Australian Government

The Treasury

REGULATION IMPACT STATEMENT

Treasury Laws Amendment (Banking Measures No.1) Bill 2017
– Non-ADI Lender Rules

October 2017

Contents

Regulation Impact Statement (RIS) version

As part of the RIS process, three versions of the RIS were prepared and provided to the Office of Best Practice Regulation (OBPR), consistent with best practice guidelines.

- On 12 July 2017, an Early Assessment version of this RIS was provided to OBPR prior the commencement of the consultation on the draft legislation (the consultation period ran from Monday 17 July 2017 to Monday 14 August 2017).
- A subsequent version, the Final Assessment – First Pass, was prepared taking into account the outcomes of the consultation as well as the comments and changes suggested by OBPR with regards to the Early Assessment version, and was submitted to OBPR prior to the finalisation of draft legislation on 5 September 2017.
- This version, the Final Assessment – Second Pass, includes updates for finalisation of the legislation and additional comments and suggestions provided by OBPR on the Final Assessment – First Pass version.

Background

Authorised deposit-taking institutions (ADIs)

Under section 9 of the *Banking Act 1959* (Banking Act), a body corporate that wishes to carry on 'banking business' in Australia may only do so if the Australian Prudential Regulation Authority (APRA) has granted an authority to the body corporate for the purpose of carrying on that business. Banking business is ordinarily understood to mean the mixture of deposit taking and lending. Once authorised by APRA to undertake banking business, the body corporate is an authorised deposit-taking institution (ADI) and is subject to APRA's prudential requirements and ongoing supervision.

Non-ADI lenders

There are other entities that engage in lending activities, but remain outside the APRA-regulated population of ADIs. These entities include Registered Financial Corporations (RFCs), securitisers and managed investment funds. Typically, these entities do not take deposits, and hence are excluded or exempted from the definition of banking business[1]. Collectively, these entities, when they engage in lending or the provision of finance, can be termed *non-ADI lenders*.

- RFCs include certain finance companies and money market corporations (MMCs). Finance companies typically provided finance for household purchases, while MMCs act like investment banks, primarily providing commercial loans and trading securities.
- Securitisers (or wholesale funders) often originate loans, but unlike ADIs, do not fund these loans by taking deposits. Rather, their funding comes by pooling these loans into securities, which are then sold to capital market investors.
- Managed investment funds refer to a wide range of investment funds where investors contribute money which is then pooled and invested. Investors are compensated with a share of the return on the investment. In some cases, this investment may be used to make some form of lending.

Regulation of non-ADI lenders

Non-ADI lenders are primarily regulated by the Australian Securities and Investments Commission (ASIC), in respect of conduct, disclosure and accountability. The aim of this regulation is to ensure that financial markets are sound, orderly and

[1] Certain RFCs are granted a specific exemption from APRA (for example, under the *Banking Exemption No.1 of 2015*), while the other entities (other finance companies, securitisers and managed investment funds) do not meet the definition of 'banking business' and therefore are excluded entirely.

transparent, users are treated fairly and markets are free from misleading, manipulative or abusive conduct.

Non-ADI lenders, as issuers of financial products and services, are required to have an Australian Financial Services (AFS) Licence granted by ASIC under the *Corporations Act 2001*. AFS Licenses primarily impose obligations relating to conduct and disclosure. Non-ADI lenders engaged in the provision of consumer (that is, not business) credit need to obtain a Credit Licence granted by ASIC under the *National Consumer Credit Protection Act 2009*. Credit Licences oblige non-ADI lenders to ensure that a credit contract is 'not unsuitable' for the customer.

Only certain RFCs have a regulatory relationship with APRA. Currently, these RFCs are required to register with APRA under the *Financial Sector (Collection of Data) Act 2001* (FSCODA) and report data to APRA in certain circumstances. RFCs which are directly exempted from the from the operation of the Banking Act under the *Banking Exemption No. 1 of 2015* are required to meet a number of conditions to qualify for the exemption. APRA has no supervisory role in respect of non-ADI lenders.

APRA may also have an indirect influence on non-ADI lenders via its regulation of ADIs. Many non-ADI lenders fund their businesses through commercial relationships with ADIs. This indirect influence is most notable when APRA imposes rules on the role of ADIs in securitisation structures, which are key to the business models of many non-ADI lenders (see for instance, APRA prudential standard APS 120 Securitisation).

Size of the non-ADI lending sector

As of late 2016, the total assets of non-ADI lenders were around $450 billion or 6 per cent of total financial system assets[2]. While non-ADI lenders are currently small as a share of financial system assets, there are estimated to be a large number of non-ADI lenders operating in Australia. Based on data on managed investments schemes, Credit and AFS Licence holders and RFCs, there may be up to 1,500 entities that could be considered to be non-ADI lenders[3].

Policy problem

Financial stability is very important to economic performance and the wellbeing of Australian households and businesses.

Consistent with its mandate to promote stability in the Australian financial system, APRA has put in place prudential measures to reinforce sound residential mortgage lending practices by ADIs. In December 2014 and March 2017, APRA wrote to ADIs

[2] See Reserve Bank of Australia, *Financial Stability Report* (April 2017). Accessed online at: 2 June 2017.
[3] Calculations based on APRA and ASIC data.

outlining a range of measures to improve lending standards. These measures included, for example, a requirement that ADIs keep investor lending growth under 10 per cent per annum. APRA, to date, has enforced these measures through its supervisory practices.

The primary purpose of these measures is to address the risks that are posed to financial stability by the build-up of household debt, the serviceability (that is the borrower's capacity to repay the loan) of which is exposed to changes in conditions. For example, if the economic environment changed to one of rising interest rates or unemployment, this would materially impact the serviceability of household debt.

The community is better placed to absorb adverse changes to the economic environment if credit is prudently originated in 'good times' (environments of increasing asset prices, near full employment and low interest rates). Prudent credit origination practices mean the community benefits from a 'buffer', the ability for households to absorb the impact of a more adverse environment without going into default. This buffer lessens the risk of credit and asset 'bubbles' bursting, leading to significant adverse economic outcomes.

Whilst credit origination practices – whether from ADIs or non-ADI lenders – can contribute to risks to financial stability, there are important differences between the source of funds between an ADI and a non-ADI lender. ADIs fund much of their lending activities via retail deposits, a source of funds which is appropriately highly protected. Non-ADI lenders, on the other hand, fund much of their activity through wholesale or international investors[4]. As a result, the diversity and sophistication of the sources of funds upon which non-ADI lenders rely contributes to financial sector stability.

However, international experience has demonstrated that, in certain circumstances, non-ADI lenders can materially contribute to financial stability risks. For instance, the Reserve Bank of Australia (RBA) has pointed to the role of the shadow banking sector in the global financial crisis, stating that:

> *"(Shadow banking) intermediation can support economic activity by providing additional funding sources for the economy, including for riskier market segments that may find it relatively difficult to access bank funding.*
>
> *However, these activities can pose risks to financial stability, which became clear during the global financial crisis. In a number of countries, a range of incentive problems in securitisation and structured finance markets undermined lending standards and asset quality. A general lack of transparency concealed an associated build-up in leverage and*

[4] As noted above, non-ADI lenders are also funded by ADIs, but this activity is already within APRA's supervisory reach.

maturity mismatch, and the extent of linkages back to the banking system. When asset quality problems materialised, investors withdrew or tightened the conditions on short-term funding. This prompted financial difficulties in investment vehicles such as money market funds (MMFs) and led to some destabilising asset 'fire sales'. In the aftermath, credit intermediation in many countries was significantly curtailed, both through the shadow banking system and the banking system given various interlinkages."[5]

Given the macroprudential measures that apply to ADIs, non-ADI lenders could be currently benefitting from a 'spill over effect', whereby lending that can no longer be done by ADIs is possibly being done by (that is, *spilling over to*) non-ADI lenders. While the Government is of the view that the activities of non-ADI lenders are not currently contributing to risks to financial stability in any material way given their small share of the sector, this possible spill over does increase the potential for the non-ADI sector to contribute to these risks in the future.

Moreover, this highlights that a regulatory gap exists – APRA and ASIC currently have limited ability to address any potential risk posed to financial stability which may emerge as a consequence of the credit origination practices of the non-ADI lending sector. ASIC is the primary regulator of non-ADI lenders, but it does not have a financial stability mandate. While APRA has the appropriate mandate (financial stability), it has little direct influence over non-ADI lenders (that are RFCs) and only a limited indirect influence in respect of other non-ADI lenders.

The need for government action

While the Government could make non-ADI lenders aware that they were contributing to risks (if that were the case) and request that they self-regulate to remove these risks in the absence of the enforcement mechanism non-ADI lenders would have limited incentive to do so. Moreover, given the number of non-ADI lenders and the fragmented nature of the sector, there is currently no single industry body that could coordinate voluntary compliance across all non-ADI lenders.

As self-regulation is unlikely to be a viable option, and given the potential implications of allowing risks to financial stability to go unmitigated, government intervention is necessary to close the regulatory gap. In Australia, responsibility for financial regulation is shared between three independent regulators – ASIC, APRA and the RBA. Any government intervention in respect of financial regulation should therefore be achieved by empowering the appropriate regulator to take action.

---

[5] See Manalo J., McLoughlin K. and Schwartz C. (2015), *Shadow Banking – International and Domestic Developments*, Reserve Bank of Australia Bulletin, March Quarter 2015 (RBA). Accessed online at: 2 June 2017.

As outlined above, APRA's mandate explicitly includes the promotion of stability in the Australian financial system and it has the necessary supervisory capability to monitor the non-ADI sector. Accordingly, empowering APRA to address these risks (when needed) is likely to ensure the desired outcomes. APRA will be able to influence credit origination practices consistently across the industry (recognising the legitimate differences between ADIs and non-ADI lenders) and will be appropriately accountable for achieving these outcomes. This will be ensured through a range of mechanisms, including Parliament and via the Government's Statement of Expectations for APRA. Before APRA can exercise any of its powers, it is required to weigh up the effects of competition and competitive neutrality.

Policy options

The Government announced in the 2017-18 Budget that it would act to ensure APRA is able to respond flexibly to financial and housing market developments that pose a risk to financial stability, by providing APRA with new powers in respect of the provision of credit by non-ADI lenders, to complement APRA's existing powers to address financial stability risks posed by the activities of ADIs. The Government also announced that it would enable APRA to collect data from these entities for the purposes of monitoring risks in the non-ADI lending sector so as to determine when to use its new powers.

Consistent with the Budget announcement, the Government's preferred option is to provide APRA with a new rulemaking power in respect of the provision of finance activities of non-ADI lenders and allow APRA to collect data from these entities (Option 1). Under this option, when APRA identifies material risks to financial stability emerging from the sector, APRA would be able to make rules that would apply to non-ADI lenders to address those risks. Compliance with a rule would be ensured through an enforcement regime. This would involve providing a directions power to APRA and instituting appropriate penalties for continued non-compliance.

An option also considered by the Government was to maintain the status quo, and require APRA to manage the financial stability risks stemming from the activities of non-ADI lenders using its current powers and functions (Option 2). This option would likely involve APRA writing to non-ADI lenders requesting a change in their lending activities, in order to mitigate financial stability risks. The Government rejected this option on the grounds that it would not address the policy problem identified, as non-ADI lenders would have no incentive to comply with any request from APRA, leaving a gap in APRA's powers should non-ADI lending practices pose a material risk to Australia's financial stability.

An alternative approach identified is to expand APRA's regulatory remit by requiring non-ADI lenders to be authorised by APRA, thereby subjecting them to the full range of APRA's prudential and other requirements (Option 3). This approach would result in an increase in regulation that would be disproportionate to the policy problem that it would solve. It would impose significant costs on non-ADI lenders (potentially putting many of them out of business) and would materially alter that nature of APRA's regulated population, blurring the lines between ASIC and APRA.

These options are further described, and their costs and benefits (including regulatory costs) analysed, below.

Costs and benefits

Option 1 – Provide APRA with monitoring and rulemaking powers

<u>Description</u>

This option involves amending the Banking Act to provide APRA with a power to make rules that would apply to the provision of finance by non-ADI lenders, should it become apparent that these activities are materially contributing to risks of financial instability. The determination of what constitutes 'materially contributing' in this context is to be an independent judgement of APRA. However, APRA would likely take the following indicative factors into account when making this judgement:

- The size of the non-ADI lending sector. The sector's share of the financial system is a relevant consideration, noting that the more significant the share, the greater the likelihood that the activities of non-ADI lenders may have material impacts on the financial system.
- The nature of activities undertaken by non-ADI lenders. This includes the types of lending undertaken by non-ADI lenders and in particular, whether the specific activities of non-ADI lenders are contributing to risks in a way that is disproportionate to their size.
- The impact of non-ADI lending practices on the ADI sector. APRA will likely consider whether the lending activities of non-ADI lenders are influencing the lending behaviour of ADIs, where such influence is both material to financial sector stability and is not able to be addressed by APRA via its supervisory tools that apply to ADIs.

The rules would be made enforceable by providing APRA a directions power and instituting appropriate penalties for non-compliance. In the first instance, APRA would able to direct entities to comply with a rule. Any subsequent non-compliance may then be met by further APRA directions or appropriate monetary penalties, as determined necessary by APRA.

The rules would also be scalable. APRA would be able to target a non-ADI lender rule to all non-ADI lenders or a subclass of the broader population of non-ADI lenders, as needed, to be determined based type of lending activities that were contributing to risks and the size of the contribution of these risks by an individual non-ADI lender. Furthermore, the rules would be only issued for a set period, reflecting the fact that the rules would only be temporary measures introduced by APRA to address a specific source of risks (a specific lending activity) when such risks arise.

In support of the regime, FSCODA would be amended to define a class of entities that would determine the non-ADI lender population[6] and enable APRA to collect data from non-ADI lenders for the purposes of monitoring these entities and determining when to issue a non-ADI lender rule.

It is important to note that this option provides a framework for APRA to make rules should it choose to do so, but it does not necessitate a rule being made. The only immediate implication of the option, if implemented, is registration. That is, non-ADI lenders that meet the appropriate criteria will need to register with APRA, which will carry with it a minor compliance cost (see *Regulatory Costs* below).

Cost-benefit analysis

This option would close the regulatory gap by providing APRA a highly-targeted tool with which to monitor and manage financial stability risks across the sector, should they emerge. The primary benefit of this is the lower potential risk of a systemic financial crisis in Australia, and hence the losses caused by such an event. An additional benefit of this option is that it does not materially alter the current regulatory architecture; that is, it does not alter APRA's mandate and breach ASIC's area of responsibility. Rather, it would merely complement APRA's existing powers in respect of ADIs.

Further, this approach suits the nature of the policy problem – which is more likely to be temporary, rather than permanent. This suggests that regulation that can be deployed only when needed and for as long as necessary is more appropriate than ongoing regulation. This appropriately reflects the Government's view that non-ADI lenders are not currently materially contributing to risks of instability in Australia's financial system.

[6] Non-ADI lenders will be defined under an expanded definition of 'registrable corporation' in section 7 of the FSCODA. This will capture all non-ADI lenders of a significant size; that is, any current RFCs and other non-ADI lenders with a stock of financing assets in excess of $50 million or that make more than $50 million of new financing in a year.

The main cost of this option is that which is incurred to a non-ADI lender's business as a result of complying with a non-ADI lender rule ('business costs'). Business costs are an opportunity cost – that is, profit forgone by a non-ADI lender as the result of compliance with a rule. Part of this profit may be conferred on non-ADI lenders as a result of the 'spill over effect' outlined above. This profit is therefore the result of inconsistent regulation across entities (both ADIs and non-ADI lenders) engaging in the same activities. Accordingly, should the situation arise where a rule is made for non-ADI lenders in respect of these activities, it would simply correct this market distortion.

A minor cost involved in this option is a result of increased resourcing for APRA. As announced in the Budget, APRA will be provided with $2.6 million over four years to conduct the regime, commencing in 2017-18. Consistent with the principle that entities that create the need for regulation pay for that regulation, $1.9 million of this is to be cost-recovered via an increase the Financial Institutions Supervisory Levies, beginning in 2018-19.

Regulatory costs

Under this option, non-ADI lenders will incur regulatory costs in the case that they comply with a non-ADI lender rule issued by APRA. However, as this option merely provides APRA the framework to make rules, and does not require APRA to issue a rule at any point in time, regulatory costs of this type will not be incurred upon provision of this power to APRA. Should APRA decide to make a rule in future, it is expected that APRA will follow standard RIS practices and consult with industry, prior to making any rule.

Similarly, while this option enables APRA to collect data from all non-ADI lenders, it does not impose any immediate requirements to provide data and therefore does not impose any related regulatory costs. APRA will need to issue a Reporting Standard (outlining the data required and how and when it is to be provided) before non-ADI lenders are required to provide such data. In making a Reporting Standard, APRA will need to go through its regular processes, including a consultation with industry and an assessment of regulatory costs through a RIS-like process.

This said, non-ADI lenders will incur some small immediate regulatory costs. To enable data collection and to define non-ADI lenders as a class of entities, the definition of 'registerable corporations' in section 7 of FSCODA is to be broadened to capture all relevant non-ADI lenders (possibly up to 1,500 entities in total). For these entities, there will be a one-off administrative cost incurred in registering with APRA. However, this will be minimal. Little is required to register; a non-ADI lender must provide the registration form and its latest financial statements to APRA (and potentially, further liaise with APRA as needed).

Aside from the above, this option will not impose any other regulatory costs on individuals, community organisations or any other businesses. Total average annual regulatory costs for this option are outlined in the table below.

Average annual regulatory costs (from business as usual)				
Change in costs ($ million)	**Business**	**Community Organisations**	**Individuals**	**Total change in costs**
Total, by sector	$1.2	$0.0	$0.0	$1.2

Option 2 – Maintain the status quo

Description

Under this option, there would be no change to nature and extent of regulation currently imposed on non-ADI lenders. In this context, should APRA wish to attempt to mitigate financial stability risks posed by the lending activities of non-ADI lenders, APRA could write to such entities requesting the change in the behaviour that APRA deems necessary to meet this goal. However, this would not be backed by any enforcement mechanism and accordingly, non-ADI lenders would have little incentive to comply with any request made by APRA.

Cost-benefit analysis

This option would not require any increase in regulation, and therefore the benefit of this option is that the costs involved would be negligible. No increase in APRA resourcing would be required – and therefore no costs would be incurred by the Government or industry. Further, non-ADI lenders would not incur any data provision costs, and would be unlikely to incur any business costs unless they chose to comply with a request from APRA (in which case, such costs would be incurred voluntarily).

However, this option is unlikely to address the core policy problem, and accordingly the potential costs of this option are significant. As non-ADI lenders would be unlikely to comply with a request made by APRA, there is little chance that the extreme negative affects posed by allowing risk to financial instability (a financial crisis) could be avoided, should these risks arise.

Regulatory costs

Another key benefit of this option is that non-ADIs would not be subject to any further statutory regulation and therefore would likely avoid any additional regulatory (compliance, administrative or other) costs. As with business costs under this option, any such regulatory costs would only be incurred voluntarily under this option – that is, should a non-ADI lender receive a written request from APRA and then choose to comply with this request.

This option will therefore not impose any regulatory costs on individuals, community organisations or any other businesses. Total average annual regulatory costs for this option are outlined in the table below.

Average annual regulatory costs (from business as usual)				
Change in costs ($ million)	**Business**	**Community Organisations**	**Individuals**	**Total change in costs**
Total, by sector	$0.0	$0.0	$0.0	$0.0

Option 3 – Require non-ADI lenders to be authorised by APRA

<u>Description</u>

A third option would be to require non-ADI lenders to become authorised as ADIs under the Banking Act. Once authorised, these non-ADI lenders would be subject to rigorous and close supervision by APRA. They would be required to comply with a range of requirements contained in Prudential Standards and provide comprehensive data to APRA under Reporting Standards. This option would require significant changes to relevant legislation (primarily the Banking Act), alter APRA's processes and increase APRA's resourcing needs.

It is assumed that under this option, APRA would only authorise the largest non-ADI lenders (of which it is currently estimated that there would be fifteen), reflecting an assumption that these non-ADI lenders would be the most likely to be able to materially contribute to risks of financial instability. This would avoid the need for APRA to have to regulate a large number of small non-ADI lenders who would be unlikely to pose a risk to financial stability. These smaller non-ADI lenders would however still need to register with APRA, so that APRA could monitor the sector and determine if and when to authorise other non-ADI lenders.

<u>Cost-benefit analysis</u>

This option would close the regulatory gap by allowing APRA to institute measures to address risks to financial stability posed by the activities of larger non-ADI lenders, in the same way that APRA has done for ADIs – that is, via a written request backed by enforcement through its supervisory functions – where needed. Accordingly, this option would address the core policy problem as APRA would be able to act to stop risks developing, thereby avoiding the potential negative impacts of these risks. This could also lead to greater transparency in the activities of non-ADI lenders and would likely increase the relative stability of the whole of the sector.

However, this option goes beyond simply addressing the policy problem. It would materially alter the current regulatory architecture, where there has not been demonstrated a need to do so. This is, it would bring non-ADI lenders under the full degree of APRA regulation and supervision, despite non-ADI lenders being otherwise mostly distinct from ADIs. Accordingly, this option would broaden APRA's role as a prudential regulator, and may blur the lines between ASIC and APRA.

This form of regulation would also be ongoing. This would impose broader regulatory costs than needed to achieve the benefits sought, given that the Government's view is that the activities of non-ADI lenders are not currently posing material risks to financial stability, albeit such risks could arise in the future.

This option would also have significant costs. Most significantly, a requirement to be authorised as an ADI would impose large business costs on any authorised non-ADI lender. For example, these entities may have to raise or set aside capital to meet capital requirements, or may find their activities constrained and accordingly incur the resulting loss of revenue or profit.

Further, non-ADI lenders do not take deposits and therefore prudential supervision of their activities does not result in the same benefits for the community. This could lead to higher prices for consumers (for example, if these non-ADI lenders increased loan rates in response to higher capital and compliance costs). It would most likely reduce the size of the sector which provides a competitive balance to the large ADIs.

Lastly, APRA would also require greater resourcing in order to undertake these functions in respect of these non-ADI lenders. This would impose significant costs on Government, or should these costs be cost-recovered, on industry.

Regulatory costs

Under this option, the regulatory burden on authorised non-ADI lenders that would be authorised by APRA would significantly increase, leading to large regulatory costs. These non-ADI lenders would incur significant one-off compliance costs (for example, updating their processes, computer systems and internal and external documentation) and large ongoing administrative costs (for example, making, keeping and providing records and notifying APRA of their activities).

These non-ADI lenders would incur these costs from the first day of implementation of this option and, while they may vary by size of the entity, feedback has indicated that there is a baseline level of cost incurred by all ADIs as a result of being authorised[7], which implies the same would be true for non-ADI lenders. The

[7] See Customer Owned Banking Association (COBA), Submission to the Financial System Inquiry (2014). Accessed online at: 27 June 2016.

remaining non-ADI lenders would need to register with APRA, to allow APRA to monitor these entities. This would impose regulatory costs on these entities – of the nature and magnitude described in Option 1.

Apart from the above, this option is unlikely to impose additional regulatory costs for individuals, community organisations or any other businesses. Total average annual regulatory costs for this option are outlined in the table below.

Average annual regulatory costs (from business as usual)				
Change in costs ($ million)	**Business**	**Community Organisations**	**Individuals**	**Total change in costs**
Total, by sector	$20.0	$0.0	$0.0	$20.0

Consultation

Draft legislation to implement the Government's preferred option that was announced in the 2017-18 Budget (Option 1) was exposed for a four week period of public consultation that commenced 17 July 2017 and concluded 14 August 2017 (a one week extension was also granted to a number of submitters at their request). During the consultation period and immediately after it, Treasury and APRA met with a number of non-ADI lenders, industry representatives and their advisers, to hear their feedback and discuss ways to improve the draft legislation.

In addition to seeking general feedback, Treasury and APRA, in their meetings with stakeholders, sought to determine whether the legislation achieved its purpose while minimising the associated regulatory burden. Further, specific feedback was also sought as to whether the definitions used to determine the class of entities that would be required to register and report data to APRA, and with respect to whom a rule could be made, were calibrated correctly.

Twenty-two submissions were received to the consultation, twenty of which were public and two confidential. Submitters included a number of non-ADI lenders and industry bodies, law firms, ADIs and consulting companies, among others. The majority of public submissions generally supported the data collection component of the measure, but raised concerns with the nature of the rulemaking and directions powers to be given by APRA. This was generally the same stance taken by industry in their meetings with Treasury and APRA. Three submissions supported the measure in its entirety.

The primary concerns raised by submitters included:

- The draft legislation did not reflect the 'reserve power' intent of Government, as there was insufficient limitation on how and when APRA may use the power. Stakeholders advised this was causing concern for their investors and could put their funding at risk.

- The class of entities which may be subject to rules was too broad. Stakeholders requested that only the entity engaged in the ultimate act of lending (the origination of the loan or financing) should potentially be subject to a rule, and that other entities that handle the same dollar of financing should not be caught.

- The directions power was not appropriately limited in scope to the breach of the rule itself. Stakeholders were concerned that APRA could issue a direction totally unrelated to the specific lending activity contributing to the risks and that such a direction could take the form of an instruction to cease lending (effectively putting a non-ADI lender out of business).

- The class of entities which may be required to register and report data was too broad.

Significant support was, in effect, expressed for Option 2, as many submitters and most stakeholders that met with Treasury and APRA felt that there was no need for the Government to act. Option 3 was not explicitly consulted on given significant consultation undertaken as part of previous Financial System Inquiries in 1997 and 2014), both of which determined that there was no need to prudentially regulate non-ADI lenders (that is, authorise non-ADI lenders in the same way as ADIs)[8].

While not explicitly consulted on, Option 3 did however form part of Treasury and APRA's consultation discussions with industry. Industry expressed a strong view that APRA should not be given any power or ability to prudentially regulate non-ADI lenders. Industry requested that any implication that APRA would be able to do so be removed from the draft legislation and that it be made clear in the associated explanatory material, that the powers given to APRA over non-ADI lenders would be in no way prudential.

Preferred option

Consistent with the Budget announcement, the Government's preferred option remains to provide APRA with a rulemaking power over non-ADI lenders (Option 1). This option would close the regulatory gap and allow APRA to manage material

[8] See p.352, Financial System Inquiry – Final Report (1997), *Chapter 8 – Financial Safety*, accessed online at: 1 September 2017; and
p. 265, Financial System Inquiry – Final Report (2014), *Appendix 1 – Significant Matters*, accessed online at: 1 September 2017.

financial stability risks in a consistent way across the entire sector (if and when such risks arise). Further, this option would not impose ongoing regulation – reflecting the Government's view that non-ADI lenders are not currently materially contributing to risks, and that regulatory intervention would only be required when such risks emerge. Lastly, this option would impose small regulatory (and other) costs on non-ADI lenders, government and APRA.

Maintaining the status quo (Option 2), which would see APRA attempt to address the policy problem through its current powers, would have advantages in that it would not require legislative or regulatory change and would so impose no additional regulatory costs. However, in the absence of a method of enforcement, any action taken by APRA to mitigate financial stability risks posed by the activities of non-ADI lenders would likely fail, as non-ADI lenders would have no incentive to comply with such an action if taken by APRA.

Requiring non-ADI lenders to be authorised as ADIs (Option 3) would address the policy problem by subjecting non-ADI lenders to the full scope of APRA's prudential and other regulation, giving APRA a significant toolkit with which to act on risks, should it see a need to do so. However, this option would fundamentally alter the current regulatory architecture, and moreover, there has not been demonstrated a need to subject non-ADI lenders to this degree of regulation. This option would also result in non-ADI lenders incurring significant costs, both in terms of business and regulatory costs, which may put some non-ADI lenders out of business and raise prices for consumers.

While the Government's preferred option remains Option 1, a number of changes were made to the legislation to implement this option to address the concerns of stakeholders raised during the consultation, while still achieving the Government's policy objective.

This included clarifying:

- the 'reserve power' nature of the proposal by narrowing the circumstances in which APRA may use the rulemaking power (for example, by restricting APRA such that it can only make rules in respect of the specific lending or financing activity that is contributing to the risks identified);
- the class of entities that may be subject to the rule – so that only the originator of the loan or financing, and not any other entity which may handle the same dollar of lending or financing, is potentially the subject to a rule;

- the directions power to ensure directions can only be issued in respect of the particular activity that is the subject of a rule and remove APRA's ability to direct a non-ADI lender to cease lending; and
- the EM's description of the 'reserve power' purpose of the rulemaking power – this included making clear that the power is only to be use in exceptional circumstances – that is, when the activities of non-ADI lenders are materially contributing to risks of instability in the Australian financial system.

No significant changes were made to the data collection component of the draft legislation as stakeholders had indicated they were broadly comfortable with this element during consultation meetings. Further, the legislation will provide APRA the flexibility to make adjustments to the class of entities that must report data, and APRA will be able to adjust the way that data is reported through its Reporting Standards. Concerns about the breadth and nature of reporting will therefore be dealt with by APRA following practical experience with the new definitions.

The changes made explicitly addressed the main concerns raised during the consultation and were developed with significant input from key stakeholders. In Treasury and APRA's meetings with industry, stakeholders expressed a reasonable degree of satisfaction that the proposed changes adequately address their concerns and appropriately balance the regulatory burden with the Government's desired outcomes.

In relation to the minor regulatory costs involved in this option, a regulatory offset has not been identified. However, Treasury is seeking to pursue net reductions in compliance costs and will work with affected stakeholders and across Government to identify regulatory burden reductions where appropriate.

Implementation and evaluation

Implementation

As outlined above, legislation is required to give effect to the Government's preferred option (Option 1). The option commences upon passage of the legislation and Royal Assent. However, while APRA would be able to make rules immediately, it is not envisaged it will do so. Non-ADI lenders will need to register with APRA first and APRA will then need to begin collecting data.

Only once APRA has this data could it make the assessment as to whether or not non-ADI lenders were materially contributing to risks of financial instability and therefore whether it was necessary to make a rule (see *Costs and benefits* – Option 1 above, for a description of what is meant by 'materially contribute'). While this information is yet unavailable, the view of the Government is that APRA would be unlikely to need to make a rule given the current size and nature of activities in the sector.

Accordingly, the only immediate impact for non-ADI lenders is the need to register. From Royal Assent, non-ADI lenders that are not currently registered as RFCs will need to begin to register with APRA. Some RFCs that are already registered may no longer be required to register (given increased monetary thresholds for determining the need to register) and may consequently be required to de-register. Importantly, APRA will provide a transitional period for entities to register, before commencing the Reporting Standards process that will enable the data to be collected.

Once non-ADI lenders are registered, APRA will begin the process of making the necessary Reporting Standard. As part of this process, APRA will consult with industry to ensure that data provision requirements for non-ADI lenders are consistent with those already imposed by the Australian Bureau of Statistics and RBA, thereby minimising any associated regulatory costs. This is usually a two-phase process where industry is consulted twice as part of APRA making the Reporting Standard and associated reporting forms.

Once the Reporting Standard is made, non-ADI lenders will begin provision of data to APRA. To make a rule, APRA will need to form the view that a specific lending activity (or activities) of non-ADI lenders are materially contributing to risks of instability in the Australian financial system. This is a relatively high bar and should be consistent with the Government's expectations as set out in the explanatory materials. In making a rule, APRA will, in all but extreme time-critical circumstances, consult with industry on the content of the rule and its impacts (including regulatory costs).

Evaluation

Evaluation of the policy will occur through three primary channels: assessment by APRA and the Council of Financial Regulators (a coordination body for financial sector regulatory policy, consisting of Treasury, RBA, ASIC and APRA, and chaired by the Governor of the RBA), feedback from non-ADI lenders (in general and to various consultations), and through Parliamentary processes.

Success of the registration process will be determined by APRA based on ASIC's data on AFS and Credit Licence holders. Given this information, APRA will be able to determine whether any entities that should be registered aren't. An assessment will also be made by APRA as to whether the implementation of the policy corrects current defects with FSCODA which means some entities that should be RFCs are currently unregistered. Industry feedback during the registration process will also be valuable in determining its success. As noted earlier, APRA will have the ability to correct issues with registration, through a discretionary power to expand or narrow the class of entities, as it deems appropriate.

The success of the data collection will be evaluated based on the usefulness of the data, whether it meets expectations and reflects current proxies. It will also be evaluated on whether the data collection process adequately minimises regulatory costs for stakeholders. The primary methods for determining this will be consultation that will occur with industry as part of making the necessary Reporting Standard prior to data being collected, and industry feedback to APRA and to the Government during, and post, the initial data collection processes.

In making a rule, APRA will endeavour to consult with industry (in all but extreme circumstances). Should one be implemented, the adequacy of the rule may be determined by Parliament, as certain rules may be legislative instruments. The success of a rule should be measured on whether it the rule reduces risks to financial stability, and this will be gauged from the data collected by APRA (hence why this is an important component on the measure). Oversight of the need for a rule will be provided by the Council of Financial Regulators.