DISCUSSION PAPER

APRA's approach to new entrant authorised deposit-taking institutions

March 2021

Contents

Executive summary

On 10 August 2020, the Australian Prudential Regulation Authority (APRA) announced it would review its licensing approach for authorised deposit-taking institutions (ADIs), including the Restricted ADI licensing framework launched in 2018. The Restricted ADI framework was designed to promote competition in the banking sector by providing a pathway for aspiring ADIs to gain a licence to conduct limited banking business while they prepared to meet the more stringent requirements of a full ADI licence[1].

Over the past three years, APRA has evolved its approach to new entrants as it gained a greater understanding of the financial and operational challenges they face gaining a firm foothold in a sector that is historically difficult to break into.

The accompanying information paper *ADIs: New entrants – a pathway to sustainability* (**the information paper**) incorporates APRA's evolved approach with the objectives of:

- Focusing applicants and new entrants on longer term sustainability rather than the short-term ambition of receiving a licence and becoming an ADI. This includes developing a sustainable business model and a continued emphasis on maturing new ADIs' business models, risk management and governance commensurate with the growth of the business.
- Benefiting all stakeholders by providing clear and consistent expectations for appropriate levels of capital and effective capital planning to support and grow a new entrant's business. Similarly, all stakeholders benefit from clear and transparent expectations in relation to how the prudential and supervisory frameworks will be applied through the period until an ADI has a sustainable business.
- Focusing applicants on adequate downside scenario planning including exit planning.

While APRA has already adjusted its application of the prudential and supervision frameworks to new entrants, APRA has now issued for consultation the accompanying information paper to outline formally its revised approach. The information paper sets out a clear, transparent and consistent approach to how APRA applies the prudential and supervisory frameworks to new entrants; both at the point of licensing and during the period the new entrant is building a sustainable business. The information paper replaces the 2018 issued information paper *ADI licensing: Restricted ADI Framework*.

This **discussion paper** summarises the main revisions to APRA's approach and provides rationale for them. It also invites submissions on the information paper. The key revisions are:

- **Pathways to sustainability** - The information paper sets out APRA's expectations for new entrants: both for the restricted and direct pathway to an ADI licence and the period following authorisation as the new entrant builds to a sustainable business. The

[1] For the purposes of clarity, in this paper only, the term ADI is used in distinction to Restricted ADI.

information paper makes it clear that achieving an ADI licence is a milestone, not a destination, given the considerable development that continues in the years following authorisation. While there remain two pathways to authorisation, the desired destination is the same: sustainability. The previous information paper covered the Restricted phase only.

- Launch of products - The information paper formalises APRA's recent expectations that entities should launch products before being granted an ADI licence. Achieving product launch, especially that of income-generating asset products, is a key milestone on the path to sustainability. In the past, APRA had been prepared to grant an ADI licence to an entity before it launched products, based on projected near-term product launch dates.

- Capital requirements - The information paper sets out a 'highest of' three methods approach to setting capital requirements. This provides clear, transparent and consistent outcomes for ADIs. APRA has set capital requirements for different new entrant risk profiles while facilitating a natural transition to the methodology for established ADIs as the new entrant grows. Transparency on these requirements should assist in better capital planning and management as a new ADI establishes a sustainable business. In the past APRA has set bespoke capital requirements for new ADIs based on their business models and risk profiles.

- Exit planning - The information paper outlines expectations that new entrants have a credible return of deposits exit option, and flags the possibility of deposit restrictions on new ADIs where this is necessary to improve confidence in the efficacy of a return of deposits. The revised approach further protects depositors in the event that the new entrant is not successful. Previously APRA provided only limited and high-level public guidance regarding its expectations around exit planning.

APRA's revised approach seeks to strike an appropriate balance between supporting entities to both enter and thrive in the banking sector, while ensuring financial stability and protecting the interests of depositors.

The revisions recognise that the typical application of APRA's prudential and supervisory frameworks is not always well-suited to the common characteristics of new entrants. New entrants face heightened risks and uncertainty as they establish the business. In some areas these risks are markedly different than those faced by established ADIs, such as the high ongoing resourcing needs to fund the growth of business and operational expansion. APRA has adjusted the application of its frameworks to focus on the areas demonstrated to be of higher risk to new entrant ADIs. These adjustments seek to ensure that a new entrant remains protected from heightened risks as the business grows, strengthening the chances of success while also protecting depositors.

New entrants will also benefit greatly from greater transparency about APRA's expectations as they develop to a sustainable business. In particular it will assist them in their forward planning and guide discussions with potential investors and other stakeholders.

APRA must also prepare for the possibility that a new entrant may not ultimately be successful. Competitive markets involve businesses being able to enter and exit, and it would be detrimental to competition if APRA set requirements at a level that guaranteed success.

To ensure depositors are protected in the event of an exit, the revised information paper sets out the more prescriptive expectations for exit planning and depositor protection.

The approach set out in the information paper represents an overall strengthening of the prudential and supervisory frameworks as they apply to new entrants. This is necessary both as a targeted response to the specific risks faced by new entrants, but also to increase financial safety in general and depositor protection in particular. The revisions may discourage marginal applicants, resulting in fewer licence applications, and may be considered a slight raising of the barriers to entry. However, APRA judges that there will be a small net positive impact on competition in the long term. By increasing the focus on reaching sustainability, it is expected that successful applicants are more likely to thrive and survive. Greater transparency on APRA's requirements will also better prepare applicants for the challenges ahead. Sustainable new entrants will provide more effective competition to incumbents than those which are perpetually reliant on additional capital raises simply to meet ongoing prudential capital requirements.

APRA is seeking written submissions on the revised information paper. Consultation will close on 30 April 2021.

Background

APRA's approach to licensing seeks to support competition in the banking sector by setting appropriate criteria for new entrants being authorised to conduct banking business, including those with innovative or otherwise non-traditional business models or those leveraging greater use of technology. Once authorised, APRA's prudential and supervisory frameworks – which are applied to all ADIs – are designed to support financial safety and stability in the financial system and respond to specific risks in individual ADIs.

APRA established a centralised licensing team in 2017 and introduced a new engagement model, significantly updated the information available to applicants and created efficiencies in licensing assessments for all licences. In 2018, a restricted licence framework was developed with a focus on facilitating increased competition and innovation in the banking sector. Central to that framework was the introduction of the Restricted ADI licence which allowed a phased approach to authorisation. Under this approach, applicants may obtain a licence to begin limited operations while still developing the full range of resources and capabilities necessary to meet the prudential framework, thereby reducing barriers to new entrants.

Since that time, APRA has licensed five new ADIs, two of which applied via the Restricted ADI licensing pathway and one Restricted ADI, which is still progressing towards its ADI licence. APRA has also engaged with more than 100 potential Restricted ADI or ADI applicants[2]. One ADI licensed in this period subsequently executed a return of deposits and exited the industry.

Broader policy initiatives

In February 2021, APRA published its policy priorities for the next 12-18 months[3]. This includes a number of policy initiatives that will impact the ADI industry.

APRA has committed to continue to progress the development of policy initiatives aimed at strengthening all regulated entities' preparedness for managing through periods of stress, including recovery and resolution. To this end, APRA has announced it will develop a new prudential standard for recovery and resolution planning with a view to releasing a draft standard for consultation in late 2021 or early 2022. Once finalised, this will further guide new entrants and contribute to a stronger framework for all ADIs.

The financial sector has undergone significant shifts in recent years and will continue to do so as business models adapt and technology evolves. Included in this are a range of business models that relate to banking in various ways, such as white labelling, partnerships and stored value facilities. APRA will continue to monitor these developments to determine how regulation should similarly adapt, such as the policy changes to purchased payment facility

[2] These figures do not include applications and enquiries from foreign branches and purchased payment facility providers.

[3] https://www.apra.gov.au/news-and-publications/apra-releases-its-policy-and-supervision-priorities-for-2021

providers that are intended to be consulted on in late 2021. This heading is to be used where there is a heading hierarchy, using heading on will create a page break.

Summary of revisions

The information paper sets out the full approach to new entrants. Below is a high-level summary of major revisions as they apply to direct applicants, Restricted ADIs, and new ADIs in the period following authorisation.

Revision	Rationale
APRA's overall approach to new entrants	
APRA adjusts the way it applies its prudential and supervisory framework to new ADIs.	The typical application of the prudential and supervisory framework is not well-suited to the common characteristics of new entrants in some areas. New ADIs will transition to APRA's regular approach once they exhibit common characteristics of an established ADI.
Guidance is provided on APRA's general expectations relating to the **structure of capital instruments, ownership and legal structures.**	APRA's experience is that undue complexity and opacity in these matters can lead to significant delays in assessing an application, and may constitute grounds for a refusal.
Detail on **eligibility criteria** for the Restricted ADI pathway has been removed; eligibility will be determined by APRA on a case-by-case basis.	Experience had shown the eligibility criteria were not needed and this better allows for innovative and idiosyncratic business strategies.
Product launch	
Restricted ADIs must achieve a **limited launch** of both an income-generating asset product and a deposit product before being granted an ADI licence. Direct applicants must achieve a **limited launch** of an income-generating asset product before being granted an ADI licence.	Product launch is key to reaching sustainability. An ADI licence is granted to allow applicants to commence banking business. Applicants must demonstrate their operational readiness to do so – a limited launch is the best way of doing this.
New ADIs will be expected to achieve a **full public launch** of income-generating asset products and deposit products shortly after authorisation, and with only a short gap in between.	Launching both asset and liability products is key to reaching sustainability. Lop-sided balance sheets can create significant risks.
Capital requirements	
For new ADIs APRA will use a 'highest of' three methods in setting ongoing Prudential Capital Requirements (PCR) for new entrants. These are: a $10m minimum; a calculation based on 6 months' operating expenses; and the normal capital requirement calculation as for established ADIs. Capital Conservation Buffer and Countercyclical Capital Buffer will be set in a manner consistent with the method used for setting PCR.	Better reflects the idiosyncratic and often fast-changing risk profile of new ADIs, when compared with established ADIs.

Revision	Rationale
For both Restricted ADIs and ADIs, APRA will specify an **Initial Capital Amount** applicable on the day of authorisation.	This provides certainty to those planning an application and reduces reliance on raising additional capital immediately after the grant of licence in order to continue to meet ongoing PCR.
Exit planning	
More detailed guidance is provided on APRA's expectations regarding exit planning, in particular: • For Restricted ADIs, the need to focus primarily on a **credible return of deposits strategy**. • For new ADIs, the need to include a **credible return of deposits strategy** as one option.	For Restricted ADIs and new ADIs in their early stages, a return of deposits is the strategy most likely to result in a successful activation and execution of the exit plan (if required).
In advance of granting an ADI licence, APRA will convey to the entity its expectations regarding **suitable trigger points** for activation of its exit plan.	A range of stakeholders – including the board, executives, shareholders and APRA – benefit from clarity and a common understanding of trigger points.
For new ADIs, APRA may specify some ongoing **deposit restrictions**.	Improves likelihood of a successful execution of an exit plan, especially a return of deposits strategy.
Clarified APRA's general expectation that for Restricted ADIs' deposit customers will be limited to **staff, friends and family only.**	Improves likelihood of a successful execution of a return of deposits strategy when depositors are known personally to the Restricted ADI.
For Restricted ADIs, testing related to the Financial Claims Scheme is to take place after limited launch of deposits, rather than before.	Assurance checks on live data is likely to be more informative than assurance checks on test data.

Consultation and next steps

APRA invites written submissions from all interested parties on its revised information paper *ADIs: New entrants – a pathway to sustainability*.

Written submissions should be sent to Licensing@apra.gov.au by 30 April 2021 and be addressed to:

General Manager, Regulatory Affairs and Licensing

Policy and Advice Division

Australian Prudential Regulation Authority

Submissions are welcome on all aspects of the revised information paper.

Important disclosure notice – publication of submissions

All information in submissions will be made available to the public on the APRA website unless a respondent expressly requests that all or part of the submission is to remain in confidence.

Automatically generated confidentiality statements in emails do not suffice for this purpose.

Respondents who would like part of their submission to remain in confidence should provide this information marked as confidential in a separate attachment.

Submissions may be the subject of a request for access made under the *Freedom of Information Act 1982* (FOI Act).

APRA will determine such requests, if any, in accordance with the provisions of the FOI Act. Information in the submission about any APRA-regulated entity that is not in the public domain and that is identified as confidential will be protected by section 56 of the *Australian Prudential Regulation Authority Act 1998* and will therefore be exempt from production under the FOI Act.

Next steps

Submissions close on 30 April 2021.

Following conclusion of the consultation period, APRA expects to issue a response paper, final information paper and updated licensing guidelines for ADIs, in quarter two 2021. The final information paper will update and replace the currently available information paper '*ADI licensing: Restricted ADI Framework*'.

Frequently Asked Questions

Does consultation on the information paper impact the current issuing of licences?

No. APRA suspended the issuing of licences in April 2020 due to the significant challenges new entrants would have faced due to economic uncertainty caused by COVID-19. The licensing of new ADIs and Restricted ADIs resumed in March 2021, as announced by APRA in August 2020, and will continue throughout the consultation period.

When will the information paper apply to new and existing applicants?

Immediately on the date the finalised information paper is released. As much of the approach described in the information paper is a formalisation of existing practice, there is no need for either a phase-in period or 'grandfathering' arrangements for existing applicants. The majority of the information paper describes APRA's current approach to licensing and the application of the prudential and supervisory frameworks to new entrants. In cases where the approach has shifted more markedly, the adjusted approach will be applied to all newly licenced entities from the date the final information paper is released.

Will the approach set out in the information paper apply to existing Restricted ADIs and new ADIs?

Yes. The majority of the information paper describes APRA's current approach to applying its prudential and supervisory frameworks to new entrants. Instances where APRA has already agreed to a certain course of action, which contradicts this approach, will be considered on a case by case basis.

Attachment A: Balancing APRA's objectives

In reviewing APRA's approach to new entrant ADIs, APRA has sought to find an appropriate balance between the objectives of financial safety and efficiency, competition, contestability and competitive neutrality, whilst promoting financial system stability. APRA considers that the approach set out in the revised information paper marginally enhances financial system stability while having a neutral impact on competition and contestability in the banking industry.

PRIMARY OBJECTIVES	
Financial safety ⬆	**Financial system stability** ⬆
Marginally enhanced. Some enhancement in overall financial safety is anticipated due to stronger capital and other expectations for new ADIs. This and stronger exit plan expectations should reduce risk to depositors.	**Marginally enhanced.** The rate of failure and the possibility of a disorderly failure are both expected to fall. This is expected to marginally enhance overall financial stability.

OTHER CONSIDERATIONS	
Efficiency ⬆	**Marginally Enhanced.** Increased transparency regarding requirements and increased certainty regarding APRA's prudential and supervisory approach are expected to enhance efficiency for current and prospective applicants.
Competition ⟷	**Unchanged.** APRA's revised approach should increase the success of new entrants but may have a marginal impact on the number that apply; the expectation is that this will be supportive of competition in the long term.
Contestability ⟷	**Unchanged.** APRA's revised approach is expected to make the pathway to a sustainable ADI clearer. It may result in slightly fewer applications for an ADI licence, which is balanced by the expectation that successful applicants are more likely to thrive and survive.
Competitive Neutrality ⟷	**Unchanged.** APRA's revised approach is not expected to have an impact on competitive neutrality.

APRA