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10 July 2020

Committee Secretary
Senate Standing Committee on Economics
Department of the Senate
PO Box 6100
Parliament House
CANBERRA ACT 2600
AUSTRALIA

Dear Committee Secretary,

Re: *Banking Amendment (Deposits) Bill 2020*

I am writing to express my strong support to the *Banking Amendment (Deposits) Bill 2020* and would advocate that the Parliament of Australia pass the proposed legislation.

About Adams Economics and John Adams

Adams Economics is a private and independent economic research and consulting business. As the founder and Principal Economic Analyst, I have prepared and lodged this submission independent of any external commercial or political relationships/associations and affiliations. This submission reflects my own research and private views regarding the proposed legislation by Senator Malcolm Roberts.

For the record, I am not currently a member or associate of any political party or political organisation.

The purpose of *Banking Amendment (Deposits) Bill 2020*

As noted in the second reading speech by Senator Roberts, the purpose of the *Banking Amendment (Deposits) Bill 2020* is to clarify the *Banking Act 1959* to ensure that the concept of bail-in (which is referred to in *Banking Act 1959* as 'conversion' and 'write-off') does not apply to Australian retail bank deposit accounts and that Australian customers can be assured that the events which occurred at the Bank of Cyprus in 2013 cannot occur in Australia.

The proposed legislation seeks to address significant community concerns regarding the legal status of their deposit funds within their bank account(s) and the legal risk of their bank account being bailed-in given:

- the bail-in of retail bank deposits which occurred with the Bank of Cyprus in Cyprus in 2013;
- the history of bail-in of retail bank deposits in Australia during the 19th century (see below);
- the Australian Government's post-2008 Global Financial Crisis (GFC) commitment to implementing a global bail-in framework as part of the work of the Financial Stability Board (FSB) under the mandate of the G20;
- the ambiguity of the conversion and write-off provisions introduced into the *Banking Act 1959* via the *Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Act 2018*;

- a legal loophole identified by John Adams of Adams Economics (i.e. myself) and Martin North of Digital Finance Analytics (DFA) and confirmed by independent solicitor Robert H. Butler (see below);

- the adoption of bail-in as a policy tool by numerous countries and jurisdictions including United States, United Kingdom, European Union, Canada, Hong Kong, and New Zealand; and

- the transparency of international bail-in policy frameworks which do place retail bank deposits accounts at risk of being bailed-in such as the policy of 'Open Bank Resolution' in New Zealand[1].

Importantly, this submission acknowledges that some of the concerns listed above were examined by the Senate Economics Legislation Committee during its 2017 inquiry examining the *Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Bill 2017.*

In advocating for the *Banking Amendment (Deposits) Bill 2020*, the purpose of this submission is not to re-litigate to issues examined in 2020, but to present new evidence which was not examined by the Senate Economics Legislation Committee or the Federal Parliament in either 2017 or 2018. The thrust of this submission is that the new evidence presented in this submission provides the Federal Parliament a compelling rationale to enacted the proposed legislation.

What is meant by bail-in?

The process of bail-in is when in a financial institution (i.e. an Authorised Deposit-taking Institution (ADI)) that is in financial difficulty recapitalises through the process of converting the institution's liabilities into owner's equity. Recapitalisation can occur either within the existing entity structure of a financial institution (i.e. the same body corporate) or through the establishment of a new entity structure (i.e. the establishment of a new body corporate).

Examples of liabilities which could be converted are:

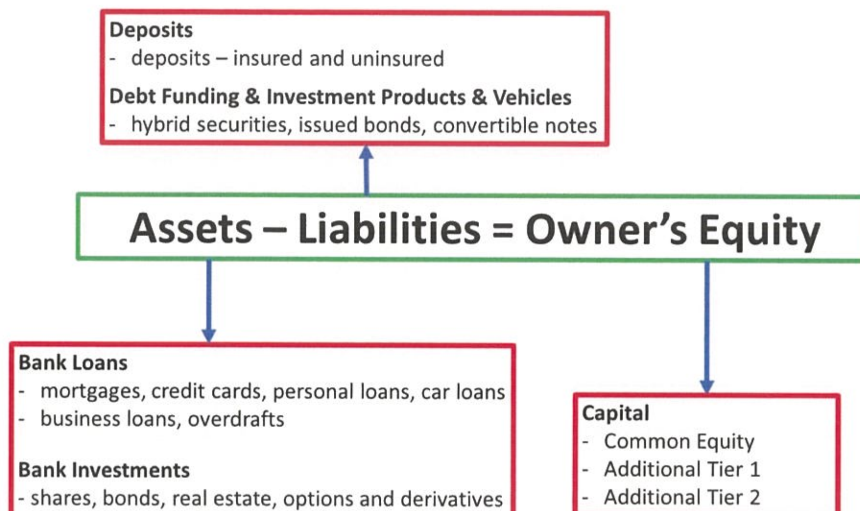
- hybrid securities such as convertible bonds, preference shares and bonds;
- secured or unsecured institutional deposits; and
- secured or unsecured retail deposits.

Historically, ADIs around the world have implemented a bail-in when they are either insolvent or on the verge of being insolvent and have not been able to secure an external injection of funds (i.e. a bail-out) either from the private sector, the government or relevant central bank.

The breakdown of an ADI's balance sheet between its assets, liabilities and owner's equity is illustrated in Diagram 1.

[1] https://www.rbnz.govt.nz/regulation-and-supervision/banks/open-bank-resolution

Diagram 1: The Bank Balance Sheet



The 2013 Bail-in of retail deposits at the Bank of Cyprus

The process of bail-in has become a topic of significant public concern both in Australia and across world, not only in the wake of the 2008 GFC and the collapse of Lehman Brothers, but more importantly in terms of the bail-in which was implemented at the Bank of Cyprus in June-July 2013 resulting from the Greek sovereign debt crisis of 2012-2013.

During 2010-2011, Cypriot banks accumulated vast quantities of high-yielding Greek bonds which became financially disastrous when the Greek Government imposed a significant haircut (in excess of 50%)[2] on bond holders as a result of a bail-out package received from the troika (the European Central Bank, the European Commission and the International Monetary Fund) in October 2011.

This, at the same time the Government of Cyprus experienced significant financial difficulties resulting from credit downgrades by Moody's and Fitch, led to the Cypriot government announcing a revenue raising bank levy in March 2013 that led to a run on Cypriot banks and a full-blown financial and banking crisis.

The resolution to the Cypriot banking crisis was the collapse of Laiki Bank and the rescue of the Bank of Cyprus which was engineered via:

- an extended banking holiday;
- a suspension of share trading in Cypriot banks on the Cyprus Stock Exchange;
- the imposition of capital controls – limiting withdraws from banks (including from Automated Teller Machines);
- transferring all high-quality assets and insured deposits from Laiki Bank to the Bank of Cyprus;
- the injection of 11.4 billion euros in emergency liquidity assistance from the European Central Bank in April 2013;

[2] http://www.passionforliberty.com/2013/05/04/the-cyprus-bail-in-part-one-timeline/

- initiating a bail-in of uninsured bank deposits at the Bank of Cyprus where 47.5 per cent of deposits above 100,000 euros were forcibly converted into bank equity (or shares) as part of a recapitalisation process[3]; and
- an additional capital raising of 1 billion euros in early 2014.

These steps were successful in stabilising the Cypriot financial system and economy, however the decision to initiate a bail-in of uninsured depositors resulted in far-reaching implications for both Bank of Cyprus depositors and shareholders. These implications included:

- impacted depositors, who were forced to take ownership in the Bank of Cyprus, were not able to liquidate their shares and retrieve cash until December 2014 (i.e. approximately 18 months later) when Bank of Cyprus shares resumed trading on the Cyprus Stock Exchange;
- Bank of Cyprus shareholders experiencing a 25 per cent crash in the value of their shares on the first day of resumed trading from 24 euro cents to 18 euro cents on 15 December 2014[4];
- the Bank of Cyprus experiencing ongoing operational issues including further loan impairments[5][6] which resulted in additional share issuances[7] that diluted the capital growth in the bank's share price;
- a suspension of trading of Bank of Cyprus shares from the Cyprus Stock Exchange on 10 January 2017[8] which were then relisted on both the Cyprus Stock Exchange and the London Stock Exchange on 20 January 2020 at a share price of 3.35 Euros; and
- a collapse in the Bank of Cyprus share price by 82.4% from 3.35 euros on 20 January 2017 to 0.59 euros on 9 July 2020.

Beyond these direct implications for the depositors and shareholders of the Bank of Cyprus, it is important to note that the decision to bail-in retail bank deposits at the Bank of Cyprus has set an international precedent which has undermined confidence in the banking system across the world (including Australia) as depositors worldwide have become concerned as to the safety of their bank deposits, especially in light of globally coordinated action by the FSB and the G20 which will be discussed below.

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[3] https://www.bankofcyprus.com/en-GB/Start/News_Archive/Recapitalisation-through-Bail-in-and-Resolution-Exit-Bank-of-Cyprus-Announcement/

[4] https://www.marketscreener.com/BANK-OF-CYPRUS-PUBLIC-COM-6494482/news/Bank-of-Cyprus-Public-loses-25-percent-of-value-in-debut-after-bailout-trauma-19550656/

[5] https://www.bankofcyprus.com/globalassets/investor-relations/press-releases/eng/20150206fy2014updateannouncementeng.pdf

[6] https://www.bankofcyprus.com/globalassets/investor-relations/press-releases/eng/20160202premfy2015updateannouncementeng_final.pdf

[7] https://www.bankofcyprus.com/globalassets/investor-relations/press-releases/eng/20150113retailoffercompletioneng.pdf

[8] https://www.bankofcyprus.com/globalassets/investor-relations/press-releases/eng/20170104-suspension-of-trading_en_final.pdf

The history of bail-in in Australia

In the context of Australian banking, some observers and commentators have dismissed the relevance of the events at the Bank of Cyprus to risks which may be faced by Australian retail depositors.

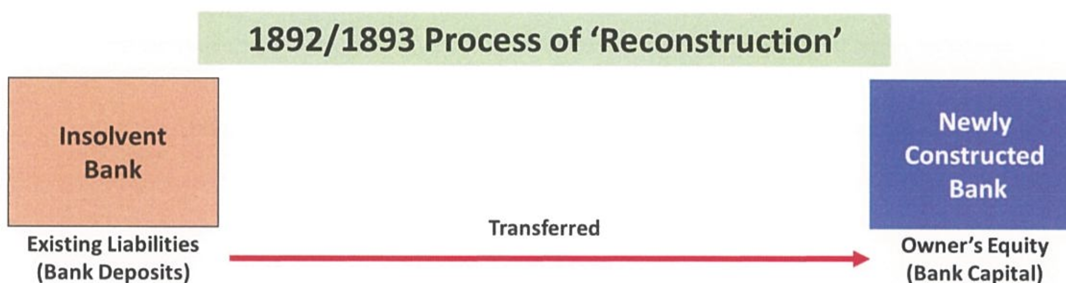
Given these observations, it is important to note that the act of bailing-in retail bank deposits is not a foreign concept to Australian banking. Rather, the bail-in of retail deposits (i.e. the conversion of bank liabilities into owner's equity) has already occurred in Australia during the economic depression of the 1890s which commenced in Melbourne in 1892.

This economic depression, which resulted from a collapse of a land boom bubble, led to multiple Australian banks and building societies, especially in Melbourne, becoming insolvent in both 1892 and 1893 and initiating a bail-in of retail bank deposits under a process called 'reconstruction'.

Under reconstruction, commercial banks which were financially insolvent would set up a new bank under a new body corporate structure and convert the deposits from the insolvent bank (i.e. its liabilities) into equity of the newly constructed bank (i.e. the depositors of the existing bank would become owners in the new bank).

The process of reconstruction is illustrated in Diagram 2

Diagram 2: The Process of 'Reconstruction'



Moreover, the process of bank 'reconstruction' has been well documented through various governmental and academic works examining the history of the 1890s depression. For example, according to the Reserve Bank of Australia[9] (emphasis added) bail-in during 1892 and 1893 occurred through the conversion of deposits into preference shares:

> *"The details of reconstruction schemes varied across banks, but all followed the same broad pattern. Shareholders were called on to invest fresh capital in the reconstructed bank and were released from liability for calls on unpaid capital from the old bank. The major part of depositors' claims were extended for long periods, generally for a minimum of four years, before any withdrawals could be made,* ***and in some cases these claims were converted into preference shares."***

From an industry-wide estimate, the scale of the reconstruction (or bail-in) was approximately 14% of total deposits as noted by Dr Chris Berg[10] in his PhD thesis:

> *"Almost every bank that had suspended in the first half of 1893 had reconstructed and reopened by mid-August that year. However, the consequences of reconstruction were severe. Of the £65 million of deposits held in banks which ultimately reopened, £9 million was converted into preference shares or*

[9] See the Reserve Bank of Australia's 2001 publication: *"the 1890s Depression"*, *https://www.rba.gov.au/publications/rdp/2001/2001-07/1890s-depression.html*

[10] Dr Chris Berg is a Senior Research Fellow for the School of Economics, Finance and Marketing at RMIT University.

interminable deposits. £42 million had been repaid by 1901, but the last repayment to depositors was made as late as 1918 (Royal Commission into Monetary and Banking Systems 1937)."

Specific Australian Bail-in Case Study

Journalist and historian Michael Cannon[11] has pinpointed a specific case study of an Australian bank being subject to bail-in of depositor funds, that being the Melbourne-based Australian Deposit and Mortgage Bank which was headed by well-known leading figure (and member of the Victorian Parliament) James Balfour MLC.

In this case study in March 1892, the Australian Deposit and Mortgage Bank experienced such significant financial difficulty as the economic depression widened that:

- it suspended payments to depositors (i.e. they imposed capital controls); and
- a bank reconstruction was proposed whereby depositors would receive 5 per cent preference shares (i.e. shareholders would be first in line to receive a 5 per cent dividend) in a reconstructed company called the Australian Mortgage and Deposit Bank.

This episode of reconstruction was reported on in glowing terms in the Melbourne publication, Tabletalk, which reported on 25 March 1892[12]:

> *"The advantage of the scheme to shareholders was manifest, for it prevents the necessity of sharp and heavy calls. Depositors will get interest which they will not if they elect to be dealt with by the liquidator, and they are not likely to get back their principal any more quickly than by taking fully paid up shares, negotiable soon in the open market. The scheme is certainly the most equitable for depositors of any company recently suspending payment."*

By June 1892, a Victorian court ordered that the reconstruction occur, although the proposed 5 per cent preference shares were reduced to only 2 per cent. However, Australian Mortgage and Deposit Bank ultimately failed as a commercially viable bank and was forced into liquidation.

Australia's commitment to a global bail-in framework

Having explained:

- what is bail-in,
- how bail-in of retail bank deposits occurred in the modern era; and
- how bail-in of retail bank deposits has already occurred in Australia history

we now seek to explain how the Australian Government has committed Australia to a global banking framework which encompasses bail-in (including of retail bank deposits) as a legitimate macroprudential policy tool.

In the period after the 2008 GFC, the Australian Government as part of the G20 committed itself to a global policy framework established by the FSB that seeks to address the problem of too-big-to-fail banks and the potential losses which taxpayers within an individual jurisdiction may be subject to if one or multiple banks were to go bust.

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[11] A detailed account of the Australian Deposit and Mortgage Bank can be found in Cannon, M., (1972), *"Land Boom and Bust"*, Heritage Publications, Melbourne, Australia.

[12] https://trove.nla.gov.au/newspaper/article/13846519

For example, at the 2010 G20 Seoul Meeting, the Australian Government committed Australia to the Summit Document[13], which included paragraph 30:

> *"We reaffirmed our view that no firm should be too big or too complicated to fail and that taxpayers should not bear the costs of resolution. We endorsed the policy framework, work processes, and timelines proposed by the FSB to reduce the moral hazard risks posed by systemically important financial institutions (SIFIs) and address the too-big-to-fail problem. This requires a multi-pronged framework combining: a resolution framework and other measures to ensure that all financial institutions can be resolved safely, quickly and without destabilizing the financial system and exposing the taxpayers to the risk of loss."*

Resulting from this commitment, the FSB issued its resolution prescription, *'Key Attributes of Effective Resolution Regimes for Financial Institutions'* (Key Attributes), and adopted the Key Attributes at its Plenary meeting in October 2011. The G20 Heads of States and Government subsequently endorsed the 'Key Attributes' at the Cannes Summit in November 2011 as *"a new international standards [sic] for resolution regimes"*[14].

Importantly, in the context of bail-in, clause 3.5(2) of the Key Attributes[15] states (emphasis added):

> *"Powers to carry out bail-in within resolution should enable resolution authorities to convert into equity or other instruments of ownership of the firm under resolution (or any successor in resolution or the parent company within the same jurisdiction), all or parts of **unsecured and uninsured creditor claims** in a manner that respects the hierarchy of claims in liquidation."*

Moreover, a further agreement and commitment to a global bail-in framework developed by the FSB was entered into by the Australian Government at the 2014 G20 meeting in Brisbane, Australia. For example, Australia as a member of the G20 agreed to paragraph 12 of the Leaders' Communique[16] which stated:

> *"We welcome the Financial Stability Board (FSB) proposal as set out in the Annex requiring global systemically important banks to hold additional loss absorbing capacity that would further protect taxpayers if these banks fail."*

The FSB's proposal is spelt out in its 10 November 2014 consultative document: *Adequacy of loss-absorbing capacity of global systematically important banks in resolution*[17], which states (emphasis added):

> *"The Key Attributes describe the powers and tools that authorities should have to achieve this objective. **These include the bail-in power, i.e., the power to write down and convert into equity all or parts of the firm's unsecured and uninsured liabilities of the firm under resolution or any successor in a manner that respects the creditor hierarchy and to the extent necessary to absorb the losses.** Hence, the resolution strategies that are being developed for G-SIBs provide for a recapitalisation by a way of a bail-in (with or without use of a bridge institution) to support the orderly resolution or wind-down of a G-SIB in a manner that maintains at a minimum continuity of critical functions."*

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[13] https://www.fsb.org/wp-content/uploads/g20_leaders_declaration_seoul_summit_2010.pdf

[14] https://www.fsb.org/work-of-the-fsb/policy-development/effective-resolution-regimes-and-policies/key-attributes-of-effective-resolution-regimes-for-financial-institutions/#footnote-1

[15] https://www.fsb.org/wp-content/uploads/r_141015.pdf

[16] https://www.consilium.europa.eu/media/23866/g20-leaders-communiqué-brisbane-summit-15-16-november-2014.pdf

[17] http://www.g20.utoronto.ca/2014/adequacy_loss-absorbing_capacty_global_systemically_important_banks.pdf

The International Implementation of the Global Bail-in Framework

Prior to exploring Australia's implementation of the FSB framework, it is important to note that the FSB's global Key Attributes framework has been adopted and implemented by several countries and regions around the world.

These jurisdictions such as the United States, United Kingdom, European Union, Canada, Hong Kong, and New Zealand have adopted powers which would allow national prudential regulators to initiate the bail-in of retail bank deposits similar to what occurred with the Bank of Cyprus in 2013.

The country with the most transparent national bail-in regime which provides for the bail-in of retail bank deposits, officially called Open Bank Resolution (OBR) is New Zealand. As noted by the Reserve Bank of New Zealand[18], under OBR (emphasis added):

> *"If a bank fails, it is placed under statutory management and closed. An assessment is made of the bank's liabilities.* ***If losses cannot be covered by shareholders and the bank's available capital, then in addition a proportion of depositors' funds are set aside and frozen for the purpose****. The bank re-opens next morning. Depositors can then access most of the money in their transaction and on-call savings accounts and conduct their normal business. How much of their funds depositors can access will be determined by an assessment of the bank's losses, and the amount, known as a de minimis, which is intended to enable depositors to conduct their daily transactions."*

The Australian implementation of the FSB global framework

Having committed itself to a global bail-in framework, the Australian Government then moved its attention towards implementing this framework through domestic legislation.

This was achieved in 2018 by the Turnbull Government when the Federal Parliament enacted the *Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Act 2018* (Crisis Resolution Act), which amended the *Banking Act 1959* by providing for the 'conversion and write-off' (alternative terminology to the word 'bail-in') of financial or capital instruments during extreme financial situations.

Under Section 11CAA of the *Banking Act 1959*, financial or capital instruments which are subject to 'conversion or write-off' include:

- Additional Tier 1 and Tier 2 capital; or
- Any other instrument.

Moreover, Section 11CAA of the *Banking Act 1959* defines conversion as:

> *"an instrument converts into one or more ordinary shares or mutual equity interests of an entity including by redeeming or cancelling the instrument or rights under the instrument, and replacing the instrument or rights with ordinary shares or mutual equity interests (as the case requires)."*

This definition encompasses the principle of bail-in (i.e. the conversion of bank liabilities to bank owner's equity).

[18] https://www.rbnz.govt.nz/-/media/ReserveBank/Files/regulation-and-supervision/banks/policy/OBR%20Made%20Simple%20WEB.pdf?la=en&revision=339f2903-b98e-4b6f-888f-33389d2adda9

How does bail-in work in the Australian context?

According to subsection 11CAB(1) of the *Banking Act 1959*, the application of conversion or write-off provisions can only occur where the financial or capital instrument:

> *'contains terms that are for the purposes of the conversion and write-off provisions'.*

This means that the legal documents associated with the financial or capital instrument must explicitly state that the financial or capital instrument is at risk of being converted or written-off under particular circumstances.

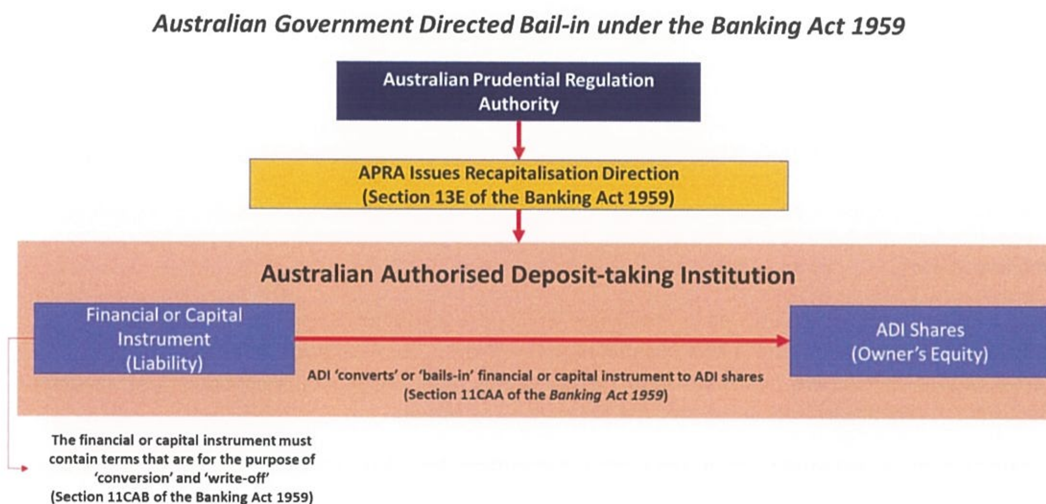
The conversion and write-off can be instigated at the discretion of the ADI (similar to the 1892/1893 process of 'reconstruction') or at the discretion of APRA as the prudential regulator via a 'recapitalisation direction' (similar to the 2013 bail-in initiated at the Bank of Cyprus).

Section 13E of the *Banking Act 1959* gives APRA the power to issue a 'recapitalisation direction' that requires an ADI to increase their level of capital if the financial institution experiences financial difficulty or if APRA believes, without the provision of external support, the ADI will not be able to:

- meet its financial obligations; or
- meet the interests of depositors; or
- carry on its business operation consistently with the stability of the Australian financial system.

The process of how an APRA directed bail-in occurs is detailed below in Diagram 3.

Diagram 3: The Process of how a government directed bail-in occurs



What types or forms of 'Instruments' can be converted or written off under the *Banking Act 1959*?

During the Senate Economics Legislation Committee 2017 inquiry into the *Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Bill 2017* and its subsequent passage through the Federal Parliament, considerable debate occurred as to what financial or capital instruments would be subject to the conversion and write-off powers during an Australian financial crisis.

General consensus among rival stakeholders was that during a financial crisis, if a bail-in is required to be executed to save one or multiple Australian ADIs, the first line of defence would be 'hybrid securities' which includes convertibles, preference shares and capital notes.

'Hybrid securities' according to the Australian Stock Exchange are (emphasis added):

> *"a generic term used to describe a security that combines elements of debt securities and equity securities. Hybrid securities typically promise to pay a rate of return (fixed or floating) until a certain date, in the same way debt securities do. However, they also have equity-like features that can mean they may provide a higher rate of return than regular debt securities. This is due to the higher inherent risk of these equity-like features. These features may include reduced certainty as to the timing and amount of income generated from holding the security,* ***the potential for the security to be converted into equity*** *or early terminated at a time not beneficial to the holder, and the holder being subordinate to other creditors in the event of insolvency."*[19]

However, beyond hybrid securities, an intense dispute occurred as to whether retail bank deposits (either insured or uninsured) would be subject to a bail-in process under the 'conversion' and 'write-off' powers of the *Banking Act 1959,* especially given that:

- Australia endorsed the FSB's Key Attributes framework (as noted above);
- clause 3.5 of the FSB's Key Attributes states that bail-in powers should include the power to convert unsecured and uninsured creditor claims into equity;
- the bail-in of retail bank deposits at the Bank of Cyprus in 2013 established a modern-day precedent; and
- other developed countries such as New Zealand have adopted very transparent bail-in regimes which do include the ability to bail-in retail bank deposits.

There are two key points to make about these concerns.

Firstly, as expressed on several Coalition MPs and Senators through correspondence with their constituents, it is not the intent of Federal Government policy for retail bank deposits (whether insured or uninsured) to be at risk of a conversion or write-off (i.e. bail-in) process. One example of such correspondence is a letter sent from the Member for Wide Bay, Mr Llew O'Brien MP to a constituent on 28 November 2018 (see at Attachment A).

Importantly, this stated position by Federal Coalition MPs is inconsistent with the FSB's global Key Attributes framework to which the Australian Government has agreed to in multiple international forums (as documented above).

Secondly, such concerns were dismissed by the Senate Economics Legislation Committee as noted in their committee report into the *Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Bill 2017 [Provisions]* on the basis that the clause 'any other instrument' in section 11CAA needed to be interpreted in conjunction with subsection 11CAB(1) as noted above.

The Senate Economics Legislation Committee's rebuttal regarding the risk of retail bank deposits being subject to bail in was noted in paragraphs 2.34, 2.37 and 2.39 of its inquiry report as follows:

- Paragraph 2.34 – *"In this instance, the term 'any other instrument' has been interpreted by the CEC as being open ended. However, as noted previously, any instrument that can be converted or written off must specifically indicate this in their terms at the time of sale."*
- Paragraph 2.37 – *"Treasury confirmed that because deposits are not classified as capital instruments, and do not include terms that allow for their conversion or write-off, they cannot be 'bailed-in'"*

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[19] https://www.asx.com.au/products/hybrid-securities.htm

- Paragraph 2.39 – *"The reforms in this bill ensure that contractual write-off or conversion provisions in relevant instruments operate in accordance with their terms."*

Importantly, this submission agrees that section 11CAA and subsection 11CAB(1) of the Banking Act 1959 need to be read in conjunction (i.e. section 11CAA cannot be read in pure isolation), however this submission asserts the inquiry report makes several misstatements regarding the law which are critical to point out. These misstatements include:

- Section 11CAB (or any other section relating to conversion and write-off) within the *Banking Act 1959* makes no reference to *'terms at the time of sale'*. This is important because terms that a financial or capital instrument is subject to conversion and write-off can be inserted at a subsequent point in time after a customer or investor takes possession of the instrument.

- Section 11CAA, under the definition of conversion and write-off, makes no reference to 'capital instruments', but makes a reference to 'any other instrument'. This is important because the phrase 'any other instrument' is open to subjective interpretation.

On this latter point, it is important to note that the Bills Digest published by the Parliamentary Library on 14 February 2018 examining the *Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Bill 2017* states (emphasis added):

> *"Item 31 of Schedule 1 to the Bill inserts proposed Subdivision B—Conversion and write-off provisions into Division 1A of Part II of the Banking Act which is to apply to certain **financial instruments**."*[20]

This reference to financial instruments is materially significant given that financial instrument as defined by International Accounting Standard 32 (IAS 32) includes deposits. Specifically, clause 32.11 within IAS 32 defines a financial instrument as:

> *"A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity."*

Moreover, the accounting standard defines cash held as a deposit within a financial institution to be a financial asset.

Identified Legal Loophole

Having established how the *Banking Act 1959* facilitates a bail-in process from a technical legal perspective and explored the policy intent, concerns and rebuttals relating to retail bank deposits, this submission now discusses a legal loophole that allows the bail-in of retail bank deposits to occur and which was not explored by the Senate Economics Legislation Committee during its 2017 inquiry.

This legal loophole was identified in October 2018 by John Adams of Adams Economics and Martin North from Digital Finance Analytics which was subsequently supported by the legal opinion of Sydney solicitor Robert Butler upon conducting his own independent legal investigation and analysis (see this analysis at Attachment B).

The legal loophole identified by Adams and North is spelt out as follows:

- the commercial relationship between an ADI and a retail depositor is legally stipulated in the deposit account's terms and conditions (T&Cs);

[20] https://parlinfo.aph.gov.au/parlInfo/download/legislation/billsdgs/5790515/upload_binary/5790515.pdf

- for retail bank deposit accounts (as a financial instrument) to be compliant with subsection 11CAB(1) of the *Banking Act 1959*, the deposit account's T&Cs must contain terms which stipulate that the bank account (as a financial product) can be either converted or written off;

- at present, no conversion or write-off clauses can be identified in the T&Cs of retail bank account products of major Australian ADIs;

- however, almost universally across the Australian banking industry, retail bank deposit account T&Cs include clauses which provides ADIs a high degree of flexibility to instigate and include unfavourable amendments without any sufficient forewarning to retail depositors – especially in situations where the ADI is at risk of a credit loss or when being directed by the Australian Government (such examples are displayed at Attachment C);

- during a severe financial crisis, an ADI, either of its own volition or at the direction of APRA can amend its retail deposit account T&Cs to include conversion or write off clauses that can be utilised either by the ADI or by APRA via a recapitalisation direction to facilitate a bail-in process.

On this last point, it is important to note that the power for APRA to direct an ADI amend its deposit account T&Cs ahead of initiating a bail-in of its retail bank deposits is contained in paragraph 11CA(2)(p) of the *Banking Act 1959*, the so-called 'catch-all' directions power, which states:

> *"The kinds of direction that the body corporate may be given are directions to do, or to cause a body corporate that is its subsidiary to do, any one or more of the following:*
>
> *(p) to make changes to the body corporate's systems, business practices or operations."*

As noted in paragraph 3.36 to the Explanatory Memorandum to the *Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Bill 2017*, one of the purposes of the 'catch-all' directions power is to provide APRA the power to overcome, ahead of time, any legal obstacles that would prevent a bail-in (among other resolution options) from occurring. Specifically, paragraph 3.36 states:

> *"In order to provide an appropriate legislative basis for the resolution planning process, it is necessary for APRA to have a clear power to make prudential standards on resolution (see 10.17) and the power to enforce these prudential standards or otherwise require actions to facilitate resolution, through directions where necessary. As such, the Bill clarifies that APRA's directions powers allow it to require a regulated entity to implement appropriate pre-positioning measures to address obstacles to resolution."*

Separately, Attachment C displays the T&Cs from nine major Australian ADIs where ADI depositors accept the ability of the ADI to make unfavourable changes to the T&CS at little to no advance notice. Attachment C also includes the T&Cs from HSBC Australia which provides HSBC Australia legal immunity if a customer were to experience capital controls (see paragraph 10.7(c) – the loss of the use of your savings) or bail-in (see paragraph 10.7(d) – the loss of anticipated savings).

Consultation conducted by John Adams of Adams Economics with the advisors of particular Australian Senators determined that the loophole outlined above was not identified or assessed during either the Senate inquiry into the *Financial Sector Legislation Amendments (Crisis Resolution Powers and Other Measures) Bill 2017* or the subsequent parliamentary debate.

Therefore, Adams and North, supported by the legal analysis of Robert Butler, have identified legitimate legal risk that a bail-in of retail deposit bank accounts could conceivably occur in Australia, contrary to the assurances of the Australian Government, the Commonwealth Treasury and APRA.

This submission makes no suggestion that the identified loophole is either intentional or deliberate, merely that it does exist.

Implications of Section 761A of the Corporations Act 2001

In discussing the legal loophole identified above, there is a legitimate question as to how the definition of a 'basic deposit product' under section 761A of the *Corporations Act 2001* (this section is displayed at Attachment D) impacts the ability of Australian ADIs to amend their T&Cs that would facilitate the implementation of a bail-in process as outlined above.

The Bills Digest published in February 2018 by the Parliamentary Library examining the *Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Bill 2017*[21] argues that retail bank deposits held by ADIs are not at risk of conversion or write-off due resulting from the passage of the Crisis Resolution Act for a number of reasons including the following:

> *"a basic deposit product, as defined under section 761A of the Corporations Act 2001, must meet certain conditions. These include limitations on the circumstances under which the balance of a deposit account can be reduced. These circumstances do not include conversion or write-off."*

Under the definition of a 'basic deposit product' defined in section 761A, ADIs are permitted to include certain clauses within their basic deposit product T&Cs which would result in the reduction of the account balance in only a limited number of circumstances. Currently, conversion and write-off are not one of the circumstances permitted under the definition.

However, it is important to note that the stated proposition of the Bill Digest is not universally accepted among the legal fraternity and that there are several elements which raise ambiguity as to whether the current definition of a 'basic deposit product' places a sufficiently robust limitation on an ADI to insert conversion and write-off provisions within their retail deposit account T&Cs. These elements include:

- whether the definition of 'basic deposit product' under section 761A is at all relevant to the issue of conversion and write-off given that the purpose of this definition is for reasons wholly disconnected to the effective resolution of financial difficulties relating to individual ADIs;

- it is unclear whether all forms of retail bank deposit accounts in Australia fall under the definition of 'basic deposit product' as defined by section 761A;

- it is unclear whether APRA's power to issue a direction under paragraph 11CA(2)(p) of the *Banking Act 1959* could override the limitations of section 761A, which if permissible, would let APRA legally order ADIs to insert bail-in provisions into their deposit account T&Cs;

- it is unclear as to whether the conversion of a retail bank deposit into share equity could be construed as a payment (for share equity) directed by Commonwealth law which is allowable under paragraph (a)(iii) of the 'basic deposit product' definition; and

- paragraph (a)(vii) of the 'basic deposit product' definition allows the Australian Government via the relevant minister (i.e. Federal Treasurer) to issue a legislative instrument which would allow ADIs to insert new circumstances, such as conversion and write-off, whereby the balance of a 'basic deposit product' is permitted to be reduced.

The last point is perhaps the most persuasive. To those who would agree with the Bills Digest that section 761A, as currently stated, places a limitation on ADIs to insert conversion and write-off clauses into their deposit account T&Cs, paragraph (a)(vii), in the middle of a financial crisis, can be used by the Federal Treasurer to provide ADIs with the ability to insert requisite bail-in clauses into their deposit account T&Cs without sufficient parliamentary scrutiny via a new legislative instrument. Such an instrument may be

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[21] https://parlinfo.aph.gov.au/parlInfo/download/legislation/billsdgs/5790515/upload_binary/5790515.pdf

formulated not to be disallowable by Parliament (i.e. a Henry VIII clause)[22] or may be utilised before Parliament has the opportunity to disallow the instrument.

The legal advice provided by solicitor Robert Butler (displayed at Attachment E) addresses why, according to his analysis, Section 761A of the *Corporations Act 2001* does not prevent ADIs operating in Australia from inserting bail-in provisions in their retail bank account T&Cs.

The effect of the Banking Amendment (Deposits) Bill 2020

Given that it is the stated policy of the Australian Government that retail bank deposits held at ADIs operating in Australia should not be at risk of conversion or write-off, this submission argues that amendments to the *Banking Act 1959* are warranted to close the identified loophole as stated above and to clarify Commonwealth law.

The *Banking Amendment (Deposits) Bill 2020,* if enacted by the Federal Parliament, would clarify the *Banking Act 1959* to legally make it crystal clear that retail bank deposits will not be subject to any conversion or write-off (i.e. bail-in) by the commercial banks or by order of:

- the Australian Government,
- the Council of Financial Regulators; or
- individual Commonwealth agencies such as APRA.

It will do so by establishing legal carve-outs for retail bank deposits in the definition of conversion and write-off under section 11CAA and subsection 11CAB(1) of the *Banking Act 1959*.

Moreover, the legislation would make it crystal clear that no Commonwealth agency (e.g. APRA) can instruct an ADI to amend its bank deposit account terms and conditions (i.e. by virtue of paragraph 11CA(2)(p) of the *Banking Act 1959*) to make them compliant with subsection 11CAB(1) of the *Banking Act 1959* – i.e. to transform their retail deposit accounts into a financial instruments which would be compliant with the requirements of conversion and write-off.

The passage of the *Banking Amendment (Deposits) Bill 2020* would legally confirm the intent of the Federal Government's stated public policy and would provide deposit holders at Australian ADIs additional legal comfort and certainty regarding the legal status of their deposits.

The Financial Claims Scheme does not protect against Bail-in Risk

Before concluding this submission, it is important to discuss the Financial Claims Scheme (FCS) given that the 2017 Senate Economics Legislation Committee inquiry report[23] suggests that the FCS protects Australian depositors. For example, paragraph 2.58 of the inquiry report states:

> *"The committee is satisfied that depositors are protected both by the FCS and under the Banking Act. Under the FCS, the Australian Government guarantees the prompt repayment of deposits at a failed Australian ADI of up to $250 000 per depositor. The Banking Act includes 'depositor-preference provisions' which give depositors priority over most other creditors in the winding up of an ADI or insurer, to the extent that depositors have not already been paid out by the FCS."*

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[22] Indeed, the current COVID-19 pandemic crisis has demonstrated how a health and economic crisis can be leveraged to make swift and dramatic changes to Commonwealth law.

[23] https://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/CrisisResolutionPowers/Report

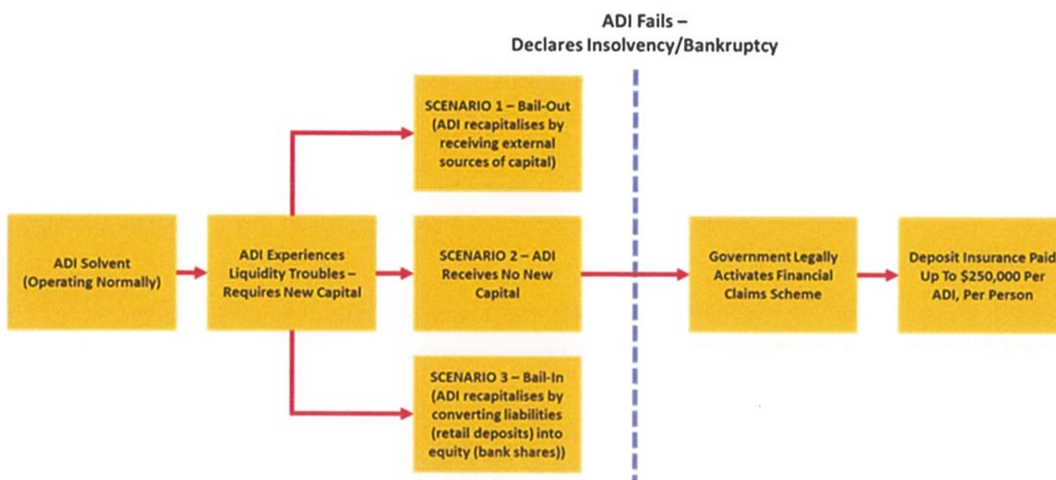
The FCS is a deposit insurance scheme which, according to the Australian Government, protects deposits of up to $AUD 250,000 per person per ADI. The FCS was created and launched by the Rudd Government in October 2008 in response to the GFC.

Importantly, despite the claims to the contrary, the FCS does not protect Australian depositors from the legal risk of bail-in (i.e. conversion or write-off). This is because the FCS can only be activated by the Australian Government in the event of an ADI declaring insolvency or bankruptcy (assuming the Australian Government has access to available funds) whereas the process of bail-in is designed to recapitalise an ADI prior to a declaration of insolvency or bankruptcy.

Thus, in effect, bail-in is a policy tool which allows the Australian Government to avoid paying deposit insurance payable under the FCS.

The distinction between the process of bail-in and the FCS is outlined in Diagram 4 below.

Diagram 4: The difference between bail-out, bail-in and the FCS



Legal vs Market and Institutional Risk

It is important to make the distinction between forms of risk which the inquiry may consider when assessing the proposed legislation. As it relates to the risk of bail-in occurring in Australia, there are three forms of risk which are worth noting. These forms of risk are:

- market risk - the risk that extreme market conditions may eventuate which leads to a financial crisis threatening the solvency of one or multiple ADIs operating in Australia;
- institutional risk - the risk that an individual ADI operating in Australia is at risk of insolvency which may in turn require that a bail-in of retail bank deposits occur; and
- legal risk - the risk that the bail-in of retail bank deposits at an ADI operating in Australia is legally permissible.

During the course of the inquiry, the Senate Economics Legislation Committee may be exposed to the argument that the proposed legislation is unnecessary given that the risk that an Australian ADI will ever require a bail-in is quite low (i.e. market and institutional risk is low).

It is important to note that this submission makes no explicit statement regarding market or institutional risk.

Rather this submission argues that the purpose of the *Banking Amendment (Deposits) Bill 2020* is to eliminate the legal risk which currently exists as shown above (or at the very least is perceived by some interested stakeholders).

Thus, irrespective of the market or institutional risk facing the Australian financial system and individual ADIs operating in Australia, passage of the *Banking Amendment (Deposits) Bill 2020* would deliver several public benefits including:

- better aligning the stated public policy of the Federal Government and Commonwealth law;
- enhancing legal and regulatory certainty; and
- boosting confidence in the Australian Banking system and in individual ADIs.

Failure to Secure Passage of the Banking Amendment (Deposits) Bill 2020

As a final point, it is important to discuss the potential consequences which would arise from the Federal Parliament not enacting the proposed legislation.

As a straight-forward and simple bill, it is important to note that passage of the proposed law does not generate any negative or detrimental public policy, legal or operational consequences for either the Australian Government or for ADIs operating in Australia.

Therefore, even if the Senate Economics Legislation Committee takes the view that the *Banking Amendment (Deposits) Bill 2020* is unnecessary to clarify the status and intent of Commonwealth law, little will be lost if the proposed legislation is enacted.

However, it is important to note that if the Federal Parliament fails to enact the proposed legislation, detrimental consequences are likely to result in the form of:

- some Australians raising questions as to the real underlying intent of Australian Government policy, especially in light of Australia's agreement to the FSB's Key Attributes framework as well as international bail-in regimes across the developed world such as New Zealand's OBR;

- undermining confidence in ADIs operating in Australia and in the Australian financial system more broadly, especially in the wake of the 2017-18 Hayne Royal Commission into Banking; and

- some Australians withdrawing their capital from ADIs operating in Australia given perceived legal uncertainties.

Conclusion

In conclusion:

- the process of 'bail-in' is where the liabilities of an ADI are converted into owner's equity. This process is typically utilised when the ADI is either insolvent or on the verge of becoming insolvent.

- a modern-day bail-in precedent was established when the bail-in of retail bank deposits occurred in 2013 at the Bank of Cyprus;

- Australia has its own history of bailing-in retail bank deposits, primarily in Melbourne during the economic depression of 1892 and 1893 under a process called 'reconstruction';

- in the aftermath of the 2008 GFC, the G20 via the FSB agreed to establish a policy framework which dealt with the 'too big to fail' problem and the financial liability that taxpayers would be exposed to in bailing out globally systemically important banks (G-SIBs) in a future financial crisis;

- the FSB's developed policy framework, the Key Attributes, seeks to improve loss absorbing capacity of G-SIBs and domestically systemically important banks through a range of policy tools including bail-in. Attribute 3.5 states that bail-in should include the bail-in of unsecured and uninsured creditor claims which includes retail bank deposits;

- the FSB's Key Attributes framework has been adopted by many developed countries and implemented through domestic legislation – including the ability to implement bail-in of retail bank deposits. The most transparent bail-in regime in the developed world which encompasses the possibility of bailing-in retail bank deposits is New Zealand which is officially called *'Open Bank Resolution'*;

- the Australian Government agreed to the development and implementation of the FSB policy framework at multiple G20 meetings including Seoul 2010 and Brisbane 2014. The Australian Government implemented the FSB's framework through securing the passage of the Crisis Resolution Act in the Federal Parliament in 2018;

- during the inquiry conducted by the Senate Economics Legislation Committee in 2017, the Australian Government and its agencies such as the Commonwealth Treasury and APRA stated that retail bank deposits, although unsecured creditors of ADIs operating in Australia, are not at legal risk from the process of bail-in given that ADI bank deposit accounts T&Cs did not have specific clauses which say these accounts could be bailed-in as required in subsection 11CAB(1);

- independent analysis by John Adams of Adams Economics and Martin North from DFA, supported by legal opinion from Sydney Solicitor Robert Butler confirms that Australian ADIs have sufficient legal wiggle room to incorporate unfavourable amendments into their T&Cs without having to give customers sufficient notice that would make them compliant with subsection 11CAB(1) of the *Banking Act 1959*. This could occur via a legal direction from APRA under paragraph 11CA(2)(p) of the *Banking Act 1959*;

- under such conditions, Australian retail bank deposits are at risk of bail-in (i.e. conversion or write-off) at the instigation of the prudential regulator APRA via a 'recapitalisation direction' issued under section 13E of the *Banking Act 1959*;

- this submission does not accept that section 761A of the *Corporations Act 2001* places sufficient limitations on the ability of ADIs operating in Australia to insert bail-in provisions into their deposit account T&Cs;

- this submission makes no comment about market risk or institutional risk when it relates to the probability of bail-in occurring in Australia;

- parliamentary passage of the *Banking Amendment (Deposits) Bill 2020* would eliminate the legal risk of bail-in of retail bank deposits occurring in Australia and would better align Federal Government banking policy to the stated law within the *Banking Act 1959*;

- the FCS does not provide Australian depositors any protection against bail-in risk; and

- there is no public policy, legal or operational downside resulting from passage of the *Banking Amendment (Deposits) Bill 2020,* however failure to pass the proposed legislation will undermine confidence in Australian banking.

I hope this submission assists the Senate inquiry in adequately assessing the *Banking Amendment (Deposits) Bill 2020* and the other associated policy issues.

Yours sincerely,

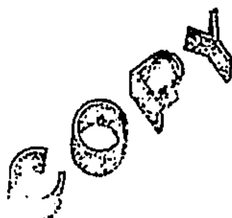
John Adams

LLEW O'BRIEN MP

Federal Member for Wide Bay

LO/RH

28 November 2018



Mr [redacted]
[redacted]
MARYBOROUGH Q 4650

Dear Mr [redacted]

I refer to your recent discussions with my office and I thank you for your representations concerning the Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Bill 2017.

The legislation does not implement any sort of 'bank bail-in' policy that would allow the seizure of deposits in times of financial instability. The Government has no intention of implementing such a policy. Rather, the Government has a number of strategies in place to ensure the safety of deposits.

Depositors are protected by the Government's Financial Claims Scheme (FCS), which guarantees deposits up to a cap of $250,000 per person, per authorised deposit-taking institution (ADI). A wide range of deposits are covered under the FCS, including term deposits, savings accounts, call accounts, pensioner accounts, trustee accounts and retirement savings accounts. While the Government retains discretion to activate the FCS when an institution fails, this discretion is underpinned by the Government's ongoing commitment to protect depositor interests, a commitment which the Government takes very seriously.

In addition, depositors' claims are explicitly protected by the Banking Act 1959. In the unlikely event of a bank failure, Australian depositors have priority claim on the assets of a failed ADI, to the extent that depositors have not already been paid out under the FCS. This is known as 'depositor preference' and has been a long-standing feature of Australia's financial system.

ADIs are also intensively supervised by the Australian Prudential Regulation Authority (APRA). APRA's statutory objectives include both protecting the interests of depositors and promoting financial system stability in Australia. While it is suggested that these objectives may be conflicting, in the case of the failure of an ADI, the objectives of protecting depositors and promoting financial system stability would be very closely aligned.

...2/

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As certain examples from the global financial crisis demonstrated, retaining the confidence of retail depositors in a crisis is crucial to minimising wider contagion affects across the banking system. Where attempts were made to impose losses on depositors, such as in the case of Cyprus, this led to severe contagion impacts which effectively undermined the whole financial system. This shows that the pursuit of financial stability in a crisis is likely reliant on the protection of deposits; the objectives are complementary rather than in conflict.

The legislation further strengthens depositor protections by reforming and updating APRA's resolution powers, and by amending the definition of 'prudential matters' to explicitly reference protection of the interests of depositors. This will in turn strengthen APRA's powers to manage the failure of an ADI is an orderly way in order to protect the interests of depositors.

I trust that this information is of interest to you.

Yours sincerely

LLEW O'BRIEN MP
Federal Member for Wide Bay

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MY REF: Bail-in:RHB

YOUR REF:

8th July 2020

Mr John Adams,
Adams Economics.

john@adamseconomics.com

Dear Sir,

RE: FINANCIAL SECTOR LEGISLATION AMENDMENT (CRISIS RESOLUTION POWERS AND OTHER MEASURES) ACT 2018 BAIL-IN PROVISIONS

I have been asked to provide an opinion as to whether the ***Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Act 2018*** ("the Act") creates a power of bail-in by Australia's banks of customers' deposits.

At a minimum, the Act empowers APRA to bail in so-called Hybrid Securities - special high-interest bonds evidenced by instruments which by their terms can be written off or converted into potentially worthless shares in a crisis.

However, the Act also includes write-off and conversion powers in respect of "*any other instrument*". The Government has contended that these words do not extend to deposits, on the basis that the power only applies to instruments that have conversion or write-off provisions in their terms, which deposit accounts do not. However, the reference to "*any other instrument*" would be unnecessary if the power only applied to instruments with conversion or write-off provisions; moreover, banks are able to change the terms and conditions of deposit accounts at any time and for any reason, including on directions from APRA to insert conversion or write-off provisions, which would thereby bring them within the specific terms of the write-off or conversion provisions of the Act.

The issue could now be simply resolved by Government passing a simple amendment to the Act to explicitly exclude deposits from being bailed in.

Bail-in is one of the 3 alternative actions which can be taken in respect of a distressed bank.

The alternatives are:-

1. Bankruptcy and liquidation of the bank;
2. Bail-out, which is the injection into the bank of the necessary capital to meet the bank's liabilities. This is the action which was undertaken after the 2008 GFC by governments through their Treasuries and Central Banks bailing out the banks with taxpayers' funds;
3. Bail-in, which is the injection into the bank of the necessary capital to meet the bank's liabilities either by the bank writing off its liabilities to creditors or depositors or converting creditors' loans or deposits into shares whereby creditors and depositors take a loss on their holdings. A bail-in is the opposite of a bail-out which involves the rescue of a financial institution by external parties, typically governments that use taxpayers' money.

The provisions of the Act as they affect bail-in require a consideration of the issue in 3 different sets of circumstances, and the provisions of the Act need to be considered separately in relation to each such set of circumstances.

Those 3 sets of circumstances are:-
(i) Hybrid Securities issued by banks;
(ii) Customer deposit accounts with banks;
(iii) Bank documentation implementing deposit accounts.

(i) Hybrid securities

The ASX describes Hybrid Securities as "*a generic term used to describe a security that combines elements of debt securities and equity securities.*" Whilst there are a variety of such securities, in short they are securities issued by banks which permit the amounts secured by the security to be converted into shares or written off at the option of the bank in certain circumstances.

The Act provides specifically for Hybrid Securities. Section 31 adds "**Subdivision B-Conversion and write off provisions**" to the Banking Act 1959 and inserts a definition Section 11CAA which provides that "***conversion and write off provisions** means the provisions of the prudential standards that relate to the conversion or writing off of:*
(a) Additional Tier 1 and Tier 2 capital; or
(b) any other instrument."

The Act also inserts Section 11CAB which provides:

"*(1) This section applies in relation to an instrument that contains terms that are for the purposes of the conversion and write off provisions and that is issued by, or to which any of the following is a party:*
(a) an ADI;
......
(2) The instrument may be converted in accordance with the terms of the instrument despite:
(a) any Australian law or any law of a foreign country or a part of a foreign country, other than a specified law; and
.....
(3) The instrument may be written off in accordance with the terms of the instrument despite:
(a) any Australian law or any law of a foreign country or a part of a foreign country;
.....

Under the Basel Accord, a bank's capital consists of Tier 1 capital and Tier 2 capital which includes Hybrid Securities.

The Section 11CAB provisions mean that any law which would otherwise prevent the conversion or write-off of Hybrid Securities does not apply unless a particular legislative provision specifically provides that it does apply. One of the principle types of legislation that this provision would be directed towards is consumer legislation, particularly those provisions which allow a Court to set aside or vary agreements if a party has been guilty of false or misleading conduct - this is precisely the sort of argument which could be raised in the circumstances referred to by outgoing Australian Securities and Investments Commission (ASIC) Chairman Greg Medcraft in an exchange with Senator Peter Whish-Wilson in the hearings of the Senate Economics Legislation Committee on 26 October 2017: Mr Medcraft said: "*There are two reasons we believe a lot of the retail investors buy these securities. One is they don't understand the risks that are in over 100-page prospectuses and, secondly - and this is probably for a lot of investors - they do not believe that the government would allow APRA to exercise the option to wipe them out in the event that APRA did choose to wipe them out.*"

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

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

(ii) Deposits

Whether or not bail-in of other than Hybrid Securities is implemented by the Act has been the subject of debate and concern since the Bill which led to the Act became public. The principal area of concern is whether or not the bail-in regime was extended by the Act to deposits made by customers with banks.

The central issue is the wording of the definition in Section 11CAA quoted above and what "*any other instrument*" means. "*Instrument*" is not defined in the Act but a "*financial instrument*" is defined by Australian Accounting Standard AASB132 as "*any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.*" As confirmed by the Reserve Bank, a deposit with an ADI bank comes under such a definition - it is a contract with terms and conditions as to the deposit being set by a bank, accepted by a depositor on making a deposit and creating a financial asset (a right of repayment) and a financial liability in the bank (the obligation to repay).

Deposits are created by "*instruments*" and are governed by the terms and conditions of those instruments.

The intent of the reference to "*any other instrument*" in Section 11CAAAA is assisted by the Explanatory memorandum which accompanied the Exposure Draft and which states:

"*5.14 Presently, the provisions in the prudential standards that set these requirements are referred to as the 'loss absorption requirements' and requirements for 'loss absorption at the point of non-viability'. The concept of 'conversion and write-off provisions' is intended to refer to these, while also leaving room for future changes to APRA's prudential standards, including changes that might refer to instruments that are not currently considered capital under the prudential standards.*"

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

"*(1) APRA may, in writing, determine standards in relation to prudential matters to be complied with by:*
(a) all ADIs; ....."

Banks are ADIs.

The various Prudential Standards issued by APRA are accordingly headed with the phrase: *"This Prudential Standard is made under section 11AF of the Banking Act 1959 (the Banking Act)."*

That power then leads into the issue of APRA using this authority to expand the meaning of "*capital*" the subject of conversion or write-off, to encompass deposits if deposits are not already covered by the reference to "*any other instrument*".

That these provisions as to conversion and write-off are not limited to Hybrid Securities is confirmed in Section 11CAA itself as quoted above. The provisions extend to "*any other instrument*" by sub-section (b) of that Section and must relate to instruments other than those referred to in sub-section (a), i.e. other than "*Additional Tier 1 and Tier 2 capital*" (being instruments which themselves contain an explicit provision for conversion or write-off). All instruments that the Act refers to as to being able to be converted or written off "*in accordance with the terms of the instruments*" come under the definition of "*Additional Tier 1 and Tier 2 capital*" - "*any other instruments*" is not only an entirely unnecessary addition if the Act is intended to apply only to instruments with conversion or write-off terms, its very broad language must be intended to encompass some other instruments ("*which are not currently considered capital*" as stated in the Explanatory memorandum) and that could extend to instruments relating to deposits.

If Section 11CAA thus extends to instruments relating to deposits then APRA can as the Prudential Regulator issue a Prudential Requirement Regulation or a Prudential Standard for the writing-off or conversion of deposits.

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

"*(1) ... APRA may give a body corporate that is an ADI ... a direction of a kind specified in subsection (2) if APRA has reason to believe that:*

.....

(b) the body corporate has contravened a prudential requirement regulation or a prudential standard; or

(c) the body corporate is likely to contravene this Act, a prudential requirement regulation, a prudential standard or the Financial Sector (Collection of Data) Act 2001, and such a contravention is likely to give rise to a prudential risk; or

(d) the body corporate has contravened a condition or direction under this Act or the Financial Sector (Collection of Data) Act 2001 ; or

....

(h) there has been, or there might be, a material deterioration in the body corporate's financial condition; or

....

(k) the body corporate is conducting its affairs in a way that may cause or promote instability in the Australian financial system.

.....

(2) The kinds of direction that the body corporate may be given are directions to do, or to cause a body corporate that is its subsidiary to do, any one or more of the following:

....

(m) not to repay any money on deposit or advance;

(n) not to pay or transfer any amount or asset to any person, or create an obligation (contingent or otherwise) to do so;

....."

This provision was inserted into the Banking Act in 2003 by the Financial Sector Legislation Amendment Act (No 1).

It is not known whether this power has been exercised by APRA. Relevantly Graeme Thompson in the address referred to above said: " ... *Particularly in the case of banks and other deposit-takers that are vulnerable to a loss of public confidence, APRA may prefer to work behind the scenes with the institution to resolve its difficulties. (Such action can include arranging a merger with a stronger party, otherwise securing an injection of capital or limiting its activities for a time.)*"

It is a relatively small step to then convert or write-off what the ADI has been prohibited from repaying or paying out.

It might be argued that APRA's powers in existing Sections of the Act are not absolute and are subject to various qualifications and limitations arising out of their context within the Act or the balance of the Section or Sections of the Act in which they appear. To avoid such an interpretation, Section 38 of the Act inserts 2 new sub-sections to Section 11CA in the Banking Act:

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

(2AAB) The kinds of direction that may be given as mentioned in a particular paragraph of subsection (2) are not limited by any other paragraph of that subsection."

APRA has already adopted the need for certain capital to be capable of conversion or write-off, regardless of laws, constitutions or contracts which may affect such decisions, the Explanatory Statement for Banking (Prudential Standard) Determination No. 1 of 2014 stating:

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

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

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

(iii) Bank documentation implementing deposit accounts

Even if the words "*any other instrument*" in Section 11CAA do not encompass deposits, there is a further issue in relation to the implementation of bail-in of deposits revolving around the issue of the documents/instruments issued by banks in opening accounts and accepting deposits from customers.

The documentation issued by each Australian bank when opening such an account, has a provision which enables the Bank to change the terms and conditions from time to time without the consent of the customer. The specifics of the power vary from bank to bank but each fundamentally contain such a power.

If APRA as the Prudential Regulator issued a Prudential Requirement Regulation or a Prudential Standard requiring a bank to insert a provision into its documentation/instruments relating to deposit-taking accounts providing for the bail-in of those deposits - their write-off or conversion - then those provisions would then clearly come within the specific provisions of conversion or write-off within the Act and the deposit the subject of the account could be

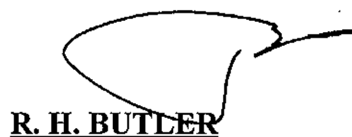
bailed-in immediately.

Such a directive could be issued by APRA in accordance with the secrecy provisions in the Australian Prudential Regulation Authority Act1998 and be implemented with little or no notice to the account holder.

As noted above, the issue could now be simply resolved by Government passing a simple amendment to the Act to explicitly exclude deposits from being bailed in i.e. written off or converted into shares.

Whilst not beyond doubt, it is my opinion that the provisions of the Act do provide for a power of bail-in of bank deposits which did not exist prior to the passing of the Act.

Yours faithfully,



R. H. BUTLER

ATTACHMENT C

Australian ADI
Changing Deposit Account Terms and Conditions

No	Institution	T&C Date of Issue	Clause	Terms
1	CBA	9 May 2020	Page 34 - Footnote 2 in Section 6.2 (Under the Table)	*"We may give you a shorter notice period, or no notice of an unfavourable change if we believe doing so is necessary for us to avoid, or reduce, a material increase in our credit risk or our loss"* https://www.commbank.com.au/content/dam/commbank/personal/apply-online/download-printed-forms/SavingsInvestment_ADB2852.pdf?ei=Terms_Full-terms
2	Westpac	14 June 2020	Page 37 - Part 4: General Information – Section 3: Changes to Terms and Conditions	*"We can also give you a shorter notice period (or no notice) if we believe that it is necessary to avoid, or to reduce, a material increase in our credit risk or our loss."* https://www.westpac.com.au/content/dam/public/wbc/documents/pdf/olb/Online_Banking_TCs.pdf

3	ANZ	29 June 2020	Page 27 - 2.16A Changes to Other Terms and Conditions	*"We may make any other change to the terms and conditions of your account by giving you reasonable notice of the change. If we reasonably consider a change is unfavourable to you, we will give you prior notice of at least 30 days. We may give you a short notice period, which may include notice on the day the change takes effect if we can reasonably consider:*
				• *the change has a neutral effect on your obligations;*
				• *the change reduces your obligations;*
				• *providing a shorter notice period is necessary for us to:*
				    ○ *avoid or reduce a material increase in our credit risk or loss;*
				    ○ *comply with legal or regulatory requirements."*
				
				https://www.anz.com.au/content/dam/anzcomau/documents/pdf/saving-transaction-products-tcs.pdf

4	National Australia Bank (NAB)	NAB Term Deposits Effective 1 March 2020	Page 24 - Part B - 5.1 Changes NAB may make	*"In addition to the other changes NAB may make to the terms and conditions in this booklet, which are detailed in this booklet, NAB may change any other terms and conditions (including by imposing new fees or charges, changing the amount, type or method of calculation of fees and charges payable). NAB will make any changes in accordance with any applicable legislation and industry codes"* https://www.nab.com.au/content/dam/nab/documents/terms-and-conditions/banking/term-deposit-tnc.pdf

No	Institution	T&C Date of Issue	Clause	Terms
5	Bank of Queensland (BOQ)	July 2020	Page 45 – Section 5.1 Changes to Terms and Conditions of Banking Services	*"We may also give you a shorter notice period (or no notice) of an unfavourable change if it is reasonable for us to manage a material and immediate risk."* https://www.boq.com.au/important-information/terms-and-conditions
6	ING	1 March 2020	Page 56 – We'll Give you notice of any changes	*"However, in some circumstances, we may tell you about a change after it has been made – but only where:* • *the change is necessary for us to avoid or reduce a material increase in our credit risk or loss; or* • *a government charge is introduced or varied and it's not advertised by a government, government agency or representative body."* https://www.ing.com.au/pdf/Orange_Everyday_Terms_and_Conditions.pdf
7	Suncorp	17 June 2020	Section 1.11 – Telling you about the changes	*"However, we may give you a shorter notice period, or no notice, of an unfavourable change if we believe doing so is, in our reasonable opinion, necessary for us to manage a material and immediate risk."* *https://www.suncorp.com.au/content/dam/suncorp/bank/documents/product-information/account-terms-and-conditions.pdf*
8	Bendigo Bank	23 March 2020	Page 15 – Section 10 Changes to Terms and Conditions and Ongoing Disclosure	*"The notice of change table below sets out how much prior notice we will give you of changes, if prior notice is required. Where no prior notice is required, we will give you notice of a change no later than the day on which the change takes effect. However, we may give you a shorter notice period or no notice of a change necessitated by an immediate need to restore or maintain the security of the Rural Bank system or individual accounts or to otherwise manage a material and immediate risk where it is reasonable for us to do so. In that case, we will give you notice of the change as soon as is reasonably practicable."* *https://www.bendigobank.com.au/globalassets/documents/disclosures/rural-bank-banking-accounts-terms-conditions.pdf*

No	Institution	T&C Date of Issue	Clause	Terms
9	Bank of Melbourne	1 June 2020	Page 68 – Other important things to understand – Section 15 – Changes to terms and conditions	*We may also make any other changes to the terms and conditions without your consent at any time:* *• as a result of any change or anticipated change in:* *– circumstances relating to the account or product or service such as, for example, changes in technology or our systems or procedures or product mix or changes to the risks of, or the features or benefits of, the account or product or service; or* *– our structure or financial position, including our cost of funds and liquidity; or* *– industry, market or best practice; or* *• for prudential reasons; or* *• if we reasonably think the change should be made:* *– to meet our legal obligations or as a result of any change or anticipated change to a relevant law, code of guidance; or* *– to reflect judgments of any court or tribunal or guidance or views of any regulator or external dispute resolution service of which we are a member; or* *– to correct errors, inaccuracies or ambiguities; or* *– to streamline the administration of the account or product or service; or* *– on the basis that it is impractical for us to continue without the change; or* *– for reasons of security; or* *• to make them clearer or simpler.* https://www.bankofmelbourne.com.au/content/dam/bom/downloads/personal/bank-accounts/SavInvesTransAccounts_Terms.pdf
10	HSBC Australia	1 July 2019	Page 100 – Section 10 Miscellaneous – Clause 10.7	*"Both you and we will not be liable to each other for any of the following losses or damages (whether you or we knew or could foresee any of these losses or damages):* *a) loss of revenue;* *b) loss of actual or anticipated profits;* *c) loss of the use of money;* *d) loss of anticipated savings;* *e) loss of business;* *f) loss of opportunity;* *g) loss of goodwill;* *h) loss of reputation; or* *i) any indirect, consequential or tortious loss or damage however caused"* https://www.hsbc.com.au/content/dam/hsbc/au/docs/pdf/savings-pds.pdf

ATTACHMENT D

Definition of a 'Basic Deposit Product' under Section 761A of the *Corporations Act 2001*

Basic deposit product means a deposit product that is a facility in relation to which the following conditions are satisfied:

(a) the terms applicable to the facility (the governing terms) do not permit the amount from time to time standing to the credit of the facility to be reduced otherwise than in consequence of one or more of the following:

(i) a withdrawal, transfer or debit on the instruction of, or by authority of, the depositor, not being on account of entry fees, exit fees or charges for the management of the funds (but this does not exclude charges for the maintenance of the facility itself);

(ii) a payment of charges or duties on deposits into, or withdrawals from, the facility that are payable under a law of the Commonwealth or of a State or Territory;

(iii) a payment that a law of the Commonwealth, or of a State or Territory, requires to be made out of the facility;

(iv) a payment that an order of a court requires to be made out of the facility;

(v) the exercise of a right to combine accounts;

(vi) the correction of an error;

(vii) any other circumstances specified in regulations made for the purposes of this subparagraph; and

(b) any return to be generated for the depositor on the amount from time to time standing to the credit of the facility is an amount that is set out in, or that is calculated by reference to a rate or rates that are set out in, the governing terms; and

(c) either:

(i) there is no minimum period before which funds cannot be withdrawn or transferred from the facility without a reduction in the return generated for the depositor; or

(ii) if there is such a period, it expires on or before the end of the period of 5 years starting on the day on which funds were first deposited in the facility; and

(d) unless subparagraph (c)(ii) applies and the period referred to in that subparagraph expires on or before the end of the period of 2 years starting on the day on which funds were first deposited in the facility—funds are able to be withdrawn or transferred from the facility on the instruction of, or by authority of, the depositor:

(i) without any prior notice to the ADI that makes the facility available; or

(ii) if the ADI that makes the facility available is included in a class of ADIs specified in regulations made for the purposes of this subparagraph—subject to a prior notice requirement that does not exceed the period specified in those regulations in relation to that class of ADIs; whether or not the withdrawal or transfer will attract a reduction in the return generated for the depositor as mentioned in subparagraph (c)(i); and

(e) any other conditions specified in regulations made for the purposes of this paragraph

Robert H. Butler

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MY REF: Bail-in:RHB

YOUR REF:

8th July 2020

Mr John Adams,
Adams Economics.

john@adamseconomics.com

Dear Sir,

RE: BANKING AMENDMENT (DEPOSITS) BILL 2020

I have been asked to provide an opinion as to a statement contained in the Bills Digest published in February 2018 by the Parliamentary Library examining the ***Financial Sector Legislation Amendments (Crisis Resolution Powers and Other Measures) Bill 2017*** suggests that retail bank deposits held by ADIs are not at risk of bail-in resulting from the passage of the Bill (now an Act of same name) because of the provisions of Section 761A of the ***Corporations Act 2001.***

The relevant Bills Digest entry states: "*a basic deposit product, as defined under section 761A of the Corporations Act 2001, must meet certain conditions. These include limitations on the circumstances under which the balance of a deposit account can be reduced. These circumstances do not include conversion or write-off.*"

I do not agree with the entry which I consider takes the reference to the definition of a "*basic deposit product*" out of context and attributes to it a meaning which does not follow from provisions in the ***Corporations Act.***

Section 761A is a definition section and contains a definition of a "*basic deposit product*", but the Section provides that the definitions are for the purposes of the Division of the Corporations Act in which they appear, namely Division 1 Chapter 7.

Division 1 Chapter 7 was inserted in 2019 by the ***Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Act 2019.*** The intent of the Design and Distribution Obligation (DDO) was to assist "*consumers to select appropriate financial products by requiring issuers and distributors to appropriately market and distribute financial products.*"

The Australian Banking Association submission to Treasury on the DDO proposals was, for example, that: "*In our view, the inclusion of Basic Products in the DDO regime does not further the policy intentions of the regime and has the effect of complicating the provision of Basic Products without providing useful consumer protection.*"

Section 760A of the Corporations Act provides that:

"The main object of this Chapter is to promote:

(a) confident and informed decision making by consumers of financial products and services while facilitating efficiency, flexibility and innovation in the provision of those products and services; and

(b) fairness, honesty and professionalism by those who provide financial services; and
(c) fair, orderly and transparent markets for financial products; and
(d) the reduction of systemic risk and the provision of fair and effective services by clearing and settlement facilities."

The definition of a "*basic deposit product*" in Section 761A of the Corporations Act does not limit the terms and conditions of such a product or the ability to change those terms and conditions but merely defines one of the products to which the provisions of the Chapter apply if they come within the definition.

The Chapter in turn sets out such matters as licensing, disclosure obligations and the like relating to such products as a "basic deposit product" - Design and Distribution Obligations.

It does not define a "basic deposit product" for any other legislation, nor does it limit the terms and conditions of a "basic deposit product" - if the product does not come within that definition then the provisions of the Chapter will not apply.

I would be happy to amplify further if you require.

Yours faithfully,

R. H. BUTLER