KING&WOOD MALLESONS

Level 61
Governor Phillip Tower
1 Farrer Place
Sydney NSW 2000
Australia

**T** +61 2 9296 2000
**F** +61 2 9296 3999

**www.kwm.com**

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To The Manager
Banking, Insurance and Capital Markets Unit
Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600

**By email:** lenderrules@treasury.gov.au

Dear Manager

**New APRA powers to address financial stability risks - non-ADI lender rules**

We refer to the call for comments on the draft Treasury Laws Amendment (Non-ADI Lender Rules) Bill 2017 (**Exposure Draft**) published by the Government on 17 July 2017, and to our subsequent meetings with representatives of Treasury and APRA.

On behalf of our clients, Firstmac Limited, Liberty Financial Pty Ltd, Pepper Group Limited and RESIMAC Limited (**Primary Contributors**), we welcome the opportunity to make this submission on an area of critical importance to Australia's financial system, including the key requirements to maintain and increase the level of competition and innovation, and the supply of finance to borrowers of all types.

Each of the Primary Contributors run successful businesses which supply credit to worthy customers, either in competition with the traditional lenders or in products, borrower types or locations that traditional lenders do not or cannot fund. This ensures continued access to credit across a wide range of borrowers, but within specialised businesses that operate to high credit assessment and enforcement standards, and which are subject to detailed oversight and regulation by ASIC, warehouse lenders, capital market investors, rating agencies and other service providers.

Our submission focuses on the current level of oversight and regulation of non-ADI lenders, the benefit of a targeted regulatory approach towards the non-ADI lending sector, as well as the likely impact and some potential unintended consequences of the legislation in its current form on the sector and capital markets more broadly. The Primary Contributors have also been involved in the preparation of the submission to be provided by the Australian Securitisation Forum, and support its contents and suggested amendments to the Exposure Draft.

**Overview**

We recognise the importance of financial stability and the need for sound lending practices. We appreciate that information about lending activities, including data from market participants, is necessary to ensure that

authorities have an accurate and complete understanding of the level of credit originated into the economy, and to assist with any targeted regulatory responses to any material risks of financial instability.

However, non-ADI lenders and ADIs are fundamentally different. While non-ADI lenders provide a range of essential functions and products to all Australians, they do not provide as broad a range of products, nor do they accept deposits, nor are they responsible for key pieces of banking infrastructure. Non-ADI lenders promote healthy competition within the finance sector, and service areas and customers that ADIs lenders cannot or are unable to service.

It follows that any regulation of non-ADI lenders cannot have the same prudential character as the regulation of ADIs. It should be limited to exceptional circumstances where the extent or nature of the non-ADI lending activity is threatening the stability of the financial system. Further, as with any regulation, it should be clear to which entities it applies and who and how they may be affected.

While the initial government announcement foreshadowed the grant of a "reserve power" targeted towards specific macro-prudential concerns in the non-ADI lending sector, the Exposure Draft goes much further than this and creates unnecessary regulatory intervention in, and the creation of regulatory uncertainty in respect of, the non-ADI lending sector. It casts an extremely wide net, both in terms of the proposed entities to be regulated and the level of regulatory oversight. We recommend that the legislation be modified to facilitate a more targeted regulatory approach to avoid causing unintended instability in the capital markets, the non-ADI lending sector and the Australian economy more generally.

## Executive summary

| Subject | Current draft | Issue | Recommendations |
|---|---|---|---|
| **Scope of legislation – who is a registrable corporation and who is a non-ADI lender** | A non-ADI lender is defined to mean a registrable corporation (within the meaning of the amended definitions in FSCODA). | • The current draft captures a wide range of entities that raise money and provide finance, whether for wholesale or retail purposes, across the capital markets (including domestic and offshore investors).<br>• While this may be appropriate in the context of the collection of data under FSCODA, it is unintentionally wide in scope and beyond the intent of the Government's proposed regulatory framework in the context of APRA's proposed rule-making power. | • The definition of "registrable corporation" in FSCODA should be clarified so that there is no double reporting.<br>• For a securitisation programme, FSCODA should make it clear that the entity upon which the reporting obligation is imposed is the originator under that programme, and no other entity.<br>• The definition of "non-ADI lender" in the Banking Act should be limited to a registrable corporation which engages in the activity of lending finance.<br>• The definition of "lending finance" should be limited to the lending of money or activities that "directly" result in the funding or origination of loans.<br>• For the purposes of providing and assessing data on the lending activities of non-ADI lenders, and in assessing the impact of the lending activities of non-ADI lenders on financial stability, the lending activities of any non-ADI lender that is related to, or an associate of, an ADI must be excluded as such lending would already be captured in the lending activities of the relevant ADI.<br>• In the context of a typical securitisation programme, we recommend that the non-ADI lender is the originator of the securitisation programme. |
| **Circumstances for making a rule** | APRA may make a rule if it considers that the lending activities of one or more non-ADI lenders "materially contributes to risks of | • Non-ADI lenders ultimately obtain their funding in the domestic and international capital markets. Investors require certainty. Uncertainty will affect the availability of funding, demand for debt securities issued by a non-ADI lender and affect the interest | • The legislation should have a more prescriptive test or "trigger" for the reserve power to be exercised. Materiality is too broad in the context of the policy that supports the legislation. |

| Subject | Current draft | Issue | Recommendations |
| --- | --- | --- | --- |
| | instability in the Australian financial system" | rate payable on those securities. In each case, the availability and cost of finance provided to borrowers will be affected and cause further competitive disadvantage to non-ADIs.<br>• It is unclear what activities will materially contribute to risks of financial instability, especially given the small market share of the non-ADIs in the mortgage lending market compared to the ADIs. | • Whilst APRA may not foresee having to use these powers in the near future, it does seek unfettered powers in the legislation. To balance APRA's desire to have unfettered legislative powers and the industry's desire for clarity and certainty, we recommend that the Explanatory Memorandum clearly describes the circumstances in which these powers may be used. We also recommend that APRA issue guidelines or letters to give a level of comfort to the industry and the capital market investors.<br>• A key consideration in determining the materiality trigger is the benefit of competition and the different market shares of non-ADI lenders compared to ADI lenders – non-ADI lenders serve an important role in financial stability by ensuring there is material competition in the Australian lending markets.<br>• In making any rule, including any rule that relates to any limit, direction or restriction on the future lending activities of the non-ADI lenders, APRA must consider and give effect to the proportionality of the lending activities of a non-ADI lender compared to an ADI, and the proportionality of the lending activities of the aggregated non-ADI lenders compared to the aggregated ADIs.<br>• Any guidelines should make it clear that APRA needs to specifically assess any competitive factors (including market share, the proportionality of the lending activities of a non-ADI lender compared to an ADI, the proportionality of the lending activities of the aggregated non-ADI lenders compared to the aggregated ADIs, and reduced access to capital markets for funding purposes) in the relevant markets before it exercises its rule-making power. |
| **Scope of the rule-making power** | APRA may determine rules in relation to matters relating to lending finance, and a rule may impose different requirements to be complied with in different situations or is | • The broad rule-making power afforded to APRA does not appear to align with the Government's proposed regulatory framework.<br>• APRA's rule-making power is broad and does not relate directly to the "lending activities" that in APRA's view are "materially contribut[ing] to risks of instability | • APRA's rule-making power must relate directly to the "lending activities" that in APRA's view are "materially contribut[ing] to risks of instability in the Australian financial system.<br>• Given that the purpose of APRA's rule-making power is limited to matters relating to financial stability, the legislation |

| Subject | Current draft | Issue | Recommendations |
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| | respect of different activities. | in the Australian financial system.<br>• The definition of "lending activities" is broad and could extend to the totality of the business of the non-ADI lender.<br>• The draft legislation does not give adequate recognition to the existing operating environment in which non-ADI's undertake their origination and wholesale funding activities. Annexure 1 to this submission sets out the current regulatory and supervisory framework that applies to non-ADI lenders, and the Primary Contributors in particular. | should:<br>- limit APRA's rule-making power to those specific macro-prudential issues which are creating the risks which it seeks to address by the rule, rather than having the potential to regulate the overall business of a non-ADI lender;<br>- exclude from APRA's rule-making power the general or specific business activities of a non-ADI lender which are beyond the scope of the Government's proposed regulatory framework (such as section 11CA(2) of the Banking Act).<br>• The legislation must make it clear that the entity upon which the rule is imposed is the non-ADI lender which is the sponsor/originator. APRA must not have any power to make a rule in respect of an existing transaction or the vehicle through which the credit is provided or the funding is raised, or the assets or cashflows that are part of any such transaction.<br>• APRA must revoke a rule once it considers that the lending activities that were the basis for that rule no longer materially contribute to risks of instability in the Australian financial system. |
| **Process for rule-making** | Not specified | • There is no overall regulatory or supervisory framework or relationship between APRA and the non-ADI lenders, and nor is one intended to be created by the Government's proposed regulatory framework.<br>• Non-ADI lenders operate sophisticated and dynamic business models, product types, borrower assessments and servicing models which are relevant to APRA's understanding of any perceived risk associated with their lending activities.<br>• Non-ADI lenders ultimately obtain their funding in the domestic and international capital markets. Investors | • In addition to consulting with ASIC, the legislation should make it clear that APRA must engage in detailed consultation with the relevant non-ADI lenders before it makes any rule.<br>• The two sections of the legislation should come into force at different times. The provisions in Schedule 2 (dealing with registrable corporations and the collection of data) should come into effect immediately upon the legislation receiving Royal Assent. The provisions in Schedule 1 (dealing with the rule-making powers in respect of non-ADI lenders) should be passed into law, but they should only become operative upon a regulation being made by the Treasurer, upon advice from APRA, if and when the need for a rule to |

| Subject | Current draft | Issue | Recommendations |
|---|---|---|---|
| | | require certainty. An absence of any certainty as to when and the process of how a rule could be made will affect the availability of funding and demand for debt securities issued by a non-ADI lender and affect the interest rate payable on those securities. In each case, the availability and cost of finance provided to borrowers will be affected and cause further competitive disadvantage to non-ADIs. | be made in respect of non-ADI lenders comes into existence.<br>• Alternatively, the legislation should contain a transitional period before any rule is made by APRA under its new powers under the legislation.<br>• The legislation should contain a transitional period after a rule is made by APRA and its effective date – a non-ADI lender must be able to meet its pipeline of commitments to borrowers before any restriction on its business takes effect.<br>• There should be an ability to rescind the rule once APRA is satisfied that the "risk of instability" has ceased. |
| **Consequences of breach** | APRA may give a non-ADI lender a direction to, amongst other things, refrain from the lending of money or from carrying out activities that result in the funding or origination of loans or other financing. | • These directions could extend to the entire business of a non-ADI lender and its entire funding programme, rather than simply the behaviour that is giving rise to the material risk of financial stability. | • A direction of this type should apply only to continued and egregious non-compliance by a non-ADI lender with any rule made by APRA.<br>• The legislation should contain a process and timing for the implementation of any rule by APRA and provide a non-ADI lender with the ability to alter its lending activities to its customers so as to comply with the rule.<br>• APRA must not have any power to make any direction that affects any other business operations of the non-ADI lender, and must have regard to the non-ADI lender's existing commitments.<br>• APRA must not have any power to make any direction in respect of a securitisation transaction, or the vehicle through which the credit is provided or the funding is raised or the assets or cashflows that are part of any such transaction. |

## Primary Contributors

The Primary Contributors represent four of the largest lenders in the non-ADI sector and have contributed to the Australian economy, by promoting positive competition within the Australian mortgage and specialist-lending market.

- **Firstmac Limited.** Firstmac Limited (**FML**) is a wholly Australian owned, Australian company headquartered in Brisbane with offices in Sydney and Singapore. FML's core business is the origination and management of prime residential home loans. In 2002 it established its own securitisation funding programme and since that time has funded over 70,000 home loans totalling approximately $30 Billion, and issued approximately $20 Billion in residential mortgage-backed securities transactions in the domestic and off-shore capital markets. In 2011, FML diversified away from a purely third party home loan distribution model and now maintains one of Australia's largest online retail home loan platforms, www.loans.com.au, in addition to providing motor vehicle and equipment financing. FML continues to play a major role in the evolution and diversification of the Australian home loan market into a more competitive market.
- **Liberty Financial Pty Limited.** Liberty Financial Pty Limited (**Liberty**) is an investment grade rated (BBB- (stable) Standard & Poor's) financial services company with operations across Australia and New Zealand. Since its founding in 1997, Liberty has consistently applied technological advances to service multiple markets with its unique combination of risk management capabilities and operational practices to generate competitive advantage and durable financial performance. Liberty pioneered mortgage solutions for underserviced customers on terms more attractive than prevailing alternatives and has since leveraged its unmatched competencies to establish operations in auto and equipment financing, commercial mortgages, personal loans, investments and, most recently insurance through its APRA licensed affiliate, LFI Group Pty Limited.
- **Pepper Group Limited.** Pepper Group Limited (**PGL**) and its subsidiaries (collectively, **Pepper**) is a diversified financial services group with businesses in Australia, New Zealand, Asia and Europe. Pepper is listed on the ASX and commenced business in Australia as a provider of home loans to consumers who fall just outside the lending criteria of traditional bank and non-bank lenders, otherwise known in Australia as the non-conforming or specialist mortgage market. Pepper has subsequently broadened its Australian business activities to also include the origination of prime mortgages, auto and equipment leases and personal loans, third party loan servicing and trust management and the provision of corporate real estate advisory services, and has businesses in 6 countries.
- **RESIMAC Limited**. RESIMAC Limited (**RESIMAC**) commenced operations in 1985, when it was established by the New South Wales state government to service and securitize residential loans for HomeFund, a New South Wales government housing program under the name of FANMAC. RESIMAC has a 32 year corporate history in originating, underwriting and servicing mortgage loans for securitisation programs. In 2016 RESIMAC merged with the ASX listed Homeloans Limited to create one of the largest on-banks with a mortgage portfolio in excess of $13bn. National Australia Bank and Macquarie remain large shareholders. RESIMAC and Homeloans originate prime and non-conforming mortgage product throughout a diverse national distribution platform that includes direct to borrower, broker and on-line.

## Current regulatory environment for non-ADI lenders

Non-ADI lenders, including the Primary Contributors operate in a highly-regulated origination environment. They are subject to continuous scrutiny by ASIC, warehouse lenders, capital market investors, rating agencies and other service providers.

Uunder the *National Consumer Credit Protection Act 2009* (Cth) non-ADI lenders are subject to ongoing ASIC oversight with regular reviews of lending policies and standards.

Non-ADI's short-term wholesale funding is commonly in the form of secured warehousing provided by the major ADI's. The regulatory requirements of these ADI lenders drive the regulatory risk capital, contingent liquidity charges and macro-prudential credit parameters reflected in warehouse facilities. In effect, macroprudential constraints placed by APRA on ADIs are effectively being applied to non-ADI lenders through the terms under which the ADIs are providing warehouse facilities to the non-ADI lenders.

Additionally, non-ADI lenders' long-term wholesale funding is typically in the form of predominantly highly rated 'AAA' asset or residential mortgage backed security issuances distributed to highly-regulated entities with comparable risk capital and liquidity regimes to those of the Australian ADI's. This sophisticated funding source represents a structural regulatory mechanism which influences non-ADI issuers' mortgage origination risk profile.

Annexure 1 to this submission sets out in further detail the current regulatory and supervisory framework that applies to non-ADI lenders, and the Primary Contributors in particular.

## Submission

### Scope of legislation - who is a registrable corporation and who is a non-ADI lender

A non-ADI lender is defined to mean a registrable corporation (within the meaning of the amended definitions in FSCODA). This definition catches a wide range of entities that raise money and provide finance, whether for wholesale or retail purposes. While this may be appropriate in the context of the collection of data under FSCODA, it is unintentionally wide in scope and beyond the stated intent of the Government's proposed regulatory framework in the context of APRA's proposed rule-making power. The non-ADI lender definition should be clarified in the context of a typical securitisation program. It is unclear if the non-ADI lender in that context is the SPV or trustee, and/or the manager, as well as the originator of the securitisation program. In any event, any APRA imposed penalties should not be directed to the securitisation trust or impact the loan assets within the trust.

This legislation catches not only those entities which provide credit directly to a retail customer, but also the financiers to that lender. If these entities are subject to the FSCODA reporting requirements, this will result in duplication of reporting: once for the monies lent by a lender to the retail customer, and then again for the monies lent by the financier to that lender, for example. The legislation should clarify whether such entities are to subject to the FSCODA reporting requirements.

The legislation also needs to differentiate between a non-ADI lender which is operating a separate and independent business, and a non-ADI lender that is related to, or an associate of, an ADI. In recent years, the market has seen further consolidation, including the acquisition by ADIs of non-ADI lenders (including mortgage brokers with lending programs). In that case, the ADI will either own or finance the lending activities (and assets) of that non-ADI lender. In the opinion of the Primary Contributors, any:

- assessment of the lending activities of the non-ADI lenders, including from the provision of data provided to APRA, must differentiate between these two categories of non-ADI lenders; and
- assessment of the impact of the lending activities of the non-ADI lenders on the material risks to stability in the financial system must take into account only the amount of credit originated by the independent non-ADI lenders,

as to do otherwise in either case could result in double-counting of the same amount of lending finance, or result in an incorrect assessment (and an over estimate) of the amount of lending finance which is being originated by non-ADI lenders.

The Primary Contributors are willing to meet further reporting obligations, and agree that such information will be beneficial to informing future regulatory approaches. However we do not appreciate the benefit of imposing onerous requirements on entities to report similar information to multiple different government agencies.

**We recommend** that the definition of non-ADI lenders:

- is limited to registrable corporations that engages in the activity of "lending finance" (this definition should be limited to the lending of money or activities that "directly" result in the funding or origination of loans);
- in respect of its application to securitisation programmes, it should only extend to the originator under those programmes and no other entity;
- for the purposes of providing and assessing data on the lending activities of non-ADI lenders, and in assessing the impact of the lending activities of non-ADI lenders on financial stability, the lending activities of any non-ADI lender that is related to, or an associate of, an ADI must be excluded; and
- reporting requirements should be streamlined to require entities to report information to a single government agency, which can then share that information with other government agencies as required, noting that any specific reporting required by APRA should be limited to lending information necessary for determining the necessity for lending rules rather than that required for FSCODA reporting currently.

### Circumstances for making a rule

APRA may make a rule if it considers that the lending activities of one or more non-ADI lenders "materially contributes to risks of instability in the Australian financial system". This is much wider legislative mandate than that originally canvassed by the Government in the Budget Papers.

Treasury have reassured the non-ADI sector that the proposed powers are "reserve powers". This phrase denotes a power which is residual, and to be used only as a matter of necessity.[1]

The legislation or ARPA guidelines should contain a more prescriptive test or "trigger" for APRA's rule-making power to be exercised. A key consideration in determining the materiality trigger is the benefit of competition – non-ADI lenders serve an important role in financial stability by ensuring there is competition in the Australian lending markets. Non-ADIs reduce contagion risks by diversifying the funding pool which ensures that the financial market is fully serviced. Removing competition can lead to financial instability by decreasing the availability and cost of funding. A recent Financial System Inquiry found that:

> *"The banking sector is concentrated, with the four major banks being the largest players in many aspects of the financial system and having significant market influence. Such concentration creates risks to both the stability and degree of competition in the Australian financial system"* (Financial System Inquiry Final Report, November 2014)

Key elements of consideration for APRA's determination of what "materially contribute[s] to risks of instability in the Australian financial system" should be clarified to provide non-ADI lenders, investors and other important capital market participants the ability to protect themselves and provide certainty. Looking specifically at mortgage lending, one must consider to what extent is market share taken into consideration in determining risk. The likelihood of the lending practices of non-ADIs materially contributing to instability in the Australian financial system is remote. Non-ADIs capture a market share of about 5% (compared to 95% of ADIs). The market share of ADI's has risen sharply following the global financial crisis, not coincidentally and commensurately with their considerable advantages. In the context of the Australian lending market, non-ADI lenders are not influential in terms of product and lending behaviour. Traditional non-ADI lenders are guided by the lending patterns of ADI lenders and investor demand. Whilst non-ADIs may service a slightly different markets to ADIs, ultimately their lending portfolio must satisfy the prudential regulations imposed on their ADI lenders.

**We recommend** that:

- specific factual circumstances must apply before any rules can be made in respect of the non-ADI lenders. This should be contained in the legislation, or at least in the regulations or guidance notes accompanying the promulgation of any rule; and
- the legislation and/or guidance notes make it clear that APRA needs to specifically assess any competitive issues in the relevant market before it exercises its rule-making power.

### Scope of the rule making power

Under the proposed legislation APRA may determine rules in relation to matters relating to lending finance, and a rule may impose different requirements to be complied with in different situations or in respect of different activities. This broad rule-making power does not appear to align with the Government's proposed regulatory framework. The only real restraint is that any rule promulgated must relate directly to the "lending activities" that in APRA's view are "materially contribut[ing] to risks of instability in the Australian financial system. However the definition of "lending activities" is broad and could extend to the totality of the business of the non-ADI lender.

APRA should not have the power to make a rule in respect of an existing transaction or the vehicle through which the credit is provided or the funding is raised, or the assets or cash flows that are part of any such transaction. Such a power would not cure any instability in the Australian financial system, but rather

[1] Massey & Anor V Wales & Ors; Massey & Anor V Cooney & Anor [2003] NSWCA 212 [38] – [39]

aggravate it. We are concerned that it could have inadvertent, detrimental consequences for non-ADI businesses.

Whilst it may not be APRA's current intention to use its powers, the mere potential for it to do so will create uncertainty for non-ADI lenders. Non-ADI lenders ultimately obtain their funding in the wholesale markets, from sophisticated lenders or from domestic and international capital markets. Any uncertainty created by APRA's potential use of its broad powers will adversely impact on the availability and cost of funding provided by capital market investors provided to non-ADI lenders, and ultimately the sustainability of the non-ADI lenders' businesses and competition in the lending sector.

Given that the purpose of APRA's rule-making power is limited to matters relating to financial stability, the legislation must make clear the macro-prudential focus of the rule-making power and exclude the general business activities and management framework of the non-ADI lender from the scope of the rule-making power.

**We recommend** that the legislation and/or guidance materials:

- limit APRA's rule-making power to those specific macro-prudential issues which are creating the risks which it seeks to address by the rule, rather than having the potential to regulate the overall business of a non-ADI lender;
- exclude from APRA's rule-making power the general or specific business activities of a non-ADI lender which are beyond the scope of the Government's proposed regulatory framework; and
- exclude any power to make a rule in respect of an existing transaction or the vehicle through which the credit is provided or the funding is raised, or the assets or cashflows that are part of any such transaction.

### Process for rule-making

The proposed legislation does not set out a clear process for rule-making and implementation of the rules, and whether there will be direct APRA consultation with non-ADI lenders regarding a proposed rule. There is no overall regulatory or supervisory framework or relationship between APRA and the non-ADI lenders, and nor is one intended to be created by the Government's proposed regulatory framework.

Non-ADI lenders operate sophisticated and dynamic business models, product types, borrower assessments and servicing models which are relevant to APRA's understanding of any perceived risk associated with their lending activities. They provide continued access to credit across a wider range of borrowers, but within specialised businesses that operate to high credit assessment and enforcement standards, and which are subject to detailed oversight by warehouse lenders, capital market investors, rating agencies and other service providers. Often, a non-ADI credit assessment or enforcement skill is tailored towards a specific segment of the market, and where that skill exists to manage that risk, which may not exist to the same standard as a traditional lender.

On this basis a more specific and targeted assessment of each segment of the market in which a non-ADI lender participates is required for any rule-making process, rather than an overall "market" or "industry" analysis. Given the nature of a non-ADI lender and its industry;

- the rule making and enforcement powers need to be more specific and different from the prudential standard and oversight approach taken with ADIs;
- APRA's assessment of the non-ADI lenders must specifically take into account the proportionate size of the non-ADI lenders, compared to the ADIs, and specifically when assessing the imposition of any limits or type of lending activities of the non-ADI lenders. This also needs to take into account the disproportionate effect on the size of a non-ADI lender's business by (for example) the acquisition or development of assets, businesses or capabilities that allow a non-ADI lender to achieve above system growth.

  As discussed above, a broad reserve power to impose rules that affect a non-ADI's business operations, will negatively affect the confidence of capital markets investors to fund those lenders, which in turn could affect the sustainability of the non-ADI's business model.

Consistent with the need for a "reserve" power, APRA's need to ensure that it is receiving complete and accurate data on the level of credit being originated into the economy and the critical need to maintain the confidence of capital market investors, we believe that the legislation should come into force at different times. The provisions in Schedule 2 (dealing with registrable corporations and the collection of data) should come into effect immediately upon the legislation receiving Royal Assent. The provisions in Schedule 1 (dealing with the rule-making powers in respect of non-ADI lenders) should be passed into law, but they should only become operative upon a regulation being made by the Treasurer, upon advice from APRA, if and when the need for a rule to be made in respect of non-ADI lenders comes into existence (that is, when APRA has satisfied itself that the lending activities of the relevant non-ADI lenders is materially contributing to the risks of instability in the Australian financial system).

**We recommend** that:

- the legislation make it clear that APRA must engage in detailed consultation with the affected non-ADI lenders before it makes any rule in relation to them;
- two sections of the legislation should come into force at different times. The provisions in Schedule 2 should come into effect immediately upon the legislation receiving Royal Assent, and the provisions in Schedule 1 should be passed into law, but they should only become operative upon a regulation being made by the Treasurer. Alternatively, the legislation should contain a clear transitional period before any rule made by APRA, under its new powers under the legislation, becomes effective;
- the legislation contain a transitional period after a rule is made by APRA and its effective date – a non-ADI lender must be able to meet its pipeline of commitments to borrowers before any restriction on its business takes effect;
- there should be an ability to rescind the rule once APRA is satisfied that the "risk of instability" has ceased and APRA should be required to review the need for maintaining a rule on regular basis; and
- any specific rule that is proposed to apply to a non-ADI lender should be no worse than any specific rule that is also applied to the ADI sector. In making any such rule, APRA must consider and give effect to the proportionality of the lending activities of a non-ADI lender compared to an ADI, and the proportionality of the lending activities of the aggregated non-ADI lenders compared to the aggregated ADIs.

## Consequences of breach

APRA may give a non-ADI lender a direction to, amongst other things, refrain from the lending of money or from carrying out activities that result in the funding or origination of loans or other financing.

These directions could extend to the entire business of a non-ADI lender and its entire funding programme, rather than simply the behaviour that is giving rise to the material risk of financial stability.

While Part IV of the Banking Act will apply, the ability of non-ADIs to challenge decisions of APRA is more limited, in terms of resources and other factors, than that of their ADI counterparts. In addition, there is no timeframe in which a non-ADI has to address the concerns of APRA. The current drafting allows APRA to make a direction that requires the non-ADI to "refrain from lending money" and/or "refrain from carrying out activities, *whether directly or indirectly, that result in the funding or originating of loans or other financing"* if APRA has "*reason to believe that the body corporate is likely to contravene a non-ADI lending rule*". Such drafting (particularly considering the discretion currently ascribed to APRA's rule determinations) is a clear impingement on due process. The weight of such a penalty, without the opportunity of remediation, is significant.

**We recommend**, that:

- any direction should apply only to continued and egregious non-compliance by a non-ADI lender with any rule made by APRA;
- the legislation should contain a process and timing for the implementation of any rule by APRA and provide a non-ADI lender with the ability to alter its lending activities to its customers so as to comply with the rule;

- APRA must not have any power to make any direction that affects any other business operations of the non-ADI lender; and
- APRA must not have any power to make any direction in respect of an existing transaction or the vehicle through which the credit is provided or the funding is raised, or the assets or cashflows that are part of any such transaction.

### Impact on non-ADI lenders

Given the nature of a non-ADI lender and its industry, the rule making and enforcement power needs to be more specific, and different from the prudential standard and oversight approach taken with ADIs. The announcements in the Budget Papers were targeted more towards macro-prudential concerns, and the Chairman of APRA described this as a reserve power. Broad and vague regulation of this type, with broad discretion on the part of APRA to introduce a rule and affect a non-ADI lender's business operations will negatively affect the confidence of capital markets investors to fund those lenders, which in turn could affect the sustainability of the non-ADI lender's business model and therefore reduce competition.

Whilst there is a requirement on the part of APRA to balance competition and competitive neutrality with the promotion of financial stability, the desire for the elimination of remote risks to financial stability should not override these competition considerations.

If the powers remain broad and non-specific, non-ADI lenders that utilise securitised funding may be adversely disadvantaged. In the absence of certainty as to when, how and why APRA may regulate, investors may question the non-ADI business model which may reduce the availability of capital markets funding and increase funding costs and limit the availability of warehouse funding, which in turn may have the unintended adverse effect on the level of loans and pricing in the retail lending market.

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We are making these submissions on behalf of the Primary Contributors, and the views expressed are those of our clients.

We would welcome the opportunity to discuss these submissions with members of the Banking, Insurance and Capital Markets Unit, and are very happy to assist should there be any queries arising from this submission. Please contact Stuart Fuller, Partner, on 02 9296 2155 / stuart.fuller@au.kwm.com.

Yours faithfully

## Annexure 1

Non-ADI lenders run specialised businesses that operate to high credit assessment and enforcement standards, and which are subject to detailed oversight by ASIC, warehouse lenders, capital market investors, rating agencies and other service providers.

- (**ASIC regulation of credit providers**) Non-ADIs that lend to consumers must hold an Australian Credit License (**ACL**). Consequently, these entities come under the ambit of ASIC's responsible lending conduct obligations in Ch 3 of the *National Consumer Credit Protection Act 2009*. This primary obligation is to conduct an assessment that the Credit Contract is "not unsuitable" for the consumer. The Act prohibits licensees from entering into a credit contract with a consumer if the credit contract is unsuitable for the consumer. On top of this, ASIC have recently announced a targeted surveillance operation to examine whether lenders are recommending more expensive interest-only loans when inappropriate to do so. In its announcement ASIC highlighted that it would be gathering data from non-ADI lenders using its compulsory information-gathering powers. ASIC are also requiring lenders to audit their hardship processes. These are examples of the many ways non-ADI lenders are held to account by ASIC in respect of their provision of home loan products to customers by ASIC.
- (**ASIC regulation by financial product issuers**) As issuers of financial products, non-ADI lenders are required to hold an Australian financial services (**AFS**) license. As an AFS licensee, non-ADI lenders are subject to specific obligations relating to (amongst other things) conduct and disclosure. Entities not directly regulated by APRA are subject to more stringent requirements under their AFS licence.

  ASIC regularly takes enforcement action against AFS licensees who engage in misconduct. An AFS licensee's compliance with its licence obligations is, "central to the protection of consumers and the promotion of market integrity".[2] The AFS licence regime itself is notable for its flexible approach which accommodates a diverse range of licensees. This diversity is reflected within the non-ADI lending sector not only in the range of lenders, but also in the tailored product delivery processes (including credit assessment and enforcement) required for often highly specialised customer segments.
- **(Warehouse Lenders)** The businesses run by non-ADI lenders are reliant on warehouse financing, provided by major ADI lenders. This funding is used by non-ADI lenders to write home loans which are then pooled and sold to investors. Warehouse lenders demand high quality asset pools in the structures which they finance for two primary reasons. First, to ensure that the non-ADI borrower has originated a pool of assets that can be publicly rated and securitised in order to regularly refinance the warehouse. Secondly a high performing asset pool is required to meet warehouse lenders' obligations under APRA regulations. Prudential standards, including Australian Prudential Standard 120 (**APS 120**), apply uniformly to ADIs' securitisation exposures, whether they are on an ADI's balance sheet or originated by another entity. Further APRA have made it known to ADIs that they would be concerned if "lending standards for loans held within warehouses are of a materially lower quality than would be consistent with industry-wide sound practices"[3]. As a result non-ADI lenders must only originate loan books which represent viable pools of investment under prudential standards, in order to secure warehouse funding from ADIs. We have already witnessed the extent to which APRA can exert its influence over non-ADI lenders through this channel. The Primary Contributors along with many other non-ADI lenders have necessarily amended existing warehouse facilities in order to facilitate compliance with warehouse lenders' APRA obligations. The warehouse facilities also typically require monthly reporting and annual due diligence and credit operational reviews.
- (**Capital market investors**) For public securitisation facilities funded by highly sophisticated capital market investors, those investors demand diversified, high quality assets pools. Non-ADI lenders must prepare comprehensive offering documents to secure capital market investment. These offering documents contain detailed data on the underlying pool mortgage loans including the payment type (eg interest only, or principal and interest), days in arrears and applicable interest rate. Sophisticated

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[2] ASIC Regulation Guide 104 Licensing: Meeting the general obligations.

[3] APRA Chairman, Wayne Byres (31 March 2017) http://www.apra.gov.au/MediaReleases/Pages/17_11.aspx.

investors use this data to scrutinise the composition and quality of the mortgage loans to be funded. If the assets appear to be of poor quality, investors will either demand a higher rate of return or refuse to invest. Both of these responses dissuade non-ADI lenders from offering loans that are otherwise expensive or impossible to fund. In this way, capital market investors force non-ADI lenders to engage in rigorous and stable lending practices.

- **(Rating Agencies)** Most warehouse and term securitisation arrangements, are subject to external credit assessment by rating agencies. Rating agencies apply stringent and comprehensive assessment processes to the underlying loans, the eligibility criteria and the concentration limits before providing ratings to those structures. Often non-ADI lenders will be unsuccessful in obtaining finance from capital markets, unless the highest rating is obtained from an external rating agency for its senior notes. Moreover under the new APS 120, warehouse financiers require warehouse structures to be externally rated, or otherwise satisfy rigorous internal credit assessments. Rating agencies represent another external pressure on the non-ADI lending sector, which drives non-ADI lenders away from originating non-compliant pools of mortgage loans. Non-ADI lenders will not originate mortgage loans if those mortgage loans prevent a rating agency from awarding the desired rating to the relevant funding structure. This is because if the desired rating is not obtained, it will be difficult for the lender to source the required funding.
- **(Lender's Mortgage Insurers)** Many of the loans originated by non-ADI lenders are covered by lenders' mortgage insurance (**LMI**) offered by APRA-regulated insurers. The cost of LMI is affected by the size of the loan, amount of deposit and the employment status of the borrower. If the cost of LMI is too high because of existence of high risk factors, the borrower will be unable to proceed to take out the relevant loan. In other cases the insurer may refuse to provide LMI, if it forms the view that the borrower is unlikely to meet its obligations under the loan agreement. In this way loan mortgage insurers serve as an additional point of verification of the quality of loans originated by non-ADI lenders.
- **(FSCODA)** The Primary Contributors are already required to report to APRA under existing *Financial Sector (Collection of Data) Act 2001* (**FSCODA**) reporting requirements. FSCODA encourages prudent practice amongst institutions by ensuring that they examine their activities in a similar manner to that of the entity to which the relevant information is reported.
- **(RBA reporting)** The RBA imposes reporting requirements for repo eligible notes. Under these requirements entities must disclose detailed data for asset backed securities including loan level, security level, transaction level, pool level, cash flow waterfall model and related data.

The combination of these existing laws and structural features function to successfully regulate non-ADI lenders such as the Primary Contributors, whilst ensuring sustainability of their business models.