Chapter XX

AUSTRALIA

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I INTRODUCTION

Australia has a sophisticated and stable banking industry, which provides a full range of banking and financial services and products.

The banking market is dominated by four major Australian banks, measured by market capitalisation: Australia and New Zealand Banking Group Limited ('ANZ'), Commonwealth Bank of Australia ('CBA'), National Australia Bank Limited ('NAB') and Westpac Banking Corporation ('Westpac').[2] Their market concentration has increased in recent years, with CBA acquiring Bank of Western Australia in October 2008 and Westpac acquiring St George Bank Limited in December 2008.

The banking market includes significant foreign banks, investment banks, a number of regional banks and non-bank financial institutions carrying on banking business, including credit unions, building societies and friendly societies.

As at 12 November 2012, there were 173 authorised deposit-taking institutions ('ADIs')[3] authorised by the Australian Prudential Regulation Authority ('APRA') to carry on banking business in Australia, comprising 25 Australian ADIs[4] (being 17 Australian banks and eight subsidiaries of foreign banks), 40 foreign ADIs,[5] nine building societies, 92 credit unions and seven others.

1 Louise McCoach and David Landy are partners at Clayton Utz. The authors would like to acknowledge the contribution of Greta Burkett, Alex Chernishev, Terence Kwong, Dominic Matthews, Caitlin Sheehy and Robert Turnbull for their research in this chapter.

2 Australian Securities Exchange, 'Financial Sector Profile' June 2011, accessed 22 December 2012 at www.asx.com.au/documents/research/financial_sector_factsheet.pdf.

3 APRA List of ADIs, accessed 13 December 2012 at www.apra.gov.au/adi/pages/adilist.aspx.

4 That is, an ADI incorporated in Australia, whether as a subsidiary of a foreign bank or not.

5 That is, ADIs not incorporated in Australia.

In addition, two entities are authorised to be non-operating holding companies ('NOHCs'). NOHCs are holding companies of ADIs that have authority from APRA under Section 11AA of the Banking Act.[6] When a body corporate seeks authority to be an ADI, APRA's permission may be conditional upon the applicant's holding company obtaining authority to be an NOHC.[7]

II THE REGULATORY REGIME APPLICABLE TO BANKS

i General

Overall regulation of the banking and finance system is divided between the Reserve Bank of Australia ('the RBA'), APRA and the Australian Securities and Investments Commission ('ASIC').[8]

The RBA (established by the Reserve Bank Act 1959 (Cth)) is Australia's central bank and has had a long-standing responsibility for the overall stability of the financial system and for monetary policy. Determination and implementation of RBA policy are vested in the Payments Systems Board and the Reserve Bank Board. However, the RBA has no role in prudential supervision of ADIs (or other financial institutions).

Technically, exchange control is an RBA function; however, at a practical level, there is no need for RBA approval where foreign exchange transactions are conducted through money market dealers and foreign exchange dealers authorised by RBA.

With the introduction of the Autonomous Sanctions Regulations 2011 under the Autonomous Sanctions Act 2011 (Cth), the RBA is no longer responsible for the administration of sanctions in the context of foreign exchange control. This responsibility now resides with the Department of Foreign Affairs and Trade ('DFAT'). The Minister for Foreign Affairs and Trade is given the power to designate a person or entity, to whom the provision of assets is prohibited.

APRA (established by the Australian Prudential Regulation Authority Act 1998 (Cth) ('the APRA Act')) is responsible for the licensing and prudential supervision of all ADIs and NOHCs authorised by APRA. It is also responsible for the prudential supervision of life and general insurance companies and superannuation funds. Its supervisory powers come from a range of legislation, principally, from the Banking Act, the Life Insurance Act 1995 (Cth) and the Superannuation Industry (Supervision) Act 1993 (Cth).

In performing its functions and powers, APRA is required to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, to promote financial system stability in Australia.[9]

Although APRA is subject to ministerial direction on its policies and priorities[10] it is the Australian government's intention that APRA should have operational

6 The Banking Act 1959 (Cth).

7 Banking Act, Section 11AA.

8 The sole regulator of Australian registered companies and a regulator of financial services.

9 APRA Act, Section 8(2).

10 APRA Act, Section 12(1).

independence, free from government intervention.[11] Accordingly, the minister responsible for administering the APRA Act[12] is prohibited from giving a direction to APRA in relation to a particular case.[13]

ASIC (established by the Australian Securities and Investments Commission Act 2001 (Cth)) has responsibility for monitoring and promoting market integrity and consumer protection, and for licensing, in relation to financial products and services. ASIC, working with the RBA, is also responsible for taking certain regulatory actions to minimise systemic risk in clearing and settlement systems. In this regard, ASIC has powers under the Corporations Act 2001 (Cth) ('the Corporations Act')[14] relating to the licensing, standard setting and direction of providers of clearing and settlement facilities.[15]

The Australian Treasury is responsible for advising the government on the stability of the financial system and on legislative and regulatory matters pertaining to financial system infrastructure.[16]

At an inter-agency level, the Council of Financial Regulators ('the CFR') aims to promote cooperation and collaboration between the RBA, APRA, ASIC and the Australian Treasury.[17] As specified in its Charter,[18] the CFR aims to contribute to the efficiency and effectiveness of financial regulation by providing a forum for discussion and collaboration between its members, in order to:

a identify important trends and issues in the financial system;

b ensure that appropriate coordination mechanisms are in place for responding to actual and potential instances of financial instability; and

c harmonise regulatory and reporting requirements.

ii ADI authorisation

Any entity that wishes to carry on a banking business in Australia is required by the Banking Act to be authorised by APRA as an ADI or have the benefit of an exemption

11 See Explanatory Memorandum, Australian Prudential Regulation Authority Amendment Bill 2003 (Cth), paragraphs 3.18 and 3.19.

12 The ministers responsible for administering the APRA Act are the Treasurer and the Assistant Treasurer.

13 APRA Act, Section 12(3).

14 The Australia-wide legislation relating to corporations, securities, financial products and related markets.

15 Reserve Bank of Australia and Australian Prudential Regulation Authority, 'Macroprudential Analysis and Policy in the Australian Financial Stability Framework', p. 3, September 2012, accessed 18 December 2012 at www.rba.gov.au/fin-stability/resources/2012-09-map-aus-fsf/pdf/2012-09-map-aus-fsf.pdf.

16 Ibid., p. 2.

17 Ibid., p. 3.

18 Reserve Bank of Australia, 'The Council of Financial Regulators' Charter', 13 January 2004, accessed 14 December 2012 at www.rba.gov.au/fin-stability/reg-framework/cfr-charter.html.

from the authorisation requirement.[19] Further approval is required for an entity to use the description 'bank' in its name.[20]

An entity will be engaging in 'banking business' for the purposes of the Banking Act[21] if it engages in:

a specific prescribed activities, including the taking of money on deposit and the making of advances of money; or

b a more general concept of banking within the meaning of paragraph 51(xiii) of the Australian Constitution (the case law with respect to this concept is not entirely clear; however, it suggests that the acceptance of deposits alone may be sufficient to constitute the carrying on of a banking business).

There are three options relevant to ADI authorisation:

a a body corporate incorporated in Australia can apply for Australian ADI status;

b a non-operating holding company of a group of companies that includes one or more ADIs can apply for NOHC status (this allows a group to diversify across, for example, banking, insurance, funds management and securities); and

c a foreign body corporate can apply for foreign ADI status. On authorisation by APRA as a foreign ADI, the body corporate will also be required to register in Australia as a foreign company under the Corporations Act (that registration will not, at a practical level, impose obligations greater than those that the foreign body corporate will assume in order to maintain its foreign ADI status).

APRA requires a foreign body corporate that is seeking foreign ADI status to provide detailed information to APRA as part of the application process, including details about the supervisory arrangements to which the foreign body corporate is subject in its home jurisdiction.[22]

There are two key restrictions on operating through branches as a foreign ADI that typically make it impractical for foreign banks to carry on retail operations as a foreign ADI:

a foreign ADIs are not permitted to accept initial deposits from Australian residents of less than A$250,000;[23] and

b a foreign ADI must disclose to prospective depositors that Division 2 of the Banking Act, which contains statutory protections for depositors, does not apply to it.[24]

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19 Banking Act, Sections 8 and 11.

20 Banking Act, Section 66.

21 Banking Act, Section 5.

22 Australian Prudential Regulatory Authority, 'ADI Authorisation Guidelines', April 2008, p. 17.

23 Ibid., paragraph 35.

24 Ibid., paragraph 36 and Banking Act, Section 11E(2). Note also that APRA is unable to apply to wind up foreign ADIs and the Minister is not entitled to make a declaration under Section 16AD in relation to them. The effect of this is that the Australian government guarantee of

As a result of these restrictions, foreign banks typically conduct their retail operations in Australia through locally incorporated subsidiaries that have Australian ADI status and their wholesale operations through an entity that has foreign ADI status. In that case, APRA requires banking transactions between the foreign ADI and the subsidiary Australian ADI to be at arm's length and on commercial terms.[25]

iii Cross-border activities by non-ADI foreign banks

A foreign bank that does not have ADI status may:

a subject to prior approval from APRA, operate through a representative office in Australia for liaison and research activities only.[26] A bank operating in Australia on this basis will also need to be registered with ASIC as a foreign company, as the liaison activities will constitute carrying on business in Australia for the purposes of the Corporations Act;[27]

b access the domestic capital markets to raise funds – a single issue of debt securities should not, by itself, constitute carrying on business in Australia and so avoids the need for registration with ASIC as a foreign company and for any specific approval for the issuance of the debt securities;[28]

c apply the proceeds of debt securities issued in Australia for its own purposes outside Australia without the need to register with APRA under the Financial Sector (Collection of Data) Act 2001 (Cth);

d use the word 'bank' (or similar) when issuing debt securities in Australia provided that:
- the debt securities are offered and/or traded in parcels of at least A$500,000; and
- all documentation clearly states that the issuer is not an ADI;[29] and

e avoid the need to apply for and hold an Australian Financial Securities Licence ('AFSL') for some arranging, underwriting and intermediating services in 'financial products' (which is widely defined) where those services are provided to wholesale investors[30] and where the foreign bank is regulated by an approved APRA equivalent regulator in its domestic jurisdiction;[31] however, unless that service was occasional only, the bank would need to register with ASIC as a foreign company carrying on business in Australia.

'protected accounts' under the Financial Claims Scheme does not apply to deposits with foreign ADIs. For further details on the Financial Claims Scheme, see Section VI.iii, *infra*.

25 Australian Prudential Regulatory Authority Guidelines, 'ADI Authorisation Guidelines', April 2008, paragraphs 42–45.

26 Banking Act, Section 67. And see APRA's Guidelines on Being Authorised as a Representative Office of a Foreign Bank (March 2007).

27 See Part 1.2 Division 3 of the Corporations Act.

28 Corporations Act, Section 21(3)(f) Part 1.2 Division 3. But see also ASIC RG 121.

29 Banking (Exemption) Order No. 82 (23 September 1996).

30 See Section IV.vii, *infra*.

31 Corporations Act, Section 911A(2)(h).

III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

Prudential supervision function

APRA has the power to establish and enforce prudential standards designed to enable APRA to discharge its prudential supervision function over ADIs, NOHCs, life insurance companies, general insurance companies and superannuation funds.[32] Each prudential standard that is currently in force is set out in full on APRA's website.[33] They cover a broad range of topics including capital adequacy, funds management and securitisation, liquidity management, large exposures, equity associations, credit quality, corporate governance and outsourcing matters in an ADI's business.

Since the release of the Basel III framework[34] in December 2010, APRA has been actively involved in implementing a series of updates to ensure that its prudential standards adopt, with appropriate modifications, the capital and liquidity enhancements under Basel III. The revised prudential standards are available on APRA's website.[35] Under those standards, the new capital requirements will take effect on an accelerated basis from 1 January 2013. This is subject to transitional arrangements with respect to the new counterparty credit risk capital requirements that are to be implemented for each ADI on a 'best endeavours' basis from the first annual reporting period beginning on or after 1 July 2013. APRA is yet to release final prudential standards implementing the Basel III liquidity enhancements. However, APRA has indicated that it will release finalised liquidity standards soon and that these will be implemented in accordance with the Basel III timetable.[36]

APRA is entitled to determine[37] whether a prudential standard applies to all ADIs or NOHCs or one or more specified ADIs or NOHCs. The prudential standards

32 Banking Act, Section 11AF; Insurance Act 1973 (Cth), Section 32; Life Insurance Act 1995 (Cth), Section 230A; and Superannuation Industry (Supervision) Act 1993 (Cth), Section 34C.

33 www.apra.gov.au.

34 The consultation package included Basel Committee on Banking Supervision, 'Basel III: A global regulatory framework for more resilient banks and banking systems', December 2010, accessed 1 December 2012 at www.bis.org/publ/bcbs189.pdf and Basel Committee on Banking Supervision, 'Basel III: International framework for liquidity risk measurement, standards and monitoring', December 2010, accessed 1 December 2012 at www.bis.org/publ/bcbs188.pdf.

35 APRA Website, 'Implementing Basel III capital reforms in Australia', September 2012, accessed 14 December 2012 at www.apra.gov.au/adi/PrudentialFramework/Pages/Implementing-Basel-III-capital-reforms-in-Australia-September-2012.aspx; APRA Website, 'Basel III capital: counterparty credit risk and other measures', November 2012, accessed 14 December 2012 at www.apra.gov.au/adi/PrudentialFramework/Pages/Basel-III-CCR-Final-November-2012.aspx.

36 APRA, 'Discussion Paper: Implementing Basel III liquidity reforms in Australia', 16 November 2011, accessed 18 December 2012 at www.apra.gov.au/adi/documents/adi_dp_iblr_november_2011.pdf.

37 Banking Act, Section 11AF.

therefore vary in their application to ADIs and NOHCs. The regulatory model adopted by APRA requires those bodies to which the prudential standards apply to be largely responsible for the implementation and monitoring of those standards. While APRA does require regular reports from ADIs, NOHCs and their subsidiaries in relation to specified matters, the Banking Act[38] and the prudential standards make it clear that the onus rests with these bodies to report to APRA any significant actual or prospective breach of a prudential standard. Such reports must be given to APRA as soon as practicable (and in any case no later than 10 business days) after the reporting entity becomes aware of the actual or prospective breach.[39] A failure by an ADI (or any of its group members) to comply with the breach reporting regime under the Banking Act is an offence that carries a penalty of 200 penalty units.[40] In extreme circumstances, officers of the relevant ADI may also be criminally liable.

To this extent the prudential standards are largely self-regulating. At the same time, if APRA has reason to believe that an ADI or NOHC has contravened or is likely to contravene a prudential standard, APRA has the power to issue directions to that ADI or NOHC requiring compliance with the standards (an 'APRA Direction').[41]

Non-compliance with an APRA Direction is an offence,[42] which carries a penalty of 50 penalty units. If an ADI or NOHC fails to comply with an APRA Direction, APRA has the power to revoke its authorisation.[43] An officer of an ADI or NOHC is guilty of an offence if: the officer's duties include ensuring compliance by the entity with a direction and the officer fails to take reasonable steps towards fulfilling this duty.[44]

Other functions

APRA has a statistical information collection function under the Financial Sector (Collection of Data) Act 2001 (Cth).[45] This Act requires all ADIs, NOHCs and their subsidiaries to provide financial data in regular standardised reports to APRA. General reporting forms require them to provide (except in the case of liquid assets which only applies to specified ADIs) data relating to exposures, impaired assets, liquid assets, commercial property and securities held, securities issued and financing arrangements.[46] Other reporting forms separately require the provision of information to APRA on capital

38 For example, see Banking Act Section 62A(1B).

39 Banking Act, Section 62A(1B)(c). Note 'significant' is defined in Section 62A(1C) for the purposes of Section 62A(1B).

40 Banking Act, Section 62A(1B). Under the Crimes Act 1914 (Cth), Section 4AA, one penalty unit currently equates to A$110.

41 Banking Act, Section 11CA(1).

42 Banking Act, Section 11CG(1).

43 Banking Act, Section 9A and Section 11AB(2)(a).

44 Banking Act, Section 11CG(2).

45 Financial Sector (Collection of Data) Act 2001 (Cth), Section 13.

46 APRA, Reporting forms and instructions accessed 29 March 2010 at www.apra.gov.au/Statistics/Reporting-forms-and-instructions-exclude-Basel-II.cfm.

adequacy, market risk, re-pricing analysis, off-balance sheet business, securitisation, specialised lending and other exposures.[47]

Foreign ADIs are also required to provide information to APRA in relation to their Australian branches, regarding standardised credit risk (off-balance sheet exposures), repricing analysis, off-balance sheet business and securitisation.

As part of the Basel III reforms, in December 2011, the Basel Committee released a consultative document proposing new disclosure and reporting requirements for the banking system.[48] These disclosure requirements are designed to enhance transparency in banks' disclosure and to promote cross-jurisdictional consistency. Once the Basel Committee publishes the final disclosure requirements, regulators in each member jurisdiction, including APRA, will be expected to implement the requirements in their home jurisdiction with appropriate modifications.

Consequences of an ADI failure

The consequences of an ADI failure are largely regulated by Section 13A of the Banking Act, which gives APRA broad powers, acting on its own or through the appointment of an administrator, to investigate the affairs of an Australian ADI or take control of an Australian ADI's business in the following circumstances:

a the ADI informs APRA that it is likely to become unable to meet its obligations or that it is about to suspend payment;

b APRA considers that in the absence of external support (1) the ADI may become unable to meet its obligations or may suspend payment; or (2) it is likely that the ADI will be unable to carry on banking business in Australia consistently with the interests of its depositors or with the stability of the financial system in Australia; or

c the ADI becomes unable to meet its obligations or suspends payment.[49]

It is an offence if an Australian ADI does not immediately inform APRA if it considers that it is likely to become unable to meet its obligations, or that it is about to suspend payment.[50]

Where an ADI statutory manager (being either APRA or an administrator of an ADI's business appointed by APRA[51]) is in control of an Australian ADI's business and APRA considers that the ADI is insolvent and cannot be restored to solvency within a

47 APRA, Reporting forms and instructions accessed 29 March 2010 at www.apra.gov.au/Statistics/Basel-II-reporting-forms-and-instructions-for-all-ADIs.cfm. APRA Reporting Forms ARF 112.2A, 117, 118 and 120.2.

48 Basel Committee on Banking Supervision, 'Consultative Document: Definition of Capital Disclosure Requirements' December 2011, accessed 23 November 2012 at www.bis.org/publ/bcbs212.pdf.

49 Banking Act, Section 13A.

50 Banking Act, Section 13.

51 Banking Act, Section 13A(2).

reasonable period, then APRA may apply to the Federal Court of Australia for an order that the ADI be wound up.[52]

APRA's powers under the Banking Act to investigate, take control of, or apply for an ADI to be wound up, do not extend to foreign ADIs.[53]

In September 2012, the Australian Treasury released a consultation paper, 'Strengthening APRA's Crisis Management Powers',[54] which includes proposals for reform in this area. In particular, it is proposed to strengthen and extend APRA's powers over distressed and potentially distressed ADIs, NOHCs, life insurance companies, general insurance companies and superannuation funds.

Priority for application of assets of an ADI in Australia

Whatever other consequences flow from an ADI becoming unable to meet its obligations or suspending payments, Section 11F of the Banking Act requires that the assets in Australia of foreign ADIs be available to meet liabilities in Australia in priority to other liabilities of the ADI. In the case of an Australian ADI, payment of creditors in liquidation is subject to statutory priorities in respect of the ADI's liabilities to APRA, protected account holders, the RBA and (if certified by APRA) providers of emergency financial support.[55]

An Australian ADI is guilty of an offence if it does not hold assets (excluding goodwill and any assets or other amount excluded by the prudential standards set by APRA) in Australia of a value greater than or equal to the total amount of its deposit liabilities in Australia and APRA has not authorised the ADI to hold assets of a lesser value.[56]

RBA as lender of last resort

If an ADI is unable to meet its obligations or is likely to suspend payments, the RBA has a discretion to act as a lender of last resort.[57] This discretion arguably allows the RBA to lend monies to any ADI (regardless of whether or not that ADI is an Australian ADI or a foreign ADI). That said, the RBA has previously stated that it will only lend to an

52 Banking Act, Section 14F.

53 Banking Act, Section 11E.

54 APRA, 'Strengthening APRA's Crisis Management Powers: Consultation Paper', September 2012, accessed 23 November 2012 at www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/2012/APRA/Key%20Docs/PDF/Discussion%20Paper.ashx.

55 Banking Act, Section 13A.

56 Banking Act, Section 13A(4). In 'Strengthening APRA's Crisis Management Powers: Consultation Paper', it has been argued that the Section 13A(3) hierarchy of priorities applying to Australian ADIs unduly constrains statutory managers from implementing a recovery plan for distressed ADIs. Therefore, it has been proposed that the schemes of priorities not apply where a statutory manager has been appointed over an ADI.

57 Reserve Bank Act 1959 (Cth), Sections 8 and 26.

ADI if it is experiencing solvency difficulties and the RBA considers that the rest of the Australian financial system would be seriously affected by the failure of that ADI.[58]

Since Australia's Federation in 1901, last-resort support has been provided sparingly by the RBA (or its predecessor), including support to the Primary Producers Bank in 1931, and three private banks in their efforts to fund illiquid building societies between 1974 and 1979.[59]

ii Management of banks

The Corporations Act

The Corporations Act requires an Australian ADI to have a minimum of three directors, at least two of whom must ordinarily reside in Australia. There is no statutory requirement for any other organ of management (board committees, supervisory boards, etc.). Nor is there any statutory rule governing the make-up of the board. The ultimate responsibility for management remains at the board level; the existence, role and responsibilities of board committees (including credit committees) are an internal management matter and do not receive any recognition under the Corporations Act, other than by Section 198D, which provides that decisions made by validly delegated board committees are as effective as decisions made by the board itself.

There are three main actors in the management of Australian ADIs (in common with all Australian incorporated companies): executives, executive directors and non-executive directors. Directors (both executive and non-executive) are subject to statutory duties of care, diligence and good faith. Those statutory duties also apply to non-directors who are involved in making decisions that affect a substantial part of the company's business or who have the capacity to significantly affect the company's financial standing.

Directors and executives owe their duties to the corporate entity, rather than to shareholders. The constitution of a wholly owned subsidiary can include a provision enabling its directors to act in the interests of the sole shareholder. Otherwise, the Corporations Act does not relevantly distinguish between holding and subsidiary companies.

The Corporations Act does not prescribe any limits on the remuneration of directors and executives, although there are limits on the level of retirement benefits that can be paid without shareholder approval and a prohibition on hedging unvested remuneration by key management personnel of disclosing entities (which includes entities listed on the Australian Securities Exchange ('ASX')).

The Corporations Act also regulates directors and officers of foreign ADIs, although not to the same extent that Australian ADIs are regulated.

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58 See speech by RBA Governor Macfarlane in 1999 quoted at p. 67 in Bryan Fitz-Gibbon & Marianne Gizycki, 'A History of Last Resort Lending and Other Support for Troubled Financial Institutions in Australia' Research Discussion Paper 2001-07, System Stability Department Reserve Bank of Australia, (2001).

59 Bryan Fitz-Gibbon & Marianne Gizycki, 'A History of Last Resort Lending and Other Support for Troubled Financial Institutions in Australia' Research Discussion Paper 2001-07, System Stability Department Reserve Bank of Australia, (2001) p. 68.

APRA Prudential Standard APS 510

The prudential standards relating to corporate governance are found in APS 510. Although APS 510 applies to all ADIs, foreign ADIs only have to comply with selected provisions.

Under APS 510, *inter alia*:

a there are rules for the size and composition of boards and management of ADIs;

b ADIs must have a written remuneration policy which, although not subject to quantitative limits, must comply with general rules to ensure that remuneration is aligned with long-term financial soundness and prudent risk-taking, and which must prohibit directors and senior officers from hedging equity-linked deferred remuneration before it is fully vested;

c all ADIs must have a board audit committee; and

d Australian ADIs must have a board remuneration committee.

ASX Listing Rules

If listed on the ASX, an ADI needs to comply with the ASX Listing Rules, which require each listed entity to publish an annual report that indicates whether the entity has complied with the guidelines set out in the ASX Corporate Governance Council's Corporate Governance Principles and Recommendations and, if it has not complied, why it has not.

iii Regulatory capital

The prudential standards relating to regulatory capital are found in APS 110 to APS 117. They are based on the standards set out in the Basel framework and aim (among other things) to ensure that Australian ADIs maintain adequate capital, on both an individual and group basis, to act as a buffer against the risks associated with their activities,[60] including by:

a holding minimum levels and ratios of certain types of capital;

b establishing and maintaining internal processes to monitor and notify any 'significant changes' in their capital base;

c having a process for applying 'risk weights' to each credit risk to which the Australian ADI is exposed;

d having a process for 'quantifying certain credit risk components to determine capital requirements for a given credit exposure';

e keeping their retail banking, commercial banking and other banking businesses separate and applying different operational risk capital requirements to each area of business; and

f keeping separate internal processes to 'manage, measure and monitor' operational, market and interest rate risks.

60 APS 110.

The prudential standards relating to regulatory capital do not apply to foreign ADIs, which are expected to meet comparable capital adequacy standards in their home jurisdictions, which must be consistent in all substantial respects with the Basel framework.[61]

Over the course of 2012, APRA released a set of revised prudential standards for regulatory capital. The revised standards are broadly in line with the Basel III reforms and became effective on 1 January 2013. The key requirements of the revised prudential standards are summarised below.

Regulatory capital requirements for Australian ADIs

Under APS 110, an Australian ADI is required to maintain, at all times, a minimum level of capital for capital adequacy purposes that, as a ratio of its total risk-weighted assets, exceeds its prudential capital ratio ('PCR'). An Australian ADI must also maintain a risk-based capital ratio in excess of its PCR.[62]

An Australian ADI's PCR is typically 8 per cent of its total risk-weighted assets.[63] APRA may increase an Australian ADI's PCR above 8 per cent where APRA believes that there are prudential reasons for doing so; for example, APRA would normally set a newly established Australian ADI's PCR above 8 per cent during its formative years.

For the purposes of determining an Australian ADI's risk-based capital ratio (and compliance with its PCR), its total risk-weighted assets is calculated as the sum of:[64]

a its risk-weighted on-balance sheet and off-balance sheet assets determined based either on a standardised approach using external credit ratings or on an internal ratings based approach as approved by APRA;[65]

b 12.5 times the sum of capital charges relating to its operational and market risks and interest rate risks on its banking books;[66] and

c its exposures (on a risk-weighted adjusted basis) to securitisations.[67]

Under APS 110, the capital to be maintained by an Australian ADI in order to meet its PCR may be comprised of Tier I capital and Tier II capital, net of all specified regulatory adjustments including deductions and amortisations.[68] New capital requirements for Tier I and Tier II capital took effect on 1 January 2013. Under transitional rules, additional Tier I or Tier II instruments that have been issued before 1 January 2013 and satisfy certain criteria[69] may continue to enjoy their status as additional Tier I or Tier

61 Australian Prudential Regulatory Authority Guidelines, 'ADI Authorisation Guidelines', April 2008, paragraphs 15 and 16.

62 APS 110, paragraph 23.

63 APS 110, paragraph 22.

64 APS 110, Attachment A, paragraph 4.

65 As determined in accordance with APS 112 and 113.

66 As determined in accordance with APS 114, 115, 116 and 117.

67 As determined in accordance with APS 120.

68 See APS 110, paragraph 22 and the definition of 'Regulatory Capital' in APS 111, paragraph 8.

69 See APRA Media Release, 'To All locally incorporated authorised deposit-taking institutions – Interim arrangements for additional Tier 1 and Tier 2 capital instruments', 30 March 2012,

II instruments, notwithstanding that they fail to satisfy the new capital requirements introduced on 1 January 2013.

Tier I capital

Tier I capital comprises capital that satisfies certain essential characteristics, including a permanent and unrestricted commitment of funds and which rank behind the claims of depositors and other creditors in the event of a winding-up. Tier I capital is divided into two categories: (1) 'common equity Tier I capital', which includes an Australian ADI's paid-up ordinary shares provided these satisfy certain criteria,[70] retained earnings, undistributed current-year earnings, accumulated other comprehensive income and other disclosed reserves including foreign currency translation reserve and certain minority interests arising from the issue of ordinary shares to third parties by a fully consolidated subsidiary, and (2) 'additional Tier I capital', which includes instruments issued by Australian ADIs that satisfy certain criteria[71] including that they are paid-up, perpetual, subordinated, contain no step-ups or other incentives to redeem, satisfy the requirements for loss absorption referred to below and cannot be callable by the issuer within five years.[72]

Tier II capital

Tier II capital comprises all other components of capital that fall short of Tier I capital but nonetheless contribute to the overall strength of the Australian ADI as a going concern. Tier II capital instruments must satisfy certain criteria set out in APS 111 including that they be paid-up, have a minimum maturity of at least five years, are subordinated to all claims except Tier I capital, contain no step-ups or other incentives to redeem and satisfy the requirements for loss absorption referred to below.[73]

Loss absorption requirements

Both additional Tier I capital and Tier II capital instruments must meet the requirements for loss-absorption set out in APS 111. Under those requirements, additional Tier I capital and Tier II capital instruments must include a provision that they will be written

accessed 18 December 2012 at www.apra.gov.au/adi/PrudentialFramework/Documents/Interim_arrangements_AT1_and_T2_capital_instruments_30_March_2012.pdf; APRA Media Release, 'To All locally incorporated authorised deposit-taking institutions – Basel III capital: interim arrangements for Additional Tier 1 and Tier 2 capital instruments', 28 September 2012, accessed 18 December 2012 at www.apra.gov.au/adi/Documents/20120928-Letter-to-industry-on-interim-arragements.pdf; APRA Media Release, 'To All locally incorporated authorised deposit-taking institutions – Interim arrangements for additional Tier 1 capital instruments', 27 May 2011, accessed 18 December 2012 at www.apra.gov.au/adi/Publications/Documents/Basel-III-interim-Tier-1-criteria_FINAL.pdf.

70 APS 111, Attachment B.

71 APS 111, Attachment E.

72 APS 111, paragraphs 27–29 and Attachment E.

73 APS 111, paragraphs 30-33 and Attachment H.

off or converted into ordinary shares of the relevant Australian ADI where a 'non-viability trigger event' has occurred.[74] A 'Non-viability trigger event' will occur in respect of an Australian ADI if:

a APRA issues a notice to the ADI that conversion or write-off is necessary because, without it, APRA considers that the ADI would become non-viable; or

b APRA determines (and notifies the ADI) that without a public sector injection of capital, or equivalent support, the ADI would become non-viable.[75]

Minimum capital requirements

The amount of Tier I and Tier II capital to be included in an Australian ADI's capital base for capital adequacy purposes, net of all required deductions as described below, is subject to the relevant Australian ADI maintaining the following minimum capital requirements:[76]

a a common equity Tier I capital ratio of 4.5 per cent;

b a Tier I capital ratio of 6.0 per cent; and

c a total capital ratio of 8.0 per cent.

New capital buffers

In line with the Basel III framework, the minimum capital requirements will be supplemented by the introduction of new capital conservation and countercyclical buffers. The capital conservation buffer will apply from 1 January 2016.[77] It will require Australian ADIs to set aside an additional amount of common equity Tier I capital equal to 2.5 per cent of an Australian ADI's total risk-weighted assets unless determined otherwise by APRA.[78] APRA will have the ability to impose the new countercyclical buffer from 1 January 2016.[79] The countercyclical buffer will require Australian ADIs to hold additional common equity Tier I capital of between zero and 2.5 per cent (as determined by APRA) of an Australian ADI's total risk-weighted assets.[80]

Any depletion of common equity Tier I capital below the buffer requirements will have the effect of bringing into force capital distribution constraints.[81] These constraints will operate to prevent Australian ADIs from making distributions affecting their common equity Tier I capital such as dividends and share buybacks. The percentage of earnings that an Australian ADI will be unable to distribute when subject to a capital distribution constraint will depend on the degree to which the capital buffer requirements have been depleted.[82]

74 APS 111, Attachment J, paragraph 1.

75 APS 111, Attachment J, paragraph 3.

76 APS 110, paragraph 22.

77 APS 110, paragraph 24.

78 APS 110, paragraph 25.

79 APS 110, paragraph 29.

80 Ibid.

81 APS 110, Attachment B.

82 Ibid.

Also in line with the Basel III framework, APRA has announced that it will impose a domestic systemically important banks ('D-SIBs') capital buffer on certain of Australia's largest banks.[83] Although the Basel Committee has also proposed the introduction of an additional capital buffer for global systemically important banks ('G-SIBs'),[84] no Australian banks are expected to qualify as G-SIBs for now. As such, it is unlikely that the G-SIBs capital buffer will be implemented by APRA for Australian ADIs in the near future.

Deductions

For the purposes of determining an Australian ADI's capital requirements, certain deductions are required to be made from its Tier I and Tier II capital.[85] The deductions to be made from common equity Tier I capital include the following items: asset impairment, deferred tax, fair value gains and losses arising from certain assets, certain goodwill and intangibles, all holdings of own Tier I capital instruments, gains from sale of assets to a securitisation and any surplus or deficit in certain ADI sponsored superannuation funds.

In addition, the following items must be deducted from the corresponding category of capital (subject to some exceptions):

a direct, indirect and synthetic equity exposures,[86] guarantees and other forms of capital support, and holdings of additional Tier I capital and Tier II capital instruments in ADIs and overseas deposit-taking institutions and their subsidiaries, insurance companies and other financial institutions;[87] and

b holdings of its own capital instruments, whether held directly or indirectly, unless otherwise exempted in writing by APRA or unless eliminated under Australian Accounting Standards from the relevant category of capital.[88]

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83 See Australian Financial Review, 'Future Forums: Banking' accessed at 18 December 2012 at www.afr.com/p/futureforums/video_future_forums_banking_nndsIFSAvBWEun3P3LyVjO. However, APRA is yet to provide details on how it proposes to implement the D-SIBs capital buffer in Australia.

84 Under Basel III, G-SIBs will be required to have a loss-absorbing capacity beyond the minimum capital requirements. The Basel Committee is of the view that the number of G-SIBs will initially be 29. However, no Australian banks are expected to qualify as G-SIBs, in which case APRA may not consider it necessary to implement the framework for G-SIBs in Australia (Basel Committee on Banking Supervision, 'Globally Systemic Important Banks: assessment methodology and the additional loss absorbency requirement. Rules text', 4 November 2011, accessed 19 December 2011 at www.bis.org/publ/bcbs207.pdf.

85 APS 111, Attachment D.

86 As defined in APS 113, paragraphs 49–52.

87 APS 111, Attachment D, paragraph 8.

88 APS 111, Attachment D, paragraph 15.

Impact on business

Regulatory capital requirements play an important role in the business activities of an Australian ADI particularly given the different risk weights assigned to various assets in determining the Australian ADI's risk-based capital ratio. Accordingly, regulatory capital considerations have a significant influence over the types of transactions entered into by an Australian ADI and the manner in which it conducts its activities.

For example, the Basel II enhancements implemented in Australia on 1 January 2012 include the assignment of higher risk weights for resecuritisation exposures to better reflect the increased risk inherent in these products.[89] This measure could reduce the future level of investment and activity in these products by Australian ADIs.

Other changes to the capital adequacy standards proposed by the Basel III reforms will impact on the capital planning activities of Australian ADIs and restrict the range of instruments that they will be able to issue to satisfy their capital adequacy requirements.

Consolidated supervision

APRA determines the capital adequacy requirements of Australian ADIs in accordance with the following classifications under APS 110:[90]

a stand-alone entities ('Level 1');
b single-industry groups ('Level 2'); and
c conglomerate groups ('Level 3').

APS 110 requires Australian ADIs that form part of a conglomerate group to satisfy the specific capital requirements for Level 3 entities. On 14 December 2012, APRA released a consultation package comprising eight draft prudential standards aimed at tightening the Level 3 supervision of conglomerate groups to enhance depositor protection.[91] It is expected that final prudential standards will be released in 2013, with a scheduled commencement date of 1 January 2014.

To supplement the specific capital adequacy requirements for conglomerate groups under APS 110, APRA has developed additional prudential standards aimed at minimising contagion risk between conglomerate group members. These additional standards are set out in APS 222.

Under APS 222, each Australian ADI that heads a conglomerate group is required to provide APRA with details of the ADI's group members, group management structure, its intra-group support arrangements, any intra-group exposures and any other information required by APRA for supervision of the group.[92] Where an Australian ADI is part of a conglomerate group headed by an authorised NOHC, the same reporting

89 APS 120, Attachment D, paragraph 24.

90 APS 110, paragraph 10.

91 APRA Media Release, 'APRA releases consultation package for the supervision of conglomerate groups (Level 3)', 14 December 2012, accessed 14 December 2012 at www.apra.gov.au/MediaReleases/Pages/12_34.aspx.

92 APS 222, paragraph 8(a).

obligations apply to the ADI and its subsidiaries.[93] Australian ADIs are also required to notify APRA in advance of any intended changes in the composition or operations of its group structure which has the potential to materially alter the overall risk profile of the ADI.[94] In addition, Australian ADIs are required to provide APRA with an outline of their group risk management policies and the procedures used to measure and manage overall group risk exposure.[95]

APS 222 also imposes various requirements and restrictions on the use of a common brand name by an Australian ADI and other members in the Australian ADI's conglomerate group, the distribution of financial products by an Australian ADI on behalf of other group members and the Australian ADI's participation in group operations.[96] These requirements also apply to foreign ADIs (and their subsidiaries operating in Australia) and to non-ADI entities operating in Australia which are directly owned by the foreign parent of an ADI or by the parent's subsidiaries.[97]

As the prudential supervisor of Australian insurance companies and superannuation funds, APRA also has powers to ensure the prudent management of these entities within an Australian banking group.[98] See Section V.ii, *infra*, for further details on the prudential supervision of superannuation funds. See Section V.iii, *infra*, for further information on the prudential supervision of insurance companies.

IV CONDUCT OF BUSINESS

i Confidentiality

Banks in Australia have a strict duty of confidence in relation to customer account details. At common law, there is a duty not to disclose to third parties the state of a customer's account or any transactions on the account. The leading authority is the English case of *Tournier*.[99] The duty covers all information relating to the account, including information obtained as a consequence of the relationship between the customer and the bank.

The four commonly agreed exceptions to the duty in *Tournier* are when the use or disclosure is: consented to by the customer, compulsory under law, pursuant to a public duty or necessary for the interests of the bank.

93 APS 222, paragraph 8.

94 APS 222, paragraph 8(c).

95 APS 222, paragraph 9.

96 APS 222, paragraphs 21–31.

97 APS 222, footnotes 7–9.

98 Superannuation Industry (Supervision) Act 1993 (Cth), Section 6, Retirement Savings Accounts Act 1997 (Cth), Section 3.

99 *Tournier v. National Provincial and Union Bank of England Ltd* [1924] 1 KB 461; [1923] All ER Rep 550.

ii Consumer credit legislation

The National Consumer Credit Protection Act 2009 ('the NCCP Act') (including the National Credit Code that comprises Schedule 1 to the Act) and related legislation came into effect on 1 July 2010.

This NCCP legislation is the principle source of regulation for the provision of consumer credit and consumer leases in Australia. It is a national regime that replaces the Uniform Consumer Credit Codes which previously applied in individual states and territories of Australia. The legislation prescribes a comprehensive licensing regime for all providers of consumer credit and services, imposing responsible lending requirements on all licensees and was enacted in response to an Australian government report on financial services and credit products in June 2008.[100]

The NCCP Act regulates all persons who engage in credit activities relating to credit regulated by the NCCP Act, by introducing a licensing requirement, as well as a new responsible lending regime.

Credit is only regulated under the NCCP Act if it is provided wholly or predominantly either:

a for personal, domestic or household purposes; or

b to purchase, renovate or improve residential property for investment purposes or to refinance credit used for such purposes.

With respect to licensing, any person who engages in 'credit activities' as defined in the NCCP Act is required to hold an Australian credit licence. At a high level, there are two categories of persons who will engage in credit activities for the purposes of the Act and will therefore need to be licensed:

a credit providers, mortgagees and beneficiaries of guarantees and providers of consumer leases and persons who perform the obligations of, or exercise the rights of those persons; and

b persons who provide a credit service, which is defined as the provision of credit assistance (which includes suggesting or assisting the entry into of a consumer contract or consumer lease with a particular credit provider or lessor) or acting as an intermediary (which is broadly defined and intended to capture all persons in the chain between the customer and the credit provider) for the purpose of securing a consumer contract or a consumer lease.

Licensees are subject to a number of general conduct obligations and must also comply with the new 'responsible lending' requirements set out in the NCCP Act. New requirements under the Act in relation to 'responsible lending' include a requirement to provide consumers with a credit guide.

The National Credit Code ('the NCC') is largely a national re-enactment of the former Uniform Credit Codes. It imposes prescriptive disclosure obligations and

100 Australian Treasury, 'Financial Services and Credit Reform Green Paper', June 2008, accessed 5 January 2012 at www.treasury.gov.au/documents/1381/PDF/Green_Paper_on_Financial_Services_and_Credit_Reform.pdf.

processes on a wide range of activities relating to the entry and ongoing conduct of the consumer credit or consumer lease transactions, as well as providing consumers with certain rights to challenge unjust transactions or unconscionable interest or charges or to apply for variations on the grounds of hardship.

Both the NCCP Act and the NCC contain various sources of civil and criminal liability for failures to comply.

In August 2012 the NCCP Act was amended by the Consumer Credit Legislation Amendment (Enhancements) Act 2012 ('the Enhancements Act'). The Enhancements Act, commencing 1 March 2013, will impose new obligations on businesses that engage in credit services, particularly in relation to consumer leases, short-term small amount loans and reverse mortgages. This includes responsible lending obligations and new disclosure requirements.

In addition, the Enhancements Act:

a introduces a cap on the maximum amount credit providers can charge under small amount credit contracts and all other credit contracts regulated by the NCC; and

b amends the hardship provisions in the NCC to make it easier for borrowers to apply for hardship relief.

iii Privacy

The National Privacy Principles ('the NPPs') which comprise Schedule 3 to the Privacy Act 1988 (Cth) ('the Privacy Act') regulate the collection, use and disclosure of 'personal information'.

Part IIIA of the Privacy Act comprehensively regulates the conduct of banks and credit reporting agencies in relation to customer credit histories (or credit reports). The Act ensures that customers can know what is on their credit report and are informed when a bank might make an adverse comment on their credit report (and how a customer can avoid this happening).

The Privacy Act has been amended by the Privacy Amendment (Enhancing Privacy Protection) Act 2012 ('the Amendment Act') which was passed on 29 November 2012 and received royal assent on 12 December 2012. The Amendment Act implements the Australian government's first stage response to the Australian Law Reform Commission's 2008 report, 'For Your Information: Australian Privacy Law and Practice'. There will be a 15-month transition period before the changes come into force, with the new provisions coming into force on 12 March 2014.

The Amendment Act will amend the Privacy Act in a number of important ways including:

a creating a single set of Australian Privacy Principles ('the APPs'), which will apply to both Commonwealth agencies and private sector organisations (replacing the existing NPPs and Information Privacy Principles that apply to the public sector);

b introducing a more comprehensive credit reporting regime; and

c clarifying the functions and powers of the Commissioner and improving the Commissioner's ability to resolve complaints and promote privacy compliance.

The APPs mirror the NPPs in many respects but are structured differently, to accurately reflect the life cycle of personal information from collection to disclosure. The APPs also expand the protections afforded to individuals regarding their personal information in certain areas, and impose new obligations in relation to the collection, handling and maintenance of personal information by APP entities. Key changes include the introduction of a new regime to regulate direct marketing and a new 'accountability' regime for transfers of personal information outside Australia.

The Amendment Act also establishes a more comprehensive credit reporting regime. The amendments expand the categories of information which can be accessed by credit providers in the credit reporting system.

iv Anti-money laundering

The Anti-Money Laundering and Counter Terrorism Financing Act 2006 (Cth) ('the AML Act') imposes obligations on 'reporting entities' who provide 'designated services' (which is widely defined to include many financial transactions). Reporting entities include banks.

The AML Act requires reporting entities to perform a number of duties, which includes implementing a compliance programme, verifying the identity of customers, reporting specified types of transactions and suspicious matters, performing ongoing customer due diligence and maintaining accurate records.

v Consumer protection

The Australian Securities and Investments Commissions Act 2001 (Cth) ('the ASIC Act') regulates consumer protection in relation to financial services, and covers unconscionable conduct, misleading and deceptive conduct and false or misleading representations.

The ASIC Act also includes an unfair contract terms regime which commenced on 1 July 2010. Under the regime, a term in a standard form contract that is found to be unfair is void. A term will be unfair if it causes a significant imbalance in the parties' rights and obligations arising under the contract and it is not reasonably necessary in order to protect the legitimate interests of the party who would be advantaged by the term, subject to certain exclusions.

vi Banking ombudsman

Persons who hold an Australian Credit Licence (which will include most banks and credit providers) are required by ASIC to be members of an ASIC-approved external dispute resolution scheme. To date, there are two: the Financial Services Ombudsman and the Credit Ombudsman Service Limited.

vii Australian financial services licences ('AFSL')

Subject to limited exceptions, a person who carries on a 'financial services business' in Australia must hold an AFSL covering the provision of the financial services.[101]

101 Corporations Act, Section 911A(1).

'Financial service' includes the provision of financial product advice, dealing in a financial product and making a market for a financial product, where 'financial product', 'dealing' and 'making a market' are widely defined to include many banking products and services.[102]

An exemption from the need for an AFSL in respect of the provision of a financial service is available to an APRA-regulated body where the service is one in relation to which APRA has regulatory or supervisory responsibilities and the service is provided only to wholesale clients.[103]

A body regulated by APRA includes an ADI and an NOHC.[104]

The distinction between a wholesale client (in respect of whom the exemption applies) and a non-wholesale (or retail) client is, of course, critical. There are specific categories of wholesale client which differ depending on the particular class of product or service being provided. For products other than general insurance products, superannuation products and Retirement Savings Account products a wholesale client will include 'sophisticated clients', 'professional investors' and persons certified as having a gross income of A$250,000 for each of the last two financial years or net assets of A$2.5 million. However, the most commonly used criterion to be certain that a financial service or financial product is provided to a wholesale client is the A$500,000 test: persons who invest more than A$500,000 in respect of a financial product will be 'wholesale' for that investment and any financial services which relate to that investment.[105]

It follows that the provision of financial products and services by an ADI to a non wholesale (or retail) client requires an AFSL.

An application for an AFSL is made to ASIC; therefore it is additional to the application to APRA for ADI authorisation. It is unlikely that an ADI will not satisfy the requirements of ASIC in relation to the AFSL. In short the application to ASIC must provide evidence of ability to satisfy statutory obligations and which involves providing ASIC detailed information in relation to internal management and operations and information demonstrating the experience and qualifications of management. Once licensed, an AFSL holder must provide periodic reports to ASIC as regards compliance with its AFSL.

The Corporations Act imposes onerous requirements upon AFSL holders in relation to disclosures to retail clients, although there is some relief in relation to basic deposit products.

The Australian government recently enacted legislation aimed at supplementing the financial services licensing regime with broader investor protections.[106] The reforms are in response to industry feedback on a 'Future of Financial Advice' ('FOFA') package

102 Corporations Act, Section 766A.

103 Corporations Act, Section 911A(2)(g).

104 APRA Act, Section 3(2).

105 Corporations Act, Sections 761G and 761GA.

106 Corporations Amendment (Future of Financial Advice) Act 2012 (Cth) passed by Parliament on 25 June 2012; Corporations Amendment (Further Future of Financial Advice Measures) Act 2012 (Cth) passed by Parliament on 25 June 2012.

released by the Australian government in April 2010.[107] In essence, the key elements of the FOFA reforms (which commenced on 1 July 2012 but which, in part, do not have effect until 1 July 2013 or such earlier date as when a participant, by notice to ASIC, 'opts in' to the new regime) will impact financial services providers (and in particular, financial advisers) and introduce, *inter alia*:

a a ban on commissions and volume-based payments and any other type of remuneration structure that creates a conflict of interest;

b a requirement for all financial advisers to be subject to a statutory best interest duty to act in the best interests of clients when giving advice;

c an ability for clients to opt out of ongoing fee arrangements at any time and the requirement on financial advisers to renew ongoing fee arrangements with their clients at least every two years;[108]

d the grandfathering of existing remuneration arrangements made before 1 July 2013 (or earlier 'opt in' date) in relation to client investments; and

e an expansion of ASIC's licensing and enforcement powers.

viii Derivatives

In line with its G-20 commitments, Australia is moving towards increased regulation of the over-the-counter ('OTC') derivatives market.

On 3 January 2013, the Corporation Legislation (Derivative Transactions) Act 2012 (Cth) ('the Derivatives Act') came into effect, setting out a framework for the reform of the OTC derivatives market by amending the Corporations Act.

The Derivatives Act itself does not impose any obligations, but rather, empowers the Minister for Financial Services and Superannuation (the 'Minister') to prescribe a class of derivatives as subject to one or more of the following mandatory obligations:

a trade reporting;

b central clearing; or

c trade execution.

Prior to exercising this power, the Minister is required to consult with ASIC, APRA and the RBA and to prepare a regulation impact statement concerning the utility, feasibility and impact of the relevant mandatory obligation(s) on the affected markets. Once a class of derivatives is prescribed by the Minister, ASIC may make derivative transaction rules ('DTRs'). These are detailed rules regarding the scope, duration, applicability and consequences for non-compliance with the mandatory obligation(s). DTRs are to be developed by ASIC in consultation with the public and relevant bodies such as APRA and the RBA. All DTRs must be approved by the Minister and the Minister may pass regulations limiting the classes of persons and transactions to which the DTRs apply.

107 Parliamentary Joint Committee on Corporations and Financial Services, Inquiry into financial products and services in Australia, 23 November 2009.

108 Please note that ASIC has the ability to exempt advisers from this requirement if they are satisfied that the adviser is subject to an appropriate 'professional code'.

Failure to comply with DTRs will trigger civil penalty provisions in the Corporations Act but will not invalidate the relevant derivative transactions themselves.

V SUPERANNUATION AND INSURANCE

i Introduction

Each of Australia's four major banks are part of a financial services conglomerate that includes a superannuation trustee company and an insurance company. As such, the regulation of the Australian banking market is inextricably linked with the superannuation and insurance industries.

ii Superannuation

The superannuation industry forms part of the modern Australian retirement income system, which is comprised of the following 'three pillars':

a a publicly provided age pension;

b mandatory private superannuation savings; and

c voluntary saving (including voluntary superannuation saving).

A strong retirement income system supports many of the macroeconomic ends that a sophisticated and stable banking industry seeks to deliver. This has led to many parallel regulatory developments in both the superannuation and banking industries. Accordingly, the banking and superannuation industries intersect at various points.

The prudential regulator, APRA, is the principal regulator of the superannuation industry, and has been since 1998. ASIC also has responsibilities in this area. APRA has recently been empowered to make and enforce prudential standards for the superannuation industry in much the same way that APRA already makes and enforces prudential standards in respect of ADIs, NOHCs, life insurance companies and general insurance companies. The new prudential standards developed for the superannuation industry are discussed in further detail below.

In general, employers in Australia contribute on a quarterly basis a percentage of an employee's salary or wages into a fund established to comply with superannuation legislation requirements (known as a complying superannuation fund). At present, the minimum level of contributions by an employer in respect of an employee is nine per cent of that employee's ordinary time earnings.

Employees generally have the right to choose a superannuation fund and move their superannuation savings between funds. Although the minimum superannuation contribution is currently 9 per cent, any employer and employee can contribute additional amounts. These voluntary contributions may be made as part of the overall terms and conditions of employment.

Alternatively, employees may make additional contributions to superannuation through salary reductions.

If the minimum contribution is not made by the employer, a special tax, called the superannuation guarantee charge ('SGC'), is imposed upon the employer. While contributions are not compulsory under legislation, the SGC makes contributing to a superannuation fund the lower cost option for employers.

A complying superannuation fund is taxed at the concessional rate of up to 15 per cent of its assessable income. Capital gains, including gains on the disposal of shares and other securities held by the fund, are taxed at the rate of 10 per cent where the asset was held for 12 months or more. The Australian government also allows deductions for employers' superannuation contributions and deductions for contributions by people who are substantially self-employed.

In general, superannuation fund members are unable to access retirement benefits until they reach a minimum age, known as the 'preservation age', or they meet a specified condition of release (for example, permanent retirement, death, permanent incapacity). The preservation age for persons born before 1 July 1960 is 55 years. For persons born after this date but before 30 June 1964, there is a gradual increase in the preservation age up to 60 years. For all persons born after 30 June 1964 the preservation age is 60 years. Payments made from a taxed superannuation fund to persons aged 60 or more are tax-free.

In December 2010, the Australian government responded to the Review into the Governance, Efficiency, Structure and Operation of Australia's Superannuation System (the 'Cooper Review' or 'Super System Review') by announcing its 'Stronger Super' package of reforms, which is made up of four main parts:

a 'MySuper' reforms that seek to create a new simple low cost default superannuation product, which will replace the current default superannuation arrangements. The current default arrangements relate to superannuation funds to which employers make compulsory superannuation contributions for employees who do not choose a superannuation fund. These funds are either selected by the relevant employer or nominated through an industrial award or enterprise agreement;

b 'SuperStream' reforms which aim to streamline back office administration and make transactions cheaper and more efficient;

c governance measures to improve trustee decisions; and

d a range of measures relating to self-managed superannuation funds.

In 2011, the Australian government engaged in further consultation regarding Stronger Super and introduced a number of bills which, at the time of writing, are at various stages of the legislative process, the majority of which have become law. The first tranche of the legislation for Stronger Super comprised the Superannuation Guarantee (Administration) Amendment Act 2012 (Cth), the Superannuation Legislation Amendment (MySuper Core Provisions) Act 2012 (Cth) and the Tax Laws Amendment (Stronger, Fairer, Simpler and Other Measures) Act 2012 (Cth).

The Superannuation Guarantee (Administration) Amendment Act 2012 (Cth) commenced on 29 March 2012 and has the effect of gradually increasing the superannuation guarantee from nine per cent to 12 per cent between 1 July 2013 and 1 July 2019. The Act also increases the age limit for superannuation contributions from 70 to 75, although the Australian government has indicated that its ultimate objective is to remove the age limit altogether.[109] The Superannuation Legislation Amendment (MySuper Core Provisions) Act 2012 (Cth) received royal assent on 28 November 2012.

109 See Parliament of Australia, 'Superannuation Guarantee (Administration) Amendment Bill 2011: Second Reading', accessed 13 December 2012 at http://parlinfo.aph.gov.au/parlInfo/

The Act aims to create a workable framework for the MySuper product. Important features of the Act are:

a superannuation funds will only be allowed to offer one MySuper product, although there will be exceptions for trustees and corporate brands in limited circumstances;

b trustees will need to obtain APRA authorisation for MySuper products offered; this will be done by showing that the product proposed to be offered complies with the core MySuper product characteristics and the trustee complies with enhanced trustee obligations; and

c new rules regarding charges to members and a list of allowable fee types.

The Tax Laws Amendment (Stronger, Fairer, Simpler and Other Measures) Act 2012 (Cth), which commenced on 29 March 2012, provides low income earners with a tax concession on their superannuation contributions.

The second tranche of Stronger Super legislation is contained in the Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Act 2012 (Cth) ('the TOPS Act'), which received royal assent on 8 September 2012. The Act brings into effects two key areas of reform. First, it empowers APRA to make prudential standards.[110] Following a two-stage consultation process that commenced in September 2011, and the release of draft prudential standards for superannuation in April 2012, on 15 November 2012 APRA announced the release of 11 final prudential standards for the superannuation industry.[111] The final prudential standards include six standards[112] covering matters common to other APRA-regulated industries (e.g., banking and insurance), where APRA's approach has been to harmonise requirements between regulated industries. The remaining five prudential standards[113] cover matters which are specific to superannuation. These include reforms the Australian government recommended that APRA implement as prudential standards, as well as the relocation of some existing requirements and guidance into new standards. At the time of writing, APRA has determined eight of the 11 released final prudential standards,[114] while three

search/display/display.w3p;query=Id%3A%22chamber%2Fhansardr%2F3641b583-a42e-4045-9472-07db51574a42%2F0016%22.

110 Superannuation Legislation Amendment (Trust Obligations and Prudential Standards) Act, Part 3A.

111 APRA Media Release, 'APRA releases quarterly superannuation statistics for September 2012', November 2012, accessed 1 December 2012 at www.apra.gov.au/MediaReleases/Pages/12_31.aspx.

112 SPS 220 Risk Management, SPS 231 Outsourcing, SPS 232 Business Continuity Management, SPS 310 Audit and Related Matters, SPS 510 Governance and SPS 520 Fit and Proper.

113 SPS 114 Operational Risk Financial Requirement, SPS 160 Defined Benefit Matters, SPS 250 Insurance in Superannuation, SPS 521 Conflicts of Interest and SPS 530 Investment Governance.

114 SPS 114 Operational Risk Financial Requirement, SPS 220 Risk Management, SPS 231 Outsourcing, SPS 232 Business Continuity Management, SPS 250 Insurance in

standards[115] remain in proposed final form and are to be determined after passage of the Superannuation Legislation Amendment (Further Measures) Bill 2012. All 11 standards are due to commence on 1 July 2013.

Furthermore, APRA has issued an additional Superannuation Prudential Standard, SPS 410 MySuper Transition, which will commence on 1 January 2013. In early 2013, APRA intends to release a suite of prudential practice guides that provide guidance on the implementation of the standards.[116]

Second, with respect to trustee and director duties, the TOPS Act implements several reforms including:

a expanding the covenants for registrable superannuation trustee licensees;

b applying new duties to trustees of registrable superannuation entities that offer a MySuper product; and

c applying personal duties to the directors of corporate trustees in their own right, all of which commence on 1 July 2013.[117]

The third and fourth tranches of the Stronger Super reforms are each respectively contained in the Superannuation Legislation Amendment (Further MySuper and Transparency Measures) Act 2012 (Cth), which received royal assent on 3 December 2012, and the Superannuation Legislation Amendment (Further Measures) Bill 2012.[118] These tranches seek to introduce a range of reforms that support and add to the first and second tranches, including the following:

a setting rules regarding fees, by which entry fees will be banned and criteria provided for charging fees in superannuation, including for the charging of financial advice;

b requiring all superannuation funds to provide minimum levels of life and total permanent disability insurance;

c improving APRA's ability to gather information and requiring disclosure and publication of key information in relation to superannuation funds;

d allowing only superannuation funds that offer a MySuper product (and exempt public sector superannuation schemes) to be eligible as default funds in modern awards and enterprise agreements;

Superannuation, SPS 510 Governance, SPS 521 Conflicts of Interest and SPS 530 Investment Governance.

115 SPS 160 Defined Benefit Matters, SPS 310 Audit and Related Matters and SPS 520 Fit and Proper.

116 APRA Media Release, 'APRA releases quarterly superannuation statistics for September 2012', November 2012, accessed 1 December 2012 at www.apra.gov.au/MediaReleases/Pages/12_31.aspx.

117 Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Act 2012 (Cth), Schedule 1.

118 See Australian Treasury, 'Stronger Super: Legislation and Regulations', accessed 13 December 2012 at http://strongersuper.treasury.gov.au/content/Content.aspx?doc=legislation.htm, for a full list of all of the Stronger Super legislation which outlines all of the amending legislation including administrative changes.

e allowing exemptions from MySuper for members of defined benefits funds;
f providing rules for eligible rollover funds and requiring trustees to transfer certain balances, known as 'accrued default amounts', of members to a MySuper product by 1 July 2017;
h voiding any provision in the governing rules of a fund that requires the trustee to use a specified service provider, investment entity or financial product;
h empowering APRA to issue infringement notices as an alternative to criminal prosecution in respect of certain breaches of the Superannuation Industry (Supervision) Act 1993 (Cth);
i requiring trustees of superannuation funds to provide reasons for decision in certain circumstances and extending the time limits in which a member can lodge a complaint;
j imposing additional requirements on entities regulated by both APRA and ASIC; and
k requiring a member who has suffered loss or damage caused by a director's contravention of the Superannuation Industry (Supervision) Act 1993 (Cth) to seek leave from the court before bringing an action, and extending the legal defence available to directors and trustees to include breaches of MySuper obligations.

It is anticipated that the majority of these proposed reforms will be enacted and take effect from 1 July 2013.

iii Insurance

Insurance companies (other than health insurance companies) are regulated by APRA in accordance with the Life Insurance Act 1995 (Cth), the Insurance Act 1973 (Cth) and different sets of prudential standard that apply separately in respect of life insurance and general insurance. In circumstances where an insurer is part of a consolidated group, certain capital adequacy requirements are required to be addressed in respect of the parent entity in addition to the insurer.[119] In those circumstances, the prudential standards will apply to the parent entity, the insurer as well any subsidiaries.

APRA has recently released revised prudential standards following its review of the prudential supervision of insurance companies ('LAGIC'). The revised standards are aimed at improving the risk sensitivity of capital standards so that:
a an insurer's regulatory capital requirement better reflects its risk profile;
b a minimum level of protection is provided to policyholders regardless of the type of policy held and of the business model or structure of the insurer; and
c the capital to be held by each insurer changes in line with changes to the levels of risk to which it is exposed.[120]

119 See, for example, GPS 113 and GPS 111.
120 APRA Discussion Paper, 'Review of capital standards for general and life insurers', 13 May 2010, accessed 14 December 2012 at www.apra.gov.au/CrossIndustry/Documents/GLI_DP_RCSGILI_032010_v7[1].pdf.

The new standards effectively harmonise APRA's approach to the regulation in Australia of capital held by insurers and make it consistent with that applied to Australian ADIs including through the adoption of a three-pillar approach to the prudential requirements and supervision of both life and general insurers.

VI FUNDING AND LIQUIDITY

i Funding sources

In order to support their lending, Australian ADIs primarily source their funds from customer deposits and (domestic and international) wholesale markets.

ii Impact on liquidity standards

A critical aspect of bank funding activities is the need for ADIs to maintain adequate liquidity. To this end, the liquidity prudential standard ('APS 210') aims 'to ensure that all ADIs[121] have sufficient liquidity to meet obligations as they fall due across a wide range of operating circumstances'.[122] It vests an ADI's board of directors and management with the responsibility to maintain an appropriate liquidity management strategy.[123] That strategy is required to address at least two scenarios – the 'going concern' scenario (which 'refers to the normal behaviour of cash flows in the ordinary course of business') and the 'name crisis' scenario (which 'refers to the behaviour of such cash flows in adverse operating circumstances specific to the ADI, where it has significant difficulty in rolling over or replacing its liabilities')[124] and must be regularly reviewed by the ADI to ensure it reflects current circumstances.[125]

The current APS 210 will be superseded by a revised APS 210 which will implement the Basel III global liquidity reforms in Australia. In November 2011, APRA released a discussion paper and revised draft APS 210, which contemplates two liquidity regimes for ADIs:

a one which will require larger ADIs to satisfy the new tests under the Basel III global liquidity standards; and

b another for smaller ADIs with simpler, retail based business models which continue to be regulated by the existing liquidity regime under the current APS 210 with some minor modifications.

The Basel III global liquidity standards introduce two new tests with the aim of ensuring banks have an adequate liquidity buffer to absorb liquidity shocks:[126]

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121 Some of the requirements in APS 210 are confined to select categories of ADIs including Australian ADIs, Australian branches of foreign ADIs and foreign-owned subsidiaries of ADIs.

122 APS 210, p. 1.

123 APS 210, p. 2.

124 APS 210, pp. 2–3.

125 APS 210 p.2.

126 Draft 'Prudential Standard APS 210 Liquidity' 1 November 2011 and APRA Discussion Paper, 'Implementing Basel III Liquidity Reforms in Australia', 16 November 2011, accessed

a liquidity coverage ratio ('LCR'): this is a test to promote short-term resilience of the bank's liquidity risk profile by ensuring that it has sufficiently high-quality liquid assets to survive an acute short-term stress scenario lasting 30 days; and

b net stable funding ratio ('NSFR'): this is a test to promote resilience over a longer period by creating incentives for banks to fund their activities with more stable sources of funding relative to the liquidity profile of their assets. The NSFR also accounts for contingent liquidity needs arising from off-balance sheet commitments. The NSFR is tested over a period of one year.

APRA has indicated that larger ADIs will have until 2015 to meet the LCR standard and 2018 to meet the NSFR standard, which is in line with the timetable for Basel III. In order to satisfy the LCR standard, ADIs must hold high-quality liquid assets that fall into two categories:

a Level 1 assets: these assets are limited to cash, central bank reserves which can be drawn down in times of stress and certain categories of government debt. Level 1 assets can comprise an unlimited share of the liquid asset pool for the purposes of the LCR and are not subject to a haircut under the LCR; and

b Level 2 assets: these assets include certain other categories of government debt and highly rated corporate bonds (issued by non-bank issuers) and covered bonds which have a proven track record as a reliable source of liquidity in the markets. Level 2 assets may not comprise more than 40 per cent of the overall liquid asset pool for the purposes of the LCR and will have haircuts applied to their current market value (a minimum of 15 per cent haircut must be applied to Level 2 assets).

In November 2012, APRA released a discussion paper[127] along with draft reporting standards that propose amendments to the current liquidity reporting framework to incorporate reporting on the LCR and NSFR. Following a period of consultation on the proposed liquidity reporting standards, APRA intends to release final liquidity reporting standards some time in 2013.

Australia has relatively low levels of government debt which may result in insufficient Level 1 and Level 2 assets being available to meet the demand for those assets by ADIs seeking to satisfy the LCR standard. To address this situation (both in Australia and in other jurisdictions in a similar position), the Basel Committee has announced that it will accept alternative standards for determining liquid assets for LCR purposes in the affected jurisdictions, including the recognition of committed liquidity facilities with a central bank for a fee. Consistent with this, the RBA and APRA announced on 17 December 2010 that an ADI will be able to establish a committed secured liquidity facility with the RBA ('CLF') to cover any shortfall between the ADI's holding of high-

13 December 2012 at www.apra.gov.au/adi/documents/adi_dp_iblr_november_2011.pdf.

127 APRA, 'Liquidity reporting requirements for authorized deposit-taking institutions', 9 November 2012, accessed 1 December 2012 at www.apra.gov.au/adi/PrudentialFramework/Documents/November-2012-ARF-210-Discussion-Paper.pdf.

quality assets and the LCR requirements.[128] The RBA has confirmed that the CLF access fee will be 0.15 per cent per annum applying to both drawn and undrawn commitments, which must be paid monthly in advance.[129]

The CLF will only be available to the larger Australian ADIs (approximately 40 in number) as APRA has indicated that it does not intend to apply the LCR requirements to smaller ADIs.[130] APRA will require all eligible ADIs to first demonstrate that they have taken all reasonable steps towards meeting their LCR requirements through their own balance sheet management before relying on the RBA facility. APRA has also stated that it may ask ADIs to confirm as much as 12 months in advance the extent to which they will be relying on the CLF to meet their LCR requirements.[131]

Securities that ADIs can use as collateral under the CLF will include all securities eligible for repoing under the RBA's normal market operations. In addition, the RBA has stated that self-securitised residential mortgage-backed securities will also be eligible under the CLF. Should an ADI lack a sufficient quantity of residential mortgages, the RBA has also indicated that it will consider other 'self-securitised' assets on a case-by-case basis.[132]

iii Financial claims scheme and government guarantee scheme for large deposits and wholesale funding

The global financial crisis prompted the Australian government to establish two schemes in October 2008 under which the Australian government guaranteed certain obligations of ADIs. The Financial Claims Scheme ('the FCS') was established to effect a government guarantee of deposits of up to A$1 million with Australian ADIs. The Guarantee Scheme for Large Deposits and Wholesale Funding ('the Guarantee Scheme') was established to effect a government guarantee of larger deposit balances with ADIs and certain ADI wholesale funding liabilities.

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128 RBA and APRA, 'Australian Implementation of Global Liquidity Standards', Joint Media Release 17 December 2010, accessed on 23 December 2012 at www.rba.gov.au/media-releases/2010/jmr-10-31.html.

129 RBA, 'The RBA Committed Liquidity Facility', Media Release 16 November 2011, accessed on 14 December 2012 at www.rba.gov.au/media-releases/2011/mr-11-25.html.

130 RBA and APRA, 'Australian Implementation of Global Liquidity Standards', Joint Media Release 17 December 2010, accessed on 23 December 2012 at www.rba.gov.au/media-releases/2010/jmr-10-31.html; APRA, 'Discussion Paper – Implementing Basel III Liquidity Reforms in Australia' 16 November 2011 accessed 13 December 2012 at www.apra.gov.au/adi/documents/adi_dp_iblr_november_2011.pdf.

131 RBA, 'The RBA Committed Liquidity Facility', Media Release 16 November 2011, accessed on 14 December 2012 at www.rba.gov.au/media-releases/2011/mr-11-25.html.

132 Ibid.

Under the FCS, which is administrated by APRA,[133] the Australian government guarantees certain 'protected accounts'[134] (originally with a cap of up to A$1 million) held at an Australian ADI in the event that the ADI becomes a 'declared ADI'.[135] Under the Banking Act, an ADI will become a 'declared ADI' if APRA has applied to the Federal Court of Australia to wind up that ADI and the Minister has made a declaration under Section 16AD of the Banking Act.[136] In May 2011, APRA released a FCS consultation paper which proposed that the FCS be automatically activated either at the time that APRA applies to the court for a winding up of an insolvent ADI or at the time that the court issues a winding-up order. That consultation paper also proposed that the Treasurer should have a discretion to activate the FCS when APRA appoints a statutory manager to an ADI, before APRA applies for the winding-up of the ADI. As at the date of this publication, these proposed amendments have not been implemented in the Banking Act. The FCS was due to expire on 12 October 2011, it being three years since its introduction.[137] On 11 September 2011, the Australian government announced the permanent extension of the FCS and, from 1 February 2012, a new permanent cap for 'protected accounts' of A$250,000 per person per ADI.[138] Under the new arrangements, term deposits existing on 10 September 2011 will continue to be guaranteed up to a cap of A$1 million until 31 December 2012, or until the deposit matures, whichever occurs first. In addition, the Australian government has clarified that certain rules will apply to rolled over deposits under the new arrangements.

On 22 December 2011, APRA released a new prudential standard for the FCS, APS 910.[139] This prudential standard sets out the minimum requirements that an ADI must meet to ensure adequate protection of protected accounts under the FCS should the ADI become a 'declared ADI', as defined under the Banking Act. The key requirements of the prudential standard include the following:

a an ADI must identify each unique account holder, to the extent practicable;

b an ADI must develop and implement a single customer view ('SCV'). The SCV identifies the aggregate protected accounts held by each account holder under the FCS with an ADI;[140]

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133 The FCS was given force by the Financial System Legislation Amendment (Financial Claims Scheme and Other Measures) Act 2008 (Cth), and the Banking Amendment Regulations 2008 (No.1).

134 Banking Act, Sections 5(4),(5),(6) and (7).

135 See Banking Act, Section 5 for the definition of 'declared ADI' and Banking Act, Section 16AF.

136 Banking Act, Sections 14F and Section 16AD.

137 APRA Fact Sheet 7, 'Financial Claims Scheme', accessed 28 November 2012 at www.apra.gov.au/AboutAPRA/.../APRA_FS7_122011_v1.pdf.

138 Australian Government and Treasury paper, 'New Permanent Claims Scheme Cap to Protect 99 Per Cent of Australian Deposit Accounts in Full', 11 September 2011, accessed 19 November 2012 at http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2011/109.htm&pageID=003&min=wms&Year=&DocType=0.

139 APS 910 Financial Claims Scheme.

140 APRA Media Release, 'APRA releases new prudential standard for Financial Claims Scheme', 22 December 2011, accessed 28 November 2012 at www.apra.gov.au/MediaReleases/

c an ADI must put in place processes and controls to ensure the integrity of SCV data; and

d the systems and data required by this prudential standard must be subject to both external audit and sign-off by the chief executive officer.

APS 910 took effect from 1 January 2012, with a two-year transition period. APRA has, however, released a consultation package which sets out a number of proposed changes to that prudential standard. Those changes focus on trying to facilitate the timely and accurate payment of account holders in the event that the ADI becomes a 'declared ADI' under the FCS.[141]

The Guarantee Scheme is administered by the RBA and was 'designed to promote financial system stability in Australia, by supporting confidence and assisting eligible ADIs to continue to access funding at a time of considerable turbulence.'[142] Under the Guarantee Scheme, customers with total deposit balances over A$1 million at a single Australian ADI (and Australian residents with total deposit balances over A$1 million at a single foreign ADI) were entitled, subject to their ADI making an application to the RBA for the Guarantee Scheme to apply to such deposits, to the benefit of an Australian government guarantee on the portion of their balances over A$1 million (with the first A$1 million of a customer's deposit held with any Australian ADI falling under the FCS). Up until 24 March 2010, 'eligible institutions' (which included Australian ADIs and, subject to certain additional requirements, foreign ADIs) were also able to apply to the RBA for the Guarantee Scheme to extend to certain types of wholesale funding liabilities. For Australian ADIs, those liabilities had to, *inter alia*, be senior unsecured debt instruments with a term of no more than 60 months.[143] For foreign ADIs those liabilities had to, amongst other things, be senior unsecured debt instruments with a term of no more than 15 months (i.e., short-term wholesale funding liabilities).[144] The Guarantee Scheme closed to new liabilities on 31 March 2010.[145] It also closed to all

Pages/11_30.aspx.

141 APRA Media Release, 'APRA release proposed amendments to prudential standard of Financial Claims Scheme', 7 November 2012, accessed 1 December 2012 at www.apra.gov.au/MediaReleases/Pages/12_27.aspx.

142 Australian Government Guarantee Website, 'About the Scheme', accessed 27 November 2012 at www.guaranteescheme.gov.au/.

143 Australian Government Paper, 'Australian Government Guarantee Scheme for Large Deposits and Wholesale Funding Rules', Schedule 3, accessed 28 November 2012 at www.guaranteescheme.gov.au/rules/pdf/scheme-rules-20042011.pdf.

144 Ibid.

145 Australian Treasury Media Release 'Government Withdraws Bank Funding Guarantee and State Guarantee', 7 February 2010, accessed 28 November 2012 at www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/013.htm&pageID=003&min=wms&Year=&DocType=0.

term deposits and 'at call' deposits held at any foreign ADI by an Australian resident on 31 December 2009.[146]

The Guarantee Scheme will remain in force for liabilities or deposits in respect of which an application was made or accepted prior to 24 March 2010:

a for guaranteed wholesale funding liabilities up to 60 months from 31 March 2010 (in other words, up to 31 March 2015);

b for term deposits held at Australian ADIs up to 60 months from 31 March 2010 (in other words, up to 31 March 2015); and

c for 'at-call deposits' held at Australian ADIs, up to October 2015.[147]

iv Tax issues

Liability for Australian income tax is based on the dual tests of source and residence and is determined in accordance with the Income Tax Assessment Act 1936 (Cth) and the Income Tax Assessment Act 1997 (Cth) (together, 'the Australian Tax Act').

Under the Australian Tax Act, an Australian resident is subject to tax on all income derived, irrespective of whether the income is Australian or foreign sourced, and all net capital gains. As a general rule, under Australian domestic law, a non-resident will be subject to Australian tax only in respect of income derived from an Australian source. Capital gains derived by a non-resident are generally not subject to Australian tax unless they are derived from the direct or indirect holding of an interest in Australian real property or in respect of an asset held in carrying on business through an Australian permanent establishment.

An Australian resident subsidiary of a foreign bank would therefore be subject to tax in Australia on its worldwide income at the company tax rate (currently 30 per cent). A foreign bank that does not carry on business through an Australian branch, on the other hand, would be subject to Australian income tax in respect of its Australian sourced income. However, where the foreign bank is resident in a country with which Australia has concluded a double tax agreement ('DTA'), the business profits of the foreign bank would generally not be taxable in Australia where the foreign bank does not have a permanent establishment in Australia.

The Australian Tax Act contains specific provisions for the taxation of Australian branches of foreign banks. Pursuant to those provisions:

a the branch is treated for certain purposes as if it were an entity separate from the foreign bank, with the result that intra-bank transactions (including loans and derivative transactions) between the branch and another part of the foreign bank will be recognised for taxation purposes;

146 Australian Government Paper, 'Australian Government Guarantee Scheme for Large Deposits and Wholesale Funding Rules', Schedule 3, accessed 28 November 2012 at www.guaranteescheme.gov.au/rules/pdf/scheme-rules-20042011.pdf.

147 Australian Government Guarantee Website, 'Questions & Answers about the Guarantee Scheme Closure to New Liabilities', accessed 28 November 2012 at www.guaranteescheme.gov.au/qa/closure.html#3.

b for the purposes of determining the foreign bank's Australian tax liability, the branch will be treated as if it were a non-resident company and all of the income of the branch will be deemed to be Australian sourced;

c where an amount is recorded in the branch's accounting records as having been provided to the branch by the foreign bank, that amount will be treated as a loan, and an amount recorded in the branch's accounts as 'interest';

d where an amount is recorded in the branch's accounting records as being 'interest':
- the branch will be entitled to a deduction for the interest, but the deduction cannot exceed the amount equal to LIBOR;[148] and
- the foreign bank will be treated as having derived the interest, and will be subject to interest withholding tax at a concessional rate of 5 per cent; and

e in certain circumstances, income and capital losses may be transferred between the branch and other Australian subsidiaries of the foreign bank.

Certain foreign banks may choose not to apply these provisions in respect of a year of income. The election is made on an annual basis and is only available where the foreign bank is a resident of a country with which Australia has concluded a DTA and the tax treatment under that DTA is more favourable. However, the interest withholding tax provisions would still apply even where such an election is made.

v Withholding tax

Interest and dividends paid to a non-resident by an Australian resident are taxed on a withholding basis: tax will be withheld from interest at a rate of 10 per cent, and from a dividend paid from untaxed profits, at a rate of 30 per cent. There is no withholding from dividends paid from after tax profits (those dividends are fully franked) or conduit foreign income (foreign income derived by an Australian subsidiary that is repatriated as a dividend to a foreign parent). These rates of withholding may be further reduced where the foreign bank is resident in a jurisdiction with which Australia has concluded a DTA. Foreign banks resident in Finland, France, Japan, New Zealand, Norway, South Africa, the UK and the US may be eligible for the interest withholding tax exemption under the applicable DTA, subject to certain safeguards, including in relation to back-to-back loans.

In May 2010, the Australian government announced that interest withholding tax rates in respect of interest paid by Australian financial institutions would be reduced from the 2013–2014 financial year. However, on 23 November 2011, the Assistant Treasurer announced that the phase down of the interest withholding tax rate on interest paid by Australian financial institutions would be deferred by one year.[149] Based on

148 The Board of Taxation is currently reviewing the appropriateness of the current LIBOR cap on the deductibility of interest. Refer to Assistant Treasurer and Minister Assisting for Deregulation, 'Board of Taxation to Review Permanent Establishment Attribution Rules', Media Release No. 36 dated 24 May 2012.

149 Assistant Treasurer and Minister of Financial Services & Superannuation, 'One-Year Deferral of Interest Withholding Tax Phase Down', Media Release No. 157 dated 23 November 2011.

this announcement, the rate of withholding for borrowings by foreign bank branches from their overseas head office will fall from 5 per cent to 2.5 per cent in 2014–2015 and to zero in 2015–2016. The rate of withholding for borrowings by other financial institutions from foreign financial institutions and borrowings by financial institutions from offshore retail deposits will fall from 10 per cent to 7.5 per cent in 2014–2015 and to 5 per cent in 2015–2016.

vi Taxation of financial arrangements

The Australian Tax Act contains comprehensive rules for the taxation of financial arrangements ('TOFA'). These provisions provide methods for calculating gains and losses arising from financial arrangements (of which some are elective), and the time at which these gains and losses will be brought to account for income tax purposes. These methodologies are intended to reflect the different methods that may be used in financial accounting standards for dealing with financial assets and liabilities.

In June 2010, the Assistant Treasurer announced that amendments will be made to ensure that Australian branches of foreign banks can rely on their audited APRA reports to satisfy the financial accounting and auditing requirements for the purposes of the Division 230 timing elections.[150] The exposure draft legislation containing these amendments is yet to be released.

vii Thin capitalisation

Thin capitalisation provisions apply to foreign controlled Australian entities, as well as foreign banks carrying on business through an Australian branch. These provisions will limit debt deductions where the relevant entity does not meet minimum equity funding requirements. A foreign bank may elect to group its Australian branch together with its wholly owned Australian subsidiaries for this purpose.

viii Debt-equity characterisation

Whereas returns paid in respect of 'debt interests' may generally be deductible, returns paid in respect of 'equity interests' are not deductible. The Australian Tax Act contains a prescriptive set of rules which must be applied to determine whether an interest constitutes a 'debt interest' or an 'equity interest' for Australian tax purposes.

Tax regulations which commenced on 12 December 2012 removed uncertainty regarding the debt-equity characterisation of certain hybrid capital instruments as a result of the Basel III capital reforms and insurance capital reforms. As a result, eligible Tier II instruments issued by ADIs on or after 1 July 2013 are not precluded from being treated as debt for tax purposes. This means that returns paid in respect of such instruments may potentially be deductible.

150 Assistant Treasurer, 'New Reforms to the Taxation of Financial Arrangements', Media Release No. 145 dated 29 June 2010.

ix Transfer pricing

Australia also has a transfer pricing regime which applies to cross-border transactions involving related parties. An arm's-length principle is used to calculate the Australian taxable income that would be expected to be derived if the parties were dealing at arm's length with each other. These provisions apply equally to dealings between a foreign bank and its Australian branch.

Australian transfer pricing rules are currently under reform.

x GST

Australia has a broad-based goods and services tax ('GST') imposed at a rate of 10 per cent on the supply of goods and services in Australia. The supply of certain goods and services, including the supply of most banking and financial services, are exempt from GST (in Australia called 'input taxed'). Others, including exported goods and services, are zero rated (or, in Australia, called 'GST free').

VII CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

Corporations Act

An Australian ADI that has more than 50 shareholders, or which is listed on the ASX, is subject to the takeover provisions in Chapter 6 of the Corporations Act, which prohibit the acquisition of more than 20 per cent of the voting shares in a company unless the acquirer follows one of a number of prescribed routes that require the terms applicable to that acquisition to be made available to all shareholders for acceptance or rejection.

Related provisions require the public disclosure of shareholdings of 5 per cent or more in a company listed on ASX and allow both a listed company and ASIC to issue compulsory tracing notices to uncover the beneficial owners of shares held through nominees and trustees.

The Corporation Act restricts an Australian ADI from financially assisting a person to acquire shares in the Australian ADI (or its holding company) without shareholder approval unless the assistance does not materially prejudice the interests of the Australian ADI (or its shareholders) or the Australian ADI's ability to pay its creditors.

Foreign Acquisitions and Takeovers Act 1975 (Cth) ('FATA')

FATA imposes a regime under which certain acquisitions of interests in Australian companies, including Australian ADIs, must be notified to the Australian government. The government can refuse permission for an acquisition which is contrary to the national interest.

The following transactions are compulsorily notifiable (with the following monetary thresholds being indexed annually for inflation):

a the acquisition by a foreign person of a substantial interest in an Australian corporation with total assets which exceed A$248 million (unless the acquirer is a US investor, in which case the notification threshold is A$1,078 million);

b takeovers of offshore companies whose Australian subsidiaries' gross assets exceed A$248 million; and
c direct investments by foreign governments and their agencies irrespective of size, including proposals to establish new businesses.

A person is taken to hold a substantial interest in a corporation if that person, alone or with any associates, is in a position to control 15 per cent or more of the voting power in the corporation or holds interests in 15 per cent or more of the issued shares in the corporation. (The terms 'control', 'interest' and 'associates' have extensive meanings.)

According to the policy statement of the Foreign Investment Review Board ('FIRB'),[151] foreign investment in the Australian banking sector needs to comply with the Banking Act, the Financial Sector (Shareholdings) Act 1998 (Cth) ('FSSA') and banking policy.

Acquisitions of interests by US investors in financial sector companies, as defined by the FSSA (which includes banks), are exempt from FATA. The FSSA continues to apply.

The FSSA

A person wishing to hold more than 15 per cent voting control of a financial sector company must apply to the Treasurer (being a cabinet minister of the Australian government) and provide the required supporting information.[152] The Treasurer may only grant the application if the Treasurer is satisfied that the proposed acquisition is in the national interest.

Banking Act

Although the Banking Act regulates banking business in Australia, there is no formal approval required by APRA under the Banking Act for the acquisition of shares in an Australian ADI. However, given the ambit of APRA's powers, it is customary when acquiring a large stake in an Australian ADI to include a condition precedent to address the possibility that APRA could act to block or impose conditions on a proposed acquisition.

ii Transfers of banking business

The Financial Sector (Business Transfer and Group Restructure) Act 1999 (Cth) ('the FS Act')[153] gives effect to a statutory regime that allows an Australian ADI to transfer all or part of its banking business to another Australian ADI. The transferring body and receiving body must be established in an Australian state or territory that has enacted legislation that ensures that the receiving body is taken to be the successor in law to the transferring body to the extent of the transfer. All Australian states and territories have enacted such legislation.

151 Australian Foreign Investment Policy, January 2012.

152 Set out in Section 13 of the FSSA.

153 Formerly the Financial Sector (Transfers of Business) Act 1999 (Cth).

For a voluntary transfer of business to take effect, APRA must receive a complying application, the transfer must be adequately adopted by the transferring body and the receiving body in accordance with specified transfer rules (for example, by approval of the body's members in general meeting), the transfer must be approved by APRA, and APRA must issue a certificate of transfer stating the transfer is to take effect. APRA may also approve mechanisms specified by either or both the transferring body or the receiving body for determining things that are to happen, or that are taken to be the case, in relation to assets and liabilities that are to be transferred, or in relation to the transfer of business that is to be effected.

Once a certificate of transfer from APRA comes into force, the receiving body becomes the successor in law of the transferring body to the extent of the transfer. That is, the transferred assets and liabilities become assets and liabilities of the receiving body without any transfer, conveyance or assignment, and to the extent of the transfer, the duties, obligations, immunities, rights and privileges applying to the transferring body apply to the receiving body. The terms and conditions of employment (including any accrued entitlement to employment benefits) of employees of the transferring body are not affected by these successor arrangements. Subject to certain exceptions, a transfer effected under the Act does not cause the receiving body, transferring body or any other person to be in breach of an Australian law or any contractual provision prohibiting, restricting or regulating the assignment or transfer of any asset or liability, or release any surety from all or any of the surety's obligations.

In granting its approval, APRA must have regard to the interests of the depositors of the transferring body and the receiving body, and the interests of financial sector as a whole. APRA must also consult with the Australian Competition and Consumer Commission, ASIC and the Commissioner of Taxation in deciding whether to approve the transfer (unless those agencies have notified that they do not wish to be consulted). APRA may impose conditions as part of its approval.

APRA may also issue internal transfer certificates under the FS Act that enable the transfer of assets or liabilities (or both) between two bodies corporate that are part of the same company group as part of a proposal by an Australian ADI for a restructure that would make the Australian ADI a subsidiary of a non-operating holding company.

APRA may also make a determination under the FS Act that a compulsory transfer of a business from one ADI to another Australian ADI occur where the transferring body has breached the Banking Act, the transferring body has informed APRA that it considers it is likely to become unable to meet its obligations or that it is about to suspend payment, and in other limited specified circumstances.

VIII THE YEAR IN REVIEW

The unprecedented level of financial markets reform was one of the key challenges that the Australian banking industry faced in 2012.

Improving the resilience of the Australian financial system has been a key focus of the Australian government, including through APRA's continued reform of the ADI prudential framework to meet Australia's ongoing commitment to implement the Basel framework in Australia.

APRA also introduced new prudential standards for the superannuation industry, updated and harmonised the capital requirements for general and life insurers, developed its prudential framework for conglomerate groups and embarked on a broader review of APRA's crisis management powers. This is likely to be an area of continued focus for the Australian government in 2013.

Additionally, the Australian government has moved towards increased regulation of Australia's OTC derivatives market to reduce the systemic risk associated with OTC derivatives and improve the transparency of this market.

There have been a number of other regulatory reforms that are unrelated to the Australian government's focus on strengthening the financial system but are nevertheless significant. This includes the formal commencement of the Personal Property Securities Act 2009 (Cth) ('PPSA') on 30 January 2012. The PPSA, implemented a single national legal framework to deal with, *inter alia*, the creation and enforcement of security interests in personal property, the priority of competing security interests (and other interests) in personal property, when a person takes an interest in personal property free of a security interest and the establishment of a national register of security interests in personal property. The PPS Regulations made under the PPSA deal mainly with the interaction between the PPSA and national consumer credit legislation and matters pertaining to the registration of security interests on the PPS register.

The introduction of new investor protections and consumer credit reforms also resulted in more regulatory activity during 2012, particularly those introduced by the Enhancements Act and the FOFA reforms.

These reforms have played out in the context of a domestic economy which has largely performed well and a global economy which has benefited from improved market sentiment since 2011.[154]

IX OUTLOOK AND CONCLUSIONS

Australia's financial system is considered to be sound and resilient due to prudent economic management, strong supervision of the financial sector and a relatively low exposure to the troubled eurozone economies. Having said this, Australia is not immune to the persistent volatility in the global markets caused by the unresolved European debt crisis, a slowdown in China's growth and fears of the US approaching a 'fiscal cliff'.

Given these concerns we expect that the regulators will continue to focus on strengthening the stability of Australia's financial system through continued regulatory reform. Navigating these regulatory reforms will be a major challenge for Australia's banking industry in 2013. Some of the more significant hurdles include:

a the transition to the new prudential and reporting standards that give effect to major elements of the Basel III capital reforms;

154 The RBA has observed that global market sentiment has improved since December 2011: Reserve Bank of Australia, 'Financial Stability Review', March 2012, accessed 14 December 2012 at www.rba.gov.au/publications/fsr/2012/mar/pdf/0312.pdf.

b the transition to the new prudential supervision framework for the superannuation industry and the new capital standards for insurers;
c the implementation of Australia's new OTC derivatives framework; and
d the proposed extension of APRA's supervisory powers.

Notwithstanding these global and regulatory challenges, the International Monetary Fund has noted that the Australian banking system is well placed to deal with the prevailing economic climate.[155] Deposit growth has continued to outpace wholesale borrowing, thereby easing banks' reliance upon expensive wholesale borrowing.[156] The RBA has noted that Australian banks have continued to post robust profits, driven by high levels of operating income and a decrease in bad and doubtful debt charges.[157]

Scenario-based stress testing by both APRA and the International Monetary Fund has shown that the Australian banking system would be able to withstand a future economic crisis due largely to the efforts of Australian banks to strengthen their capital position through the use of equity issues and profit retention.

155 International Monetary Fund, 'Australia: Financial System Stability Assessment', dated 26 October 2012, p. 1.

156 Reserve Bank of Australia, 'Financial Stability Review', March 2012, accessed 14 December 2012 at www.rba.gov.au/publications/fsr/2012/mar/pdf/0312.pdf.

157 Ibid.

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Louise McCoach is a partner in Clayton Utz's banking and financial services group. Her practice covers a broad range of banking and regulatory work, including advising on prudential supervision matters and the regulation of financial institutions. Ms McCoach also has extensive experience in debt capital markets, securitisation and derivatives including acting for creditors to securitisation restructures and advising on related enforcement and insolvency-remoteness issues. Ms McCoach's experience extends to acting on CDO transactions and innovative derivatives-based facilities for commercial paper programmes and advising on associated regulatory, capital adequacy and netting issues.

DAVID LANDY

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David Landy is a partner in Clayton Utz's corporate advisory and M&A group and has over 20 years' experience. His broad range of corporate law experience includes mergers and acquisitions, corporate and financial market regulation and general corporate and commercial advice.

Mr Landy has extensive experience in corporate and financial market regulation (including Corporations Act, ASX Listing Rules and ASX Settlement Rules), mergers and acquisitions, capital management (share buybacks and capital reductions), capital raisings, Australian Securities Exchange (ASX) listings, employee share plans and equity incentive plans and Financial Services Reform.

Mr Landy has also assisted organisations and their boards in establishing and reviewing their corporate governance frameworks.