Regulation Impact Statement

Banking exemption order for Registered Financial Corporations

(OBPR ID: 2013/15018)

Background

This Regulation Impact Statement addresses the Australian Prudential Regulation Authority's (APRA's) proposed changes to Banking (Exemption) Order No 96.

APRA's mandate is to ensure the safety and soundness of prudentially regulated financial institutions so that they can meet their financial promises to depositors, policyholders and superannuation fund members within a stable, efficient and competitive financial system. In so doing, APRA is required to promote financial system stability in Australia. APRA carries out its mandate through a multi-layered prudential framework that encompasses licensing and supervision of financial institutions.

Under section 9 of the *Banking Act 1959* (the Banking Act), a body corporate that wishes to carry on banking business in Australia may only do so if APRA has granted an authority to the body corporate for the purpose of carrying on that business. Banking business is defined in section 5 of the Banking Act to be:

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

(ii) other financial activities prescribed by the regulations for the purposes of this definition.

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.

There are other entities whose activities fall within the definition of banking business but that have been granted an exemption by APRA from the need to be authorised. APRA has the power under section 11 of the Banking Act to determine that certain or specified provisions of the Banking Act do not apply to entities while the determination is in force.

Registered entities, or Registered Financial Corporations (RFCs), are one such class of entity. RFCs are entities whose sole or principal business activities in Australia are the borrowing of money and the provision of finance. RFCs include finance companies and money market corporations. Finance companies have existed in some form in Australia since the 19th century and grew relatively rapidly in the 1960s as a result of not being subject to the same constraints imposed on the regulated banking sector. They offered financing for both companies and households. Finance was typically provided to households for housing, cars and household goods. RFCs raise funds in both the wholesale and retail markets; however, the overwhelming majority of RFCs raise funds in the wholesale market via the issuance of debentures or unsecured notes. Retail funding is typically by way of at-call and term debenture products. Retail product offerings in some cases have features and characteristics typically offered by ADIs. These can include at-call access and transactional banking features such as Bpay, EFTPOS, ATM and cheque.

At 31 July 2014, there were 79 RFCs with greater than $200 million in total assets and therefore required to submit data to APRA under *Reporting Standard RRS 320.0 Statement of Financial Position*. There were an additional 277 known RFCs not required to report data to APRA as they fall below the reporting threshold. Of the 79 reporting RFCs, 37 have deposit liabilities, of which three currently accept funds from retail investors. Total deposit liabilities (to residents) of reporting RFCs was $29,455 million, of which $459 million was held by three RFCs that accept retail funds. These three RFCs, which will be directly affected by APRA's proposals, represent eight per cent of reported RFC deposit liabilities by number and two per cent by value. Retail deposit liabilities of these RFCs account for at least 50 per cent of their total deposit liabilities for two of the three, but in all three cases it appears that they do not offer at-call products. There are eight other RFCs which fall below the reporting threshold but which are affected by APRA's proposals. Six of these eight appear to offer at-call accounts to retail investors.

While the business of RFCs falls within the definition of 'banking business' under the Banking Act, such entities — commonly referred to as finance companies — have been exempt from the need to be ADIs and to meet APRA's prudential requirements. This exemption is historical in nature. Under earlier versions of the Banking Act, finance companies were deemed to be carrying on banking business but not the 'general business of banking', as they were essentially operating only to offer consumer finance. Hence, governments of the time considered it appropriate that RFCs be exempted from the need to be authorised.

The regulatory arrangements for RFCs were reviewed in the *Financial System Inquiry Final Report* (Wallis Report) in 1997. The Wallis Report noted that finance companies did not take deposits but funded their operations, mainly in the wholesale market, through the issue of debentures that were subject to the public fundraising provisions of the Corporations Law. It also considered that, since companies' liabilities were longer term with less than five per cent of liabilities at call, and since maturity mismatch would be minor, the threat of a run or contagion would be remote. For these reasons, the Wallis Report recommended that finance companies should continue to be exempted under the Banking Act. This was consistent with the Wallis Report's general preference to preserve a spectrum of risk in financial markets for reasons of economic efficiency.

Accordingly, RFCs have been allowed under Banking (Exemption) Order No 96 (the RFC Exemption Order) to undertake 'banking business' without being authorised under the Banking Act or subject to prudential supervision. APRA has responsibility for the RFC Exemption Order and has imposed certain conditions under it. These conditions require RFCs to give certain warnings to investors, including a prudential supervision warning stating that the RFC is not authorised under the Banking Act or supervised by APRA and that the investment will not be covered by the depositor protection provisions in the Banking Act. Otherwise, APRA has not imposed any prudential requirements on the operation of RFCs.

The Australian Securities and Investments Commission (ASIC) also has responsibility for RFCs as they are incorporated bodies subject to the *Corporations Act 2001.* ASIC also imposes disclosure requirements on RFCs.

RFCs are not subject to any form of mandatory capital adequacy or liquidity requirements.

Problem

RFCs are essentially conducting banking business. In Australia, entities that conduct banking business are required to be authorised deposit-taking institutions should they wish to conduct such business. As this RIS notes, the business of some RFCs has increasingly moved into the retail banking area through product offerings which are essentially banking products. Therefore, the traditional role of such entities and the underlying reason for the exemption from being authorised has been eroded over time. As the Wallis Report recommended, 'any extension of the deposit-taking roles of these entities beyond the scope of the exemption should require licensing and regulation as a DTI [deposit-taking institution]'. APRA's proposals do not seek to regulate such entities; rather, they strengthen the conditions under which RFCs that wish to conduct unlicensed banking in the retail market would be required to meet should they wish to continue to operate in this market without authorisation as a deposit-taking institution and the associated regulatory oversight that comes with such authorisation.

Two specific developments necessitate a review of the operation of the RFC Exemption Order:

- the emergence of RFC funding models relying on retail fundraising has blurred the distinction between some RFCs and ADIs; and

- as a consequence, Australia's arrangements do not conform with the global principle governing the permissible activities of banking institutions.

Blurring of distinctions between RFCs and ADIs

Over recent years, the traditional funding model of RFCs, based mainly on wholesale fundraising, has been replaced for a number of RFCs by reliance on fundraising from retail investors. Debentures have been marketed to such investors using the same terminology as ADIs, such as 'at-call accounts' and 'term deposits'. This short-term retail funding profile was not contemplated by the Wallis Report or by the RFC Exemption Order. This profile has the potential to cause confusion. Notwithstanding disclosure requirements, there is a risk that investors may form the impression that exempted entities are effectively the same as ADIs, and the products they offer the same as ADI products. The raising of funds on an at-call or short-term basis also increases the risk of maturity mismatches on RFC balance sheets.

These risks materialised in the failure of Banksia Securities Limited (Banksia), an RFC, in October 2012. Banksia collapsed owing approximately $662 million to around 16,000 investors who held investments in some 23,000 accounts. These included:[1]

Total amount owing ($m)	Type and number of accounts	Average account holding
603.4	16,894 term accounts	$35,500
15.3	320 superannuation accounts	$47,800
36.2	3,560 at-call accounts	$101,700
1.1	200 deeming accounts	$5,500
0.8	8 estate accounts	$100,000
0.2	30 mortgage access accounts	$6,700
5.8	1,640 target saver accounts	$3,500

The majority of these investments were held in two products: term accounts and at-call accounts. The receiver and manager to Banksia has identified a number of 'key reasons' for the failure of Banksia, including relatively high-risk lending against

[1] McGrath Nicol report *Banksia Securities Limited, Cherry Fund Limited (Receivers and Managers report to debenture holders)*, 7 December 2012.

inadequate security, high levels of loan arrears, inadequate provisioning policies and maturity mismatches.[2]

The impact of the Banksia collapse on retail investors has raised two major and distinct policy concerns. The first is the adequacy of disclosure requirements in achieving their intention of informing retail investors as to the nature and type of product in which they are investing. The second is the product offerings by RFCs and the advertising, marketing and presentation of such products.

On the first issue, evidence suggests that some retail investors in Banksia were not fully cognisant of the nature of the entity and product in which they were investing, even though Banksia met relevant requirements for prospectuses and investor disclosures. Dr Sharman Stone, MP noted in a statement to the House of Representatives, quoting from an article by Matthew Drummond for the *Australian Financial Review* (AFR), that:

‘I quote here a special reference to what has happened to Banksia in an article just written by Matthew Drummond in the Australian Financial Review:

The Banksia collapse has returned the spotlight to the wide regulatory gap between banks, which are closely supervised by APRA, and companies who issue unrated, unlisted debentures and invest the proceeds in risky construction and property loans.

He goes on to say:

Such companies receive comparatively no oversight despite many collapses. For the past five years, following the $300 million Westpoint collapse, they have been required to disclose whether they hold suggested minimum amounts of capital and face no sanctions if they do not.

I am most concerned that in fact we look harder at the regulation of this particular non-banking sector, given that there are a lot of people who are not familiar with how to interpret what can be a complicated prospectus. In the case of Banksia, there were people who were into the second generation of trusting what they called their local bank. This agency also sponsored local sporting clubs. It was beloved by its community. This is a shock for them. I am grateful to Centrelink for trying to help them right now. More needs to be done in that regard. The process is still being sorted. I have to mourn, with my community, the loss of this bank and hope that people get some cash soon, literally to put food on the table.’[3]

The misconception of Banksia as a bank highlights that disclosures clearly did not serve to inform investors as intended.

The Chairman of ASIC has also noted:

‘Frankly, our experience over the last few years has shown that disclosure is not enough, in many cases, for investors — that often they don’t read it. Therefore we have to think about the way in which some products are marketed. Banksia is an

[2] op. cit., p. 20

[3] Dr Sharman Stone, Member of Parliament, Address to the House of Representatives, 1 November 2012.

example where people were not even receiving the prospectus, because on rollover they are exempted from the provision of a prospectus.'[4]

On the second issue, the nature and marketing of product offerings by RFCs, the AFR reported in November 2012 that 'clients of Banksia Securities Limited thought it was a bank as it offered what purported to be "at call deposit accounts" which allowed them to withdraw their money at any time.'[5] Many people (particularly from small regional areas) had the majority of their savings, including funds received from selling major assets (such as farms), invested in the retail debentures of Banksia. Some retail investors had their salaries paid directly into Banksia and, as one community member said, in Victoria 'people used it like a savings or everyday account.'[6]

The collapse of Banksia and subsequent investor reaction has demonstrated that, despite the disclosure requirements in the current RFC Exemption Order, there has been clear misunderstanding by investors as to the nature of the entity they are investing with and the nature of the product in which they are investing. Some investors in Banksia believed that their investments were the equivalent of an ADI product. While disclosures are a mechanism for informing investors, they are not adequate as the sole mechanism for ensuring that investors are appropriately protected; evidence suggests that no matter how clear disclosures are, not all investors read or understand such disclosures.[7]

Conformance with global principles

The global principle governing the permissible activities of banking institutions is set out in the Basel Committee on Banking Supervision's (Basel Committee's) *Core Principles for Effective Banking Supervision.*[8] The relevant principle requires, *inter alia*, that the taking of deposits from the public be reserved for institutions that are authorised and prudentially supervised as banking institutions. Australia seeks to be compliant with the *Core Principles*.

In its 2012 review of Australia's observance of the *Core Principles*, as part of its Financial Sector Assessment Program (FSAP), the International Monetary Fund (IMF) noted:

'Australian law permits the existence of non-authorised and non-supervised deposit-taking institutions. The number of such institutions is small and the scale of their activities is predominantly *de minimis*, however there are major global institutions

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[4] Parliamentary Joint Committee on Corporations and Financial Services, *Testimony of Greg Medcraft, Chairman, Australian Securities and Investment Commission — Oversight of the Australian Securities and Investment Commission* on 3 December 2012, *Hansard Committee Transcripts*, p. 12.
[5] Australian Financial Review, 'Shadow banking system needs overhaul', 1 November 2012.
[6] Sydney Morning Herald, 'Let down by banking on Banksia', 2 November 2012.
[7] Refer to page 22 (first dot point), ASIC Report *230 Financial literacy and behavioural change* (March 2011).
[8] Basel Committee on Banking Supervision, *Core Principles for Effective Banking Supervision*, at http://www.bis.org/publ/bcbs230.htm.

benefitting from this exemption within the Australian market and deposit-like facilities are being offered to the public.[9]

The IMF recommended that APRA:

‘Revise the conditions for exemption from section 11 of the Banking Act for RFCs to ensure, at a minimum, that such exemptions be limited to institutions reliant wholly on wholesale funding.’

The IMF’s recommendation can be put into a global context. Globally, policymakers and regulators have stepped up their focus on ‘shadow banks’ in the wake of the global financial crisis, which saw considerable stress in both banking and shadow banking systems. The shadow banking system is defined as a system of entities and activities outside the regulated banking system that provides credit intermediation. In Australia, the term ‘shadow banking’ encompasses a broad range of entities including RFCs, hedge funds and structured investment vehicles. While it is recognised that shadow banking entities have a role to play in financial intermediation, such entities undertake the same (or similar) activities as regulated entities but without the rigorous scrutiny that applies to the prudentially regulated sector. This allows bank-like institutions to raise deposit-like funding to make bank-like loans, which they can do with considerably more gearing than regulated entities. Shadow banking entities can therefore earn potentially large profits but their investors can be susceptible to significant losses; the size of the shadow banking system can also pose systemic risks in some jurisdictions. For these reasons, global policymakers have been promoting a sharper boundary between the regulated and unregulated banking systems and greater oversight of shadow banks that pose systemic risks.

Government response

In response to the collapse of Banksia, the then Australian Government in December 2012 announced its *Roadmap to a Sustainable Future for Finance Companies.*[10] Under the *Roadmap*, ASIC and APRA were to consult in 2013 on proposals to strengthen the regulation of finance companies that issue debentures to retail investors. The proposals have two broad aims. The first is to improve the financial strength of retail debenture issuing finance companies. The second is to more clearly differentiate debentures issuers from ADIs that are regulated under APRA’s prudential framework.

The *Roadmap* contains specific proposals that address the second aim. These involve amendments to the RFC Exemption Order to prohibit RFCs using terms like ‘deposit’ to describe their debentures, to prohibit RFCs from issuing these products on an at-call basis, and to require that debentures have a minimum maturity period such as 31 days. The objectives of these proposals are to facilitate investor understanding that retail debentures have a different risk profile from ADI deposits, and to reduce the likelihood of issuers being subject to large numbers of investors seeking to redeem their debentures at very short notice.

[9] Australia, Basel Core Principles for Effective Banking Supervision: Detailed Assessment of Observance, 21 November 2012 at http://www.apra.gov.au/AboutAPRA/Publications/Pages/default.aspx.

[10] Refer to the media release from the Minister for Financial Services and Superannuation at http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2012/093.htm&pageID=003&min=brs&Year=2012&DocType=0.

The then Government asked APRA to consult on these specific proposals.

Objectives of APRA's proposals

Consistent with the former Government's *Roadmap*, APRA proposed amendments to the RFC Exemption Order aimed at reducing the risk that a retail investor in an RFC would confuse such an investment with an ADI deposit or other deposit-like or transactional ADI product. The proposals were set out in its Discussion Paper, *Banking Act exemptions and section 66 guidelines*, released in April 2013.

The proposed amendments are:

- to restrict the use of the words 'deposit' and 'at-call', and derivatives of those words, by RFCs by including additional conditions on the RFC Exemption Order;
- to require retail debenture offerings to have a minimum initial maturity period of 31 days. An investor would not be able to redeem, and an RFC would not be able to repay, any funds for a minimum of 31 days from the date they are invested; and
- to prohibit RFCs from providing certain transaction facilities, including ATM access to an account with the RFC, BPAY, EFTPOS and cheque account facilities.

APRA proposed that these new requirements would take effect from 1 July 2013, but it offered a transition period for existing debenture issues. Such issues would need to comply with the proposed requirements at the earlier of their next rollover date or 30 June 2016.

APRA's proposals relate only to product offerings to retail investors. APRA considers that wholesale investors would be sufficiently knowledgeable about the nature and risks of an investment in an RFC.

The objectives of APRA's proposals are to:

- ensure the continued appropriateness of the conditions under which exemptions from the need to be authorised under the Banking Act are provided for entities that engage in banking business; and
- ensure that retail investors understand that the nature of investments in RFCs is different to deposits with an ADI and have a different risk profile.

APRA's proposals would result in a sharper regulatory boundary between the prudentially regulated ADI sector and other fundraising entities engaged in banking business as RFCs. The proposals seek to limit the type of fundraising activities of RFCs and, in so doing, minimise any confusion on the part of retail investors as to whether an entity in which they are investing is prudentially regulated and supervised. APRA's proposals do not seek to prevent RFCs from offering products to retail investors as long as those products do not in appearance, or in fact, offer banking-like features including the ability to transact at-call. APRA's proposals would require RFCs to ensure the products they offer are distinct from banking products offered by ADIs. RFCs will still be able to avail themselves of the RFC Exemption Order provided they meet the conditions attaching to the Order on an ongoing basis.

The then Australian Government did not wish to pursue the IMF's recommendation, in its 2012 FSAP review, that the RFC Exemption Order be limited to entities reliant wholly on wholesale funding.

APRA's proposed approach is recognition that strengthening disclosure requirements will not itself be sufficient to achieve its regulatory objectives. Expanded disclosure may place more information in front of investors. However, in its Report 230 on *Financial literacy and behavioural change*, ASIC has noted that 'people (including investors) are often overwhelmed by the volume and complexity of information available to them, including disclosure material such as Product Disclosure Statements, prospectuses and annual reports.'[11] The Report further found that 'investors (across different comparison groups) chose not to read the prospectus or ignored the information in it.'[12]

These findings reinforce other survey results about the limited community understanding of Australia's financial regulatory arrangements. A survey conducted in 2006 by Roy Morgan Research for the Reserve Bank of Australia found, *inter alia*, that few people could correctly identify the prudential supervisor of banks, building societies and credit unions from a multiple choice list.[13] The most common answer was 'other/can't say' (36 per cent) followed by 'Reserve Bank' (28 per cent). Only 14 per cent correctly identified APRA. These findings were supported by a subsequent (unpublished) Roy Morgan Research survey for APRA in 2011. This survey concluded that 'awareness and understanding of the regulations that apply to financial institutions generally and whether or not regulations apply to banks, building societies and credit unions were…at low levels. Similarly, awareness of APRA and its regulatory role regarding financial institutions was also at a low level'.

In view of these findings on financial literacy, and the particular experience of the Banksia failure, APRA concurs with the view that the potential for investor confusion can be more effectively addressed through restrictions on the types of products offered to retail investors by RFCs. If a non-prudentially regulated entity is able to offer ADI-like products and use ADI-like terms to describe those products, it is perhaps unsurprising that retail investors may be confused about the nature of the entity with which they are investing. In many cases, it has become difficult to distinguish between some products offered by RFCs and those offered by ADIs. Even in the presence of disclaimers and disclosures, investors in such products may be confused about the nature and risks of the product.

One alternative regulatory response would be to require retail investors in RFC products to sign an acknowledgement to the effect that they understand the RFC is not prudentially regulated and that the product is not subject to the depositor preference provisions of the Banking Act or the Financial Claims Scheme. This alternative is subject to the same limitations as that of expanded disclosure, in that the investor may still not understand the implications of that acknowledgement, particularly if the disclaimer is in the fine print. Asking an investor to acknowledge that a product, which looks and works like a transactional ADI account, is not in fact an ADI account

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[11] Australian Securities and Investments Commission, *Report 230: Financial literacy and behavioural change,* March 2011, p. 22.

[12] op. cit., p. 38.

[13] Reserve Bank of Australia, *Financial Stability Review,* March 2006, p. 45-46.

may only add to investor confusion. The alternative will also do little to sharpen the regulatory boundary between ADIs and RFCs, in terms of products offered.

This alternative is not considered further.

Options

APRA has identified three options:

1. maintain the existing Exemption Order unchanged;
2. fully implement the proposals as released for consultation; or
3. seek voluntary adoption of the proposals.

Impact analysis

Assessment of costs and benefits

The costs associated with APRA's proposals fall into two classes. The first are those pertaining to the operational and administrative costs of making the changes proposed by APRA. The second are those associated with any change in the funding profile of RFCs affected by the proposals.

As part of the consultation process, APRA specifically requested submissions on the cost-benefit impact of implementing the proposals, and invited respondents to use the OBPR's Business Cost Calculator to estimate costs. A few submissions did provide quantitative data on the likely cost impact of the proposals and, where relevant, that data has been included in this Regulation Impact Statement.

The benefits that will arise should the proposals be adopted are not easily quantifiable. They include the reduced likelihood of retail investors suffering loss because they were unaware that they were investing in a non-prudentially regulated entity with a higher risk profile than an ADI. They also include the enhancement to Australia's international reputation from APRA's greater conformity with relevant global principles in this area and with emerging best practice on regulatory approaches to shadow banking systems.

In each option, the stakeholders that would be affected include RFCs, retail investors who invest in RFC products, APRA and the Government.

Option 1 – Maintain the existing exemption order unchanged

Under this option the Exemption Order would continue unchanged. The proposals to ensure a clearer distinction between debentures and ADI deposits would not be implemented.

RFCs

For RFCs raising retail funds, the benefits of maintaining the RFC Exemption Order unchanged would be that they would continue to be able to offer debentures with ADI-like features through at-call product offerings and using terminology traditionally associated with ADI products. RFCs would not incur any additional costs under this option.

Retail investors

For RFC investors, this option would mean that the potential for confusion, given the commonality of some product offerings of RFCs with ADIs, would continue. Investors in RFC products might continue to invest believing they have the benefit of prudential regulation, depositor preference and the Financial Claims Scheme when in fact this would not be the case. As demonstrated by the collapse of Banksia, retail investors, even when presented with the required prudential supervision warning, may still fail to comprehend that RFCs are different to ADIs and that their product offerings do not come with the protections and prudential underpinnings of products offered by ADIs. Although some retail investors in RFCs may have been alerted to the risks of such investments through the media coverage of the Banksia collapse and make an informed decision as to whether to leave their money in an RFC or move it to an ADI, other investors may continue to believe they have a deposit with an ADI and might remain unconcerned. In this context, it is worth noting that the proposals on which ASIC has been consulting as part of the former Government's *Roadmap* would not of themselves address the problem of retail investor confusion.[14] ASIC's proposed measures address the financial viability and soundness of an RFC (in terms of increasing the required financial resources to be held and enhancing the monitoring role played by debenture trustees); the strengthened disclosure requirements would only focus on the historical financial performance of RFCs. For these reasons, APRA's proposals are not substitutable with proposals being consulted on by ASIC.

APRA

For APRA, this option would mean that the regulatory boundary between prudentially regulated and non-prudentially regulated financial institutions would remain blurred. Australia would not conform with the Basel Committee's *Core Principles* governing the permissible activities of banking institutions. This would mean that Australia would be out of step with emerging international best practice on regulatory approaches to shadow banking and impose a currently non-quantifiable cost, should further failures occur, including to Australia's international reputation.

Government

For the Government, maintaining the RFC Exemption Order would involve contingent costs, as RFCs would be free to continue to market, advertise and present themselves in a similar way to ADIs and to offer products that appear similar — in terms of key features, functionality and terminology — to those offered by ADIs. Contingent costs could be incurred through any government assistance measures to support investors if such action was considered appropriate and necessary. The failure of Banksia prompted a number of *ad hoc* governmental responses, including specific Centrelink support to retail debenture holders,[15] as well as immediate financial and

[14] ASIC's proposals include mandatory minimum capital and liquidity requirements; a new requirement to provide investors a prospectus at the time when an investor is deciding whether to roll over an investment; and certain clarifications of the role and powers of debenture trustees.

[15] McGrath Nicol, *Receivers and Managers' Report to BSL and CFL Debenture Holders,* 7 December 2012, p. 15.

other assistance by the Victorian Government to local communities impacted by the collapse.[16]

In a general sense this option would allow the small number of RFCs who offer banking-type products to continue to do so without the resultant impacts on their business of APRA's proposed changes. Retail investors would also continue to utilise transactional banking facilities offered by RFCs, however they would continue to face a heightened risk of loss of some or all of their funds should their RFC fail and without the safeguards offered by banking products within the ADI sector. For APRA there would be no change and the net benefit would be zero. For Government there is continuing reputational risk and expectation of Government support should RFCs continue to offer banking type products and further RFCs fail with the resultant impact and losses that would follow for retail investors. In APRA's assessment the net benefit to society of this option is negative due to the potential adverse material impacts for retail investors that would be incurred should further RFCs fail. In APRA's view the administrative and compliance costs not incurred by RFCs by maintaining the status quo would not offset the costs of this Option to retail investors. This is evidenced by the fact that the compliance costs (refer to Attachments A and B) are significantly smaller on an individual RFC basis than the potential losses should an RFC fail – assuming that all retail investors' funds would be at risk of loss under such a scenario.

Option 2 – Fully implement the proposals

Under this option, APRA would implement the proposals, outlined above.

RFCs

For RFCs, the costs of this option would be small on an industry-wide basis, but could be significant for those RFCs that offer at-call products to retail investors. APRA is aware of eleven RFCs that issues debentures to retail investors but only six of these appear to offer retail at-call products. Five of these RFCs operate as consumer finance companies while the sixth offers cash management and margin lending services to its stockbroking clients.

For the five RFCs who offer at-call products to retail investors, the proportion of at-call versus total funding ranges from approximately five to 36 per cent with an average at-call holding of 17 per cent.[17] APRA's proposals to prohibit RFCs offering at-call products have the potential to have a significant impact on the business of these RFCs. They would potentially need to replace existing at-call funding with term funding with a minimum term of 31 days. They may suffer an outflow of funds initially, the degree to which this is sustained would depend on the ability of an RFC to replace at-call funding with term funding. Given longer terms to maturity usually offer a higher return, it is not unreasonable to assume that some investors would be happy to forgo immediate access to their funds in order to receive compensation in the form of a higher return. The opportunity cost of this would be the interest differential

[16] See the series of measures of immediate assistance announced by the Victorian Government's Banksia Working Group on 8 November 2012: http:///www.premier.vic.gov.au/media-centre/media-releases/5322-assistance-measures-for-communities-affected-by-banksia-collapse.html.

[17] For one of these entities the at-call component of funding is included with term funding out to three months thereby overstating the at-call holdings for that particular RFC and therefore increasing the average at-call holding for RFCs collectively.

between at-call funding and 31-day term funding. Based on a sample of affected RFCs that operate as consumer finance companies this differential is estimated at 0.5 per cent based on an estimate of the difference between at-call and 31-day term funding (30 days used as a proxy) and also drawing on the Debt Maturity Profile of these RFCs, where available, and their average weighted interest rate for each time period. Therefore, on average, an RFC would, under this proposal, need to pay an additional 0.5 per cent in interest for the same funds. The benefit for RFCs would be that they would have greater certainty over their funding as funds could only be withdrawn with 31 days' notice. This would also allow better liquidity management as the risk of an unexpected large call on an entity's funding on any one day would be reduced.

Of these five RFCs, none appear to offer ATM, EFTPOS, or BPay. BPay is offered by the RFC that operates cash management and margin lending services. It is therefore reasonable to conclude that the proposal to prohibit RFCs from offering transactional banking facilities such as these will only impact on one entity, with negligible impact on the commercial practices of the RFC industry generally.

For the sixth entity, being the stock-broking business, all funds are at-call, as APRA understands it, as investors use their cash management account to settle transactions they have entered into. This is not a typical finance company arrangement.

Affected RFCs have submitted that they may need to change their business model to reflect the replacement of at-call funding, a low-cost source of funds, by term funding. Some RFCs have indicated that they may cut costs to offset the effect of such a change in funding profile, either through staff attrition or other means. For those RFCs that operate consumer finance businesses the impact would depend on the degree to which they could substitute term funding for existing at-call funding, whether through retention of existing business or attracting new business. This will depend on a number of factors. The first is whether investors have at-call accounts because they wish to have immediate access to their funds. If they do, then it is likely that these funds would move elsewhere, notably to the ADI sector and traditional banking products with at-call access and transactional banking features. If at-call access is not an issue, then the move from an at-call to a 31-day term product, with an associated higher interest rate, is unlikely to be an issue for such an investor. They would be likely to trade off the ability to access their funds in return for a higher interest rate in the same way that all such term products operate – that is, the investor trades off accessibility for a higher return.

RFCs may also benefit from the introduction of a minimum term as it will add to their liquidity and assist in their asset and liability management. Removing at-call access would reduce the likelihood of a sudden unexpected withdrawal of funds from an RFC which would aid in their liquidity management. It would also assist somewhat in managing the maturity profile of their interest bearing liabilities.

APRA agrees that its proposals will have an impact on those RFCs that are heavily reliant on at-call funding, however providing a reasonable transition period to allow these RFCs to move to term-only funding would help to alleviate this cost. Individual RFCs that have substantial transactional processing operations, as was the case with Banksia, would be significantly impacted and may need to reduce staff numbers. However, only one submission on APRA's proposals indicated this may be necessary. It would appear, based on a review of websites of the RFCs with at-call business that transactional processing is unlikely to be a significant part of their operations, hence the impact on staff numbers would be expected to be minimal.

The ability of RFCs to change their business models, and the costs associated with this are not expected to be significant. All five RFCs that operate finance company businesses already offer term products; hence they are already set up to offer this type of business. For the broking firm which is reliant on access to an at-call cash management account, APRA has previously been led to understand that a substitute product offered by a third party is well advanced.

APRA does not expect any RFCs to close should this proposal be adopted. This is based on the fact that all affected RFCs are mature businesses. The ultimate impact will be how well they manage the transition to offering term-only products. They may, as noted earlier, suffer an outflow of at-call funds initially, but this can be minimised through offering an appropriate return on a slightly longer-dated product. Over time, they should also be able to replace at-call business with new term business. It is acknowledged, however, that all affected RFCs are likely to face increased in expenses, at least in the short term.

Submissions also argued that the proposed transition period for the replacement of at-call business was too short and that the impact of a restriction on offering at-call accounts would be less onerous if a suitable transition period were available. APRA will take these concerns into account and offer a suitable transition period. RFCs will be allowed to continue existing at-call accounts until the end of the transition period, which will allow RFCs time to communicate changes to these account-holders and for account-holders to indicate whether they wish to transfer funds into a term product by that date.

APRA's other proposed amendments to the RFC Exemption Order, including restrictions on the use of certain terms, will require changes to marketing documentation, Product Disclosure Statements and other relevant promotional material. (In response to submissions, APRA is also proposing that RFCs provide a revised prudential warning noting that RFC products are not covered by the Financial Claims Scheme for ADIs.) RFCs will incur costs in making these changes but these costs are expected to be marginal. APRA has proposed transitional arrangements to minimise the costs of compliance with the revised prudential warnings.

The benefits to RFCs from this option derive from the enhanced disclosure requirements and clear product differentiation vis-à-vis ADI products, which will ensure that investors are better informed as to the nature of the RFC and its product offerings. Where RFCs use short-term funding to extend long-term credit, and thereby generate maturity mismatches, they remain vulnerable to a run on funds that could be highly destabilising. To the extent that retail investors better understand the nature of their investments and do not have at-call access to their funds, such a run is less likely.

More broadly, APRA does not expect any material impacts on markets or product offerings or the pricing thereof. As noted earlier, these proposals will affect six RFCs. As noted elsewhere in this RIS, RFCs are exempt from the need to be authorised under the Banking Act. This exemption is required because the business of RFCs falls within the definition of 'banking business' in the Banking Act, however, the existence of the exemption is not intended to be a licence for exempt entities to act like ADIs and offer banking-like products. The data indicates that there are only a very small number of entities who have sought to move into the retail market through offering banking-like products. APRA's proposals to limit fund raising activities of RFCs to 'term' business would not therefore be expected to have a material impact on the availability of banking products or services or the pricing of those products. Nor is it expected that distribution of funding between RFCs will be affected, RFCs typically don't compete against each other, as they tend to be the only RFC operator in each market in which they operate. Any competition is more likely to be with smaller ADIs. Typically, ADIs have greater regulatory costs and offer lower rates versus RFCs which face lower regulatory costs due to the absence of prudential oversight and offer higher rates of interest. This proposal would be likely to lead to some funding flowing back into the ADI sector – but, this is expected to be limited to investors with transactional funds seeking a 'bank account' that provides transactional banking functionality. As RFCs and ADIs operate in a different part of the risk spectrum – hence, those non-transactional funds seeking higher risk/return are unlikely to flow into the ADI sector.

Retail investors

APRA's proposals will only impact on retail investors; there are no proposals to change existing arrangements for wholesale investors.

As noted, one of the issues that APRA's proposal seeks to address is the potential for an investor in an RFC product may misunderstand the nature of the entity they are investing with and the nature of the product in which they are investing. The costs and benefits of this proposal will differ depending on whether a retail investor is 'informed' or 'uninformed'.

For 'uninformed' retail investors in RFCs, the benefits of this option are greater transparency and clarity around the nature of the entity they are investing with and the type of product in which they are investing. In the case of investors, whether informed or uninformed, who currently use RFC at-call products for their transactional banking needs, there may be some minor costs in opening a transaction account at an ADI if they do not already have such an account. This will serve to highlight that RFCs and their product offerings are not transactional banking substitutes. However, the number of investors who do not already have a transaction account with an ADI is unlikely to be large. APRA has estimated that approximately 15 per cent of an RFC's at-call customers are likely to fall into this category and would need to open an account at an ADI. This equates to a cost of $9,000 which represents the cost of time for these customers to open bank accounts.

APRA

For APRA, this option would involve minor additional costs in the form of staff and other costs for re-making and registering the legislative instrument to incorporate the proposals. The qualitative benefits would be substantial. There would be a clearer regulatory boundary between RFCs and ADIs and thus a reduced probability that retail investors would confuse investments in such products with those offered by ADIs. There would be greater conformance with the Basel Committee's *Core Principles* and Australia would be more in step with emerging international best practice on regulatory approaches to shadow banks.

Government

For the Government, this option meets the objectives of strengthening the regulation of finance companies that issue debentures and ensuring there is a clearer distinction between debentures and ADI deposit products. There are no material costs for the Government through the adoption of this option. The option might also lead to lower contingent costs through a reduced expectation of government assistance to investors in a failed RFC, as investors could not credibly make the argument that they were confused about the nature and risks of their investments.

In summary, this option imposes the greatest costs on RFCs but also confers the greatest benefits on retail investors and Government. The costs to RFCs are set out in Attachment B. The benefits to retail investors and Government are intangible, but for investors would be at least equivalent to the amount of funds not at risk of loss due to RFCs offering banking products. The cost for those investors who have to open transactional banking accounts at an ADI would be minimal. It would only affect those investors who did not have a transactional account at an ADI and the cost of opening the account would be the cost of the time taken to open the account and the difference in costs between a bank account with the ADI versus an RFC.

Option 3 – Seek voluntary adoption of the proposals

Under this option, APRA would write to RFCs requesting them to voluntarily meet certain 'standards' when raising funds from retail investors. The focus of these standards would be on ensuring retail RFC investors do not confuse their investments with ADI deposits.

RFCs

For RFCs, the costs and benefits would be those already identified under Option 1 (if the particular RFC in question chooses not to adopt the standards) or Option 2 (if the particular RFC in question does choose to adopt the standards).

Retail investors

As with RFCs, the costs and benefits for retail investors would be those identified under Option 1 (if the RFC in question chooses not to adopt the standards) or Option 2 (if the RFC in question does choose to adopt the standards).

APRA and Government

For APRA, there may be a minor reduction in direct costs as the development of a letter to RFCs would be less resource-intensive than amendments to the RFC Exemption Order. However, there are limited benefits for APRA and the Government under this option, for three reasons:

- reliance on voluntary compliance by RFCs would not address concerns raised by the IMF about Australia's compliance with the Basel Committee's *Core Principles*;
- it is unlikely that all RFCs would fully and consistently implement standards on a voluntary basis. Voluntary standards are most successful when entities can perceive neutral or positive benefits and costs are minimal. Neither of these conditions apply in this case. Complying RFCs would be at a competitive disadvantage to non-complying RFCs, a situation that would further impede

adoption. Inconsistent adoption would only compound existing misunderstandings by investors; and
- the Government would still face contingent costs, identified under Option 1, of assistance measures to support investors in the event of the failure of an RFC.

This option does not address the objectives of strengthening the regulation of finance companies that issue debentures to retail investors unless there was to be widespread uniform adoption. There is no compelling reason why the RFC industry would take such an approach and, since RFCs are not subject to prudential supervision by APRA, the risk of loss to retail investors might only become obvious at the point of another failure of an RFC. Hence, assuming that most RFCs did not voluntarily adopt the proposals, the net cost of this option would be the same, or similar to Option 1.

Compliance costs

A summary of the key compliance costs can be found in the following reports:

Attachment A – Regulatory Burden Measurement tool; and

Attachment B – Regulatory Burden and Cost Offset Table.

APRA has compiled these reports based on data provided by RFCs. The costs include terminology restriction costs associated with updating product disclosure statements and other advertising and marketing material; staff costs including those associated with compliance and legal review of material; costs for revising material on websites; information technology updates and costs associated with review of business models to ascertain the impact on of the proposals on RFC business models including with respect to funding, advertising, marketing and investment.

Consultation

APRA released a Discussion Paper, *Banking Act exemptions and section 66 guidelines*, setting out details of its proposals on 19 April 2013. Written submissions were requested by 24 May 2013.

APRA received 13 submissions on its proposals. Submissions generally were from RFCs that will be most affected by the proposals because they accept funds from retail investors, including at-call funds. APRA also met with representatives from industry and with a number of RFCs and engaged in informal communications via email and telephone. It also responded to a number of requests for information and clarification.

Many submissions indicated support for the general rationale of the proposals but expressed concerns with the proposed transition period. Indeed, the key matter raised in submissions was the transition period. There was widespread concern that the proposed commencement date for the proposals, of 1 July 2013, would be difficult to meet. Submissions also expressed some uncertainty as to the intent of the proposals with respect to all at-call accounts and queried whether such accounts would be accorded a transition period. Some submissions queried the reasoning behind the 31-day initial minimum maturity period for future debenture issues as opposed to a shorter maturity period.

One submission raised specific concerns about the potential cost of substituting at-call funding with term funding and the resultant impact on its business stating ‘this cost would not be easily absorbed or recovered and would result in substantial changes to business operations including staff rationalisation'. APRA acknowledges that there will be a business cost in not allowing RFCs to offer at-call products. The impact of this is unclear; however, for investors there would be clear benefits associated with APRA's proposal in this regard, including increased returns on an investor's funds in return for access being limited to a minimum 31-day call. RFCs would benefit from improved liquidity as funds would not be repayable on demand. The loss of funding due to restrictions on at-call investments would only expected to impact on those investments where investors are using their account for banking purposes, and as noted earlier, the intent of APRA's proposals is to make clearer the regulatory boundary between the prudentially and non-prudentially regulated financial sectors and ensure that investors are not confused as to the nature of the product and the entity they are investing with.

Another submission raised specific concerns around the costs of prohibiting the offering of at-call accounts in the context that such accounts represent a critical part of its business model. This submission argued for special consideration and an increased transition period to acknowledge the unique nature of its business model. APRA understands that this RFC has made alternative arrangements for providing an at-call facility by an ADI so transition and cost issues have been largely mitigated.

In response to this feedback, APRA wrote to RFCs on 24 May 2013 proposing to allow them to continue to operate their existing retail at-call business until 30 June 2014, but not to accept any new at-call business from 1 July 2013. After further consideration of submissions, APRA now proposes to delay commencement of the amended RFC Exemption Order to a date to be advised. RFCs will be able to continue to accept new at-call business until that date. This will allow RFCs time to inform their retail investors of the changes, to continue to plan for the necessary changes to marketing and promotional material and to amend their business models to take into account the required changes in their funding profile.

Conclusion and recommended option

The *status quo* confers no additional costs on RFCs but would mean that retail investors might continue to invest in RFC products without the additional information that would assist them in distinguishing RFCs and their product offerings from those of ADIs. This risk may increase over time should further RFCs decide to offer unregulated retail banking-like products.

Under Option 1, APRA would be allowing RFCs to continue to operate without added safeguards designed to minimise the risks that retail investors in RFCs form the impression that an RFC is the same as an ADI and that the products it offers have the same protections as an ADI product. The proposals to make clearer the distinction between debenture issuers and ADIs would not be implemented. The current blurring of distinctions between the regulated banking system and the shadow banking system would not be addressed, leaving Australia at variance with global principles in this area.

Under Option 2, RFCs that rely on retail at-call funding will incur additional costs in replacing that source of funds with term funding. The impact on individual RFCs will vary, depending on their current reliance on at-call funding and the consequences for their risk premia of the proposals (if adopted) to improve the financial strength of retail debentures issuers. The expected benefits to RFC investors, in the form of greater transparency and clarity about RFCs and their product offerings, are harder to quantify. However, APRA believes that the overall public policy benefits of a better informed investor community and a clearer distinction between debenture issuers and ADIs clearly outweigh the costs to the small number of RFCs affected. The clearer distinction will also bring Australia more into conformance with global standards and with emerging international best practice on regulatory approaches to shadow banks.

It is therefore recommended that Option 2 be adopted, but that commencement of the amended RFC Exemption Order be delayed to allow sufficient time for RFCs to undertake the necessary operational and administrative changes to meet the new requirements. For those RFCs that wish to continue to offer transactional-banking facilities, they would be able to seek to be licensed as an ADI by APRA.

Implementation and review

If implemented, APRA's requirements will be reviewed as necessary to ensure they continue to reflect good practice and remain relevant and effective. The RFC Exemption Order would be reviewed every five years, unless APRA considers there are circumstances that make it necessary and reasonable to review the Order earlier.

Compliance with the Australian Government Guide to Regulation

As consultation for these proposals commenced before the implementation of the revised Government Guide to Regulation, APRA has opted to complete a single-stage RIS.

Regulatory Offset

A regulatory offset has been identified and agreed with the OBPR from within the Treasury portfolio (refer to Attachment B).

Regulatory Burden Measurement report

Proposal name		Banking exemption order for registered financial corporations
Reference number		2013/15018
Problem and objective		
Problem		Refer RIS
Objective		Refer RIS
Explanatory information		
Refer RIS		
Option 1		
Option name		Maintain the status quo
Option description		Maintain the Banking Exemption order that applies to RFCs unchanged.
Businesses affected		6
Timeframe (years)		10
	Cost per business	**Total cost for all businesses**
Start up cost	na	na
Average ongoing compliance cost per year	na	na
Option 2		
Option name		Fully implement the proposals as released for consultation
Option description		This option involves full implementation of APRA's proposal as consulted on in the April 2013 discussion paper on this topic. The key proposed change being that RFCs would no longer be allowed to offer at-call products to retail investors.
Businesses affected		6
Timeframe (years)		10
	Cost per business	**Total cost for all businesses**
Start up cost	$7,557.32	$45,344
Average ongoing compliance cost per year	$7,557	$45,344
Option 3		
Option name		Seek voluntary adoption of proposals
Option description		This option would involve RFCs to voluntarily meet certain standards when raising funds from retail investors.
Businesses affected		6
Timeframe (years)		10
	Cost per business	**Total cost for all businesses**
Start up cost	na	na
Average ongoing compliance cost per year	na	na

Attachment B – Regulatory Burden and Cost Offset Table

Using the OBPR's Business Cost Calculator, APRA has estimated that this regulation results in average annual compliance costs for the RFC sector of approximately $454,000 amortised over a 10 year period. This is outlined in the Regulatory Burden Cost Offset table below. Costs have estimated based on a sample of data provided by RFCs.

Regulatory Burden and Cost Offset (RBCO) Estimate Table

Average Annual Compliance Costs (from Business as usual)

Sector/Cost Categories	**Business**	**Not-for-profit**	**Individuals**	**Total by cost category**
	$	**$**	**$**	**$**
Administrative Costs	0.00	n/a	0.00	0.00
Substantive Compliance Costs	45,343.90	0.00	0.00	45,343.90
Delay Costs	0.00	n/a	0.00	0.00
Total by sector	45,343.90	0.00	0.00	45,343.90

Annual Cost Offset

	Agency	**Within portfolio**	**Outside portfolio**	**Total**
	$	**$**	**$**	**$**
Business	0.00	45,343.90	0.00	45,343.90
Not-for-profit	n/a	0.00	n/a	0.00
Individuals	0.00	45,343.90	0.00	45,343.90
Total	0.00	45,343.90	0.00	45,343.90

Proposal is cost neutral ?	yes/no	yes
Proposal is deregulatory ?	yes/no	no
Balance of cost offsets	**$**	0.00