

Australia: Financial Safety Net and Crisis Management Framework—Technical Note

This technical note was prepared based on the information available at the time it was completed in November, 2012. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of Australia or the Executive Board of the IMF.

The policy of publication of staff reports and other documents by the IMF allows for the deletion of market-sensitive information.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org • Internet: <http://www.imf.org>

**International Monetary Fund
Washington, D.C.**

FINANCIAL SECTOR ASSESSMENT PROGRAM UPDATE

AUSTRALIA

FINANCIAL SAFETY NET AND CRISIS MANAGEMENT
FRAMEWORK

TECHNICAL NOTE

NOVEMBER 2012

INTERNATIONAL MONETARY FUND
MONETARY AND CAPITAL MARKETS DEPARTMENT
LEGAL DEPARTMENT

Contents	Page
Glossary	3
I. Executive Summary.....	4
II. Introduction	8
III. Institutional Arrangements, Coordination, and Preparedness.....	10
A. Domestic Inter-Agency Coordination and Information Sharing.....	10
B. Cross-Border Coordination and Information Sharing.....	13
C. Crisis Preparedness	14
IV. Early Intervention of Problem ADIs.....	16
A. Liquidity Assistance.....	16
B. Corrective Measures for Problem ADIs.....	18
V. Resolution of Non-Systemic ADIs	19
A. Resolution Under Private Control.....	20
B. Statutory Management	20
C. Winding-Up.....	22
D. The Financial Claims Scheme.....	24
VI. Crisis Management and Resolution of Systemically Important Banks	28
A. Developing Credible Contingency Plans	29
B. Private Sector Involvement/Burden Sharing.....	30
C. Official Financial Support.....	31
VII. Cross-Border Resolution and Crisis Management.....	33
Table	
1. Summary of Recommendations.....	7
Box	
1. Examples of APRA’s Directions Powers	19
Annexes	
I. Status of Recommendations from the 2006 FSAP	35
II. Challenges to Decisions Taken by APRA.....	36
III. An Informal Comparison of Australia’s FCS to the Deposit Insurance Core Principles ..	38
IV. United Kingdom and United States—Summary of RRP Requirements	42

GLOSSARY

ADI	Authorized Deposit-taking Institution
APRA	Australian Prudential Regulation Authority
APRA Act	<i>Australian Prudential Regulation Authority Act 1998</i>
APRA Regulations	<i>Australian Prudential Regulation Authority Regulations 1998</i>
ASIC	Australian Securities and Investments Commission
Banking Act	<i>Banking Act 1959</i>
Business Transfer Act	<i>Financial Sector (Business Transfer and Group Restructure) Act 1999</i>
CFR or Council	Council of Financial Regulators
Corporations Act	<i>Corporations Act 2001</i>
CLF	Committed Liquidity Facility (Basel III)
DGS	Deposit Guarantee Scheme
ELA	Emergency Liquidity Assistance
FCS	Financial Claims Scheme
FDIC	Federal Deposit Insurance Corporation (U.S.)
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSSSA	Financial System Stability Special Account
IDA	Interbank Deposit Agreement
IMF or Fund	International Monetary Fund
MOC	Memorandum of Cooperation
MoF	Minister for Finance and Deregulation
MOU	Memorandum of Understanding
OBA	Open Bank Assistance
PAIRS	Probability and Impact Rating System
P&A	Purchase and Assumption Transaction
RBA	Reserve Bank of Australia
RBA Act	<i>Reserve Bank of Australia Act 1959</i>
RBNZ	Reserve Bank of New Zealand
RRP	Recovery and Resolution Plan
SCV	Single Customer View
SOARS	Supervisory Oversight and Response System
TTBC	Trans-Tasman Council on Banking Supervision

I. EXECUTIVE SUMMARY

- 1. Australia has a history of few bank failures, even fewer financial crises, and its banking sector emerged from the global financial crisis relatively well.**¹ With an eye toward international developments, the Australian authorities have taken commendable steps to strengthen the financial safety net and crisis management framework over the last several years. The Government's well-coordinated response to the global financial crisis included adopting significant legislative changes in October 2008 to put in place guarantee arrangements for retail deposits, among other enhancements to the financial safety net and crisis management framework. Further improvements were made in June 2010 and the Government is currently pursuing additional legislative changes.
- 2. The Australian financial sector institutional framework primarily comprises four agencies with clear mandates and distinct allocations of power.** These agencies—the Reserve Bank of Australia (RBA), the Australian Treasury (Treasury), the Australian Prudential Regulation Authority (APRA) and the Australian Securities and Investments Commission (ASIC)—together comprise the Council of Financial Regulators (CFR or Council), which facilitates strong coordination and information exchange among the agencies on financial sector policy issues. The CFR is a non-statutory, coordinating body chaired by the Governor of the RBA created 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 operates in normal times and in crisis situations, meeting quarterly, and, as necessary on an ad hoc basis.
- 3. The authorities have made good progress in crisis preparedness and should continue planning in this area as a key priority.** The CFR has been developing crisis resolution strategies (which includes policy and operational guidance as well as pre-drafted documentation) and conducted crisis simulation exercises in 2007 (in-house by APRA), 2009 and 2011. Recent legislative and policy developments in the Australian safety net and crisis management framework have not been tested (as there have been no opportunities to use the framework), other than in simulation exercises. Conducting broad, drastic crisis simulations on a periodic basis and targeted simulations more frequently should be an important focus.
- 4. Past simulation exercises revealed the need for legislative changes to prevent premature disclosure of sensitive information.** Australia's securities disclosure regime requires, for the protection of investors, immediate and continuous disclosure of information that could reasonably be expected to have a material effect on the price or value of an ADI's securities. There is a high probability that any resolution or crisis response measures will impact the price or value of an authorized deposit-taking institution's (ADI's)² securities.

¹This note was prepared by David Parker (Monetary and Capital Markets Department) and Dinah Knight (Legal Department).

²The term "ADI" primarily refers to banks, building societies, and credit unions.

Poor coordination of compliance with the disclosure requirements, timing of resolution or crisis response actions, and the overall public communication strategy regarding these actions could pose risks to financial stability (e.g., through depositor runs) or thwart resolution actions (e.g., through the stripping of the ADI's assets by insiders) or cause market disruptions. Legislative changes that reduce tension between investor protection and financial stability should be pursued.

5. **Powers for early intervention in problem banks (including to provide liquidity assistance) and to resolve non-systemic banks appear robust.** Liquidity assistance in the first instance would be accomplished via the RBA's daily repo auction process; in the second instance, assistance would be negotiated on an individual institution basis, in consultation with APRA vis-à-vis supervisory and solvency concerns. The scope of eligible collateral that the RBA accepts through its normal market operations makes it extremely unlikely that an ADI would be unable to obtain adequate liquidity under most circumstances. Legislation grants APRA strong powers to direct ADIs to take corrective actions. Such powers (e.g., the power to order a recapitalization or to remove or replace directors and officers) could be used to facilitate the resolution of an ADI while it is under private control. APRA also has appropriate grounds to appoint a statutory manager to resolve an ADI before it becomes insolvent. Powers to compel a purchase and assumption transaction are robust. APRA could issue a determination that an ADI should transfer assets and /or liabilities to a willing, healthy ADI, a bridge bank, or asset management company while the failing bank is under private control or under statutory management (including immediately before a winding-up). Winding up occurs through a court-based procedure with APRA involvement.

6. **Australia protects depositors via depositor preference in the priority of claims for winding up and through the Financial Claims Scheme (FCS).** The FCS, which has a narrow pay box mandate, was first adopted in October 2008, and was confirmed by the Government as a permanent feature of Australia's financial system in 2010. The FCS covers deposits per depositor per ADI up to AU\$ 250,000, a level that fully covers around 99 percent of deposit accounts and over 50 percent of deposits by value. The FCS is ex post-funded and backed by an AU\$ 20 billion standing budgetary appropriation per FCS declaration; although currently there is no clear plan to mobilize these funds. As an ex post-funded scheme, a failed ADI will never contribute (other than via shareholder losses imposed at failure). Also, there is no requirement that remaining open ADIs contribute to defray any expenditures under the scheme. Disbursements are expected to be recovered through asset liquidation recoveries and the government has an option to impose an industry levy if there is a shortfall. This arrangement falls short of international best practices that banks should bear the cost of their own failures. The authorities should re-evaluate the merits of ex-ante funding for the FCS with a view toward converting it to an ex-ante funded scheme.

7. **Several additional improvements to the FCS are needed to prevent depositor payout delays.** There has been a slow start to the ADIs' implementation of a single customer view (SCV) record-keeping system—a feature that is critical to accurate and timely insured depositor reimbursement. APRA should ensure that ADIs implement the SCV on, or where

possible, before the agreed deadline. The trigger for payout could also contribute to delayed payouts. Activation of the FCS is at the discretion of the Treasurer following APRA's application to the Court for the winding up of an ADI; steps are underway to streamline this process. In addition, APRA's plans for depositor reimbursement from the FCS appear to be limited to options such as transfer of deposit book to another ADI, checks drawn on RBA, electronic transfers to accounts at another ADI, or other similar cash payments. A more efficient method would be to institute a competitive process whereby other ADIs would bid on the opportunity to assume a failed ADI's insured deposits. As the situation stands, it is unclear how promptly a payout from the FCS could be made, and it is doubtful that a payout could be made in line with emerging best practice (i.e., within 7 days).

8. **Additional measures are needed to manage the failure of systemic ADIs or system-wide banking crises.** Under a pilot program, APRA required the six largest ADIs to develop recovery plans. APRA has not yet begun formal, ADI-specific resolution planning. For the largest ADIs, recovery and resolution planning should become a permanent part of the financial safety net. For smaller ADIs, it may also be wise to consider whether some form of contingency planning requirement should be imposed, comparatively truncated in relation to the ADI's size and relative importance to the system. The authorities should adopt additional tools that reinforce the view that the industry should bear the costs of bank failures. There are a number of potential ways to do this. For example, an ex ante, industry-funded resolution fund could be created, provisions for statutory bail-in could be included in the legal framework, a financial sector transaction tax could be levied, or systemically important institutions could be required to hold capital with higher loss absorbency. A simple approach may be (in addition to converting the FCS to a pre-funded scheme) to require the larger ADIs to hold higher loss absorbing capital, given that the necessary infrastructure is already in place. When all else fails, the authorities have at their disposal solid but flexible arrangements to provide public financial support to the banking sector in order to mitigate systemic risks. In particular, as part of the legislative reforms in 2008, the Financial System Stability Special Account (FSSSA) (which provides for standing budgetary authorization in tranches of funding of up to AU\$ 20 billion each to troubled ADIs for recapitalization or for other similar purposes) was put in place. Treasury should be prepared to operationalize a bridge bank, if needed.

9. **Commendable steps have been taken to facilitate cross-border cooperation with the New Zealand authorities, but further work on cross-border aspects of resolution and crisis management is needed.** APRA and the New Zealand prudential supervisor have reciprocal statutory obligations to support the other agency in meeting its statutory responsibilities for prudential regulation and avoid causing damage to the other country's financial system. In addition, there is a resolution policy working group under the Trans-Tasman Council on Banking Supervision (TTBC), and a Memorandum of Cooperation (MOC) has been signed among the relevant authorities. Cross-border crisis management arrangements with other jurisdictions are less advanced and should be pursued, as appropriate. Powers to resolve or facilitate a coordinated resolution of a foreign ADI (i.e., a

domestic branch of a foreign bank) could be broadened to include the appointment of a statutory manager, the ability to order a compulsory business transfer or the ability to apply to the Court for a winding-up order. 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. Enhancements to the RBA's ability to exchange information with foreign authorities would also prove useful.

Table 1. Summary of Recommendations

Crisis Preparedness
(i) 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).
(ii) Legislative changes should be made to forestall premature disclosure of sensitive information as a result of "continuous disclosure" obligations.
Financial Claims Scheme
(iii) Re-evaluate the merits of ex-ante funding for the FCS with a view toward converting it to an ex-ante funded scheme.
(iv) APRA should ensure that ADIs implement the SCV on, or where possible, ahead of schedule.
(v) FCS should be automatically activated on APRA's application to the court for the winding up.
(vi) Introduce competitive bidding for Purchase and Assumption (P&A) transactions or for paying agent bank.
(vii) Exclude insider deposits from coverage and offset overdue customer loans.
(viii) 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.
Crisis Management and Resolution of Systemically Important Banks
(ix) The Treasury must be prepared to have a unit established to own and control government-owned ADIs, whether bridge or nationalized.
(x) 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).

Table 1. Summary of Recommendations (Concluded)

Crisis Management and Resolution of Systemically Important Banks (continued)
(xi) 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.
Cross-Border Resolution and Crisis Management
(xii) Take steps to enhance cross-border coordination arrangements with other jurisdictions.
(xiii) Enhance RBA's ability to exchange information with foreign authorities.
(xiv) 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.
(xv) 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.
(xvi) Legislation should provide for transparent and expedited processes for the recognition and enforcement of out-of court resolution decisions taken by foreign authorities.

II. INTRODUCTION

10. **Since the global financial crisis began, there has been increased emphasis on ensuring that every jurisdiction has an effective financial safety net and crisis management framework in place.** This is particularly important in jurisdictions like Australia that have systemically important financial sectors.³ Emerging good practice suggests that a number of key features should be included in the financial safety net and crisis management framework, such as: (i) sound institutional arrangements with explicit inter-agency coordination mechanisms, including a solid legal basis for the exchange of confidential information in times of distress; (ii) strong powers that allow for the early intervention into a problem bank to preempt its failure; (iii) robust resolution powers; (iv) a well-designed deposit guarantee scheme, and—as a last resort—(v) solid but flexible arrangements for providing government financial support.

11. **Australia has a history of few bank failures, even fewer financial crises, and its banking sector emerged from the global financial crisis relatively well.** Although ADIs did experience some funding pressure at the height of the global financial crisis, there were

³The IMF has identified 25 jurisdictions, including Australia, as having systemically important financial sectors that should be subject to FSAPs every five years. See <http://www.imf.org/external/np/sec/pr/2010/pr10357.htm>.

no ADI failures. In fact, the last failure of an Australian depository institution occurred in the early 1990s, and no depositor has lost money in the failure of a depository institution in Australia since 1931.⁴ A well-coordinated response to the global financial crisis helped maintain financial stability. That response included the Government's introduction of guarantee arrangements for retail deposits and temporary guarantees for wholesale funding in October 2008.⁵

12. While it is hopeful that financial stability in Australia will continue, crisis preparedness is essential given the structure of the Australian banking sector. The Australian banking sector is highly concentrated and dominated by four ADIs, which together hold approximately 76 percent of total banking assets.⁶ In part, this concentration results from voluntary industry consolidations in response to bank distress.⁷ The four major ADIs have largely similar business models with limited diversification among themselves. The major ADIs enjoy a funding cost advantage due primarily to their systemic size and implicit government support. While their pricing power helps sustain profitability, their size implies that, in the event of a major ADI failing, the impact on the financial system and the economy as a whole would be potentially enormous.

13. With an eye toward international developments, the Australian authorities have taken commendable steps to strengthen the financial safety net and crisis management framework over the last several years. The 2006 FSAP identified a number of weaknesses in the framework for ADI resolution and crisis management (Annex I). At the time, the authorities had relatively constrained powers to resolve an ADI prior to insolvency and there was no deposit guarantee scheme in place. Significant legislative changes were adopted in 2008 and 2010 to enhance the safety net and crisis management framework and the authorities are currently pursuing additional legislative changes.

⁴A few relatively small depository institutions, including the State Banks of Victoria and South Australia and Pyramid Building Society, failed in the late 1980s and early 1990s following financial deregulation in the mid-1980s. However, depositors suffered no losses. In 1931, the failure of the Primary Producers Bank of Australia caused depositors to lose a portion of their deposit balances. Grant Turner, "Depositor Protection in Australia" *Reserve Bank of Australia Bulletin* (December Quarter 2011).

⁵The Guarantee Scheme for Large Deposits and Wholesale Funding closed for new liabilities at the end of March 2010. The Financial Claims Scheme (Australia's deposit insurance scheme) was confirmed in 2010 as a permanent feature of Australia's financial system. It is capped at \$250,000 per person, per ADI.

⁶The remainder of the banking sector comprises four mid-sized and a number of small Australian-owned banks, credit unions and building societies (representing approximately 8 percent of banking sector assets), foreign-owned ADIs (representing approximately 3 percent of banking sector assets), and branches of foreign ADIs (representing approximately 9 percent of banking sector assets).

⁷Contributing factors include the merger of two mid-sized Australian ADIs in 2007, the acquisition of smaller competitors by two of the large ADIs during 2008, and the reduction of lending by foreign-owned ADIs in the wake of the global financial crisis. These developments led to the four largest ADIs increasing their share of banking sector assets by approximately 10 percentage points between 2005 and 2010. Financial Stability Board (FSB), "Peer Review of Australia," *Review Report* (September 2011).

14. **Recognizing that the effectiveness of the safety net and crisis management framework has not fully been tested, this note examines the arrangements that have been put in place and makes recommendations for improvement.** This note is structured as follows: Part II analyzes the existing domestic and cross-border institutional framework and coordination arrangements, including steps taken to ensure crisis preparedness; Part III discusses the powers available for early intervention of problem ADIs, including mechanisms for liquidity assistance; Part IV examines the tools available for the resolution of non-systemic ADIs; Part V focuses on the tools available to address a system-wide crisis or to resolve a systemically important ADI; and Part VI addresses special issues that arise in cross-border-resolution and crisis management.

III. INSTITUTIONAL ARRANGEMENTS, COORDINATION, AND PREPAREDNESS

15. **A well-established institutional framework for financial stability is a precondition to effective use of financial safety net and crisis management tools.** Increasingly, the need for having sound coordination mechanisms and ex ante planning at both the domestic and cross-border levels is being recognized. At minimum, such a framework should provide for clear mandates for the institutions involved and explicit coordination mechanisms, including a solid legal basis for the exchange of confidential information in times of distress. In times of calm, ex ante planning to facilitate effective policy communication and decision-making among key stakeholders should be an important focus and will help to minimize mistakes during crises and ultimately reduce costs. An assessment of the Australian financial stability arrangements, including coordination mechanisms, information sharing and crisis preparedness follows.

A. Domestic Inter-Agency Coordination and Information Sharing

16. **The Australian financial sector institutional framework primarily comprises four agencies with clear mandates and distinct allocations of power.** Responsibilities are divided along functional lines:

- **The RBA performs traditional central bank functions**, including conducting monetary policy and payment system oversight and serving as the lender of last resort. The RBA has an implicit financial stability mandate, and is generally recognized as having responsibility for overall financial stability in Australia.
- **APRA is the prudential supervisor and resolution authority.** APRA regulates and supervises ADIs,⁸ general and life insurance companies, and most members of the superannuation industry and serves as the resolution authority for these institutions.⁹

⁸ADIs are primarily banks, credit unions, and building societies.

⁹Although APRA is the resolution authority for all of the institutions it supervises, this Technical Note focuses only on ADIs.

In addition, APRA administers payouts under the FCS in respect of ADIs and general insurers. In performing its functions, APRA is required to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, promotes financial system stability in Australia. The protection of depositors and policyholders is also part of APRA's legal mandate under the relevant industry acts (i.e., *Banking Act 1959*, *Insurance Act 1973* and *Life Insurance Act 1995*). APRA has statutory obligations to protect the interest of depositors and policyholders.

- **The Treasurer and the Minister for Finance and Deregulation (MoF) are gatekeepers for the use of public funds in support of ADI resolution and crisis management.** The Treasurer is vested with powers to approve certain actions that could potentially put public funds at risk.¹⁰ More specifically, the Treasurer's consent is required for the activation of the FCS and the FSSSA (which are backed by standing budgetary appropriations); for APRA to direct a failing ADI to transfer its business to a healthy institution (which, under the Australian Constitution could trigger compensation requirements for certain property holders); 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 MoF regulates government spending. Actions by the Treasurer that could result in public expenditures require the consent of the MoF.
- **ASIC is the conduct of business regulator and consumer protection authority.** ASIC has responsibility for assessing and advising on the implications of a potential crisis situation for financial markets and investors, and the disclosure implications of any resolution actions taken with respect to a publically-traded company (including the four major ADIs).

17. **There is strong coordination and exchange of information between the agencies, largely facilitated through the Council of Financial Regulators (CFR).** The CFR is a non-statutory, coordinating body chaired by the Governor of the RBA and comprising representatives from the RBA, Treasury, APRA and ASIC (i.e., CEOs of each and/or their respective nominated deputies). As specified in its Charter, 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 operates both in normal times and in crisis situations. It has four scheduled meetings each year, and as necessary meets on an ad hoc basis. In normal times, it operates as a forum for members to share information and views on issues and trends in the financial system and to discuss

¹⁰The Treasury is responsible for advising Government on policy and reforms that promote a sound financial system, including on financial distress management and arrangements. It also has responsibility for advising Government on matters relating to the exercise of the Treasurer's powers and on the broader economic and fiscal implications or of developments that pose a threat to the stability of the financial system.

regulatory reforms. In fact, the CFR regularly forms working groups to study policy issues. For example, a working group has recently examined the regulation of the OTC derivatives market in Australia.¹¹ There is also a CFR Crisis Management Working Group. In crisis times, the CFR would act as a forum to coordinate responses to potential threats to financial stability. In this regard, in 2008 the CFR Agencies entered into an MOU on Financial Distress Management.¹²

18. Informal coordination within the Council and separate, formal coordination mechanisms promote informed decision-making on financial sector policy issues.

Although the CFR is a coordinating body on crisis management and ADI resolution issues, each agency remains independently responsible for discharging its statutory duties. Nonetheless, it is expected that key financial sector policy decisions will be discussed at the Council. This expectation is supported by more formal coordination mechanisms. For example, APRA has an obligation to notify the Treasurer when an ADI is under financial distress.¹³ This is a flexible obligation that allows APRA to determine on a case-by-case basis when such notifications should be made, taking into consideration the facts and circumstances. While this obligation extends to the Treasurer, the authorities contemplate that the entire Council would be informed, at least in cases of severe distress of an ADI. The response to the distress would be discussed at the Council, which would assess the situation and form a consensus as to which measures (or package of measures) should be taken to produce the best outcome. The discussions within the Council are a non-binding consultation process. Ultimately the party that holds the relevant powers is responsible for taking appropriate action.

19. The activities of the CFR are supported by an adequate legal basis for information sharing. In general, the confidentiality of ADI-specific data is protected under secrecy laws in the APRA Act, and subject to disclosure in accordance with purpose and use requirements. In particular, APRA has the power to share non-public information, including regarding the financial condition of an ADI with Treasury, the RBA, or ASIC, provided that APRA is satisfied that the disclosure will assist the agency concerned in the performance of

¹¹See CFR discussion paper: <https://www.rba.gov.au/media-releases/2011/mr-11-11.html>.

¹²There are also bilateral MOUs in place between APRA and Treasury, APRA and the RBA, APRA and ASIC, and ASIC and the RBA that further facilitate inter-agency coordination. For example, an APRA-RBA Coordination Committee, which was established by MOU, comprises senior executives of the two agencies and meets approximately every 6 weeks. There is no bilateral MOU between RBA and Treasury, although the RBA has a statutory duty to liaise with and keep the Treasury fully informed on all matters which jointly concern them, and issues where the two agencies have shared or overlapping responsibilities.

¹³Section 10 of the *Australian Prudential Regulation Authority Act 1998* (APRA Act). See also, Section 10A of the APRA Act (providing that the Parliament intends that APRA should, in performing and exercising its functions and powers, have regard to the desirability of APRA cooperating with other financial sector supervisory agencies).

its functions.¹⁴ APRA also has the ability to impose confidentiality obligations on the receiving party at the time of disclosure of the non-public information.¹⁵ The RBA, Treasury and ASIC also have the ability to disclose protected information to the other CFR Agencies in certain circumstances.¹⁶

B. Cross-Border Coordination and Information Sharing

20. The four major Australian ADIs have significant operations in New Zealand.

Each has a wholly-owned subsidiary and two of the four also have substantial branches there.¹⁷ The New Zealand operations of these ADIs account for approximately 10 percent of their global consolidated assets and a similar share of their total profits. Conversely, they account for about 90 percent of New Zealand's banking sector assets. Additionally, the credit ratings of each of the New Zealand subsidiaries are set with reference to the financial position of their respective parents.

21. Commendable steps have been taken to facilitate cross-border cooperation between the Australian and New Zealand Authorities.

In 2005-2006, both the Australian and New Zealand parliaments enacted laws that imposed reciprocal obligations on APRA and the New Zealand prudential supervisor, the Reserve Bank of New Zealand (RBNZ), to support each other in meeting statutory responsibilities for prudential regulation and financial stability. As a result, APRA has an explicit statutory obligation: (i) to support the New Zealand authorities in meeting their statutory responsibilities for financial stability in New Zealand; (ii) to the extent reasonably practicable, avoid any action that is likely to have a detrimental effect on financial system stability in New Zealand; and (iii) to consult with and consider the advice of the New Zealand authorities, when practicable, before taking action that is likely to have a detrimental effect on financial system stability in New Zealand.¹⁸ In addition, the Trans-Tasman Council on Banking Supervision (TTBC) was formed in 2005 to enhance cooperation in the supervision and resolution of trans-Tasman banks.¹⁹ The TTBC

¹⁴Section 56 of the APRA Act and Regulation 5 of the *Australian Prudential Regulation Authority Regulations 1998* (APRA Regulations).

¹⁵Subsection 56(9) of the APRA Act.

¹⁶See Sections 79A and 79B of the *Reserve Bank of Australia Act 1959* (RBA Act); Section 127 of the *Australian Securities and Investments Commission Act 2001*; and Regulation 2.1 of the *Public Services Regulations 1999*.

¹⁷The subsidiaries are (with the Australian parent in parentheses): ANZ National Bank (ANZ), ASB Bank (Commonwealth Bank of Australia), Bank of New Zealand (National Australia Bank), and Westpac New Zealand (Westpac Banking Corporation). Westpac and Commonwealth Bank also have significant branches.

¹⁸The primary obligations are set out in Section 8A of the APRA Act.

¹⁹The actual terms of reference for the TTBC in 2005 were to promote a joint approach to banking supervision that delivers a seamless regulatory environment. In particular the TTBC was asked to: (i) enhance cooperation on the supervision of trans-Tasman banks and information sharing between respective supervisors; (ii) promote

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 a Memorandum of Cooperation (MOC) on the management of trans-Tasman bank distress.

22. **The authorities are encouraged to take steps to enhance cross-border coordination arrangements with other jurisdictions.** Given the relative significance of cross-border links with the banking sectors of countries other than New Zealand, arrangements for coordination on bank resolution and crisis management are at much earlier stages. Other cross-border operations of Australian ADIs are limited, and, in the aggregate, account for approximately 5 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. At this point, APRA has in place bilateral MOUs on supervisory matters with a number of foreign supervisory agencies, including those in the US and UK. Discussions for the development of other MOUs focused on bank resolution and crisis management with the U.S. and other relevant jurisdictions are ongoing.

23. **Enhancements to cross-border coordination arrangements should include legislative changes that ensure that all CFR agencies are well-positioned to exchange information.** APRA and ASIC have a strong legal basis to share information with foreign authorities and to protect the confidentiality of information received. Except for confidential APRA data that it discloses, RBA has no explicit power to impose confidentiality on protected information that it discloses.²⁰ Thus, for example, the RBA could not impose on Treasury an obligation to keep confidential information that RBA received from a foreign supervisory authority. The RBA and Treasury are working to amend the RBA Act to provide the RBA with a legal basis to share information and to protect the confidentiality of information it receives more in line with APRA's powers.

C. Crisis Preparedness

24. **Maximizing crisis preparedness through ex-ante planning should continue to be a key priority.** Both the CFR and the TTBC are actively being used as forums to enhance crisis preparedness. The CFR and the TTBC have been developing crisis resolution strategies which include policy and operational guidance as well as pre-drafted documentation, and conducting crisis simulation exercises. The CFR conducted a domestic crisis simulation

and review regularly trans-Tasman crisis response preparedness relating to events that involve banks that are common to both countries; and, (iii) guide the development of policy advice to both governments, underpinned by the principles of policy harmonisation, mutual recognition and trans-Tasman coordination.

²⁰In the domestic context, the information exchanged between the CFR Agencies will likely be protected under the APRA Act, as well as their own agency acts.

exercise in 2009 and the TTBC conducted a trans-Tasman exercise in 2011.²¹ Given a number of recent legislative and policy developments in the Australian safety net and crisis management framework, the framework has not been fully tested. Conducting broad, drastic crisis simulations on a periodic basis and targeted crisis simulations more frequently should be an important focus.²² The authorities may also want to consider the value of cross-agency and APRA only (as appropriate) simulations centered on (i) an idiosyncratic crisis (e.g., fraud causing major losses at a systemic ADI); (ii) problem areas revealed in previous simulations; (iii) system-wide disruptions (e.g., liquidity shocks); and (iv) testing components of the framework that have never been used (e.g., depositor payouts under the FCS or unsecured lending by the RBA). Additional desktop exercises, particularly in problem areas, should also be considered.

25. When it is necessary to take measures to address problem ADIs, the importance of effective and timely communications in maintaining public confidence cannot be overemphasized. The aim is to convey a message that the authorities have taken strong and sober action that will, in due course, fortify the banking sector. Lacking an effective communications arrangement, the authorities will often spend much of the time on the defensive, countering criticism that may or may not be reasonable or correct. This can result in elevated tension and an undesirable effect on the banking system's reliability and effectiveness.

26. Further developing a communication strategy could prove useful for the CFR agencies to harmonize their efforts to advance a consistent message to the public.²³ The strategy could include:

- Building effectual relationships and trust with the media representatives who cover the financial system in regular times (which can boost the positive treatment in crisis times).
- Identifying one spokesperson to carefully coordinate and manage information on behalf of all the CFR Agencies; or at maximum, one per agency. To prevent any ambiguity and misunderstanding, all communication should be provided in simple terms. Public statements should emphasize that the authorities have acted in the best interests of the depositors and banking system stability.

²¹In 2007, APRA conducted its own simulation exercise but this exercise was conducted before key features of the current safety net were put in place—namely, APRA's ability to impose statutory management prior to an ADI's insolvency and the FCS.

²²For example, the FDIC conducts several focused simulation exercises each year.

²³CFR has established a Working Group on Crisis Communication which is now in operation. This working group is dedicated to developing crisis management communications strategies, material and logistical arrangements.

- Ensuring that timing of communication is well-coordinated and tested through simulation exercises.

27. **Legislative changes should be made to forestall premature disclosure of sensitive crisis resolution information.** The Australian securities law regime requires immediate and continuous disclosure to investors when a covered entity becomes aware of information which is not generally available and which a reasonable person would expect to have a material effect on the price or value of the shares, debentures or other interests in the entity. Failure to do so could result in liability for directors that fail to comply with this requirement.²⁴ The need for a resolution package, or the early stages of crisis resolution discussions, for example, would reasonably be expected to have a material effect on the price or value of the ADI's securities. Any ADI covered by the securities regime (i.e., a publicly listed ADI) would be required to make the appropriate disclosures so as to comply with the Corporations Act. Poor coordination of compliance with the disclosure requirements with resolution actions and the overall public communication strategy could pose risks to financial stability (including through depositor runs); stripping of the ADI's assets by insiders; or market disruptions. Legislative changes could usefully: (1) make clear that a direction by APRA to keep certain information confidential is binding and supersedes any requirement to the contrary in the Corporations Act; (2) the failure of a director to disclose such information in accordance with the continuous disclosure regime will not result in liability for the director; and (3) require ASIC to consider systemic stability issues and consult APRA when evaluating contraventions of the disclosure requirements.

IV. EARLY INTERVENTION OF PROBLEM ADIS

A. Liquidity Assistance

28. **Generally, central banks have a variety of tools to provide liquidity assistance in ordinary times and in crisis situations.** In Australia, the availability of high quality liquid assets is limited due to prudent fiscal policy and the resulting limited supply of government bonds. As a result, liquidity arrangements are non-traditional, as further described below.

29. **The scope of eligible collateral that the RBA accepts through market operations makes it extremely unlikely that an ADI would be unable to obtain adequate liquidity under most circumstances.** RBA generally provides liquidity to ADIs through:²⁵ (i) normal open market operations via daily repos against eligible collateral (bonds of highly rated sovereigns and supra-nationals, and New Zealand's government) and (ii) repos against a broader scope of collateral (which could include an ADI's bonds or AAA rated asset backed

²⁴Section 675 of the Corporations Act.

²⁵RBA has no reserve requirements; and reportedly has seen no need for such a tool.

securities (including, related party residential mortgage backed securities and asset-backed commercial paper)). Liquidity assistance in the first instance would be accomplished via RBA's daily auction process; in the second instance assistance would be negotiated on an individual institution basis, in consultation with APRA vis-à-vis supervisory and solvency concerns. These procedures involve haircuts on collateral, the size of which are determined by the RBA. Haircuts are progressively higher for liquidity assistance outside of normal market operations.

30. Using one of the alternative special arrangements provided under Basel III, Australia will establish a Committed Liquidity Facility (CLF) to assist ADIs in satisfying the Liquidity Coverage Ratio. The CLF will enable participating ADIs to access a pre-specified amount of liquidity by entering into repurchase agreements of eligible securities outside the RBA's normal market operations. Access to the CLF will be contingent upon ADIs paying ongoing fees, and supervisory consultations with APRA. In particular, APRA will need to be assured that ADIs have taken all reasonable steps towards meeting their Liquidity Coverage Ratio requirements through their own balance sheet management, before relying on the CLF.²⁶

31. In systemic situations, RBA could provide unsecured liquidity assistance, but would only do so with a government guarantee. This would be discussed and arranged through the CFR, likely in conjunction with a package of measures that would address the ADI's distress. To date, the RBA has never had to provide unsecured liquidity assistance and thus the Government has not been confronted with a request for a guarantee. It would be advisable for RBA, in conjunction with the CFR and the Treasury to run a simulation to test the process of obtaining the guarantee to allow that funds for unsecured lending by the RBA are available on a timely basis.

32. Special arrangements between the four largest ADIs have long been in place in order to alleviate concerns regarding systemic liquidity. Under the inter-bank deposit agreements (IDAs) entered into between the four large ADIs, any one of the subject ADIs could be required (at the direction of APRA) to place a maximum AU\$ 2 billion deposit into one of the other three large ADIs. The deposits would be secured by low-risk conventional mortgage loans. The IDA program would prove useful only when one of the four largest ADIs was experiencing a liquidity shortage; if the liquidity shortage were systemic and affecting all four large ADIs, then obviously the IDA program would not be sufficient. Since these instruments will not qualify as sufficiently high quality liquid assets to meet the Liquidity Coverage Ratio under Basel III, this program will likely be phased out over time.

²⁶See <http://www.rba.gov.au/media-releases/2011/mr-11-25.html>.

B. Corrective Measures for Problem ADIs

33. **APRA has developed two programs designed to facilitate risk-based supervision, which will enable it to detect weaknesses in ADIs early with the objective of avoiding major problems within the banking system and responding to any increasing risks as they emerge.** The Probability and Impact Rating System (PAIRS) combines on and off-site analysis within a program designed to formalize the dynamic assessment of the key risks, management and controls and capital support for an ADI and its supervisory action plan. The supervisory action plan gives consideration to the key risks and issues and the systemic importance of ADI. The model contains both quantitative and qualitative measurements.

34. **In conjunction, the Supervisory Oversight and Response System (SOARS) is designed to use PAIRS results to identify ADIs at risk of failure.** SOARS is used to determine how supervisory concerns based on PAIRS risk assessments should be acted upon, aiming to ensure that supervisory interventions are targeted and timely. It is designed to match supervisory intensity consistently to the probability and impact of failure signals coming out of PAIRS. SOARS is weighted in order that larger problem ADIs receive greater attention and oversight than smaller ones. Both systems provide useful management tools in allocation of staff resources and the design of the most effective corrective measures for an ADI to extricate itself from problem status. That is, as problems occur, APRA will devote more specialist staff for analysis and suggestions for improvement and will give particular attention to external signals such as ADI ratings, share prices, media items; with a goal to gaining as much knowledge as possible to help in implementing a remediation plan for the problem ADI. **APRA implements enforcement measures on a progressive basis, attempting to achieve the desired improvement with the least intrusive measure.** Therefore, as problems appear, APRA may implement informal measures such as moral suasion or send a post-review letter containing findings to be addressed within certain deadlines.

35. **If problems persist, APRA has very broad powers to compel action by issuing directions.** Under Section 11CA of the Banking Act, APRA may direct an ADI (including an ADI under statutory management) or the holding company of an ADI to: (i) act or to refrain from acting in a certain manner or (ii) cause a subsidiary of the ADI or a subsidiary of the holding company of an ADI to act or to refrain from acting in a certain manner. Section 11CA authorizes APRA to issue directions with respect to, inter alia: imposing penalties, removing and replacing personnel, and implementing a Recovery Plan (Box 1). Under Section 13E of the Banking Act, APRA also has comprehensive powers to issue a direction to an ADI to recapitalize. APRA does not have formal prompt corrective action powers or requirements; however, as the PAIRS probability of failure rating rises the ADI is subject to more intense supervision and enforcement actions where necessary. Depending on the nature of the direction (except those involving the resolution of a distressed ADI), the decision could be subject to a full review on the merits by the Administrative Appeals Tribunal (Annex II).

Box 1. Examples of APRA's Directions Powers

Circumstances Justifying Direction
<p>The ADI or holding company has contravened a legal provision.</p> <p>The ADI or holding company has contravened a prudential regulation, requirement or standard.</p> <p>The ADI or holding company is likely to contravene a legal provision, a prudential regulation, requirement or standard.</p> <p>The direction is necessary for protection of depositors.</p> <p>The ADI or holding company is, or is about to become, unable to meet its liabilities.</p> <p>There is, or might be, a material risk to the security of the assets of the ADI or the holding company.</p> <p>There is, or might be, a material deterioration in the financial condition of the ADI or the holding company.</p> <p>The ADI or the holding company is conducting its affairs in an improper or financially unsound way</p> <p>The failure to issue a direction would materially prejudice the interests of depositors.</p> <p>The ADI or the holding company is conducting its affairs in a way that may cause or promote financial instability in Australia.</p>
Types of Directions²⁷
<p>To comply with the whole or part of the Banking Act or other applicable legislation.</p> <p>To comply with the whole or part of a prudential regulation, requirement or standard</p> <p>To order an audit (by an auditor chosen by APRA) at the expense of the ADI.</p> <p>To remove a director or senior manager.</p> <p>To ensure a director or senior manager does not take part in the management of conduct of the ADI, except as permitted by APRA.</p> <p>To appoint a person or persons as director or senior manager of the ADI for a term directed by APRA.</p> <p>To remove any auditor and appoint another auditor to hold office for a term directed by APRA.</p> <p>Not to give any financial accommodation to any person.</p> <p>Not to accept the deposit of any amount.</p> <p>Not to borrow any amount.</p> <p>Not to accept any payment on account of share capital except payments in respect of calls that fell due before the direction was given.</p> <p>Not to repay any amount repaid on shares.</p> <p>Not to pay a dividend on any shares.</p> <p>Not to repay any money on deposit or advance.</p> <p>Not to pay or transfer any amount or asset to any person, or create an obligation (contingent or otherwise) to do so.</p> <p>Not to undertake any financial obligation (contingent or otherwise) on behalf of any other person.</p> <p>Anything else as to the way in which the affairs of the ADI or holding company are to be conducted or not conducted.</p>

V. RESOLUTION OF NON-SYSTEMIC ADIS

36. **The authorities are of the view that any ADI—regardless of size—could be systemic, depending on the circumstances surrounding its distress.** Policy guidance contemplates that an analysis of systemic impact at the point of failure will be undertaken

²⁷Directions must be given by notice in writing.

prior to the adoption of a resolution strategy for an ADI. Tools for the resolution of systemic ADIs and to manage a system-wide banking crisis are discussed in Part VI. This Part discusses the components of the financial safety net that are applicable to the resolution of a non-systemic ADI: resolution under private control (including through the use of direction and business transfer powers); statutory management by APRA or its designee; winding-up under a court-based procedure; and activation of the FCS.

A. Resolution Under Private Control

37. **The resolution framework allows for the possibility that a problem bank could be resolved while under private control.** Provided ADI management is willing and able to facilitate the ADI's resolution,²⁸ APRA could use its powers of direction (Box 1) to resolve an ADI under private control. As noted above, APRA could order an ADI to recapitalize or to implement a recovery plan. In addition, under the *Financial Sector (Business Transfer and Group Restructure Act) 1999* (Business Transfer Act), APRA could issue a determination that an ADI should transfer assets and /or liabilities to a healthy ADI, a bridge bank, or an asset management company (a "compulsory business transfer").²⁹ Given that assuming official control over an ADI through appointing a statutory manager could have adverse impacts on market confidence or cause disruption to critical banking functions, resolving an ADI while under private control is an attractive resolution option.

B. Statutory Management

38. **Where the ADI's management is unwilling or unable to facilitate a resolution while the ADI is under private control, or such an approach is undesirable, APRA is empowered to appoint a statutory manager.** APRA may appoint itself or another person as statutory manager. A statutory manager other than APRA is subject to the directions of APRA. APRA may appoint a statutory manager under broad and appropriate grounds, including where:

- the ADI informs APRA that it considers it is likely to become unable to meet its obligations or that it is about to suspend payment;
- APRA considers that, in the absence of external support, the ADI:
 - (i) may become unable to meet its obligations; or

²⁸Under the Corporations Act, directors may be held personally liable for the debts incurred by a corporation that is trading while insolvent. In practice, this threat of liability encourages management to voluntarily take actions to resolve a corporation in distress, including by relinquishing control of the corporation. Section 588G of the Corporations Act. Similarly, under the Banking Act, an officer of an ADI commits an offense and is subject to a fine if he refuses or fails to take reasonable steps to ensure that the ADI complies with a recapitalization direction. Section 11CG and 13Q of the Banking Act.

²⁹A compulsory transfer of business under the Business Transfer Act is subject to consent from the appropriate Minister, who may or may not be the Treasurer.

- (ii) the ADI may suspend payment; or
 - (iii) it is likely that the ADI will be unable to carry on banking business in Australia consistently with the interests of its depositors; or
 - (iv) it is likely that the ADI will be unable to carry on banking business in Australia consistently with the stability of the financial system in Australia.³⁰
- The ADI becomes unable to meet its obligations or suspends payment.

39. **The role of the statutory manager will vary depending on whether APRA has adopted an “open” or “closed” resolution strategy.** In an open resolution, the role of the statutory manager is to enable the ADI to meet its existing obligations and to continue business either through the existing ADI or in another entity. In a closed resolution, the role of the statutory manager is to position the ADI for orderly liquidation. This could involve withdrawing the ADI from the payment system or facilitating the transfer of the deposit book to another ADI, for example. In a closed resolution, the ADI is closed to new business and APRA petitions the court to wind-up the ADI. APRA must appoint a statutory manager to an ADI before it can apply to the court for winding-up.

40. **A statutory manager has ample power to take a wide range of resolution actions.** While the role of a statutory manager may differ in an open and closed resolution, the available tools are the same. A statutory manager assumes all of the powers of the ADI’s board of directors and senior management.³¹ A statutory manager does not assume the powers of its shareholders, but APRA’s powers of direction (Box 1) coupled with powers explicitly assigned to the statutory manager by law appear to be sufficient to prevent shareholders from interfering with resolution activities. As noted above, in addition to its ordinary powers of direction, APRA has the power to order a compulsory business transfer of all or part of the failing ADI to a healthy ADI, a bridge bank or an asset management company. Among the powers explicitly assigned to a statutory manager under the Banking Act are:

- i. to sell the whole or part of the ADI’s business on any terms and conditions that the statutory manager considers appropriate;
- ii. to alter an ADI’s constitution to allow more flexibility for the statutory manager to act where the alteration promotes the protection of depositor interests and financial system stability in Australia;

³⁰Section 13A of the Banking Act.

³¹Directors cease to hold office on the appointment of a statutory manager. Removal of management is at the discretion of the statutory manager.

- iii. to take the following actions to recapitalize an ADI:³²
 - a. issue, cancel or sell shares, or rights to acquire shares in the ADI;
 - b. reduce the ADI's share capital by cancelling any paid up share capital not represented by available assets; or
 - c. vary or cancel rights or restrictions attached to shares or a class of shares.

41. **Statutory management may only be terminated by APRA once conditions in the Banking Act have been satisfied.**³³ More specifically, APRA may terminate statutory management when: (1) the ADI's deposit liabilities have been repaid, or APRA is satisfied that suitable provision has been made for their repayment; (2) APRA considers it no longer necessary for a statutory manager to remain in control of the ADI's business; or (3) APRA has applied to the Court for the ADI to be wound up and a liquidator has been appointed. There is no time limit for the termination of statutory management. The authorities should consider whether it would be beneficial to include limits to the duration of statutory management under the Banking Act.³⁴ Including such limits would: (i) motivate the statutory manager to diligently work towards a prompt resolution; (ii) promote financial stability by decisive action; and (iii) eliminate the uncertainty of a government controlled ADI for an indefinite time-span.

C. Winding-Up

42. **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. Under the Banking Act, APRA may apply for an ADI to be wound up if the ADI is under statutory management and APRA considers that the ADI is insolvent and cannot be restored to solvency within a reasonable period. Alternatively, APRA may choose to apply under the Corporations Act for an ADI to be wound up. Under the Corporations Act, there are two potential types of grounds for the winding-up of a corporation—general grounds and grounds based on the insolvency

³²Section 14AA of the Banking Act. Exercise of the recapitalization powers is subject to providing written notice to shareholders of the ADI explaining the effect that the Act will have on their interests. The effectiveness of the power is not affected by anything to the contrary in, the Corporations Act; the ADI's constitution; contracts to which the ADI is party; and relevant Australian Securities Exchange listing rules. Prior to taking steps to recapitalize the ADI, the statutory manager must obtain and consider a report on the fair value of the shares and rights concerned prepared by an independent expert. However, if APRA determines that delaying the recapitalization until the completion of the report would negatively impact depositors or financial stability in Australia, the recapitalization may proceed while the report is pending. APRA would be required to publish its written determination and a notice to that effect in the Government Gazette. Section 14AB of the Banking Act.

³³Subsection 13C(1) of the Banking Act.

³⁴For example, statutory management could be limited to one year, with a possible extension (e.g., six months or one year), for rare instances where more time is needed to finalize a transaction.

of the corporation. Among the general grounds are those that would allow the Court to order the winding-up of a corporation where the affairs of the corporation are being conducted in a manner that: (i) is oppressive or unfairly prejudicial to, or unfairly discriminatory against, a shareholder or shareholders or (ii) is contrary to the interests of the shareholders as a whole and where the court is of the opinion that it is just and equitable that the company be wound up.³⁵ The Corporations Act also provides that a Court may order that corporation be wound up in insolvency.³⁶ Section 95A provides that a company is solvent if it is able to pay all debts, as and when they become due and payable. Whether APRA chooses to apply under the Banking Act or Corporations Act for an ADI to be wound up, the actual winding up of the ADI is to be conducted in accordance with the Corporations Act.

43. **The winding-up of an ADI will not commence without APRA's consent and involvement.** The Banking Act provides that APRA may apply for an ADI to be wound up if the ADI is under statutory management and APRA considers that the ADI is insolvent and cannot be restored to solvency within a reasonable period.³⁷ The Corporations Act also provides that APRA may apply to the Court for the winding up of an ADI under both general grounds and insolvency grounds.³⁸ Other than APRA, specified parties under the Corporations Act, including the ADI itself or its creditors, may also apply to a Court for a winding-up of an ADI on either of the two applicable grounds mentioned above. However, a party who wishes to apply to the court for the winding-up of an ADI must first notify APRA; failure to do so will result in criminal liability. This advance notice gives APRA the opportunity to impose statutory management on an ADI if proceeding with the court-based liquidation would have a negative impact on financial stability. Importantly, the legal consequences of the appointment of a statutory manager include: (i) the imposition of an automatic stay on legal proceedings that have commenced against the ADI (including winding-up proceedings) and (ii) the termination of the appointment of any administrator appointed by the court in connection with an insolvency proceeding.³⁹

44. **The priority of payments in winding-up of an ADI is governed by both the Banking Act and the Corporations Act.** Section 555 of the Corporations Act provides that, except where specifically provided for elsewhere, all debts and claims proved in a winding up rank equally, and if the property of the company is insufficient to meet them in full, they must be paid proportionately. The Banking Act modifies this regime for ADIs.⁴⁰ Subsection

³⁵Paragraph 461(1)(f) of the Corporations Act.

³⁶Section 459A the Corporations Act.

³⁷Section 14F of the Banking Act.

³⁸Section 459P and paragraph 462(2)(h) of the Corporations Act and Regulation 5.4.01 of the *Corporations Regulations 2001*.

³⁹Sections 15A and 15B of the Banking Act.

⁴⁰See Section 70B of the Banking Act.

13A(3) of the Banking Act provides that, in the event of an insolvency, the assets of the ADI in Australia will be made available to meet its liabilities in the following order:

1. any amounts owing to APRA for FCS payments made in respect of the ADI;
2. any amounts owing to APRA for administrative costs of activating the FCS payments made in respect of the ADI;
3. the ADI's customer account liabilities in Australia that exceed FCS coverage;⁴¹
4. any debt the ADI owes to the RBA;
5. any liabilities under the IDA or similar arrangement; and
6. any other liabilities in the usual order of priority apart from Subsection 13A(3) (i.e., that under the Corporations Act).

D. The Financial Claims Scheme

45. **Prevention of ADI failures is the preferred method of depositor protection; however, in a market economy, prevention is not always successful, and when it is not, ADIs should be allowed to fail in an orderly manner.** In such situations it is important to have a mechanism that will both provide depositors' protection from excessive loss, but also contribute to financial stability. In Australia this is addressed by legally stipulating depositor preference in the winding up of an ADI (i.e., depositors have a higher claim priority than other unsecured creditors) and by an ex post-funded depositor protection scheme. The Deposit Insurance Core Principles and the Key Attributes for Effective Resolution Regimes both stress the importance of ensuring that banks bear at least some of the cost of bank failures.⁴² It is recommended that Australia change the depositor protection scheme to an ex ante funded scheme, collecting premiums from ADIs periodically to build up a reserve fund against future ADI failures.⁴³ An ex ante deposit insurance scheme would have a credible and adequate reserve fund, which should be invested with an emphasis on liquidity and safety over return. The fund would be built up from flat-rate periodic assessments on ADIs' deposits with an objective to implement risk-based assessments over time.

⁴¹See Part VI below. Discrimination against creditors on the basis of their nationality, location of their claim or jurisdiction where it is payable is contrary to Key Attribute 7.4.

⁴²See Deposit Insurance Core Principle 11 (Funding) and Key Attribute 6 (Funding Firms in Resolution).

⁴³An alternative could be to establish an industry-funded resolution or stability fund (either as a separate fund or combined with the FCS) that respects the same priority of payments. Either way, there should be an investment policy whereby the fund's assets be invested with an objective of liquidity and safety over return. Funds should not be placed with member ADIs.

46. **Australia’s depositor protection scheme, the FCS was created in October 2008⁴⁴, and is included in the Banking Act as Part II, Division 2AA, Subdivision B –**

Declaration of ADI. The FCS is administered by APRA, and a department within APRA has been established to perform this function. As such, there is no governing board and the FCS it is not a separate legal entity. This provides economies of scale and mitigates potential coordination problems between resolution and depositor payout. FCS is a narrow mandate scheme, meaning that its responsibilities are limited to reimbursing protected depositors.

47. **Determination of whether the FCS will apply is currently declared by the Treasurer subsequent to APRA applying to the Federal Court for an insolvent ADI to be wound-up.** There are two potential risks to this approach. First, since activation of the FCS is at the discretion of the Treasurer, lack of certainty for depositors in terms of whether the FCS will be activated could result in depositor runs. Second, the courts could possibly refuse APRA’s application for winding up which could in result in the Treasurer having declared the FCS but the ADI not being wound-up. To address the first risk, the mission recommends that the FCS should be automatically activated on APRA’s application to the court for the winding up.⁴⁵ The second risk is unlikely to materialize given that judicial review is limited (Annex II) and the discretion granted to a statutory manager is broad.

48. **The FCS is a form of an ex post funded scheme that is backed by an AU\$ 20 billion standing budgetary appropriation per declared ADI, although currently there is no clear plan to mobilize these funds.**⁴⁶ There is no requirement that remaining open ADIs contribute to defray any expenditure under the scheme; disbursements are expected to be recovered via asset liquidation recoveries, and there is an option for the government to impose an industry levy to make up any shortfall.⁴⁷ A typical ex-post funded scheme acts as a loss-sharing or mutual guarantee agreement among the banks to reimburse depositors in case of a bank failure. These types of schemes are usually organized and administered privately, and, in case of an insured event, the surviving banks contribute ex post to repay depositors. A potential advantage of such a scheme is that banks would have strong incentives to monitor each others’ activities, which would increase market discipline. This market discipline

⁴⁴At the same time the FCS was introduced, a temporary guarantee scheme for large deposits and wholesale funding was also introduced. Large deposits were considered those in excess of AU\$ 1 million, with maturities of 5 years or less.

⁴⁵The authorities report that the Government has committed to correct this deficiency.

⁴⁶It should be noted that the current government debt limit is AU\$ 300 billion; depending on the actual level of debt and the required draw down of funds for depositor reimbursement, there might be a need to increase the legislative debt limit to allow for the reimbursement.

⁴⁷FCS is legally subrogated to depositor claims and therefore enjoys depositor preference; however, it must be noted that financial assets deteriorate swiftly during a liquidation process and there is no guarantee that recoveries will be sufficient to replenish the government (public) expenditure. In the spirit of hoping for the best while preparing for the worst, the authorities may want to consider making it mandatory for ADIs to make up any shortfall.

feature is missing from the Australian deposit protection scheme since the ADIs are not required to contribute. Another disadvantage of ex-post schemes—potentially significant delays in deposit repayment—still exists in Australia since there is no clear plan to mobilize the extant budget appropriation. Pro-cyclicality, caused by ex post levies on remaining ADIs to cover any shortfalls will depend on whether the authorities exercise the option to require such assessments.

49. **Given the extreme concentration of the Australian banking system and that ADIs are not required to pay ex ante or ex post premiums, the FCS effectually increases moral hazard greatly in the financial sector.** Mechanisms that can be used to reduce moral hazard, such as risk-adjusted premiums, are rendered irrelevant. Additionally, as mentioned above, this arrangement falls short of both DICP 11 – Funding and Key Attribute 6 (for effective resolution) which specify that the cost of ADI failures should be borne by the banking industry.

50. **Most deposit insurance schemes worldwide are ex ante funded through regular premiums payment by member banks and there is a growing trend toward such schemes.** An ex ante fund usually has a number of advantages. First, public confidence may be enhanced by the mere existence of a fund. In particular, assuming proper advance preparation, it allows for prompt depositor reimbursement by ensuring that there are no obstacles to obtaining necessary funding. Second, ex ante schemes have the ability to smooth premium payments over the economic cycle, reducing the risk that banks will face demands for contributions when their balance sheets are already under stress. One of the main disadvantages of an ex ante funded scheme, however, is that in a highly concentrated banking system, such as Australia's, it may be difficult to establish a fund of sufficient size that the deposit guarantee would seem credible. Notwithstanding this fact, the FCS should be converted to an ex ante deposit insurance scheme. Its unique design—advance budget appropriation and no mandatory requirement for remaining ADIs to contribute—does not compensate for the tangible effect of a specific reserve fund for depositor reimbursement. An ex ante scheme can also be used to help funding in a bridge bank situation (see below).

51. **At the time of its introduction, the FCS guaranteed deposits up to AU\$ 1 million per account-holder, per ADI; however, that was subsequently reduced to AU\$ 250,000 from February 1, 2012.**⁴⁸ This level fully covers around 99 percent of eligible depositors and over 50 percent of deposits by value. Generally, deposit guarantee schemes (DGS) aim to fully cover a relatively high number of depositors, but a relatively low deposit amount. This design feature is to protect smaller, financially unsophisticated depositors who could not be expected to monitor an ADI's risk profile on their own. In this context, AU\$ 250,000 still

⁴⁸Term deposits which existed on or before September 10, 2011, are covered up to AU\$ 1 million until December 31, 2012 or their maturity, whichever comes first.

represents very high coverage; however, it follows an international trend that developed in response to the global financial crisis.⁴⁹

52. **Coverage is per depositor, per ADI, including trust accounts and corporate account-holders.** All deposit accounts are covered, including legal entities and insiders. There is no provision to offset deposit reimbursement to overdue or matured loans. Although the Treasurer has discretion to deny payments under the scheme (e.g., to insiders), insider deposits should be explicitly excluded from coverage as should deposits of customers with overdue or matured loans, to which the deposit should be offset. There is an official Government guaranteed deposits seal; however, ADIs are not required to display it. Since membership in FCS is mandatory for ADIs, the authorities should make it mandatory for ADIs to display the Government's guaranteed deposits seal. ADIs are also required (through Corporation Regulations under the Corporations Act) to, in product disclosure statements for protected accounts, disclose that the account-holder may be entitled to a payment under the FCS and provide APRA's contact details as a source for further information on the FCS.⁵⁰ Also, all information regarding the FCS in ADIs' advertising or brochures, etc. must be supplied by APRA in order that ADIs do not misrepresent the scheme in order to attract depositors from other ADIs.

53. **APRA has met resistance from ADIs in implementing single customer view (SCV) recordkeeping, a feature that is critical to insured depositor reimbursement.** The ADIs are admittedly hampered in these efforts by the lack of a unique citizen identification number (such as the Social Security Number in the U.S.). However, it will be much easier for ADIs to introduce this approach to customer recordkeeping while they have an ongoing relationship with the customer. If such a system is not in place when a ADI fails, then APRA or its delegate will have to sort and aggregate accounts themselves to make insurance determinations, potentially resulting in a great delay in depositor repayment (depending on size and complexity of ADI). APRA, therefore, should ensure the ADIs implement the SCV on, or where possible, ahead of, the agreed timeframe of January 1, 2014.

54. **Finally, FCS plans for depositor reimbursement appear to be limited to options such as checks drawn on RBA, electronic transfers to accounts at another ADI, or other similar cash payments.** A more efficient method would be to institute a competitive process whereby other ADIs would bid on the opportunity to assume a failed ADI's insured deposits. Similar to a U.S. FDIC P&A, this technique represents an excellent opportunity for an acquiring ADI to either increase market share or to expand into areas where it does not have a presence. A P&A is an alternative method for reimbursing depositors. Paying a premium for deposits (and perhaps options on banking premises) is much more cost-effective than

⁴⁹International deposit insurance experts are currently analyzing the effects of this expanded coverage with respect to funding (and concomitant effects on ADIs' financials), credibility, and sovereign exposure.

⁵⁰Compliance with these requirements is administered by ASIC.

obtaining premises and soliciting deposits on a *de novo* basis. Additionally, the efficiency of this procedure limits financial disruption to a community; and helps maintain public confidence in the banking system (see Annex III for An Informal Comparison of Australia's FCS to the Deposit Insurance Core Principles). Regardless of the method chosen, FCS should plan to use the failed ADI's data processing system, premises and employees, at least temporarily, to ensure efficiency and continuity in insured depositor reimbursement (an exception may be made when an assuming bank is confident that deposit records can be swiftly converted). The methods in the topic sentence should be considered contingency, or back-up, plans in case the failed ADI's data processing system was corrupted.

VI. CRISIS MANAGEMENT AND RESOLUTION OF SYSTEMICALLY IMPORTANT BANKS

55. **The structure of the Australian banking sector calls into question whether extraordinary tools for resolving large ADIs may be necessary.**⁵¹ The banking sector is highly concentrated and dominated by four ADIs, which together hold approximately 76 percent of total banking assets. The remainder of the banking sector comprises four mid-sized and a number of small Australian-owned ADIs, credit unions and building societies (representing approximately 8 percent of banking sector assets), foreign-owned banks (representing approximately 3 percent of banking sector assets), and branches of foreign banks (representing approximately 9 percent of banking sector assets). With respect to the large ADIs, ordinary liquidation proceedings could prove unmanageable due to their size and interconnectedness.

56. **Aside from the challenges posed by the large ADIs, the authorities should also be prepared to manage a systemic banking crisis which can occur where trouble manifests in more than one ADI.** The authorities should keep in mind that the failure of an ADI of any size can possibly have systemic effects. This could be reflected by a depositor run on ADIs, borrowers ceasing loan payments, and/or a serious credit crunch. In such situations, the authorities must take steps to avert contagion to other ADIs.

57. **More needs to be done to ensure that the authorities are well-positioned to resolve a systemically important ADI or to address a systemic banking crisis.** As a result of the banking sector structure, moral hazard is high. The large ADIs enjoy a funding cost advantage due, in large part, to the probability that government support would be provided in the event of their failure. And, as described above, even the small ADIs enjoy a costing advantage since they pay nothing for the FCS guarantee. The FCS is ex post funded and an ADI that fails enjoys the benefit provided by the FCS without incurring costs, further contributing to moral hazard. To address this risk, 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. These two things should provide greater incentives for an ADI's

⁵¹ Australia's crisis management framework includes such measures as bridge bank, recapitalization, merger, etc., and they are exploring bail-in options.

shareholders and large creditors to impose more discipline on management to operate safely and soundly, thus helping to reduce moral hazard. As a last resort, the authorities should ensure that solid but flexible arrangements for providing official financial support are in place. These issues are further discussed below.

A. Developing Credible Contingency Plans

58. **Since the global financial crisis, many jurisdictions are now focusing on developing Recovery and Resolution Plans (RRP) for their larger ADIs.** In fact, the resolvability of systemically important institutions is an important focus of the Key Attributes.⁵² These plans not only provide valuable information to the supervisory authority regarding the ADI's operations and how they might be wound up, but also provide a tool for ADI management to obtain a better grasp on the inherent risks in their own operations. The U.K. and U.S. are well-advanced in their work on RRP (Annex IV).

59. **APRA initiated a pilot program in 2011 that required the six largest ADIs in Australia to develop recovery plans according to APRA's specifications, and intends to apply the same requirement for medium-sized ADIs.** Institution-specific resolution planning has not yet begun, although it has been discussed in CFR and APRA is actively considering it. The recovery planning exercise presented a rather severe scenario in which the ADIs capital and liquidity positions were considerably impaired. The recovery planning focused primarily on the mitigating measures that the ADIs could accomplish, without official support, to overcome these impairments and re-establish their financial stability within a realistic timeframe. Draft plans were submitted in late 2011; final plans, signed by the CEO and board of the ADI, are due by the middle of 2012. Analyses of the draft plans reportedly revealed comprehensive approaches for returning the ADIs' capital and liquidity to required levels in case of a rigorous financial shock, including proposals to, *inter alia*, raise capital and sell subsidiaries and/or other businesses.

60. **Many countries require all banks to prepare contingency plans and submit them to the supervisory authority.** These plans generally are not nearly as detailed as Recovery Plans; however, they should include funding sources in times of distress and that ADIs ensure that the assets and documentation that would be required to support collateralized borrowing from the RBA are always in good order. APRA should determine whether extant liquidity and capital contingency plans are adequate for these purposes.

61. **It is recommended that APRA formalize the requirement for the larger ADIs to prepare recovery plans and commence resolution planning for these institutions.** In addition, APRA is encouraged to consider whether it would be beneficial to apply the

⁵²See Key Attribute 9 (requiring institution-specific cross border resolution agreements for G-SIFIs), Key Attribute 10 (requiring resolvability assessments for G-SIFIs), and Key Attribute 11 (requiring recovery and resolution planning for institutions that could be systemically important or critical at failure).

resolvability framework applicable to G-SIFIs under the Key Attributes (i.e., institution-specific cross-border resolution agreements and resolvability assessments) or a version thereof, to the larger ADIs. As mentioned above, APRA has decided to require medium-sized ADIs to also prepare Recovery Plans. It may also be worth considering whether some form of contingency planning requirement should be extended to all ADIs, comparatively truncated in relation to the ADI's size and relative importance to the system. Such plans should be valuable in increasing the efficiency and reducing potential costs should a systemic ADI need to be resolved. As part of the on-going supervision process, APRA should annually check to ensure that the ADIs' required recovery and contingency plans are up-to-date and adequate.

B. Private Sector Involvement/Burden Sharing

62. **Private sector solutions that do not require the use of public funds should be the favored approach to resolving ADIs, even the systemically important ones.** As noted above, the resolution framework does currently contemplate that resolution of an ADI under private control should be possible and recognizes that ADI capitalization is the responsibility of private ADI management and owners. With some encouragement from a direction by APRA, if necessary, ADI management and owners should be expected to attempt to raise capital from existing shareholders or prospective capital providers, undertake sale of the whole institution or particular assets, or voluntarily merge with another institution. However, it must be noted that sale or merger prospects may be limited due to the high concentration in the banking sector and the need to balance financial stability concerns with competition concerns. The development of recovery plans should help clarify potential avenues for private sector resolution options.

63. **The authorities should adopt additional tools that reinforce the view that the industry should bear the costs of bank failures.** In Part V.D., the benefits of pre-funding the FCS are described. But, there are other tools that could be similarly effective at reducing moral hazard that are being adopted or explored by other jurisdictions. For example, an ex ante, industry-funded resolution fund could be created; provisions for statutory bail-in could be included in the legal framework, a financial sector transaction tax could be levied, or capital surcharges could be imposed on systemically important institutions, to build capital with higher loss absorbency. These tools are not mutually exclusive. Nor is necessary that each jurisdiction have all of these tools in place. The selection of which tool or tools will be most effective in Australia should be informed by lessons learned through the development of RRP. Recognizing that the authorities will most likely strive to balance efficiency with ensuring that proper incentives are built into the framework, a simple approach may be, in

addition to converting the FCS to pre-funded scheme, to require the larger ADIs to hold higher loss absorbent capital, given that the necessary infrastructure is already in place.⁵³

C. Official Financial Support

64. **When all else fails, the authorities should have at their disposal solid but flexible arrangements to provide public financial support to the banking sector in order to mitigate systemic risks.** This assistance could take many forms including, direct capital injections, partial purchases of an ADI's stocks or the full nationalization of the ADI, direct loans to the ADI or placement of government deposits with the ADI. These types of financial assistance are commonly referred to as open bank assistance (OBA).

65. **OBA is strongly discouraged except to mitigate systemic risk in the banking sector, when the need for speedy action makes OBA virtually the only viable solution** (and then it should be accompanied by strong conditions). In general, the approach selected for a bank's resolution should be the "least costly" form of resolution. OBA is seldom the least costly form of resolution. On paper, such a plan may *look* like the least costly form of resolution; but the reality is that plans to resolve a bank in this manner are usually speculative and optimistic. Bank losses are virtually always greater than those identified by bank examiners; and the resolution cost is bound to be greater than originally thought. Additionally, bank insiders know the bank's condition better than bank examiners; therefore, the temptation and the opportunity for asset stripping are great. At best, the outcome following OBA is uncertain. Other objections to OBA include:

- It is a poor financial decision ("pouring good money after bad"), and will likely result in further financial losses.
- OBA increases moral hazard. If ailing banks know that OBA is readily available, they could use the funds to engage in ever more risky activities gambling for resurrection"), which will significantly increase losses, and potentially damage financial sector stability.
- Political pressure could compel OBA for an ailing bank when it is not a good business decision or necessary for financial stability.
- OBA can lead to psychological entrapment, with a great financial cost ("We've already injected 50 million; and now they need another 25 million. We need to protect our investment.")

⁵³If political problems prevent converting the FCS to an ex ante scheme, then an alternative could be a resolution or stability fund (or a combined fund (e.g., as in Sweden)) as long as it adheres to the priority of payments under Subsection 13A(3) of the Banking Act.

66. **Various means of providing public financial support are available for the authorities to support a distressed ADI under the existing framework.** Unsecured liquidity support is available from RBA with a government guarantee (see above). And the FSSSA provides for standing budgetary authorization in tranches of funding of up to AU\$ 20 billion each to troubled ADIs for recapitalization or for other similar purposes. The authorities could also establish a bridge bank or an asset management company.

67. **Creating a “bridge” bank via a P&A can be a more effective and less risky alternative to nationalizing a bank.** Although there are variations, generally the bridge bank is established to receive the deposits and good assets of a systemic bank. Often, uninsured deposits and other creditors’ liabilities are also transferred. The bridge bank can be allowed to undertake some or all of the regular business of the bank, such as providing new credit and rolling over existing loans. Taking control of a bank through a bridge P&A can limit losses to the authorities by leaving bad assets, shareholders’ claims, contingent and other liabilities in a bankruptcy, or receivership, estate, rather than assuming a problem bank’s liabilities as sovereign liabilities, as in a typical nationalization. If there is a reasonable expectation that a bridge bank can be quickly sold to a solvent bank, then there may be no need to inject capital (depending also on local requirements).

68. **Keeping in mind that the bridge bank resolution tool should only be applied to systemic banks;⁵⁴ it becomes clear that this option is no panacea.** Typically, a bridge bank is designed to be owned and operated for a temporary time until it can be privatized.⁵⁵ The problem with the bridge bank option—just as with the ability to transfer some or all of the distressed ADI’s business to another ADI under Part 4 of the Business Transfer Act—is, unless the acquiring ADI is a foreign bank, Australia’s banking sector will be even further concentrated, which is undesirable as it further exacerbates moral hazard. This concentration risk could possibly be mitigated by a managed divestiture process. For example, the government may offer 20 percent ownership rights in annual offerings spanning five years or so; resulting in a more widely held bank. Alternatively, the bridge bank could be resolved via a multi-acquirer process; whereby, branches or clusters of branches could be offered to relatively smaller potential acquirers and split among various successful bidders.

69. **The Treasury must be prepared to have a unit established to own and control government-owned ADIs, whether bridge or nationalized.** This unit would own and/or control the ADI (shares), be responsible for the appointment of directors, applying the government’s ownership and control policies, and developing exit strategies. APRA or the CFR should maintain a list of suitable ADI managers for appointment, when needed, to

⁵⁴Although in cases of external systemic shock, it may be a reasonable resolution mechanism to create a bridge ADI to accept the business and operations of several non-systemic ADIs.

⁵⁵Country experience varies; however, somewhere along the lines of 1 year with possible extensions or up to 3 years with no extensions are common.

bridge banks or ADIs that will be capitalized by the government. Before being appointed by the minister, these candidates should go through a strict elimination interview and they should be approved by APRA.

VII. CROSS-BORDER RESOLUTION AND CRISIS MANAGEMENT

70. **Regardless of whether there is failure of an ordinary bank under ordinary times or of systemically important bank, there could be cross-border implications.** From the perspective of Australia as a host jurisdiction, a material deterioration of the financial position of a foreign bank (in the case of a branch located in Australia) or of a foreign parent of an ADI (in the case of a subsidiary located in Australia) could have spill-over effects in the Australian banking sector. This could be manifested in demands for increased up-streaming of profits or liquidity, the transfer risky assets to the Australian entity or the transfer of good assets out of the Australian entity.

71. **APRA's ability to manage the distress of a foreign bank that operates in Australia through a branch could usefully be strengthened.** The Banking Act includes provisions that would minimize the risks that the resolution of a foreign bank that operates in Australia through a branch would pose to financial stability in Australia. In particular, Subsection 11CA(2B) of the Banking Act gives APRA the power to direct a foreign bank that operates through a branch in Australia not to transfer assets out of Australia. It could also prove useful if APRA were to have powers to take control of domestic assets of a foreign bank that operates through a branch in Australia through the appointment of a statutory manager, the ability to order a compulsory business transfer or the power to apply to the Court for the domestic branch of a foreign bank to be wound up. Such powers could allow APRA to support a resolution carried out by a foreign authority or to support financial stability in Australia, as necessary.

72. **Legislation should provide for transparent and expedited processes for the recognition and enforcement of out-of-court resolution decisions taken by foreign authorities.** In general, to enforce a foreign judgment in Australia an applicant must seek recognition and enforcement under either the common law or the statutory regime. The statutory regime allows for the recognition and enforcement of certain foreign judgments by way of a streamlined registration procedure.⁵⁶ However, a foreign judgment can be registered only if it originated from certain courts of countries prescribed by regulation and if the judgment fulfils the criteria in the statute.⁵⁷ Where statute does not apply, the common law governs the recognition and enforcement of foreign judgments. Under the common law, it is necessary to apply to an Australian court to have the foreign judgment recognized and

⁵⁶Foreign Judgments Act 1991.

⁵⁷*Foreign Judgment Regulations 1992*. A foreign court can be added to the list of prescribed courts if Australia is satisfied that it will give substantial reciprocity of treatment to the judgments of Australian courts.

enforced. To grant such an application, the Australian court must be satisfied that the foreign court has exercised a jurisdiction that the Australian court recognizes, that the parties are identical to the parties to the foreign proceeding, that the judgment is for a fixed sum of money, and that the judgment is final and conclusive. In neither case, would recognition of decision of a foreign resolution authority made out-of court be recognized. Legislation could, for example, be amended to provide that decisions of foreign resolution authorities made out-of-court be considered as foreign judgment that are subject to recognition and enforcement through the streamlined procedures already in place. However other measures, such as empowering APRA to take measures under the domestic resolution regime that support and are consistent with the resolution measures taken by a foreign resolution authority could also prove effective.

73. Finally, the priority of payments for the distribution of proceeds in a winding-up should be amended so as to not discriminate against creditors on the basis of the location of their claim or jurisdiction where it is payable. As noted above, Subsection 13A(3) of the Banking Act provides that, in the event of an insolvency, the assets of the ADI in Australia will be made available to meet its liabilities in the following order:

1. any amounts owing to APRA for FCS payments made in respect of the ADI;
2. any amounts owing to APRA for administrative costs of activating the FCS payments made in respect of the ADI;
3. the ADI's customer account liabilities *in Australia* that exceed FCS coverage;
4. any debt the ADI owes to the RBA;
5. any liabilities under the IDA or similar arrangement; and
6. any other liabilities in the usual order of priority apart from Subsection 13A(3) (i.e., that under the Corporations Act).

Emerging good practice suggests that domestic legislation providing for the priority of payments in the event of the insolvency of a financial institution should not discriminate against creditors on the basis of their nationality, the location of their claim or the jurisdiction where it is payable.⁵⁸ Current legislation is contrary to this practice in that certain customers with accounts in Australia will receive payment ahead of similar types of customers with accounts outside of Australia.

⁵⁸See Key Attribute 7.4.

Annex I. Status of Recommendations from the 2006 FSAP

Recommendation	Status
The failure and crisis management framework should clearly establish the legal foundation and policy approach to achieve speedy, least-cost and minimally disruptive resolution of nonviable institutions.	Significant improvements have been made to the legal framework since the 2006 FSAP ⁵⁹ and the authorities have actively engaged in developing policy guidance for bank resolution and crisis management.
The questions of deposit insurance and policyholder protection should also be an element of a comprehensive framework for resolution of failed institutions and crisis management.	The Government has put in place the Financial Claims Scheme to protect depositors and insurance policy-holders.
The authorities should consider introduction of express provisions into the Banking Act to seize control of a failing institution while it is still “solvent” and to impose a resolution without shareholder and creditor consent.	The triggers for statutory management have been amended to allow for pre-insolvency intervention in a failing ADI.
The authorities should consider arrangements that would facilitate purchase and assumption transactions of failed institutions when these can result in lower cost resolution outcomes.	Existing and new provisions enable APRA to transfer the business of a failing ADI to, a healthy ADI, a bridge bank, or an entity that is not regulated (for example, an asset management company).
The framework for crisis management should aim at: (i) preserving financial and economic stability during a crisis; (ii) avoiding moral hazard and enhancing market discipline before a crisis; and (iii) reducing the fiscal cost of a crisis.	With the growth of the four large ADIs, moral hazard has actually increased. Further improvements should be made to the legislative framework to avoid moral hazard, enhance market discipline, and reduce the potential fiscal cost of a crisis. (See Table 1. Summary of Key Recommendations)
Build on the progress made within the Trans-Tasman Council to improve coordination in crisis management, given the New Zealand exposure of the ADIs.	The TTBC has developed cross-border resolution policy guidance and in 2011 conducted a simulation exercise.

⁵⁹See *Financial System Legislation Amendment (Financial Claims Scheme and Other Measures) Act 2008* and *Financial System Legislation Amendment (Prudential Refinements and Other Measures) Act 2010*.

Annex II. Challenges to Decisions Taken by APRA

➤ **Administrative decisions by APRA are subject to three types of review at the request of the interested party and subject to conditions in the Banking Act:**

- *Internal Review by APRA.* Certain decisions (identified in Part VI of the Banking Act) are subject to internal review within 21 days. In such case, APRA must reconsider the decision, and provide reasons for its decision to the applicant.
- *Merits Review by the Administrative Appeals Tribunal.* Certain decisions (identified in Part VI of the Banking Act) are appealable to the Administrative Appeals Tribunal within 28 days of finalization of the internal review by APRA. The Administrative Appeals Tribunal has power to consider the decision on its merits, and may substitute its own decision for the decision made by APRA. A decision by the Administrative Appeals Tribunal is itself subject to appeal before the Federal Court.
- *Judicial Review.* All administrative decisions of APRA (other than most decisions of APRA in respect of the FCS) are subject to judicial review under the *Administrative Decisions (Judicial Review) Act 1977*. However, decisions may only be challenged on the grounds that: the decision was made for an improper purpose; there was a failure to provide natural justice in respect of the decision; the decision was *ultra vires* or the decision was motivated by bad faith. As a result, the Court may set aside the decision of APRA but may not substitute its own judgment.

Section 58 of the APRA Act provides that APRA, an APRA member, an APRA staff member, or an agent of APRA is not subject to liability to any person in respect of anything done, or omitted to be done, in the exercise or performance, or the purported exercise or performance, of powers, functions or duties conferred or imposed on APRA, an APRA member or an APRA staff member by law, provided the act or omission is not done in bad faith. Similar protection is applicable to a statutory manager under Sections 14C and 14D of the Banking Act.

➤ **Decisions subject to internal review or merits review under Part VI of the Banking Act are as follows:**

- decisions to refuse authorization to carry on banking business, and decisions to impose or vary a condition on such authorization;
- decisions to refuse to grant an exemption from certain requirements of the Banking Act;
- decisions to revoke the authorization of a holding company;
- decisions to make prudential standards in respect of a particular bank;
- decisions to issue directions to an ADI based on one of the following triggers:

- a) the ADI or a holding company has contravened a provision of: (i) the Banking Act, the *Financial Sector (Collection of Data) Act 2001*; or the *First Home Saver Accounts Act 2008*;
 - b) the ADI or a holding company has contravened a prudential requirement regulation or a prudential standard;
 - c) the ADI or a holding company is likely to contravene this Act, a prudential requirement regulation, a prudential standard, the *Financial Sector (Collection of Data) Act 2001* or the *First Home Saver Accounts Act 2008*, and such a contravention is likely to give rise to a prudential risk; or
 - d) the ADI or a holding company has contravened a condition or direction under the Banking Act or the *Collection of Data Act*; or
- decisions to remove an appointed auditor on the ground of the auditor being unfit or improper for the position. However, note that APRA may separately direct that an auditor be removed on other grounds not rendering the direction reviewable on the merits;
 - decisions to remove and / or replace a director or senior manager of a ADI on the ground of the director/senior manager being unfit or improper for the position. However, note that APRA may separately direct that a director or senior manager be removed on other grounds not rendering the direction reviewable on the merits;
 - certain decisions of APRA in respect of covered bonds; and
 - decisions by APRA in respect of permission to use restricted expressions, e.g., ‘bank’, ‘banker’ and ‘banking’.
- **Certain key decisions that could be taken in the course of bank resolution and crisis management are not covered by Part VI of the Banking Act and thus are subject to judicial review but are not subject to internal review or merits review, including:**
- decisions to issue directions to an ADI on grounds other than those specified above;
 - decisions by APRA relating to the appointment and conduct of a statutory manager to a bank;
 - decisions by APRA directing banks to undertake a recapitalization; and
 - decisions by APRA to formally investigate the affairs of a ADI.

Annex III. An Informal Comparison of Australia's FCS to the Deposit Insurance Core Principles

Core Principle	Comment
<p>1 – Public policy objectives Public policy objectives should be formally specified and well integrated into the design of the deposit insurance system. The principal objectives for deposit insurance systems are to contribute to the stability of the financial system and protect depositors.</p>	<p>In performing its functions, APRA is required to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and to protect the interest of depositors. These objectives necessarily flow through to its administration of FCS.</p>
<p>2 – Mitigating moral hazard Moral hazard should be mitigated by ensuring that the deposit insurance system contains appropriate design features and through other elements of the financial system safety net.</p>	<p>Although the quality of prudential supervision provides some comfort regarding moral hazard, given the extreme concentration of the Australian banking system and the fact that ADIs are not required to pay ex ante or ex post premiums, the FCS effectually increases moral hazard in the financial sector.</p>
<p>3 – Mandate The deposit insurer's mandate must be clearly and formally specified and be consistent with the stated public policy objectives and the powers and responsibilities given to the deposit insurer.</p>	<p>The Banking Law's Subdivision B – Declaration of ADI, makes FCS's "paybox" mandate clear.</p>
<p>4 – Powers A deposit insurer should have all powers necessary to fulfill its mandate and these should be formally specified. All deposit insurers require the power to finance reimbursements, enter into contracts, set internal operating budgets and procedures, and access timely and accurate information to ensure that they can meet their obligations to depositors promptly.</p>	<p>The Banking Act's Part II, Division 2A, Subdivision B – Declaration of ADI, provides APRA with all powers necessary to accomplish the narrow mandate of the FCS.</p>
<p>5 – Governance The deposit insurer should be operationally independent, transparent, accountable and insulated from undue political and industry influence.</p>	<p>The FCS is administered by a department within APRA. Although APRA has operational independence, FCS lacks a Supervisory Board which would give it operational independence; however, that is mitigated by its narrow, ex post role.</p>
<p>6 – Relationships with other safety-net participants. A framework should be in place for the close coordination and information sharing, on a routine basis as well as in relation to particular banks, among the deposit insurer and other financial system safety-net participants. Such information should be accurate and timely (subject to confidentiality when required). Information-sharing and coordination arrangements should be formalized.</p>	<p>Since the FCS is administered by a department within APRA, it enjoys economies of scale in information-sharing and coordination with other safety net members.</p>
<p>7 – Cross-border issues Provided confidentiality is ensured, all relevant information should be exchanged between</p>	<p>APRA appears to have adequate powers to share information on a cross- border basis.</p>

<p>deposit insurers in different jurisdictions and possibly between deposit insurers and other foreign safety-net participants when appropriate.</p>	
<p>8 – Compulsory membership. Membership in the deposit insurance system should be compulsory for all financial institutions accepting deposits to avoid adverse selection.</p>	<p>FCS membership is mandatory for all ADIs incorporated in Australia; however, ADIs are not required to display certificates of membership (see Principle 12).</p>
<p>9 – Coverage Policymakers should define clearly in law, prudential regulations or by-laws what is an insurable deposit. The level of coverage should be limited but credible and be capable of being quickly determined. It should cover adequately the large majority of depositors to meet the public policy objectives of the system and be internally consistent with other deposit insurance system design features.</p>	<p>The coverage seems high—fully covering over 99 percent of depositors and over 50 percent of deposit amounts by value. Although there was a comparative study with other deposit insurance schemes internationally, more granular analysis of deposit distribution in the Australian banking sector—a common method to determine a coverage level that covers a large number of depositors but a relatively small amount of deposits by value-- appears not to have been undertaken. Coverage includes many entities which most schemes exclude, especially insiders and related parties. There is no provision to offset a depositor's claim against his/her matured or past-due loan.</p>
<p>10 – Transitioning from a blanket guarantee to a limited coverage deposit insurance system When a country decides to transition from a blanket guarantee to a limited coverage deposit insurance system, or to change a given blanket guarantee, the transition should be as rapid as a country's circumstances permit. Blanket guarantees can have a number of adverse effects if retained too long, notably moral hazard. Policymakers should pay particular attention to public attitudes and expectations during the transition period.</p>	<p>Australia never had a blanket guarantee system. Australia introduced FCS with an initial AU\$ 1 million “cap” in 2008, and subsequently reduced it to AU\$ 250,000 in 2012, with no adverse public consequences.</p>
<p>11 – Funding A deposit insurance system should have available all funding mechanisms necessary to ensure the prompt reimbursement of depositors' claims, including a means of obtaining supplementary back-up funding for liquidity purposes when required. Primary responsibility for paying the cost of deposit insurance should be borne by banks since they and their clients directly benefit from having an effective deposit insurance system.</p>	<p>The FCS is a unique ex post system, with a AU\$ 20 billion appropriation from the budget. Banks pay no premiums; any expenditure is expected to be recouped via recoveries on asset liquidation (although there is an option for the Government to impose an industry levy to make up for any shortfall). In direct contravention of this principle, ADIs bear no explicit upfront cost for depositor protection, greatly increasing moral hazard.</p>
<p>12 – Public awareness In order for a deposit insurance system to be effective, it is essential that the public be informed on an ongoing basis about the benefits and limitations of the deposit insurance system.</p>	<p>ASICs website (and the Moneysmart website) contains information about the Government's guarantee on deposits together with information regarding the Government's guaranteed deposits seal. Display of the seal is voluntary, in accordance with Guidelines (also publicly</p>

	<p>available).</p> <p>Since membership in FCS is mandatory, it should be mandatory for all ADIs to display the Government's guaranteed deposits seal.</p> <p>In addition, Corporation Regulations require ADIs, in product disclosure statements for protected accounts to disclose that the account holder may be entitled to a payment under the FCS and provide APRA's contact details so further information on the FCS can be obtained from them.</p> <p>APRA, as applicable, should provide standard language for ADIs to use in their deposit product descriptions and advertising in order that no ADI use non-standard language to imply "better" coverage.</p>
<p>13 – Legal protection</p> <p>The deposit insurer and individuals working for the deposit insurer should be protected against lawsuits for their decisions and actions taken in "good faith" while discharging their mandates. However, individuals must be required to follow appropriate conflict-of-interest rules and codes of conduct to ensure they remain accountable. Legal protection should be defined in legislation and administrative procedures, and, under appropriate circumstances, cover legal costs for those indemnified.</p>	<p>The FCS is administered by a department of APRA so relevant staff are employees of APRA. APRA employees enjoy adequate protection.</p>
<p>14 – Dealing with parties at fault in a bank failure</p> <p>A deposit insurer, or other relevant authority, should be provided with the power to seek legal redress against those parties at fault in a bank failure.</p>	<p>APRA has authority to pursue parties at fault in an ADI failure.</p>
<p>15 – Early detection and timely intervention and resolution</p> <p>The deposit insurer should be part of a framework within the financial system safety net that provides for the early detection and timely intervention and resolution of troubled banks. The determination and recognition of when a bank is, or is expected to be, in serious financial difficulty should be made early and on the basis of well-defined criteria by safety-net participants with the operational independence and power to act.</p>	<p>APRA has powers in this regard, which appear adequate.</p>
<p>16 – Effective resolution processes</p> <p>Effective failure-resolution processes should: facilitate the ability of the deposit insurer to meet its obligations, including reimbursement of depositors promptly and accurately and on an equitable basis; minimize resolution costs and disruption of markets; maximize recoveries on</p>	<p>APRA has powers in this regard, which appear adequate.</p>

<p>assets; and reinforce discipline through legal actions in cases of negligence or other wrongdoings. In addition, the deposit insurer or other relevant financial system safety-net participant should have the authority to establish a flexible mechanism to help preserve critical banking functions by facilitating the acquisition by an appropriate body of the assets and the assumption of the liabilities of a failed bank (e.g., providing depositors with continuous access to their funds and maintaining clearing and settlement activities).</p>	
<p>17 – Reimbursing depositors The deposit insurance system should give depositors prompt access to their insured funds. Therefore, the deposit insurer should be notified or informed sufficiently in advance of the conditions under which a reimbursement may be required and be provided with access to depositor information in advance. Depositors should have a legal right to reimbursement up to the coverage limit and should know when and under what conditions the deposit insurer will start the payment process, the time frame over which payments will take place, and whether any advance or interim payments will be made as well as the applicable coverage limits.</p>	<p>Despite prompt information sharing and coordination, with APRA, the lack of a single customer view (SCV) extant among the banks would prevent FCS from meeting its goal of beginning depositor reimbursement within 7 days of the trigger event. APRA should require all banks institute SCVs within a reasonable time frame. APRA should consider a competitive process whereby other ADIs could bid on the opportunity to act as paying agent for the insured deposits (Experience has shown that assuming banks usually retain more than 70 percent of transferred deposits)</p>
<p>18 – Recoveries The deposit insurer should share in the proceeds of recoveries from the estate of the failed bank. The management of the assets of the failed bank and the recovery process (by the deposit insurer or other party carrying out this role) should be guided by commercial considerations and their economic merits.</p>	<p>Australia has depositor preference and FCS, as subrogee, enjoys a higher claim priority than other unsecured creditors.</p>

Annex IV. United Kingdom and United States—Summary of RRP Requirements

United Kingdom

Recovery plans

A Recovery Plan should have the following features:

- a sufficient number of credible options to cope with a range of scenarios, including particular and market-wide stress;
- options to return the firm to a stable and sustainable position following capital shortfalls and/or liquidity pressures; and
- appropriate governance processes, including intervention conditions and procedures, to ensure timely implementation of recovery options in a range of stress situations.

Key elements

- A detailed exposition of how the implementation of the Recovery Plan fits within the firm's existing risk management framework.
- An explanation of the triggers that would indicate when the plan should be invoked.
- A comparative summary of the firm's complete list of recovery options.
- A description of each option using a consistent framework.
- A list of key executives/managers who will be involved in each recovery action and the roles they would play, as well as key staff at group level.
- A communication plan (internal and external) to accompany the recovery options, which outlines the issues to be considered when implementing the options to prevent doubts on the viability of the firm and to preserve the confidence of markets and other stakeholders.

Resolution plans

The information and analysis provided to the authorities will help the authorities to prepare a resolution plan with the following aims to:

- ensure that resolution can be carried out without public financial support;
- minimize the impact on financial stability;
- minimize the effect on depositors and consumers;
- allow decisions and actions to be taken and executed in a short space of time (for example, over a 'resolution weekend'); identify those economic functions for which continuity is critical to the economy or financial system; identify those economic functions which would need to be wound up in an orderly fashion; identify and

consider ways of removing barriers which may prevent critical functions being resolved successfully;

- allow a resolution that separates the identified critical economic functions from noncritical activities which could be allowed to fail; and
- enhance international cooperation and crisis management planning between international regulators for G-SIFIs.

Ultimately, resolution information and analysis will allow the authorities to commit more credibly to putting firms that fail to meet threshold conditions into resolution in an orderly manner with minimal impact on the financial system, regardless of the size or complexity of the firm.

Key elements

- Overall group structure diagram.
- A high-level understanding of the economic functions performed within or in some way dependent on each significant legal entity.
- A breakdown of group balance sheet by significant legal entity.
- An understanding of major financial dependencies between legal entities.
- An understanding of the firm's interconnectedness with other banks.
- Operational dependencies.
- Other dependencies.

Further details can be found at:

http://www.fsa.gov.uk/pages/Library/Policy/CP/2011/11_16.shtml

United States

Resolution Plan

Each nonbank financial company supervised by the Federal Reserve Board and each bank holding company with total consolidated assets of \$50 billion must periodically submit to the Board, the Federal Deposit Insurance Corporation, and the Financial Stability Council a resolution plan or “living will” that includes:

- information regarding the manner and extent to which any insured depository institution affiliated with the company is adequately protected from risks arising from the activities of any nonbank subsidiaries of the company;
- full descriptions of the ownership structure, assets, liabilities, and contractual obligations of the company;
- identification of the cross-guarantees tied to different securities;
- identification of major counterparties;
- a process for determining to whom the collateral of the company is pledged; and
- any other information that the Board and the corporation jointly require by rule or order.

The proposed rule would require a strategic analysis by the covered company of how it can be resolved under Title 11 of the U.S. Code (the “Bankruptcy Code”) in a way that would not pose systemic risk to the financial system. In doing so, the company must map its:

- business lines to material legal entities and provide integrated analyses of its corporate structure;
- credit and other exposures;
- funding, capital and cash flows;
- the domestic and foreign jurisdictions in which it operates; and
- its supporting information systems for core business lines and critical operations.

The Dodd-Frank Act requires that in applying the requirements of section 165(d) to any foreign nonbank financial company supervised by the Board or any foreign-based bank holding company, the Board give due regard to the principle of national treatment and equality of competitive opportunity, and to take into account the extent to which the foreign financial company is subject, on a consolidated basis, to home-country standards that are comparable to those applied to financial companies in the United States.

The proposed rule requires that each covered company periodically submit to the Board and corporation:

- (i) a plan for the rapid and orderly resolution of the Covered Company under the Bankruptcy Code in the event of material financial distress at or failure of the Covered Company (“Resolution Plan”); and
- (ii) a report on the nature and extent to which the Covered Company has credit exposure to other significant nonbank financial companies and significant bank holding companies and on the nature and extent to which other significant nonbank financial companies and significant bank holding companies have credit exposure to the Covered Company (“Credit Exposure Report”).

Further details can be found at:

<http://www.federalreserve.gov/newsevents/press/bcreg/20110412b.htm>