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Our Ref NZB
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To whom it may concern,

Arnold Bloch Leibler's Submission: Draft Legislation: Treasury Laws Amendment (Non-ADI Lender Rules) Bill 2017

Please find attached Arnold Bloch Leibler's submission in response to Treasury's request for stakeholder views on the exposure draft of the *Treasury Laws Amendment (Non-ADI Lender Rules) Bill 2017* released on 17 July 2017.

Could you please kindly acknowledge receipt at your earliest convenience.

Yours sincerely

Nathan Briner
Partner

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Arnold Bloch Leibler Submission: Draft Legislation: Treasury Laws Amendment (Non-ADI Lender Rules) Bill 2017

14 August 2017

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Arnold Bloch Leibler Submission:
Draft Legislation: Treasury Laws Amendment (Non-ADI Lender Rules) Bill 2017

1. Introduction

Arnold Bloch Leibler welcomes the opportunity to provide this submission in response to Treasury's request for stakeholder views on the exposure draft of the *Treasury Laws Amendment (Non-ADI Lender Rules) Bill 2017* released on 17 July 2017 ("**Draft Bill**").

Arnold Bloch Leibler is regularly involved in many of the most significant financing transactions in the country. Our submission is largely based on our experience in acting for:

- non-ADI lenders that:
    - predominantly raise their capital from sophisticated private investors (domestically and internationally); and
    - provide commercial funding in connection with:
        - property development and other property investment transactions, including refinancings; and
        - corporate business borrowers ("**SME Borrowers**"),

      (but not typically to personal residential mortgage borrowers or personal finance borrowers); and
- property investors, property developers and SME Borrowers, including those that frequently borrow from non-ADI lenders.

The changes contemplated by the Draft Bill have the potential to affect a broad variety of participants in the finance industry.[1] Our submission primarily focuses on the potential consequences of the Draft Bill on commercial lending in the property finance sector and to SME Borrowers.

2. Key Points

- The non-ADI lending sector has been and continues to be vital in helping to provide competition and liquidity in the Australian property finance and SME Borrower market.
- Increased oversight and regulation of the sector by the Australian Prudential Regulation Authority ("**APRA**") may assist in promoting financial stability, but over-regulation could have serious consequences for the property sector and the economy overall.
- If APRA is granted new powers, APRA must use them in a focused and measured manner, targeting areas of the market that are likely to pose systemic risks, without restricting much-needed non-ADI lending activity in the current market.

[1] Including participants in the corporate and retail lending sectors and the secondary debt markets.

- While APRA and Treasury have indicated that the new power over non-ADI lenders is intended to be a "reserve power", this is not consistent with the wording of the Draft Bill.
- If the Draft Bill becomes law, the industry must be given an opportunity to provide feedback on the potential adverse consequences of any proposed rules affecting the sector.

We set out our further high level comments and feedback on the Draft Bill below.

3. Important role of shadow banking sector

Any proposed regulation of the shadow banking sector must take account of the critical role this sector now plays in the Australian economy.

In our experience, increased macroprudential regulation by APRA in recent months has limited senior debt funding of construction and other property transactions by traditional Australian banks (ADIs).

The reduced liquidity has increased costs for borrowers, while 'loan to value' and pre-sales covenants have further tightened.

The non-ADI lender sector has been, and continues to be, vital in helping to redress the reduction of liquidity in the property finance market. In particular, non-ADI lenders have been active in funding viable property investments and developments, and assisting homeowners and investors to complete purchases of off-the-plan apartments.

If increased regulation results in non-ADI lenders limiting or ceasing lending, or significantly raising borrowing costs, this could have very serious consequences for SME Borrowers, property developers and other participants in the property industry.

In the property development industry, it could discourage further construction and housing supply which will exacerbate current housing affordability issues in certain areas of Australia's key residential markets.

Given the fundamental importance of the property sector and SME Borrowers to the Australian economy, any new rules associated with the Draft Bill must be proportional. In particular, if APRA is granted additional powers, any rules introduced by APRA should not restrict non-ADI financing models which simply increase liquidity and provide competition to ADIs (which dominate the Australian lending environment) and do not pose material risk to the financial system.

4. Limited need for regulation in the sector

Shadow banking remains a small share of market

Given the size and importance of ADIs to the stability of the Australian financial system, APRA has a vital role overseeing these institutions, principally to protect depositors who are not in a position themselves to monitor and influence the behaviour of ADIs.

The Reserve Bank of Australia has acknowledged that the shadow banking sector currently poses only a limited risk to financial stability due to its small share of the financial system and minimal linkages with the regulated sector.[2]

It is not clear to us that there are true 'systemic risks' to financial stability which arise from the participation of non-ADI lenders in most lending markets, for reasons we explain later in this

[2] Financial Stability Review, April 2017, Reserve Bank of Australia, page 41.

submission. The manner in which non-ADI lenders obtain funding, conduct their lending businesses and participate in the financial markets is fundamentally different to ADIs.

If APRA is granted new powers, in introducing any new rules, APRA must have regard to the comparatively small influence this sector has on the financial system as a whole.[3] This is particularly the case in the context of property development finance and SME borrowing.

While this may change over time, it would appear unlikely that finance provided by non-ADI lenders is currently "materially contribut[ing] to risks of instability in the Australian financial system", as contemplated in the Draft Bill.

The reporting obligations contemplated by the Draft Bill should assist in monitoring the situation.

Capital sources

Non-ADI lenders do not require the same degree of regulation as ADIs. They do not have depositors to protect, nor do they receive the benefit of a government guarantee that is paid for by taxpayers and depositors. This distinction is critical.

Our clients predominantly raise their required capital from wholesale investors, such as high net worth investors, local superannuation funds, foreign pension funds and other international investors. They generally seek investor funds on a loan and project-specific basis (or sector/opportunity basis), and do not seek short-term warehouse funding from ADIs, nor participate in the debt securitisation market.

Investors in these development and investment loans are sophisticated. They generally understand the potential risks, and are capable of pricing and bearing these.[4] We do not consider that there is a meaningful additional role for APRA to perform in regulating investments of this nature on behalf of investors of this type.

As our clients typically source investors on a deal by deal basis, they are incentivised to engage in prudent lending practices. If they fail to do so, sophisticated investors will either place their funds with other non-ADI lenders that follow these practices or in alternative asset classes. If losses are suffered by non-ADI lenders in connection with these loans, these losses are absorbed by the investors, and are not transmitted to the financial system more broadly.

The Financial Stability Board has previously recommended that regulators focus their attention on shadow banking entities that have the potential to pose systemic risks.[5]

In our view, non-ADI property finance lenders that fund their activities in this manner are unlikely to pose such risks, and should not be the focus of APRA's attention.

Commercial and retail lending

Recent prudential measures by APRA have targeted residential mortgage lending practices by ADIs. We understand that one of the purposes of the Draft Bill is to ensure that non-ADI lenders cannot pursue lending practices in this space in a manner that is contrary to APRA's overriding policy objectives.

We see merit in this approach, however it should be noted that there are distinctions between the retail and commercial property finance markets that should influence APRA rule-making.

[3] The size of the shadow banking system comprises approximately 6% of all financial system assets. Ibid.
[4] For example, various non-bank lenders under their AFSLs are limited to offering investment opportunities to wholesale investors who must meet certain minimum investment criteria. This prevents them offering investments to unsophisticated retail investors.
[5] *Shadow Banking: Strengthening Oversight and Regulation*, October 2011, Financial Stability Board.

Commercial borrowers in the property investment and development sectors are generally more sophisticated than retail mortgage borrowers. This distinction is already recognised by the fact that lenders in the latter class are subject to ASIC's responsible lending requirements.

The Draft Bill requires APRA to consult with ASIC in making, varying or revoking any rules, and this is appropriate in the retail lending space. This implicitly recognises that the main focus of APRA regulation should be in the retail mortgage lending market.

5. Application of regulation

Registrable Corporations

The Draft Bill proposes amendments to the definition of "registrable corporations" in the *Financial Sector (Collection of Data) Act 2001* (Cth) ("**FSCODA**"), in order to widen the class of corporations that must be registered with APRA under that legislation.

These corporations:

- must comply with statistical reporting obligations under FSCODA; and
- may be subject to rules made by APRA as a consequence of the Draft Bill.

We understand and support the objectives of this change, particularly to the extent that it results in the increased collection of relevant data and promotes a deeper understanding of the market. This understanding may also confirm that increased regulation of non-ADI lenders is not required. However, policymakers should be aware that these changes are likely to impose significant additional compliance costs for lenders which did not previously fall within this definition. Alternative means of collating this data (which avoids these costs to lenders, and therefore borrowers) should be investigated.

Additionally, an overriding consideration must be to continue to ensure that the information APRA requires from registrable corporations is targeted towards identifying material risks of instability in the financial system. There is no value in imposing an additional and unnecessary administrative burden on non-ADI lenders, where the information being collected delivers no real benefit in achieving APRA's stated aims.

The Draft Bill extends the scope of registrable corporations to entities that are not predominantly operating in the finance sector. By expanding APRA regulatory oversight to these entities, there is a risk that such corporations may not be aware of the requirement to register under FSCODA (or the need to comply with any rules subsequently implemented by APRA).

If these provisions of the Draft Bill are enacted, any new rules should not apply retroactively. In addition, there should be an appropriate transition period in which APRA engages in a publicity and education campaign to limit the risks of inadvertent non-compliance.

APRA's broad powers

The Draft Bill provides APRA with broad power to determine rules if it considers that "an activity or activities engaged in by one or more non-ADI lenders in relation to lending finance materially contribute to risks of instability in the Australian financial system". [6]

Public comments by APRA chairman Wayne Byres and Treasurer Scott Morrison suggest that this power is intended to be a "reserve power" that will only be used by APRA in rare situations.[7]

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[6] New Section 38C(1) of the Banking Act 1959 (Cth), as contemplated by the Draft Bill.
[7] 'Shadow banks fear APRA overreach', Australian Financial Review, 26 July 2017.

However, this is not consistent with the wording of the Draft Bill. Once a broad framework is formalised in legislation, there is a risk that the powers could be used in future to impose broad macroprudential requirements on non-ADI lenders.[8]

The broad scope of the Draft Bill has the potential to create uncertainty in the sector. In particular, the Draft Bill does not define "materially" or "instability" or provide non-exhaustive examples of circumstances where APRA may intervene with its rule making powers.

It would appear that APRA's current intention is to use these powers in a targeted manner, however further public guidance is required.

For example, if APRA does not currently intend to impose additional costs and regulatory burdens on non-ADI lenders in the commercial lending space (as we would expect), those market participants would welcome clarification.

It is equally critical that before APRA implements any rules affecting the sector, it engages in a further detailed consultation process with all relevant stakeholders.

This will provide affected parties with a greater level of certainty and the opportunity to provide feedback. This process would help to ensure any new rules are proportionate and do not have unintended consequences on the financial system.

In summary, we caution regulators to avoid over-reaching in a manner that could have unintended consequences on competition and liquidity in the Australian economy in order to regulate participants whose activities are not material to the maintenance of broader financial stability.

[8] Imposition of uniform and blanket requirements (such as possible limits on percentage increases in certain categories of lending) may not be appropriate across all non-ADI lenders, including for example without limitation, non-ADI lenders with smaller loan books or less consistent deal flow.