

Banking and Financial Instruments

LAWS3413

EXAM NOTES

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Module 1 – Legal Supervision of Banks and ADIs

1. Overview of trends in the Australian financial system, and introduction to the regulatory institutions in the Australian financial system:

- Three main trends in the Australian financial system:
 - The decline in cheques: there is a substantial drop in the use of cheques, dropping below 100 million a year in November 2017
 - The use of cash and ATM withdrawals is also falling in Australia
 - The growth of electronic payments: in 2017, cards overtook cash as the most popular form of payment
- The current regulatory framework (since 1998) for the Australian finance sector is a result of the recommendations of the Wallis Inquiry, with three key regulators in the financial sector
 - Australian Prudential Regulation Authority (APRA)
 - Responsible for prudential regulation of deposit taking institutions
 - Australian Securities and Investments Commission (ASIC)
 - Responsible for business conduct and consumer protection regulation in the financial markets, and the conduct of business in the finance sector
 - Reserve Bank of Australia (RBA)
 - Responsible for monetary policy, overall systemic stability and the regulation of the payments system
- These three regulators are statutory corporations, each being constituted under its own statute form which it derives its capacity, and, at least, its initial powers to act
- The 5 major categories of participants in Australia's finance system as identified by Weerasooria (5th ed., 2000, p. 4) are:
 - The Reserve Bank of Australia (Australia's central bank)
 - Banks (within Authorised Deposit-taking Institution [ADI]): there are three categories
 - Australian owned banks
 - Australian incorporated foreign subsidiary banks, i.e. Australian companies that are subsidiaries of foreign banks, e.g. HSBC Australia Limited
 - Branches of foreign banks operating in Australia
 - Non-bank financial intermediaries (NBFIs) (also within ADIs):
 - Building societies: cooperatives that provide mortgage finance to their members, though almost all died out by now
 - Credit unions: mutual organisations where membership is for people linked together in a certain way, and the object is to provide consumer credit at a competitive rate
 - Insurance and superannuation industry
 - Securities industry

2. Payment systems

- In order for participants in the financial sector to transfer value, you need payment systems, the means by which debts are settled by economic agents
- The Reserve Bank defines a "payments system" as:
 - "[A] broad term which describes the payment instructions by which individual payments are made or funds transferred, ranging from cash to sophisticated mechanisms on the internet; payments clearing arrangements by which financial institutions exchange the resulting instructions; and payments settlement arrangements for the final transfer of value between financial institutions."
- Hence, there are three parts to payment systems:
 - The way in which individual payments are transferred to each other:
 - Direct debit/credit – electronic instructions that enable payment to/from a customer's account
 - Use of cash
 - Use of credit cards
 - Cheques
 - Clearing of payment instructions:
 - Transmit and reconcile payment between financial institutions prior to settlement
 - Settlement of payment:
 - The actual transfer of value between financial institutions
 - This is often done through netting, the deferment of final settlement of the payment until netting to determine the net claims a financial institution has against another financial institution

3. The Banking Sector: Key Regulators and Governing Legislation

Reserve Bank of Australia (RBA)

- The Reserve Bank is responsible for monetary policy, overall systemic stability and the regulation of the payments system; it has exclusive power to issue Australian bank notes, but it is no longer the prudential regulator of banks
- Relevant Act is the *Reserve Bank Act 1959* (Cth)
- The Reserve Bank Board:
 - Responsible for monetary policy, regulation of the supply of money and interest rates
 - The Reserve Bank seeks to control the cash rate for overnight loans between banks and financial intermediaries, as well as interest rates by publically releasing its monetary decisions
 - It then defends its target cash rate through its open market or domestic operations, because it controls the exchange settlement funds that the banks use to settle their transactions between themselves
 - If the Reserve supplies more exchange settlement funds than the banks need, the banks will try to shed that money by lending it out, creating a tendency for the cash rate to fall; conversely, if they need more money and the Reserve limits supply, they will borrow from elsewhere, and they will raise their cash rate
- The Payments System Board
 - Responsible for the Reserve's Payment Systems policy
 - Under s 10B of the *Reserve Bank Act 1959* (Cth), the Payment Systems Board is responsible for controlling risk in the financial system, promoting efficiency in the payments system and promoting competition in the market for financial services
 - The *Payment System Regulation Act 1998* (Cth) gives the Reserve power to comprehensively regulate payment systems
 - E.g. by determining the rules for participating in payments systems, setting standards for payments systems etc.
- The New Payments Platform (NPP):
 - The NPP will be an open access infrastructure for fast payments in Australia, allowing near real-time funds availability to recipients

Australian Prudential Regulation Australia (APRA)

- APRA is responsible for the prudential regulation of financial sector bodies
 - Its role is to minimise the risk that the entities it regulates will be unable to fulfil their promises
 - In doing so, it promotes the interests of the beneficiaries of those entities (e.g. depositors) as well as the stability of the financial system

Australian Prudential Regulation Authority Act 1998 (Cth)

3 Definitions

(2) Each of the following is a **body regulated by APRA**:

- (a) an ADI, within the meaning of the *Banking Act 1959*;
- (b) an authorised NOHC, within the meaning of the *Banking Act 1959*;

Note: ADI is short for authorised deposit-taking institution, NOHC is short for non-operating holding company...

7 Establishment of APRA

- (1) The Australian Prudential Regulation Authority is established by this section.
- (2) For the purposes of the finance law (within the meaning of the *Public Governance, Performance and Accountability Act 2013*)
 - (a) APRA is a listed entity; and
 - (b) the Chair is accountable authority of APRA; and
 - (c) the following persons are officials of APRA:
 - (i) the Chair;
 - (ii) the other APRA members;
 - (iii) the APRA staff members; and
 - (d) the purposes of APRA include:
 - (i) the purposes of APRA referred to in section 8; and
 - (ii) the functions of APRA referred to in section 9.

Australian Prudential Regulation Authority Act 1998 (Cth)

8 Purpose for establishing APRA

- (1) The main purposes for which APRA exists are as follows:
 - (a) regulating bodies in the financial sector in accordance with other laws of the Commonwealth that provide for prudential regulation or for retirement income standards;
 - (b) administering the financial claims schemes provided for in the *Banking Act 1959* and the *Insurance Act 1973*; [this is for account holders who have insolvent ADIs]
 - (c) developing the administrative practices and procedures to be applied in performing that regulatory role and administration
- (2) In performing and exercising its functions and powers, APRA is to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balance these objectives, is to promote financial system stability in Australia.

9 APRA's functions

APRA has the following functions:

- (a) the functions conferred on it by or under this Act or any other law of the Commonwealth;
- (b) the functions conferred on it by or under any law of a State or Territory in accordance with subsection 9A(1);
- (c) the function of providing prudential regulation or advice services under agreements entered into in accordance with subsection 9A(2).

- As the prudential regulator, APRA issues standards under s 11AF of the *Banking Act 1959* (Cth)

Australian Securities and Investments Commission (ASIC)

- ASIC is responsible for business conduct and consumer protection regulation in the financial markets, and the conduct of business in the finance sector; corporate regulator, who describes their role as:
 - "We protect markets and consumers from manipulation, deception and unfair practices. We regulate advising, selling and disclosure of all financial products and services to consumers, except credit. We are also the Corporations Law watchdog, promoting honesty and fairness in companies and markets."
- ASIC regulates consumer protection in relation to financial services in the financial system, and the *Australian Securities and Investments Commission Act 2001* (Cth) contains consumer protection provisions that apply specifically to financial services
- ASIC is also the regulator for misleading and deceptive conduct in relation to financial services, and has licensing power in relation to financial service providers (Corporations Act, Pt 7.6)

New Council of Financial Regulators

- This is a new non-statutory body that includes the Reserve, APRA, ASIC and the Treasury, and all of those bodies engage in a share of information, discuss issues, monitor systemic risk, and coordinate if there is a major shock to financial stability

Commonwealth Legislative Power over Banks and Financial System

- Under s 51 of the *Constitution*, the Commonwealth Parliament has legislative power over:

Australian Constitution

51 Legislative powers of the Parliament

The Parliament shall, subject to this Constitution, have power to make laws for the peace, order, and good government of the Commonwealth with respect to:

- (xii) currency, coinage, and legal tender;
- (xiii) banking, other than State banking; also State banking extending beyond the limits of the State concerned, the incorporation of banks, and the issue of paper money;
- (xiv) insurance, other than State insurance; also insurance extending beyond the limits of the State concerned;
- (xiv) bills of exchange and promissory notes
- (xvii) bankruptcy and insolvency;
- (xx) foreign corporations, and trading or financial corporations formed within the limits of the Commonwealth

4. What is a bank? What is “banking business”? What do these terms mean? Do these terms matter anymore?

- What is a bank? It is an ADI that has been granted authority by APRA to use the word “bank”, “banker”, “banking” or similar words: s 66
 - Banks are participants in financial markets that have developed to facilitate business between savers and deposit-taking institutions

Banking Act 1959 (Cth)

66 Restriction on use of certain words and expressions

- (1) A person commits an offence if:
- (a) the person carries on a financial business, whether or not in Australia; and
 - (b) the person assumes or uses, in Australia, a restricted word or expression in relation to that financial business; and
 - (c) neither subsection (1AB) nor subsection (1AC) allows that assumption or use of that word or expression; and
 - (d) APRA did not consent to that assumption or use of that word or expression; and
 - (e) there is no determination in force under s 11 that this section does not apply to the person.

Note 1: For the meanings of **restricted word or expression**, **assume or use** and **financial business**, see subsection (4).

...

- (1AC) It is not an offence against subsection (1) for an ADI to assume or use the word **banking** in referring to the fact that it has been granted an authority under this Act.

Note: For example, an ADI may, in its letterhead, refer to itself as being authorised under the *Banking Act 1959* to carry on banking business.

- (1B) A consent may be expressed to apply to a particular person or to persons included in a class of persons.

- (2) APRA may, at any time:
- (a) impose conditions, or additional conditions, on a consent; or
 - (b) vary or revoke conditions imposed on a consent; or
 - (c) revoke a consent.

...

- (4) In this section:
- (a) a reference to a restricted word or expression is a reference to:
 - (i) the word **bank**, **banker** or **banking**; or
 - (ii) the expression **building society**, **credit union**, or **credit society**; or
 - (iii) any other word or expression specified in a determination in force under subsection (5); or
 - (iv) any other word or expression (whether or not in English) that is of like import to a word or expression covered by any of the previous subparagraphs; and

...

- (5) APRA may, by legislative instrument, determine that a specified word or expression is to be a restricted word or expression for the purposes of this section.

- These sections and restrictions seek to give the public confidence in the banking system

- What is an ADI? An ADI is a corporation/body corporate that APRA has authorised to carry on banking business, i.e. a body corporate in relation to which an authority under subsection 9(3) is in force.
 - Both banks and NBFIs may be ADIs for the purposes of s 9 of the *Banking Act 1959* (Cth)

Banking Act 1959 (Cth)

5 Interpretation

authorised deposit-taking institution means a body corporate in relation to which an authority under subsection 9(3) is in force.

9 Authority to carry on banking business

- (2) A body corporate which desires authority to carry on banking business in Australia may apply in writing to APRA for authority accordingly.
- (2A) APRA may, by legislative instrument, set criteria for the granting of an authority to carry on banking business in Australia.
- (3) If an application has been made, APRA may grant the body corporate an authority to carry on banking business in Australia. The authority must be in writing, and APRA must give the body corporate written notice of the granting of the authority.

Note 1: The fact that a body corporate is granted an authority to carry on banking business in Australia does not mean it is entitled to call itself a bank. To do this, the body corporate will need to have consent under section 66.

- Under section 66A, it is an offence for a non-ADI to refer to itself as an ADI

Banking Act 1959 (Cth)

66A Restriction on use of expressions *authorised deposit-taking institution* and *ADI*

- (1) A person, other than an ADI, commits an offence if:
 - (a) the person carries on a financial business, whether or not in Australia; and
 - (b) the person assumes or uses, in Australia, the expression **authorised deposit-taking institution**, or **ADI**, in relation to that financial business; and
 - (c) there is no determination in force under s 11 that this section does not apply to the person.

Note 1: For the meanings of **assume or use** and **financial business**, see subsection (2).

...

- (2) In this section:
 - (a) a reference to an expression being assumed or used includes a reference to the expression being assumed or used:
 - (i) as part of another expression; or
 - (ii) in combination with other words, letters or other symbols; and
 - (b) a reference to a financial business is a reference to a business that:
 - (i) consists of, or includes, the provision of financial services; or
 - (ii) relates, in whole or in part, to the provision of financial services.
- (3) However, this section does not prohibit the use of the letters ADI as part of another word.

Note: For example, the letters **adi** appear in the word **traditional**. Use of the word **traditional** is not prohibited in this section.

- What is “banking business”? It is a statutory term, defined in section 5 of the *Banking Act 1959*
 - This definition reflects the common law difference that banking business involves taking money on deposit and making advances of it, and of financial activities prescribed in the financial regulations as banking business

Banking Act 1959 (Cth)

5 Interpretation

banking business means:

- (a) a business that consists of banking within the meaning of paragraph 51(xiii) of the Constitution; or
- (b) a business that is carried on by a corporation to which paragraph 51(xx) of the Constitution applies and that consists, to any extent, of:
 - (i) both taking money on deposit (otherwise than as part-payment for identified goods or services) and making advances of money; or
 - (ii) other financial activities prescribed by the regulations for the purpose of this definition.

- Banking business and Purchased Payment Facilities (PPFs): s 6 *Banking Regulations 1966* (Cth)
 - PayPal, as a purchased payment facility, meets the requirements set out below, as customers have a right to demand refund of money that is held in a PayPal digital account
 - Therefore PayPal functions as a payment system, not an investment
- The term “banking business” matters because purchased payment facilities may qualify as banking business in the sense that the corporations engaging in those activities must have permission from APRA, and must comply with regulations

Banking Regulations 2016 (Cth)

6 Banking business – purchased payment facilities

For the purposes of subparagraph (b)(ii) of the definition of **banking business** in subsection 5(1) of the Act, the provision of a purchased payment facility (within the meaning of the *Payment Systems (Regulation) Act 1998*) is a banking business if APRA determines that the facility:

- (a) is of a type for which the purchaser of the facility is able to demand payment, in Australian currency, of all, or any part, of the balance of the amount held in the facility that is held by the holder of the stored value (within the meaning of the *Payment Systems (Regulation) Act 1998*); and
- (b) is available, on a wide basis, as a means of payment, having regard to:
 - (i) any restrictions that limit the number or types of people who may purchase the facility; and
 - (ii) any restrictions that limit the number or types of people to whom payments may be made using the facility.

- Common law meaning of “banking business”

Commissioners of the State Savings Bank of Victoria v Permewan, Wright & Co Ltd

Principles	<p><u>Griffith CJ (narrow view)</u></p> <ul style="list-style-type: none"> • The State Savings Bank was not a bank because customers were not (with the exception of friendly societies who were customers) permitted to operate their accounts by cheque (p. 465) <p><u>Isaacs J (“reservoir test”)</u></p> <ul style="list-style-type: none"> • “The essential characteristics of business in banking...may be described as the collection of money by receiving deposits upon loan, repayable when and as expressly or impliedly agreed upon, and the utilisation of the money so collected by lending it again in such sums as are required. These are the essential functions of a bank as an instrument of society. It is, in effect, a financial reservoir receiving streams of currency in every direction, and from which there are outflowing streams where and as required to sustain and fructify or assist commercial, industrial or other enterprises or adventures” (pp. 470-471) <ul style="list-style-type: none"> ◦ In essence, money in through deposits, and money out through lending/investments, and if you do both those things you are engaged in banking business ◦ If you engage in banking business, you need to be a licenced corporation with permission from APRA to do so
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- The “reservoir” view of banking business was upheld by the High Court in **PP Consultants Pty Ltd v Finance Sector Union**, where Gleeson CJ, Gaudron, McHugh and Gummow JJ said:
 - “The essential characteristics of the business of banking are ‘the collection of money by receiving deposits upon loan, repayable when and as expressly or impliedly agreed upon, and the utilisation of the money so collected by lending it again in such sums as required’. It involves the creation of distinct debtor and creditor relationships between the bank and those who deposit money with it and, also, between the bank and those who borrow from it” [17]

5. Commonwealth’s deposit and wholesale funding guarantees (financial claims scheme)

- Conventionally, the Reserve did not guarantee bank deposits, as this may encourage banks to engage in riskier investments to the detriment to the stability of the financial system as a whole
- On the other hand, a guarantee can give depositors the confidence to remain invested with the financial institution, avoiding capital flight and helping to maintain liquidity
- During the GFC, the Rudd government announced that they would guarantee deposits at Australian banks and locally incorporated subsidiaries of foreign banks, but not deposits at branches of foreign banks or Australian branches in foreign countries
- Originally, deposits in excess of \$1 million paid a fee for the guarantee, but since 2012 there has been an upper limit of \$250,000, where accounts above that do not attract the guarantee
- The legislative scheme for this is in the *Banking Act 1959* (Cth)
 - The amending legislation introduced a new division, Division 2AA; this scheme applies to protected accounts, and also to covered financial products, terms that are defined in s 5

Banking Act 1959 (Cth)

5 Interpretation

covered financial product has the meaning given by subsection (8).

protected account has the meaning given by subsections (4), (5), (6) and (7).

- (4) Subject to subsections (5), (6) and (7), a **protected account** is an account or covered financial product that is kept by an account-holder (whether alone or jointly with one or more other account-holders) with an ADI and either:
 - (a) is an account that is prescribed by the regulations for the purposes of this paragraph; or
 - (b) is an account, or covered financial product, that is kept under an agreement between the account-holder and the ADI requiring the ADI to pay the account-holder, on demand by the account-holder or at a time agreed by them, the net credit balance of the account or covered financial product at the time of the demand or the agreed time (as appropriate).
- (5) An account is not a **protected account** on and after 12 October 2011 unless:
 - (a) it is recorded in Australian currency; or
 - (b) it is kept with an ADI that is a declared ADI on 12 October 2011.
- (6) A covered financial product that is kept with an ADI and is not an account is not a **protected account** if APRA applies under section 14F on or after 12 October 2011 for an order that the ADI be wound up.
- (7) An account or covered financial product is not a **protected account** if the account or covered financial product is prescribed by the regulations for the purposes of this subsection.
- (8) The Minister may declare that a specified financial product is a **covered financial product**.

Banking Act 1959 (Cth)

16AD Declaration that Subdivision C applies in relation to ADI

- (1) The Minister may declare that Subdivision C applies in relation to a specified ADI if APRA has applied under section 14F for the ADI to be wound up.

Note: The Minister cannot make a declaration relating to a foreign ADI because APRA cannot apply for a foreign ADI to be wound up: see section 11E.

- (2) The declaration must also specify the amount (if any) that is to be credited to the **Financial Claims Scheme Special Account** in connection with the application of Subdivision C in relation to the declared ADI. If APRA’s application under s 14F was made on or after 12 October 2011, the amount must not be more than \$20,000,000,000.