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The Treasury  
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### **Submission on New APRA Powers to Address Financial Stability Risks - Non-ADI Lender Rules**

Pepper Group Limited (“**Pepper**”) welcomes the opportunity to provide its feedback on the proposed legislation.

Pepper has also participated in the preparation of the submission by King and Wood Mallesons (“**KWM**”) which has been prepared on behalf of a number of non-ADIs and we endorse the detailed feedback on the proposed legislation which has been given in that document. We have also had the benefit of reviewing the submissions of the Australian Securitisation Forum, the Mortgage and Finance Association of Australia (MFAA) and the Australian Financial Industry Association and broadly support the submissions of those organisations.

Pepper is making its own submission to emphasise our significant concerns about the impact the proposed legislation may have on the availability of finance to ordinary Australians. The cohort that we believe find themselves disenfranchised by the major banks includes the self-employed, blue-collar workers and migrant families all of whom make up a key component of the Australian economic and political landscape.

We also wish to take this opportunity to address some of the myths surrounding non-banks, and, in the process dispel any suggestion that the loan portfolios of non-bank lenders are riskier than those of the banks.

Whilst we endorse any reasonable initiatives to support the stability of the Australian financial system, we think that the government should be very cautious about enacting such broad regulatory powers that have potential unintended consequences for the customers of the non-banks.

Given that the non-bank sector represents less than 5% of the home loan lending market, it is not unreasonable to question whether additional regulation of non-banks is necessary, efficient or warranted.

## **Who is Pepper?**

Pepper Group has built a unique, diversified, global portfolio of financial services businesses which include Lending, Advisory and Asset Servicing across the residential and commercial property sectors - as well as in consumer, auto and equipment finance. As a people focused lender, over 17 years we have developed flexible loan solutions based on individual credit assessment, which enables us to support many borrowers who fall outside the credit criteria of the major banks. Our customers include many hard working self-employed borrowers who are able to manage repayments, but who often struggle to get a loan from the banks. As we think about our customer's future we consider ourselves as their partners in helping to finance their ambition.

Since 2001, we have helped over 100,000 Australians achieve their financial goals and we live our mission: to help people succeed. We are one of the top 300 companies listed on the Australian Securities Exchange (ASX:PEP). Our offices span Australia, Asia and Europe. We're a global leader in alternative solutions with over 600,000 customers worldwide and \$50.8 billion in assets under management as at 31 March 2017 – comprising of \$7.7 billion in lending assets and a servicing portfolio of \$43.1 billion.

Although Pepper focuses on markets that the Banks do not, or no longer, service, that should not be misinterpreted to suggest that Pepper's underwriting standards are any less stringent, or that our loan portfolios are somehow riskier, than those of larger ADI's. On the contrary, because we lend to customers who may, for example, have had prior credit defaults, we have generally employed more conservative underwriting standards not dissimilar to those that APRA has more recently sought to impose on the banks. Amongst other examples, Pepper has for many years assessed all home loan applications using an interest rate buffer of at least 2% above the customer's applicable interest rate, has applied floor rates to our loan assessments, and applied discounts to any non-salary income. In respect of interest only loans, we have required borrowers to demonstrate capacity to meet the principal and interest repayment obligation that would apply following the end of the interest only period. Furthermore, we do not use automated loan approvals for our mortgage applications in contrast to many of the ADI's. Instead, a credit officer manually assesses each home loan application on its merits based on a detailed and thorough review of all aspects of the customer's circumstances.

As a further check on our approach to credit assessments, as we obtain funding for our loans from warehouse lines and the debt capital markets, we are required to meet the strict eligibility requirements of our funders and the lending standards required by investors. Such requirements include restrictions on the mix of investor versus owner occupied loans (in the case of our home loan portfolios), or the mix of asset classes (in the case of our asset finance portfolios) and governance around acceptable loan to value ratios.

Pepper's commitment to lending responsibly is also demonstrated by the arrears performance of our loan portfolios which, over many years, has have generally been lower than the applicable Standard & Poor's arrears index. Furthermore, we have experienced less than 0.1% of cumulative losses on the \$7.2bn of prime and non-conforming home loans we have funded between 2010 and 2016. This in turn represents a loss of approximately 0.02% per annum which compares favourably with ADI's over a similar timeframe. .

## **What are Pepper's concerns with the proposed legislation?**

Whilst we acknowledge that the stability of the financial system should be of critical concern and an aim of government regulation we believe the legislation as proposed is too broad and will lead to regulatory uncertainty.

A strong and stable financial system will ensure that non-bank participants like Pepper, will continue to grow their businesses with confidence and, in doing so, boost much needed competition in the financial sector.

To highlight our concerns about regulatory uncertainty, we note that under the proposed legislation it would be possible for APRA to suddenly impose capital adequacy requirements on non-banks. Whilst we accept that it is not the intent of the legislation, this may not be how investors in the debt capital markets could view the legislation. Investors, particularly offshore investors who do not have a good appreciation of the Australian regulatory environment, could be inclined to take a conservative view of risk and consider the “worst case scenario”. Importantly the concerns of these investors are unlikely to be allayed by public statements which suggest that the powers will only be used in limited circumstances.

Capital market investors have particular reason for concern, given APRA made changes to APS120 in 2008 that prohibited ADI’s from calling RMBS issues pursuant to date based calls. This change had retrospective effect that significantly reduced the value of the investments held by investors globally at that time. Investors therefore have legitimate reason to be concerned by the proposed legislation that APRA might in future take regulatory action that could have negative retrospective impact on investments in RMBS issues from non-banks.

Such uncertainty has a particularly negative effect on the non-bank lenders who are reliant upon the public debt capital markets in order to meet their funding needs. Investors are inherently cautious about where they place their money and the price at which they will invest into a deal. If an investor thinks that the regulatory landscape could change overnight as a result of APRA making an order under the proposed legislation, they may either choose not to invest, or they will increase their price to account for that additional risk. Again, this is particularly true of offshore investors.

Since inception, Pepper has raised AUD\$9.7 billion in the domestic and international debt capital markets. Pepper has worked hard over the last several years to diversify our investor base to include blue chip overseas investors in our RMBS programs and since 2010 close to 50% of the funding we have raised in the debt capital markets has come from offshore. These investors include banks, insurance companies, superannuation and pension funds, money market funds and fund managers.

Pepper has sought this diversification because we want to ensure stability in our funding, which, in turn, adds to the overall stability of the financial system. If the availability of offshore based funding is reduced as a result of the proposed legislation it may unintentionally undermine a critical funding option for the non-bank sector.

We are also concerned that the legislation’s breadth will see securitisation SPVs and those who invest in them ensnared in this regulatory net. Again, while we accept that this is not the intent of the legislation it could nonetheless have adverse consequences for the availability of funding in the debt capital markets if the legislation proceeds in its current form.

### **Why should the government care about those concerns?**

Pepper concedes that, when balanced against the stated aim of financial stability, the government is unlikely to be sympathetic to the concerns of institutional investors in securitisation transactions. However, we think that the government should be very focused on the consequences for ordinary Australians, particularly self-employed, blue collar, migrant families, and first home buyers, if, as a result of this legislation, non-bank lenders, like Pepper, have more limited access to the debt capital markets, or the cost of accessing those markets greatly increases.

It will mean that Pepper's borrowers, who cannot meet the bank's lending criteria, will be unable to get a loan to purchase a house, or will have to pay significantly more to do so. It will mean that first home buyers, who can't get a loan from a bank because their parents are helping them with the deposit may be further locked out of the housing market. Without non-bank lenders like Pepper, borrowers like these who have the capacity to repay, but who the banks will not lend to, will be disenfranchised.

Furthermore, the stated aim of the government and APRA to encourage more competition in financial services will be significantly compromised as uncertainty caused to funding coupled with a risk of the homogenous application of lending rules across both the bank and non-bank sector will limit choice for customers who need it most. The non-bank sector in Australia has performed a critical role in ensuring that ALL deserving Australians have access to a home loan, not just those chosen by the traditional banks.

The performance of Pepper's loan book before, during and after the GFC demonstrates the fact that careful manual assessment of each borrower's needs and capacity to pay has resulted in very low levels of arrears and losses for Pepper and our customers.

Pepper's customers comprise both younger and older families with modest incomes and diverse backgrounds. These customers are made up of mostly migrant and blue-collar families living in major cities as well as rural and regional Australia. These customers are more likely to exhibit higher credit risk making it difficult for them to get a loan from the banks.

In addition, over a quarter of our customers are self-employed or earn forms of income not accepted by traditional banks for the purposes of a home loan.

Enclosed with this submission is a document which provides further information about the types of people Pepper helps to obtain financing.

Non-bank customers would be adversely affected by unintended consequences of the proposed legislation. Given the critical role these people play in the Australian economy; we believe that the government should consider such unintended consequences carefully.

### **What could be done to address Pepper's concerns?**

We believe the stability of the Australian financial sector and certainty for non-bank lending are not mutually exclusive.

Pepper submits that instead of legislating the proposed changes to the *Banking Act*, the government should first rectify the reporting regime under *FSCODA*. We submit that the changes to *FSCODA* should be made in the manner outlined in the KWM submission. Pepper would strongly support those changes as we believe that the drafting of the existing *FSCODA* legislation is confusing and does not allow for ease of reporting particularly by non-banks who generally employ securitisation trust structures which do not fit neatly into the existing *FSCODA* regime. We submit that this would be easily fixed if the suggestions in the KWM submission are adopted and could be implemented reasonably quickly.

We do not believe that there is any necessity to immediately introduce the more fulsome changes that are proposed because:

- all of the non-bank lenders are already heavily regulated by ASIC under the *National Consumer Credit Protection Act* so any immediate issues can be addressed through ASIC's existing powers;

- APRA already has indirect oversight over non-bank lenders given that the majority of warehouse lines are provided by ADIs. If the government's concern is that non-banks were to start writing loans to borrowers with a weak ability to repay, and this should become a systematic problem, the concern has no historical or current basis;
- as publicly stated, there is no immediate matter that APRA is concerned about with the non-banking sector and, given the limited size and market share of the sector (5%), the likelihood of the lending practices of non-ADIs materially contributing to instability in the Australian financial system is extremely remote.

Giving APRA better data about the non-banking sector would allow both APRA and the government to make a determination about whether regulation is warranted at all. Should the government determine further regulation is in fact required, this data will serve to inform policymaking to ensure that any adverse consequences are limited or avoided entirely. It is not apparent to us why the government would want to impose further regulation on an already highly regulated sector without being armed with all of the relevant information.

If, however, the government is determined to impose regulatory oversight by APRA on the non-banking sector, we submit that it is essential that such regulation is introduced in a manner that does not result in the exclusion of a whole segment of ordinary Australians from accessing housing finance. In circumstances where many Australians already feel like they are locked out of the housing market, we submit that the government should not make changes that would serve to further disenfranchise this section of the community.

The KWM submission outlines numerous ways that the government could amend the legislation which we believe would, at least, limit the potential adverse consequences we have outlined above. We would strongly encourage the government to consider adopting these in a revised draft of the proposed legislation if they are determined to proceed with changes to the *Banking Act*. At the very least, we think that the government should spend more time consulting with the industry before implementing any changes.

We would be happy to discuss any questions you may have in relation to this submission.

Yours sincerely



Michael Culhane  
Group CEO