largest banks represent about 77 percent of overall system assets (foreign branches 9 percent and foreign subsidiaries 3 percent). Market shares of major banks are highest (over 75 percent) in markets for loans to small businesses, housing loans, personal deposits and issuance of credit cards. Among general insurers, market shares are highest (80 percent or higher) for lenders mortgage insurance, reinsurance and travel insurance.

**2. The four largest banks have been designated as domestic systemically important banks (D-SIBs) in Australia.** The list of D-SIBs is based on an APRA 2013 study following the Basel Committee principles-based minimum framework for D-SIBs.<sup>4</sup> APRA used indicators such as size, interconnectedness, substitutability/financial institution infrastructure (including factors related to the concentrated nature of the banking sector), and complexity to determine D-SIBs. The study confirmed that the four major banks consistently rank highest across a range of activities and that there are significant differences between these banks and the next group of banks across almost all indicators. Consequently, these four banks were made subject to the D-SIB framework, including a requirement for an additional 1 percent of risk-weighted assets in Common Equity Tier one capital.

**3. Australian banks are well-capitalized, liquid, and have a long history of delivering high profits.** Banks’ total regulatory capital ratio is 14.7 percent (CET1 ratio of 10.6 percent) as of end-2017 against the requirement of 8 percent (excluding the capital conservation buffer of 3.5 percent for the D-SIBs and 2.5 percent for other banks). D-SIBs are subject to a 1 percent surcharge, which is part of their capital conservation buffer of 3.5 percent. Each of the major banks’ CET1 ratios is well above the minimum requirement including the D-SIB surcharge and around the top quartile of large, international banks—one of the reference metrics identified by APRA to support the policy objective that banks are “unquestionably strong.” Banking sector profitability remains high in global terms, although it has declined in recent years. Banking sector liquidity appears reasonable, and asset quality remains relatively high, with average nonperforming Loans (NPLs) of only one percent. Banks carry high exposure to residential and commercial real estate. Residential mortgages form over half of bank lending. Banks’ dependence on wholesale funding has come down in recent years, partly in response to encouragement by the

<sup>3</sup> The Technical Note was prepared by Peter Löhmus from the IMF Monetary and Capital Markets Department for the Australian FSAP. The analysis was based on information provided by the authorities, publicly available information, and discussions with the RBA, ASIC, APRA, Treasury, RBNZ, banks and other financial institutions, and private sector experts.

<sup>4</sup> Information Paper on “Domestic systemically important banks in Australia.”

<https://www.apra.gov.au/sites/default/files/information-paper-domestic-systemically-important-banks-in-australia-december-2013.pdf>.



authorities, but remains high at about one-third of total liabilities, of which nearly two-thirds is from international sources.

**4. A bank levy was introduced in 2017 on banks with over A\$100 billion in total liabilities.<sup>5</sup>**

The proposal was announced by the Government in the 2017–18 budget and its primary purpose is to ensure that “the banking sector makes a fair contribution to the economy given its unique role in economy and the associated systemic risks that it imposes; improving competition and accountability; and complementing prudential reforms.”<sup>6</sup>

**5. Bank failures in Australia have been rare, indicating strong prudential regulation and supervision, supported by sound management at individual financial institutions.** A few smaller financial institutions failed in the late 1980s and early 1990s during a period of stress in the banking system that followed financial deregulation in the mid-1980s, but these failures were resolved without disruptions. A bold response by the authorities to the recent global financial crisis—including the introduction of the Financial Claims Scheme (FCS) as well as guarantee arrangements for large deposits and for wholesale funding,<sup>7</sup> on which a significant share of the banking sector was heavily dependent, as well as the facilitation of a private takeover of a weaker bank—helped to maintain financial stability.

**6. This note is structured as follows:** Part I analyzes the existing legal and institutional frameworks, including coordination arrangements; Part II focuses on crisis preparedness, including recovery and resolution planning as well as the RBA’s lender-of-last resort functions; Part III discusses resolution tools (including for foreign branches) and safeguards; Part IV focuses on systemic crisis management and resolution funding; Part V discusses the Financial Claims Scheme and Part VI addresses special issues that arise in cross-border resolution.

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<sup>5</sup> Based on this threshold, the levy applies to the five largest banks. The levy rate is set at 0.015 percent, paid each quarter on bank’s liabilities with some exclusions, including the FCS covered deposits and some high-quality prudential capital.

<sup>6</sup>[https://www.aph.gov.au/About\\_Parliament/Parliamentary\\_Departments/Parliamentary\\_Library/FlagPost/2017/June/The\\_Major\\_Bank\\_Levy\\_explained](https://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/FlagPost/2017/June/The_Major_Bank_Levy_explained).

<sup>7</sup> In October 2008, the Australian Government introduced a deposit guarantee scheme, the FCS, to protect deposits up to a A\$1 million as well a temporary guarantee for large deposits and wholesale funding (the Guarantee Scheme) for amounts in excess of a A\$1 million. The Guarantee Scheme was subsequently closed to new liabilities in March 2010 and the FCS limit was reduced to a A\$250,000 effective from February 2012.

## INSTITUTIONAL AND LEGAL FRAMEWORK

**7. The Australian financial sector institutional framework primarily comprises four agencies with the following mandates and allocations of power:**

- (i) ***APRA was established by the Australian Prudential Regulation Authority Act 1998.*** It is responsible for prudential regulation and supervision of authorized deposit-taking institutions (ADIs), as well as life and general insurance companies (including reinsurers and friendly societies) and the superannuation (retirement savings) industry (other than self-managed superannuation funds). APRA is also the lead resolution authority in respect of those sectors in Australia and has a wide range of enforcement and crisis management powers to deal with institutions engaging in unsafe and unsound practices, including certain related entities, and in some cases anyone who deals with a regulated entity or its related entities. APRA also administers payouts under the FCS in respect of ADIs and general insurers. In performing its functions, APRA's statute requires it to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, promote financial system stability in Australia. Pursuant to the Banking Act, APRA's duty is to exercise its powers and functions for the protection of the depositors and for the promotion of financial system stability in Australia. It entitles APRA to manage or respond to circumstances in which the ability of an ADI to meet its obligations may be threatened.
- (ii) ***The RBA performs traditional central bank functions, including conducting monetary policy operations and serving as the lender of last resort, as well as Financial Market Infrastructure (FMI) oversight.*** The RBA has a role both in mitigating the risk of financial disturbances that may have systemic consequences, and in responding to a financial system disturbance. It has responsibility for oversight of FMIs and for advising the relevant Ministers on developments in relation to FMIs.
- (iii) ***The Treasurer and the Minister for Finance are responsible for the use of public funds and guarantees in ADI resolution and crisis management.*** The Treasurer is vested with powers to approve actions that could potentially put public funds at risk. The Treasurer's consent is required for the activation of the FCS and the Financial System Stability Special Account (FSSSA), which also requires the approval of the Finance Minister; for APRA to direct a failing ADI to transfer its business to a healthy institution (which could trigger compensation requirements for certain property holders under the Australian Constitution);<sup>8</sup> and for the Government to directly provide official financial support (e.g., guarantees or capital support) to one or more troubled ADIs or other regulated entities). The Treasurer also decides applications to hold significant ownership stakes in ADIs, although this power has

<sup>8</sup> This effect on the property rights of shareholders and creditors is recognized in the Financial Sector (Transfer and Restructure) Act 1999. Under s. 44 of the Act, the Commonwealth is liable to pay a reasonable amount of compensation to a person where the operation of APRA's transfer of business powers under the Act have resulted in the acquisition of that person's property other than on 'just terms.' APRA has not used its compulsory transfer of business powers, so there are no precedents as to how Australian courts may interpret 'just terms,' in terms of an appropriate benchmark against which to assess the compensation due, the process for assessing compensation or the form it should take. In light of the Commonwealth's liability for compensation, the Minister may require some estimate of the Commonwealth's potential exposure prior to giving a declaration under s. 25A. This would likely necessitate the preparation of a (necessarily imperfect) valuation of the ADI's business to be transferred prior to making the determination, as well as any relevant counterfactual valuations against which to compare it.

been delegated to APRA for ADIs with under a A\$1 billion in assets. The Treasury provides advice to the Government on policy and possible reforms that promote a sound financial system, including on financial distress management arrangements.

(iv) ***Australian Securities and Investments Commission (ASIC) was established by the Australian Securities and Investments Commission Act 2001.*** ASIC is responsible for monitoring, regulating and enforcing corporations and financial services laws, and for promoting market integrity and consumer protection across the financial services sector and the payments system.

**8. The Council of Financial Regulators (CFR) is the coordinating body for work on crisis preparedness in Australia across the main financial agencies.** The CFR is chaired by the Governor of the RBA and comprises representatives from the RBA, Treasury, APRA and ASIC (Heads of each and/or senior representatives). The purpose of the CFR is to contribute to the efficiency and effectiveness of financial regulation by providing a high-level forum for cooperation and collaboration among its members. The CFR does not have any legal personality, or legal powers, or any regulatory functions separate of those of its members. The CFR provides advice and non-binding recommendations, on behalf of member authorities, to the Government on financial sector (stability) matters; and provides input to deliberations of member agencies on some policy issues.

**9. The CFR has established escalation protocols with communication modalities between and within the agencies.** The CFR holds four scheduled meetings each year, and as necessary meets on an ad hoc basis. In crisis times, the CFR would act as a forum to coordinate responses to potential threats to financial stability. The objectives, principles and processes dealing with stresses in the Australian financial system are set out in a special Memorandum of Understanding (MoU) between the members of the CFR. Regular update teleconferences are held between senior representatives from each institution to report on developments in their respective areas.

**10. A number of CFR working groups, as part of the CFR structure, undertake more detailed policy development work and other agencies may participate in some working groups.** The CFR crisis preparedness work (other than for FMIs) is further facilitated by a dedicated CFR's Crisis Management Working Group (CMWG). The CMWG is focusing on Australia's financial crisis management arrangements, developing crisis resolution strategies (which includes policy and operational guidance as well as pre-drafted documentation), and conducting crisis simulation exercises. The CMWG has meetings or teleconferences every three weeks and is the first point of contact in a crisis. The CFR FMI Crisis Management Working Group is responsible for, amongst other things, developing the FMI crisis management toolkit and establishing FMI crisis communication arrangements. The CFR may consider giving to its Crisis Communication Working Group, another permanent CFR working group, a stronger prominence in the day-to-day crisis preparedness work.

**11. There is also strong bilateral coordination among the four CFR member agencies.** The broad terms of these coordination arrangements are set out in various bilateral MOUs, covering operational matters such as information sharing, and prompt notification of any regulatory decisions likely to impact on the other agency's area of responsibility. There is an adequate legal basis for information sharing. In

particular, APRA has the power to share non-public information, including regarding the financial condition of an ADI with other CFR agencies, provided that APRA is satisfied that the disclosure will assist the agency concerned in the performance of its statutory duties.

**12. Over the recent years, APRA aligned a number of its existing crisis management functions into a single Resolution and Enforcement Unit (R&E).** This unit covers policy and framework development, internal processes for responding to a failure or crisis event as well as working with APRA frontline supervisors to develop industry responsiveness through improved recovery and resolution planning. The unit, which currently has approximately 25 staff, and which also covers APRA's enforcement function, supports both ongoing supervisory activities and potential resolution actions as well as the administration of the FCS, which may be important to managing the orderly exit of an ADI or general insurer from the industry. APRA maintains a Financial Crisis Management Plan that guides R&E in identifying, managing and responding to a financial crisis. The plan focuses on material and immediate issues that require consideration when there is a sudden and serious escalation resulting in an immediate doubt about the ongoing viability of an APRA regulated entity. The R&E unit could be further strengthened by assigning dedicated legal experts to work with the unit as opposed to outsourcing the tasks to the APRA's legal department.

**13. There has been notable progress made in strengthening the legislative and regulatory framework guiding bank safety net and crisis management work since the 2012 FSAP.** In 2012, the authorities issued a consultation paper, *"Strengthening APRA's Crisis Management Powers,"* (Consultation Paper)<sup>9</sup> which discussed a large number of proposals for improving APRA's crisis management capacity. The consultation process was put on hold pending the outcome of the 2014 Financial System Inquiry (FSI). The FSI was launched to "lay out a 'blueprint' for the financial system over the next decade" and covered a wide range of issues, including those related to the financial safety net. In its response, the Government agreed that regulatory settings should provide regulators with stronger and clearer powers in the event that a prudentially regulated financial entity or any part of the financial market infrastructure (FMI) fails.<sup>10</sup> The government also agreed to consider other important crisis-related reforms, such as the implementation of a requirement for additional loss absorbing capacity. That latter requirement has not been included in recent legislative amendments and is being progressed separately.

**14. The Financial Sector Legislation Amendment Bill (Crisis Resolution Powers and Other Measures, 2017) received Royal Assent in March 2018 (the Crisis Management Act, (CMA)), further broadening APRA crisis management powers.**<sup>11</sup> The CMA confers new powers on APRA to resolve financial institutions (banks and insurance companies) in distress. It strengthens APRA powers regarding conglomerate groups, statutory management, directions powers, transfer powers, conversion and

<sup>9</sup> <https://static.treasury.gov.au/uploads/sites/1/2017/06/Discussion-Paper-1.pdf>

<sup>10</sup> <http://fsi.gov.au/publications/final-report/>

<sup>11</sup> The CMA amended the Banking Act 1959, Insurance Act 1973, Life Insurance Act 1995, Australian Prudential Regulation Authority Act 1998, Payment Systems and Netting Act 1998 and the Financial Sector (Business Transfer and Group Restructure) Act 1999 (renamed as Financial Sector (Transfer and Restructure) Act).

write-off of capital instruments, stays, foreign branches, FCS, wind-up, and resolution planning. In particular, the CMA:

- Strengthens APRA's statutory and judicial management regimes to ensure their effective operation in a crisis. For example, the CMA allows the appointment of a statutory manager to insurers, and group entities of authorized ADIs and insurers;
- Enhances the scope and effectiveness of APRA's existing directions powers;
- Improves APRA's ability to implement a transfer;
- Ensures the effective conversion and write-off of capital instruments in accordance with APRA's prudential standards;
- Enhances stay provisions to ensure that the exercise of APRA's powers against one entity in a group does not trigger adverse rights under contracts of other relevant entities in the same group;
- Improves APRA's ability to respond when the Australian branch of a foreign regulated entity may be in distress;
- Increases the efficiency and operation of Australia's deposit insurance scheme (FCS), and ensures that it supports the crisis resolution framework;
- Enhances and simplifies APRA's powers in relation to the wind-up or external administration of regulated institutions, and other related matters; and
- Ensures that APRA has clear powers to make appropriate prudential standards on resolution planning and to require institutions to take measures to improve their preparedness for resolution where appropriate.

**15. The legal framework would be further enhanced if APRA had clearly defined statutory resolution objectives and accountabilities explicitly stated in the law.** The Australian legal framework does not contain a standalone resolution regime for banks although statutory manager's powers could be used to achieve a resolution on a going concern basis and to give directions to an ADI.<sup>12</sup> The resolution powers are provided to APRA under the same legislation as for its supervisory function (See Chapter on Resolution Regimes). Overall, APRA has a wide range of statutory powers to respond to distress in its regulated financial institutions, including by enforcing compliance with prudential requirements and by taking control of a distressed ADI and/or relevant parts of its group. However, consent of the Treasurer is required if APRA were considering using certain resolution powers. For example, APRA would need the

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<sup>12</sup> The main acts governing the relationship between APRA and ADIs are: Banking Act 1959; Reserve Bank Act 1959; Financial Sector (Shareholdings) Act 1998; Corporations Act 2001; and Financial Sector (Collection of Data) Act 2001; Financial Claims Scheme (ADIs) Levy Act 2008. The Financial System Legislation Amendment (Resilience and Collateral Protection) Act 2016 includes a power to temporarily stay close-out rights in resolution.

consent of the Treasurer to direct a compulsory transfer of business from a bank, a holding company of a bank, or a subsidiary of a bank. Furthermore, the declaration of the FCS and the activation of the FSSSA is the responsibility of the Treasurer, limiting the autonomy of APRA. The independence of the resolution authority should be strengthened to allow APRA to effect least cost resolution using FCS funds without requiring the prior consent of the Treasurer.

**16. Notwithstanding the recent progress in strengthening the resolution framework, steps to operationalize these tools remain to be completed.** Conducting broad, severe crisis simulations along with desktop exercises, on a periodic basis (e.g., biennial) and targeted simulations more frequently should remain an important priority. This is particularly important as the recent legislative and policy developments in the Australian crisis management framework have not been tested. Given the recent policy and market developments, the crisis simulation exercises could focus on testing components of the framework that have never been used (e.g., new FCS powers or unsecured lending by the RBA); idiosyncratic crisis (e.g., cyberattack causing major losses at a systemic ADI); or system-wide disruptions (e.g., liquidity shocks).

## CRISIS PREPAREDNESS

### A. Early Supervisory Intervention<sup>13</sup>

**17. The prudential framework in Australia provides APRA with a broad range of powers to take discretionary actions based on the perceived risk profile of the bank and the nature and severity of the identified problems.** While APRA does not have formal prompt corrective action requirements, it has developed two programs designed to facilitate risk-based supervision, which will enable it to detect weaknesses in ADIs early. These risk assessment and supervisory response tools, known as the Probability and Impact Rating System (PAIRS) and the Supervisory Oversight and Response System (SOARS), are used to identify and address weaknesses in ADIs before these shortcomings weaken bank's balance sheet and adversely affect earnings and regulatory capital.

**18. PAIRS is APRA's risk assessment model incorporating two dimensions: the probability and impact of the failure of an APRA-regulated entity.** PAIRS is a formalized dynamic assessment method combining APRA's on- and offsite analysis within a program designed to formalize the key risks (strategic, liquidity, credit, operational, and market and investment risk); board, management, risk governance and controls; capital coverage/surplus, earnings and capital support for an ADI combined with its impact to inform the development of supervisory action plans. The supervisory action plan is the forward plan of supervision activities based on the PAIRS risk assessment of an ADI. The PAIRS model contains both quantitative and qualitative measurements.<sup>14</sup>

<sup>13</sup> This Chapter draws also on the FSAP Detailed Assessment of Observance Basel Core Principles for Effective Banking Supervision. See CP15 and CP16 for capital planning and stress testing.

<sup>14</sup> <https://www.apra.gov.au/sites/default/files/2018-02-pairs-guide-ud-external.pdf>

**19. SOARS is APRA’s main tool to achieve consistent application of supervisory intervention and is built upon PAIRS results identifying ADIs at risk of failure.** The supervision intensity of a regulated entity is derived from the combination of the PAIRS probability rating and impact rating. SOARS comprises four supervision stances: normal, oversight, mandated improvement, and restructure. For entities in the “mandated improvement” category, APRA intervenes actively. The activities to be undertaken include, inter alia, requiring remediation plans and monitoring milestones; revised business plans; governance changes; increasing capital/liquidity requirements, issuing directions, and others.<sup>15</sup> APRA’s internal framework includes escalation procedures for dealing with entities in times of stress, moving from a SOARS stance of Normal to Restructure.

**20. APRA’s escalation framework is built upon heightened supervision, the Escalation and Enforcement Committee (EEC) and the APRA Financial Crisis Management Team (FCMT).** The EEC is part of the formal escalation framework for banks (and insurers) experiencing stress. The EEC, chaired by the R&E General Manager, is a key advisory body in circumstances where APRA is considering moving beyond its day-to-day supervisory actions. While it does not have decision-making powers, bringing a problem bank (or insurer) to EEC is the first step in cases where there is a reasonable prospect of use of APRA powers in respect of that institution. The EEC includes APRA’s staff from frontline supervision, risk, resolution, and legal teams. It facilitates a coordinated, consistent, and timely approach to any decisions that may involve APRA using its powers. The EEC maintains a watchlist of potential problem entities, based on the SOARS ratings and other information provided by supervisors. Under more severe financial conditions of an entity, the EEC will recommend to the APRA executive board that an FCMT is convened to decide on more critical steps, including the resolution of the bank. This FCMT comprises senior staff from APRA’s executive and the relevant supervisory, risk, resolution, enforcement and legal teams. The FCMT also coordinates APRA’s engagement with other CFR agencies and the public.

**21. APRA has a comprehensive set of direction power to compel a regulated entity to take specific action to address particular prudential issues that have been identified.** The CMA further enhances the scope and efficiency of APRA’s direction powers to regulated institutions and their related entities. For example, it extends APRA’s ability to issue directions to subsidiaries of authorized non-operating holding companies (NOHC) and subsidiaries of regulated entities; provide ‘catch-all’ directions powers to provide APRA with the flexibility to make directions about other matters regarding the affairs of the regulated entity that are not contemplated by the other kinds of general directions listed in the Banking Act; clarify that APRA may issue directions requiring entities to take specified actions to facilitate resolution, whether in normal times or during crisis; and extend APRA’s ability to issue recapitalization directions to a regulated entity’s NOHC and certain other holding companies.

<sup>15</sup> <https://www.apra.gov.au/sites/default/files/attachments/0417-soars-guide.pdf>



## B. Recovery and Resolution Planning

**22. APRA started to develop recovery planning requirements initially for the six largest banks, including four systemic banks in 2011.** This was followed by extending the requirement to 12 medium-sized banks in 2013, and later to three key service providers. The total number of ADIs which have prepared full recovery plans is 21, which includes all large banks, representing about 90 percent of the assets held by the banking sector. These plans have been assessed by APRA several times, and written feedback has been provided to the ADIs. The most recent entity-specific feedback was provided early-2018 and the next round of revised plans submitted in 2019. In addition, APRA has been conducting recovery planning work with smaller ADIs in a way that is proportionate for the size of the entity and the risk/impact of failure. Last year, APRA released a letter to 81 ADIs requesting that they prepare proportionate recovery plans and to date, 60 recovery plans have been submitted to APRA for review, with the remainder due by end-2018. APRA plans to extend its recovery planning work to include foreign-owned ADI subsidiaries and branches.

**23. Some ADIs are starting to embed operational testing practices into their risk management frameworks and test recovery plans.** Guidance on recovery planning was provided by APRA advising ADIs to conduct regular (at least annual) tests and training exercises focusing on internal escalation processes, functioning of crisis management teams, and determination of communication plans. The recovery planning guidance also outlines that stress testing exercises are another important means of testing the credibility of recovery plans, in particular the extent to which the recovery options provide appropriate mitigating actions under specific stress scenarios. In this context, banks need to consider not only how recovery options might preserve the continuity of critical functions, but also the possibility that some recovery options might endanger this continuity. APRA's R&E team has been engaged in banks' stress testing process to assess the links between ADIs' mitigating actions in a stress scenario and their recovery plans. It would be also advisable if a guiding framework for triggers and early warning indicators is developed by APRA, to highlight when recovery options might need to be activated.

**24. The recent changes in the resolution framework provide APRA the powers to pre-position the supervised institutions in order to improve their resolvability.** The revised industry acts (Banking Act, Insurance Act, and Life Insurance Act) provide APRA pre-positioning direction powers whereby APRA can assess how its powers could be used to resolve a relevant entity or group in a credible and orderly way, and whether there are any obstacles to resolution. If there are obstacles, APRA will work with the supervised institution to address them. Where the appropriate pre-conditions are met, APRA is empowered to give a direction to a regulated entity, but also to authorised or registered NOHC and subsidiaries to do any one or more of the following: (i) to make changes to the entity's systems, business practices or operations; or (ii) to reconstruct, merge or otherwise alter all or part of the business, structure or organisation of the body corporate or of the group constituted by the body corporate and its subsidiaries.

**25. There is a need to accelerate APRA's work on resolution planning, particularly for the large ADIs.** A pilot resolution planning project, along with a resolvability assessment, was commenced by APRA in 2016. APRA's particular focus is on resolution strategies which reflect critical functions within relevant



ADIs that may need to be maintained in resolution. Following passing of the CMA, this work is planned by APRA to be fed into a framework for establishing credible resolution plans, which it would use as a basis for resolving a failed institution. The plans would include a methodology for assessing critical functions, conducting resolvability assessments of relevant institutions based on a preferred resolution strategy, identifying pre-positioning measures that could help to improve an institution's resolvability, funding strategies, and developing the processes and guidance for reflecting preferred resolution strategies.

**26. Recovery and resolution planning should form part of an iterative process by which resolvability assessments can inform resolution plans and test their feasibility.** For the largest ADIs, recovery and resolution planning should become a permanent part of the financial safety net. In particular, APRA should monitor the use of operational testing by the largest ADIs more closely, and give them more guidance, if needed. Recovery plans should become an integral part of the bank's strategic risk management framework, be consistent and integrated with the bank's stress testing, and with capital and liquidity planning exercises (ICAAP and ILAAP), while reflecting the exceptional nature of shocks and be fully understood and approved by banks' management and their boards. APRA should be in a position to assess the banks' interconnectedness to other institutions or to the financial system in general in the recovery plans and through resolution planning. APRA is requesting that ADIs submit a summary detailing the approach, results and learnings from the most recent operational testing of recovery plans by 2019.

**27. APRA is also advised to expand recovery planning requirements to financial conglomerates on a group basis.** To date, recovery planning activities have primarily been focused on most of the underlying ADIs, general insurers and life insurers that are part of these groups. At the same time, APRA has identified eight systemic financial conglomerates that are required to comply with prudential standards, e.g., capital, ICAAP, risk management, liquidity, etc., but it has not yet extended recovery planning requirements to them. In 2017, APRA launched a similar exercise with a targeted group of large general insurers and life insurers. There are cases where these institutions would be part of a financial conglomerate and group recovery plans are expected subsequently.

## C. Liquidity Support

**28. The systemic liquidity management in Australia is embedded in RBA's open market operations (OMOs) and its standing facilities.** The RBA regularly provides liquidity to ADIs through its OMOs, with ADIs competing for repo funding through an auction process. In addition, ADIs that maintain accounts with the RBA can access the RBA's standing facilities, which include a facility where the RBA can choose to extend overnight funding via repo, with interest charged at a margin above the cash rate target. RBA has no reserve requirements for ADIs.<sup>16</sup> The collateral framework has been adjusted over the years to address changes in collateral supply, changes in market functioning during the global financial crisis, payment system innovations, and new banking regulations. In its market operations, the RBA typically accepts the following collateral: Australian and state government bonds; eligible ADI paper; highly rated asset-backed securities; highly rated supranational paper; and highly rated corporate paper,

<sup>16</sup> The authorities argued that the RBA's open repo requirements are a form of 'reserve requirements' in practice. However, these are not reserve requirements for the purpose of implementing monetary policy, but are available only to support the smooth functioning of the payments system, by providing after-hours liquidity.

where the counterparty is not materially related to the credit quality of the security. All collaterals are subject to haircuts to manage the risk to the RBA's balance sheet.

**29. A number of central banks, including the RBA, have set up Committed Liquidity Facilities (CLFs) aimed at assisting their banks in meeting the Liquidity Coverage Requirements (LCR) envisaged under Basel III.** The CLFs were recognized by the Basel Committee as means through which banks can access a specified amount of liquidity using repurchase agreements with the central bank to compensate for lack of high quality liquid assets (HQLA) on the market to meet liquidity requirements. The main element of a CLF is the commitment, subject to payment of a fee, by the central bank to provide liquidity to certain eligible institutions against collateral. Given the scarcity of high-quality liquid assets in Australia, the RBA announced a CLF in late-2011 and has arrangements with most of the domestically incorporated ADIs subject to the LCR to enable them to fully satisfy the liquidity rules. Under the CLF, it is currently possible for ADIs to self-securitize portions of their loan books and present the highly-rated tranches of these securities to the RBA. The RBA has discretion to broaden the eligibility criteria for eligible securities at any time.

**30. As a condition precedent to the entry into a repo under the CLF, the RBA can seek written confirmation from APRA that it does not object to the utilization proposed by the ADI.** Subsequently, APRA has to be assured that ADIs have taken all reasonable steps towards meeting their LCR through their own balance sheet management, before relying on the CLF. In addition, it is a requirement (condition precedent) to each CLF utilization that the ADI has positive net worth in the opinion of the RBA, after consulting with APRA. The RBA has tested the activation of the CLF facility with banks, including obtaining required affirmations from banks' CEOs and from APRA on bank's positive net worth.

**31. In systemic situations, the RBA could provide unsecured liquidity assistance to balance sheet solvent ADI.** In the case where an ADI has entirely exhausted the collateral it would be able to make available to the RBA, the RBA could, as a last resort, lend on an unsecured basis and with government indemnity. This liquidity support would be discussed with other CFR agencies, likely in conjunction with a package of measures that would address the ADI's distress. After the consultation with the CFR, the RBA would then decide whether support should be given.

**32. The RBA is encouraged to formalize the Emergency Liquidity Assistance (ELA) framework and draw up clearly defined conditions for it.** As speedy implementation of ELA, in combination with other crisis management tools, is essential to its being effective in a crisis situation, the RBA would benefit from a more predefined liquidity assistance framework. The existing ambiguity in providing ELA makes it harder for the RBA to quantify potential risks and prepare for any responses during severe liquidity stresses (e.g., approaches to collateral, lending limits, government indemnity). The framework should include, inter alia, modalities for solvency assessment (moving from point-in-time to forward looking assessment), for obtaining a government indemnity, and for decisions whether the RBA can lend to an undercapitalized bank in a recovery, or possibly in a resolution mode. The framework should require all ELA to be collateralized and consider applicable risk control measures (such as eligibility, valuation, and haircuts) applying to lending to banks beyond the CLF. It would be also advisable for RBA, in conjunction with the CFR and the Treasury, to run a simulation test, including the process of obtaining a government indemnity to assure that funds for unsecured lending by the RBA are disposed on a timely basis.

## RESOLUTION REGIME

### A. Resolution Tools

**33. Australia has a relatively well-developed set of resolution tools.** The Banking Act and the Financial Sector (Transfer and Restructure) Act<sup>17</sup> provide APRA the following resolution powers: direction powers for banks to take certain actions to facilitate resolution, including to remove and replace management or recapitalize an institution, without shareholder approval if necessary; powers to appoint a statutory manager to control and operate a bank under APRA's directions; business transfer powers (including a P&A transaction and establishing a bridge bank); and winding up powers. The consent of the Treasurer would be required if APRA were considering using certain resolution powers. For example, APRA would need the consent of the Treasurer (unless the Treasurer determines consent is not required) to direct a compulsory transfer of business from a bank, a holding company of a bank, or a subsidiary of a bank. The winding up of an ADI would be conducted in accordance with the Corporations Act.

**34. APRA's direction powers are comprehensive and were further enhanced in the recent CMA.**<sup>18</sup> APRA direction powers can be used in several ways, including enforcing prudential requirements, as an early intervention tool to enable APRA to manage problems affecting regulated bodies 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 ADI; directions can be used to implement a range of resolution options, including facilitating recapitalization. Hence, the framework allows for the possibility that a problem bank could be resolved while under private control as APRA could order an ADI to recapitalize or to implement a recovery plan.

**35. The new "catch-all" directions powers in the 2018 CMA provide APRA with the flexibility to make directions to the ADIs that are not contemplated by the other kinds of general directions listed in the Banking Act.** In addition, APRA now has the ability to issue a direction to subsidiaries of ADIs, insurers or NOHCs in a stress affecting an ADI that is part of a financial group. Also, the CMA provides for clearer immunity for an institution, its directors, management, employees and agents when taking reasonable steps to comply with an APRA direction in case there is a concern by the company and directors that they may breach other relevant industry acts, such as the Corporations Act (noncompliance with an APRA direction will give rise to a criminal sanction).

**36. The APRA-appointed ADI statutory manager's powers and functions are broad-based.** Where the ADI's management is unwilling or unable to facilitate a recovery or resolution while the ADI is under private control, or such an approach is undesirable, APRA is empowered to appoint a statutory

<sup>17</sup> The Financial Sector (Transfer and Restructure) Act 1999, which provides for voluntary transfers of business, compulsory transfers of shares and business and group restructures relating to ADIs, general insurers, and life companies, is administered by APRA.

<sup>18</sup> See 2012 FSAP TN (Box 1) for more details about the directions powers and statutory manager powers prior to the 2018 CMA.

manager (it can appoint itself or another person). A statutory manager other than APRA is subject to the directions of APRA. APRA may appoint a statutory manager under broad and appropriate grounds, and without court approval. A statutory manager can assume all of the powers of the ADI's board of directors and senior management. With a statutory manager having the powers and functions of the ADI's board, coupled with powers explicitly assigned to the statutory manager by law, this appears to be sufficient to prevent shareholders from interfering with resolution activities.<sup>19</sup> As the authorities are well aware, the statutory management power should be used very cautiously as the appointment of a statutory manager could destabilize the bank by triggering or exacerbating funding runs. The Banking Act does not compel APRA to make the appointment of a statutory manager public, nor to specify the duration of such an appointment. Also, the law does not require explicitly that APRA should specify the powers of the statutory manager at the time of the appointment, based on what is proportionate in the circumstances. To date, no statutory manager has been appointed to an ADI in Australia.

**37. The 2018 CMA included a number of elements which strengthen the statutory manager's powers.** For example, the CMA extended the scope of statutory management to authorized NOHCs of a regulated entity and domestically incorporated subsidiaries of an authorized NOHC or regulated entity, to address the resolution of groups. The amendments also allow APRA to appoint a statutory manager to a 'target body corporate' that is incorporated in Australia in certain circumstances.<sup>20</sup> The CMA adds new triggers for the appointment of a statutory manager to a foreign ADI: (i) an application for the appointment of an external administrator of the foreign ADI, or for a similar procedure in respect of the foreign ADI, has been made in a foreign country; or (ii) an external administrator has been appointed to the foreign ADI, or a similar appointment has been made in respect of the foreign ADI, in a foreign country. The CMA also enhances the statutory immunity provisions applying to statutory and judicial managers.

**38. APRA's business transfer powers are provided under the Financial Sector (Transfer and Restructure) Act 1999.**<sup>21</sup> It enables APRA to transfer all or part of a distressed ADI's assets and/or liabilities to another (healthy) ADI or to a bridge bank. Also, non-regulated business (such as failed ADI's assets) may be compulsorily transferred from a regulated entity to an entity that is not regulated (such as an asset management vehicle). The transfer determination can be made under various circumstances, including if an ADI has indicated that is likely to become insolvent and could not be restored to solvency within a reasonable period.<sup>22</sup> The 2018 CMA clarifies APRA's transfer powers to the extent that APRA may now give effect to transfers of business even in the absence of relevant State or Territory legislation being in place and allows for transfer of shares.

<sup>19</sup> The statutory manager can, for instance: (i) sell or otherwise dispose of the whole or any part of the ADI; (ii) alter the ADI's constitution, rules or other arrangements; (iii) issue or cancel shares, or rights to acquire shares; etc.

<sup>20</sup> The definition of "target body corporate" includes entities that provide essential services to the regulated entity or to whom an appointment is necessary in order to facilitate the resolution of the regulated entity.

<sup>21</sup> A compulsory transfer of business under the Financial Sector (Transfer and Restructure) Act is subject to consent from the appropriate Minister, who may or may not be the Treasurer.

<sup>22</sup> Financial Sector (Transfer and Restructure) Act 1999, Section 25.

**39. APRA's winding up powers enable it to act in situations where a regulated institution is insolvent or about to become insolvent.**<sup>23</sup> In general, the winding-up of an ADI is governed by the Corporations Act under the same rules that apply to any other corporation. APRA may apply for the winding up of an ADI under either the Banking Act or the Corporations Act.<sup>24</sup> The winding-up of an ADI will not commence without APRA's consent and involvement. The CMA broadened APRA's role in the liquidation of a regulated entity under the Banking Act. For instance, APRA has the power to apply to the Court for directions regarding any matter arising under the winding up of an ADI, when an entity is under the control of either a liquidator or a provisional liquidator. APRA has also the right to apply to the Federal Court of Australia for an order that an ADI be wound up if APRA considers that the ADI is insolvent and could not be restored to solvency within a reasonable period, without first having to appoint a statutory manager. The priority of payments in winding-up of an ADI is governed by both the Banking Act<sup>25</sup> and the Corporations Act (for the rest of the creditors).

**40. Notwithstanding this progress, steps to operationalize these tools remain to be completed.** Most importantly, while the mechanics of the bridge bank and asset separation tools have been discussed in the CFR and have been documented, financing the operations either through the FCS and/or the FSSSA have to be still worked out. There is also need for APRA to develop a detailed set of current data for banks' assets based on which it could undertake swift asset valuations for solvency and viability assessment purposes in a resolution. The banks should be required to populate this data on short notice and this would be subject to regular testing by APRA, with occasional external audit. APRA should also be internally ready to undertake a viability assessment under acute time pressure, with pre-approved methodology and resources. These systems should be occasionally tested. To avoid disruptions to the payment system, testing should be done for potential situations where the bank resolution involves a bank being temporarily withdrawn from the payment system and then re-entered.

<sup>23</sup> Australia: Financial Safety Net and Crisis Management Framework—Technical Note, 2012 for more detailed description (<https://www.imf.org/external/pubs/ft/scr/2012/cr12310.pdf>) .

<sup>24</sup> See relevant provisions of the Corporations Act and the Banking Act, including section 16AAA (3) of the Banking Act."

<sup>25</sup> Banking Act, Section 13(A) (3): 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: (a) first, the ADI's liabilities (if any) to APRA because of the rights APRA has against the ADI because of section 16AI or 16AIC; (b) second, the ADI's debts (if any) to APRA under section 16AO; (c) third, the ADI's liabilities (if any) in Australia in relation to protected accounts that account-holders keep with the ADI; (d) fourth, the ADI's debts (if any) to the Reserve Bank; (e) fifth, the ADI's liabilities (if any) under an industry support contract that is certified under section 11CB; (f) sixth, the ADI's other liabilities (if any) in the order of their priority apart from this subsection.

## B. Resolution Safeguards

**41. The use of resolution powers can have major impacts on the rights and financial position of shareholders, creditors, and others.** Safeguards are intended to provide market participants with a greater degree of certainty about how the bank failure and resolution may affect them, which is critical for continued confidence in and effective functioning of the financial system. Remedies under safeguards should be of an ex post nature, with no capacity to unwind a resolution once implemented. The main principles to follow under the resolution are as follows: (i) resolution should respect hierarchy of claims with flexibility to depart from *pari passu* treatment of creditors of the same class; (ii) no creditor (or shareholder) should be left worse off than had the bank or other entity been wound up under conventional insolvency law (“no creditor worse off than in liquidation”); (iii) the option of ex post monetary compensation for any party left worse off under the resolution; and (iv) appeal rights and ex post rights of judicial review with compensation from misuse of powers.

**42. Australia has a compensation framework to deal with acquisition of property from a person other than on just terms in relation to the banking, general and life insurance frameworks, and compulsory transfers of business.** These principles rely on the general provision in the Constitution regarding compensation for confiscation of peoples' property. The recent CMA applies this compensation framework to the new compulsory transfers of shares.<sup>26</sup> The other set of safeguards apply to stay provisions, which were further enhanced in the CMA, to ensure that the exercise of APRA's powers against one entity in a group does not trigger adverse rights under contracts of other relevant entities in the same group. The safeguards from the Financial System Legislation Amendment (Resilience and Collateral Protection) Act 2016 continue to apply in addition to the new safeguards, such as the requirement that APRA must be satisfied that a declaration to make a stay permanent in a transfer of business would not have a detrimental effect on any counterparty to a close-out netting contract to which the declaration would apply.

**43. However, there is no ‘no creditor worse off’ framework in the current legislative framework in Australia.** The Key Attributes provide that while it is critical for effective resolution that all resolution powers be exercisable without any need for shareholder consent or triggering any other third-party rights that prevent, impede or interfere with resolution, the legal framework should provide for an ex post valuation of the NPV outcome for creditors affected by a resolution transaction. It should then provide a comparison with the assessed likely NPV outcome that would have prevailed under a conventional winding up. This serves as the basis for determining compensation for creditors rendered worse off, and where the process is presided over by a court, with appeal rights. In addition to compensation schemes, methodology for calculating compensation, who provides compensation, and what mechanisms exist for challenging any determination as to the amount of compensation payable should be introduced.

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<sup>26</sup> Banking Act, Section 69E.

## C. Resolution of Foreign ADIs (Foreign Branches)

**44. The resolution authority should have resolution powers over local branches of foreign banks.** According to the Key Attributes, the resolution authority should have the capacity to use its powers either to support a resolution carried out by a 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. Where a resolution authority acting as host authority takes discretionary national action, it should give prior notification and consult the foreign home authority.

**45. The recent legislative changes have provided APRA with more powers in relation to foreign ADIs (but also to general insurers and life companies) to the extent of their Australian business.**<sup>27</sup>

These institutions are now subject to the statutory management regime and more extensive APRA powers for winding-up, transfer of business and revocation of authorization. The Banking Act requires that the Australian assets of an insolvent foreign ADI be available to meet the ADI's Australian liabilities in priority to its other liabilities. APRA can issue any directions to a foreign ADI, where the ADI is in distress or financial system stability is at risk, which it can issue to a locally incorporated ADI, other than in relation to capital or the appointment or removal of directors. APRA has powers to direct a foreign regulated entity not to transfer assets out of Australia. APRA may also apply to the Federal Court for an order that a foreign ADI be wound up (based on the Corporations Act).<sup>28</sup>

**46. The recent CMA has provided APRA with powers to appoint a statutory manager to the foreign ADI.** It also clarifies APRA's powers to wind up a foreign ADI and powers to implement a voluntary or compulsory transfer of business of the foreign ADI. While the appointment of a statutory manager to a domestic ADI causes its directors to cease to hold office, APRA considered this approach unsuitable regarding a foreign ADI which will have other operations outside Australia that are not within the scope of statutory management in Australia. Instead, the CMA provides that the directors of the foreign regulated entity are prevented from acting in relation to the Australian business assets and liabilities of a foreign regulated entity, or the management, to the extent that it relates to such assets and liabilities, once the entity is under statutory management.<sup>29</sup>

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<sup>27</sup> "Foreign ADI" is a foreign bank that receives authority to operate through a branch. A foreign bank operating through a subsidiary is an ADI.

<sup>28</sup> When: (i) the foreign ADI is unable to meet its liabilities in Australia, or in one or more foreign countries, as and when they become due and payable; (ii) an application for the appointment of an external administrator of the foreign ADI, or for a similar procedure in respect of the foreign ADI, has been made in a foreign country; and (iii) an external administrator has been appointed to the foreign ADI, or a similar appointment has been made in respect of the foreign ADI, in a foreign country. Banking Act: Division 1B 11EA 1.

<sup>29</sup> Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Bill 2017. Explanatory Memorandum. [http://parlinfo.aph.gov.au/parlInfo/download/legislation/ems/r5989\\_ems\\_d5c61274-9551-412b-9ecb-8a423f880f1b/upload\\_pdf/649526.pdf;fileType=application%2Fpdf](http://parlinfo.aph.gov.au/parlInfo/download/legislation/ems/r5989_ems_d5c61274-9551-412b-9ecb-8a423f880f1b/upload_pdf/649526.pdf;fileType=application%2Fpdf).



**47. While APRA could use its power to apply for winding up to support or facilitate action by a foreign resolution authority, the CMA does not contain a statutory recognition of action taken by foreign regulators.**<sup>30</sup> While the interaction of home regulator action and host regulatory powers and duties remains a complex subject, and the CMA explanatory memorandum indicates that the APRA's intention is to work with authorities in other jurisdictions to coordinate resolution actions where appropriate, it may nevertheless be beneficial in certain circumstances to have more certainty in coordinating national proceedings. For instance, Australia could adopt steps specifying the grounds under which one jurisdiction would recognize the transfer of ownership or property from a failing financial institution directly to a private firm, to a national insolvency authority, or to a bridge financial institution. Mutual recognition could also extend to substantive decisions on claims and other resolution decisions. Legislative changes that facilitate recognition and enforcement of out-of-court resolution decisions taken by foreign authorities and that prevent discrimination against creditors on the basis of the location of their claim or jurisdiction where it is payable should also be pursued.

## SYSTEMIC CRISIS MANAGEMENT AND RESOLUTION FUNDING

**48. Ordinary liquidation proceedings are likely to be infeasible in respect of large ADIs due to their size and systemic importance.** As for any business, the possibility of failure is essential to enforce market discipline and discourage excessive risk taking. However, for these incentives to work effectively, it is essential to ensure that the costs of failure are borne fairly and efficiently, and do not endanger the broader financial system or real economy.

**49. One of the key focuses of post-crisis financial sector reforms around the world has been the so-called "too-big-to-fail" problem.** In this context, regulators must ensure that banks have a sufficient level of loss-absorbing capacity (LAC) available at the time of resolution. The FSB Total Loss-Absorbing Capacity (TLAC) principles require global systemically important banks (G-SIBs) to have financial instruments available during resolution to absorb losses and enable them to be recapitalized to continue performing their critical functions while the resolution process is ongoing.<sup>31</sup> The LAC requirements—bolstering gone-concern loss absorbency and recapitalization capacity—are expected to mitigate financial stability risks, including moral hazard, associated with banks that are large, perform critical functions or are highly interconnected with other parts of the financial system and, ultimately, reduce the cost to taxpayers of government bailouts of banks in a financial crisis. The "too big to fail" problem is markedly high for D-SIBs in most jurisdictions. For the past few years, LAC frameworks for both G-SIBs and D-SIBs have been adopted internationally with the objective to ensure an orderly resolution by making a wider

<sup>30</sup> Other powers, such as the transfer of business powers, could also be used to support or facilitate in this way.

<sup>31</sup> The FSB TLAC Term Sheet stipulates that "Eligible external TLAC should contain a contractual trigger or be subject to a statutory mechanism which permits the relevant resolution authority to effectively write it down or convert it to equity in resolution." Loss-absorbing capacity qualifying instruments comprise essentially all capital instruments and other long-term debt that can be written down or converted into equity. Debt must be unsecured, have a tenor longer than one year, contractual and subordinated to ineligible obligations (typically liabilities that cannot be written down or converted without resulting in significant legal implications).



range of debt holders absorb losses (“bail-in”), instead of using public funds (“bailout”). For D-SIBs and smaller banks the exact requirements have been adjusted based on their size and risk profiles.

**50. While no Australian bank has been designated as a G-SIB, the four major banks have been classified as being domestic systemically important banks.** The 2014 FSI stated that “when seeking funding in wholesale markets, the internationally active Australian banks must compete against banks that meet these global requirements” and called for APRA to implement a framework for minimum loss-absorbing and recapitalization capacity for ADIs that is in line with international practice and that facilitates the orderly resolution of Australian ADIs by minimizing the likelihood of public support. Specifically, the FSI expressed a preference for introducing securities with contractual bail-in features for gone-concern cases, rather than creating a statutory bail-in regime. However, while the new CMA clarifies the procedures and provides more legal certainty for the conversion and write-off of the already existing AT1 and T2 capital instruments, it did not introduce new requirements for additional LAC.

**51. The authorities agree that the additional loss-absorbing capacity could mitigate the impact of any perceived implicit government guarantee and the accompanying market distortions this creates.** APRA is considering now, in collaboration within other CFR agencies, how best to apply additional requirements in relation to further loss absorbency, particularly in relation to D-SIBs and is in the process of refining and calibrating an approach tailored to Australian conditions. A discussion paper on the topic is expected to be released in late-2018. It is also important to note that the availability of sufficient loss absorbing capacity is an important pre-requisite for all resolution options, including a bridge bank and P&A as well as internal loss absorbing capacity for SPE strategies.

**52. Statutory bail-in powers should be considered as an additional and complementary tool for the resolution of systemically important financial institution (SIFIs).**<sup>32</sup> Compared to other key resolution mechanisms, bail-in can in certain circumstances offer a more appropriate resolution tool for distressed SIFIs, whose primary problem is inadequate capital. It involves recapitalization through relatively straightforward mandatory debt restructuring and could therefore avoid some of the operational and legal complexities that arise when using other tools (such as P&A transactions), which require transferring assets and liabilities between different legal entities and potentially across borders.<sup>33</sup> Australia has adopted a cautious public stance on creditor bail-in; however, the resolution authority should also be able to, upon entry into resolution, convert or write-down any contingent convertible or contractual bail-in instruments whose terms had not been triggered prior to entry into resolution (Key Attribute 3.5). Without this tool, the requirements for increasing loss absorbing capacity are likely to be higher, with potentially relevant cost implications.

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<sup>32</sup> Bail-in is a statutory power of a resolution authority, as opposed to contractual arrangements, such as contingent capital requirements.

<sup>33</sup> “From Bail-out to Bail-in: Mandatory Debt Restructuring of Systemic Financial Institutions.” IMF Staff Discussion Note, 2012.

**53. The workability of bail-in for large institutions is complicated by the nature of the creditors in the current AT1 and T2 framework whereby the AT1 is widely held by domestic retail investors.<sup>34</sup>**

In this context, the authorities should ensure strong investor protection for retail investors (if any) in LAC. In order to facilitate effective resolution regimes, retail investors' exposure to complex LAC instruments should be subject to robust safeguards (e.g., through rigorous requirements to disclose the risks, or sufficiently high minimum lot sizes); or, alternatively, the sale of certain instruments to the mass retail market should be prohibited.

**54. As a very last resort, the authorities should ensure that solid but flexible arrangements for providing official financial support are in place.** In the case of a severe systemic crisis, there is still a need for a fiscal backstop by the government, either directly to recapitalize ailing banks, to the resolution funds (in some jurisdictions) or indirectly as through indemnities provided to the central bank. If this were the case, the authorities would benefit from readily available terms sheets they could operationalize in a short timeframe to stem the crisis and minimize moral hazard (i.e., appropriate shareholder dilution and pricing, funding, exit strategy).

**55. In this regard, operational modalities of the FSSSA, the A\$20 billion standing budgetary appropriation for financial crisis management purposes should be discussed by the CFR and be specified in the legal framework as soon as feasible.<sup>35</sup>** The FSSSA was set up, (a) to "protect the interests of depositors of ADIs in ways that are consistent with the continued development of a viable, competitive and innovative banking industry; or (b) protecting financial system stability in Australia."<sup>36</sup> The FSSSA could be used to fund deposit transfers and the transfer of other business, transfer non-deposit ADI business (e.g., transferring impaired assets at assessed market value to an asset management vehicle), as well as to fund recovery structures in an open resolution as long as the FCS has not been declared (the funds could be also used for the insurance industry). The stated FSSSA goals appear to overlap now with the broadened FCS mandate in some areas, creating ambiguity. As a way of enhancing protection for taxpayers, the Australian authorities should also consider establishing broad principles as how the Government will recover the costs of funding a resolution for the FSSSA (as it is legislated for the FCS) by establishing a priority claim on the rump ADI for funds released by the FSSSA and to impose a levy on the financial industry as a means of making up any shortfall in recoveries.

**56. The recently introduced bank levy could be more closely tied to the resolution framework; for instance, by converting it to support an ex-ante funded resolution fund.** While similar levies, paid directly into the government general revenue, have been introduced in a number of advanced jurisdictions, it is advisable over a longer term to use the bank levy to build up a dedicated resolution fund. It can be also argued that the bank levy payment in Australia into general revenue by only the five largest ADIs does not eliminate moral hazard but may even increase this risk. While the focus should be

<sup>34</sup> In Australia, an Additional Tier 1 Capital or Tier 2 Capital instrument must include a provision under which, on the occurrence of a non-viability trigger event it will be immediately and irrevocably: (i) converted into the ordinary shares of the ADI or its parent entity, (ii) converted into mutual equity interests; or (iii) written off.

<sup>35</sup> This is in addition to the Financial Claims Scheme Special Account, which is used to fund the FCS.

<sup>36</sup> Banking Act Section 70C.

for Australia to create a pre-funded deposit insurance scheme (see Chapter below on Deposit Insurance), supported by a well-defined ex post funded resolution scheme, an ex ante funded resolution fund would not be unique.

**57. Further efforts are needed to stand ready to manage the failure of systemic ADIs or a systemic banking crisis.** The ongoing work to build into the system features that would reduce the probability and likely cost to taxpayers through the increase in the loss absorbing capacity (in the form of contractual bail-in instruments) and to mitigate moral hazard should take priority. To address this, the authorities should develop credible contingency plans and build into the system features that will ensure that ADIs bear the costs of their own failures. On the other hand, the resolution plans and crisis response measures should be developed in a way that protects banks' critical functions, government funds and systemic stability. As also implied by the FSI, the work on additional LAC should be accompanied by a strong legislative framework, including by ensuring certainty of creditor hierarchy and strong legal basis for exposing creditors to losses. The no-creditor-worse-off concept should be also introduced (this concept would be particularly important for statutory bail-in). The authorities should also consider what actions they would take to limit contagion between the larger banks and with other financial institutions.

## DEPOSIT INSURANCE (FINANCIAL CLAIMS SCHEME)

**58. The FCS is an ex post funded deposit insurance facility, backed by a standing budgetary appropriation.**<sup>37</sup> Payouts of deposits covered under the FCS are initially financed by the Government through a standing appropriation of A\$20 billion per failed ADI. Additional funds could be made available, if needed, subject to parliamentary approval.<sup>38</sup> In cases where the Commonwealth Government is short of cash (liquid assets) at the time of the determination, APRA may, with the Treasurer's written approval, and on behalf of the Commonwealth, borrow money on terms and conditions specified in, or consistent with, the approval.<sup>39</sup> To date, the FCS, which also covers the insurance industry, has been declared once in respect of a small general insurer.

**59.** APRA is responsible for administering the scheme and recovers payments and accompanying expenses from the assets of the failed bank. Any shortfalls can be recovered from other banks via an ex post industry levy based on the Financial Claims Scheme (ADIs) Levy Act 2008. The FCS covers all deposit accounts, including legal entities and non-resident AUD deposits with locally incorporated ADIs; it does not, however, cover ADI branches abroad and the foreign branches in Australia.<sup>40</sup> Australia is also

<sup>37</sup> The Australian Financial Claims Scheme Special Account (FCSSA) was established in 2008 to provide for the funding of the FCS.

<sup>38</sup> A\$100 million is made available for covering expenses for each FCS declaration.

<sup>39</sup> The borrowing must not be of an amount greater than the sum of the amounts specified in declarations under either section 16AD of the Banking Act 1959 or section 62ZZC of the Insurance Act 1973 as amounts that are to be credited to the Financial Claims Scheme Special Account; or be for a period longer than 12 months. (Australian Prudential Regulation Authority Act 1998, 54E)

<sup>40</sup> Foreign branches are not permitted to accept initial retail deposits from Australian residents of less than A\$250,000, which may mitigate some of the financial stability risks

applying “national depositor preference” treatment where domestic depositors rank ahead of depositors in foreign branches of the domestic bank, which is not in line with the Key Attributes, as it comprises discriminatory treatment on the basis of the location in which the claim is payable. The FCS is currently covering deposits per depositor per ADI up to A\$250,000, a level that fully covers nearly 97 percent of total deposit account holders,<sup>41</sup> and approximately 48 percent of deposits by value, as of end-2017. The size of total ADI deposits in Australia is A\$1.9 trillion, including A\$1.5 trillion for the four largest banks and A\$246 billion for other Australian banks (excluding foreign subsidiaries), with foreign subsidiaries, credit unions, and building societies making up the remainder.

**60. The recent changes in the crisis management framework broadened the FCS “paybox” mandate by allowing the FCS funds to be used to support a compulsory transfer of business (P&A).**

The scope of the FCS funding for a transfer of business extends to the amount to which each account-holder would be entitled to under the FCS. Further improvements were made to the framework by bringing forward the trigger point for the determination of applying the FCS by the Treasury. Prior to these changes, the determination of whether the FCS will apply was declared by the Treasurer subsequent to APRA applying to the Federal Court, while the amended Act allows the Treasurer to declare the FCS once a statutory manager has taken control of the ADI (or the general insurer), reducing the uncertainty for depositors in terms of whether the FCS will be activated. The least-cost safeguard should be applied when FCS is used for supporting P&A.

**61. Further enhancements have been also made to the operational side of the FCS, addressing a number of recommendations made in the 2012 FSAP.** APRA’s Prudential Standard APS 910 Financial Claims Scheme (APS 910) (2013) focuses on banking industry readiness to operationalize the FCS. It sets out the minimum requirements that locally incorporated ADIs must meet to enable prompt and accurate payouts to be made to depositors should the FCS be triggered for ADIs. The key requirements of APS 910 are that an ADI must identify each unique account-holder and develop and implement a Single Customer View, along with payment, reporting and communication requirements. It also makes the Board and senior management of an ADI responsible for ensuring that appropriate policies and procedures are in place to ensure the integrity of the operations, internal controls and relevant information. ADIs are required to demonstrate that relevant systems and processes are in place to ensure operational preparedness to meet APS 910 requirements. Moreover, the readiness to apply FCS is included in APRA prudential reviews in the normal course of supervision. APS 910 external audit work is also aligned with the ADI’s routine audit work. A cross-agency crisis exercise for execution of FCS was carried out and a dedicated FCS website<sup>42</sup> was launched in 2016. A testing schedule has been developed and released to the banks.

**62. The 2012 FSAP recommended to re-evaluate the merits of ex-ante funding for the FCS with a view toward converting it to an ex-ante funded scheme.** The funding arrangements were addressed in the 2014 FSI. While the FSI noted a number of positive features of an ex ante FCS funding model

<sup>41</sup> While APRA does not have current data available for covered household and corporate deposits, the FCS covered around 99 percent of household deposit accounts during the 2012 FSAP.

<sup>42</sup> [www.fcs.gov.au](http://www.fcs.gov.au) .

(including that regulatory costs should be proportionately borne by those contributing to the need for regulation or benefiting from that regulation), it ultimately recommended retaining an ex post model. The Australian government accepted the FSI recommendation to retain the existing ex post funding scheme, noting that the increasing costs to the banking sector and the further plans to strengthen the resilience of the financial sector would reduce the risk of failure and mitigate the costs of failures that do occur. Also, it was argued that Australia's strong depositor preference arrangements and a relatively small reliance on deposit funding underpin the reduced risks of an ADI's assets being insufficient to meet FCS protected deposits (in insolvency of an ADI, the deposit insurer pays out insured deposits and then has priority over all other creditors, including uninsured depositors, in liquidation). Given the FSI recommendation, Australian agencies do not see a current need to revisit this issue.

**63. It is nevertheless recommended that Australia move from ex-post funded depositor guarantee scheme to ex ante funded, collecting premiums from ADIs to build up a reserve fund against future ADI failures.** The Deposit Insurance Core Principles and the Key Attributes both stress the importance of ensuring that banks bear at least some of the cost of bank failures (other than via shareholder losses imposed at failure) and an ex ante funding (with a back-up line of credit from the government). The FCS continues to fall short of these principles. Given the high concentration of the Australian banking system and that ADIs are not required to pay ex ante or ex post premiums, the government-funded FCS effectively increases moral hazard in the financial sector.<sup>43</sup> It should be also noted that it may take years for the Government to recover the funds, plus interest, from the banks under the current arrangement.

**64. Further improvements to the FCS are called for to increase its effectiveness and reliability.** As the activation of the FCS is at the discretion of the Treasurer, which is an inherent nature for ex post funded schemes, the trigger for payout could still potentially contribute to delayed payouts and introduce uncertainty to depositors (and policyholders). APRA has tested ADIs' readiness to prepare Single Customer Views and to transmit the check and electronic funds transfer payment files to the RBA, the two core deposit payout mechanisms. Further work may be needed by APRA and RBA to ensure that these payment methods would meet the emerging best practice for deposit payout deadline of seven days. The recent changes in the legislation allow an ADI to assume all or part of the failed ADI's insured deposits, with funding from the FCS. The FCS funds can also be used, up to the aggregate FCS entitlement for protected accounts, to cover a funding gap between assumed assets and liabilities (P&A transactions). These measures are new and yet to be operationalized (which can be challenging given the current issues with account transferability). Options where other ADIs would bid on the opportunity to assume deposits should be considered.

**65. The current coverage of A\$250,000, covering around 97 percent of protected deposit account holders in full, is relatively high compared to international practices, increasing government funding risk and moral hazard.** Also, the FCS coverage should explicitly exclude interbank deposits or deposits of individuals who are regarded as responsible for the deterioration of an institution,

<sup>43</sup> See discussion on premiums in an IADI Guidance Paper on "Funding of Deposit Insurance Systems" [https://www.iadi.org/en/assets/File/Papers/Approved%20Guidance%20Papers/Funding%20Final%20Guidance%20Paper%2006\\_May\\_2009.pdf](https://www.iadi.org/en/assets/File/Papers/Approved%20Guidance%20Papers/Funding%20Final%20Guidance%20Paper%2006_May_2009.pdf).

including deposits belonging to the directors, managers, large shareholders, auditors and other insiders of the failed banks. The authorities may also discuss—in the broader systemic financial stability context—the appropriate approach to protect superannuation fund clients to the extent they are exposed to bank failures through their funds' cash allocations to the banks (in such a situation it is the fund itself (as represented by its trustee or trustees) that will be regarded as the 'account holder' under the FCS, not each individual member); and to what extent the failure of a superannuation fund may pose financial stability risks.

## CROSS-BORDER COORDINATION

**66. The high concentration of the Australian banking sector coupled with strong presence of its banks in New Zealand calls for further strengthening of cross-border cooperation.** The New Zealand market represents the largest and most systemically critical overseas exposure of the four major Australian banks, amounting to 12.7 percent of their total assets, and about 85 percent of assets of the New Zealand market. Each of the four Australian largest ADIs has a wholly-owned subsidiary and two of the four also have substantial branches there.<sup>44</sup> Other cross-border operations of Australian ADIs are more limited, and, in the aggregate, account for approximately 7 percent of banking sector assets. Australian operations of foreign banks (mainly in the form of branches) account for around 12 percent of domestic banking sector assets.

**67. The high interdependence with New Zealand led to the formation of the Trans-Tasman Council on Banking Supervision (TTBC) in 2005.** The TTBC was set up with the goal of enhancing information sharing, promoting a coordinated response to financial crises, and guiding policy advice to the two governments in relation to banking supervision. The TTBC, which is chaired by the respective country Treasuries, recommended legislative changes to lay the foundation for enhanced cooperation between APRA and the Reserve Bank of New Zealand (RBNZ).<sup>45</sup> As such, reciprocal legislation was passed in Australia and New Zealand in 2005-2006, requiring supervisors in each country, when taking regulatory action, to seek to avoid disruption to the financial stability of the other country. Furthermore, a Memorandum of Cooperation (MOC) on the management of trans-Tasman bank distress was signed in 2010 by the TTBC agencies. The MOC sets out, inter alia, high-level objectives and principles of trans-Tasman bank resolution and burden sharing issues. The MOC underlines that the Australian participants will have responsibility for the design and implementation of capital support for the parent bank and the New Zealand participants will have responsibility for the design and implementation of capital support for the New Zealand subsidiary, but are less clear on details (e.g., would New Zealand inject capital on the group level (SPE) or to its subsidiary (MPE)).

<sup>44</sup> The New Zealand banking supervisor requires that foreign banks conduct major retail operations through a separately licensed and capitalized subsidiary. Some minor (wholesale) activities are conducted through New Zealand branches of the Australian parent bank.

<sup>45</sup> The TTBC comprises representatives of the Australian and New Zealand Treasuries, the RBA, RBNZ and APRA. ASIC also participates in TTBC deliberations. In 2010, the TTBC agencies, along with ASIC, signed an MOC on the management of trans-Tasman bank distress.

**68. There is a need to develop more detailed approaches to cross-border resolution.** The resolution strategies for systemically important financial institutions that are being developed internationally are broadly based on two stylized approaches: (i) SPE (Single Point of Entry) resolution, in which resolution tools are applied to the ultimate holding company by a single national resolution authority, and (ii) MPE (Multiple Point of Entry) resolution, in which resolution tools are applied to different parts of the group by two or more resolution authorities acting in a coordinated way. Some major differences in the regulatory approach in resolution, followed in Australia and New Zealand, are worth noting in this context. Australia has formal deposit insurance and New Zealand has not. New Zealand has adopted open bank resolution, whereby a failed bank would be placed under statutory management and reopened the next business day (the policy embedded in Open Bank Resolution framework).<sup>46</sup>

**69. There is yet no consensus between the Australian and New Zealand authorities on the modalities of resolution strategies, as also pointed out in the New Zealand FSAP (2017).**<sup>47</sup> The Australian authorities have expressed preference for a SPE strategy, which is considered, in general, as a preferred option for D-SIBs.<sup>48</sup> The RBNZ, however, has focused on establishing the capacity for a stand-alone resolution of the subsidiary, using their form of bail-in. This approach, effectively an MPE, would separate the subsidiary from the parent bank, which involves risks both for the parent and the subsidiary.

**70. The TTBC agencies have developed high-level guidance on the management of trans-Tasman bank distress and both jurisdictions have undertaken considerable work on a single point of entry (SPE) resolution options.**<sup>49</sup> In 2017, the TTBC undertook a large-scale crisis simulation which focused on finding a joint resolution approach and aimed to test coordination and communication aspects of joint crisis management using the SPE resolution option. It was subsequently agreed that TTBC agencies would continue to consider the feasibility of alternative options in the future work program in order to have both preferred and fallback options.

**71. Steps should be taken to minimize the potential cost of resolution and contain instability in both countries.** Further discussions and simulation exercises are, however, warranted, including for idiosyncratic scenarios where shocks are hitting either New Zealand or Australian banks (as opposed to common shocks). Also, the TTBC should engage in bank specific resolution discussions as the Australian banks differ both in their exposure and inter-connectedness (sharing critical functions, etc.) regarding their New Zealand subsidiaries, possibly implying varying parent support and spill-over effects. The

<sup>46</sup> The RBNZ approach to bail-in would be to use it to absorb losses beyond those already borne by shareholders (i.e., the parent bank) and to facilitate a recapitalization of the New Zealand subsidiary (or to fund the capitalization of a bridge bank).

<sup>47</sup> See <https://www.imf.org/en/Publications/CR/Issues/2017/05/10/New-Zealand-Financial-Sector-Assessment-Program-Technical-Note-Contingency-Planning-and-44899>.

<sup>48</sup> For instance, a bail-in of debt in the subsidiary to fund capital in the parent to be channeled back to the subsidiary.

<sup>49</sup> An SPE resolution involves the application of resolution tools to a single legal entity within the group, generally the parent or financial holding company of the group (termed the 'resolution entity').



funding modalities, both public and private, should be also discussed. In broad terms, for instance, any funding provided from New Zealand via SPE to an Australian parent bank must be structured legally so that the funds are channeled via the parent back to the subsidiary in New Zealand.<sup>50</sup> In this context, the two countries should also closer coordinate their regulatory steps including foreign exposure and capital requirements.

**72. The arrangements for coordination on bank resolution and crisis management with other countries continue to warrant further development.** While cross-border crisis management issues are discussed in dedicated supervisory sessions, expanding the existing supervisory MOUs, focused on bank supervision, to explicitly cover resolution and crisis management, by setting out the process for information-sharing before and during a crisis as well as the progress on effective group-wide resolution plans and enhancing resolvability, is important. Particularly, the cross-border crisis management arrangements with some smaller jurisdictions continue to be less advanced. The national deposit preference rule,<sup>51</sup> applicable to ADIs under the Banking Act, as well as ring-fencing of foreign-owned uninsured bank branches, can increase the cost of bank failures. Such regimes, if deployed without effective cross-border cooperation, present obstacles to the orderly and fair resolution of international financial institutions and the FSB has called for them to be reformed.

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<sup>50</sup> In accordance with the FSB TLAC requirement, both the parent and subsidiary have to prepare to absorb losses, however, the cost for Australian ADIs' to issue LAC, internal and external, in the context of the OBR in New Zealand can be high.

<sup>51</sup> National depositor preference regimes exist where, in accordance with the law or regulation of the home country, the claims of depositors in the home country are preferred to the claims of branch depositors outside the home country if the firm becomes insolvent.



## Annex I. Status of Recommendations from the 2012 FSAP

| Recommendations                                                                                                                                                                                                                                                                                                                                                  | Status                                                                                                          |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------|
| Conduct broad, drastic crisis simulations on a periodic basis and targeted crisis simulations (e.g., including testing responses to a systemic liquidity shock or coordination between RBA and Treasury on unsecured lending backed by a government guarantee) frequently (e.g., full simulations every two years and more focused simulations more frequently). | Partly implemented (except for testing the ELA framework)                                                       |
| Legislative changes should be made to forestall premature disclosure of sensitive information as a result of “continuous disclosure” obligations.                                                                                                                                                                                                                | Implemented (in CMA)                                                                                            |
| Re-evaluate the merits of ex-ante funding for the FCS with a view toward converting it to an ex ante funded scheme.                                                                                                                                                                                                                                              | Not implemented. Discussed in 2014 FSI, authorities do not support this recommendation.                         |
| APRA should ensure that ADIs implement the SCV on, or where possible, ahead of schedule                                                                                                                                                                                                                                                                          | Implemented                                                                                                     |
| FCS should be automatically activated on APRA’s application to the court for the winding up.                                                                                                                                                                                                                                                                     | Partly implemented. Treasurer to declare the FCS once a statutory manager has taken control of the ADI          |
| Introduce competitive bidding for Purchase and Assumption (P&A) transactions or for paying agent bank.                                                                                                                                                                                                                                                           | Not implemented; planned                                                                                        |
| Require ADIs that are covered by the FCS to display the Government’s guaranteed deposits seal; Advertising or brochures for the FCS should be supplied by the appropriate Government agency.                                                                                                                                                                     | Not implemented. However, a FCS website has been set up                                                         |
| The Treasury must be prepared to have a unit established to own and control government-owned ADIs, whether bridge or nationalized.                                                                                                                                                                                                                               | Implemented                                                                                                     |
| Adopt additional tools that reinforce the view that the industry should bear the costs of bank failures (e.g., higher loss absorbency capital for systemic ADIs).                                                                                                                                                                                                | Partly implemented. D-SIB surcharge imposed                                                                     |
| Require systemic ADIs to prepare recovery plans; other ADIs to prepare contingency plans (i.e., truncated recovery plans); and APRA should prepare resolution plans for systemic ADIs.                                                                                                                                                                           | Partly implemented. Recovery planning process is advanced. Resolution planning has only recently been commenced |
| Take steps to enhance cross-border coordination arrangements with other jurisdictions.                                                                                                                                                                                                                                                                           | Partly implemented. Work still in progress                                                                      |
| Amend the priority of payments for the distribution of proceeds in a winding-up so as to not discriminate against creditors on the basis of the location of their claim or jurisdiction where it is payable.                                                                                                                                                     | Not implemented                                                                                                 |
| Broaden powers to resolve or facilitate a coordinated resolution of a domestic branch of a foreign bank by extending the framework for compulsory business transfers, statutory management and winding up to such operations.                                                                                                                                    | Implemented (in CMA)                                                                                            |
| Legislation should provide for transparent and expedited processes for the recognition and enforcement of out-of-court resolution decisions taken by foreign authorities.                                                                                                                                                                                        | Not implemented                                                                                                 |