



# INFORMATION PAPER

## ADIs: New entrants – a pathway to sustainability

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# Contents

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<b>Glossary</b>	<b>4</b>
<b>Executive summary</b>	<b>6</b>
<b>Background</b>	<b>8</b>
<b>Chapter 1 - ADI licensing</b>	<b>10</b>
1.1    The direct pathway	10
1.2    The restricted pathway	10
1.3    The application process	11
<b>Chapter 2 - Restricted ADIs</b>	<b>13</b>
2.1    APRA's prudential and supervisory approach to Restricted ADIs	13
2.2    Ending the restricted phase	21
<b>Chapter 3 - New ADIs</b>	<b>23</b>
3.1    Characteristics of new ADIs	23
3.2    APRA's prudential and supervisory approach to new ADIs	24
3.3    Transitioning to the prudential and supervisory approach for established ADIs	33
<b>Chapter 4 - General requirements for all new entrants</b>	<b>34</b>
4.1    When can an entity call itself a 'bank'?	34
4.2    Structural considerations	35
<b>Attachment A: Summary comparison of ADI requirements and expectations</b>	<b>38</b>
<b>Attachment B: Restricted ADI Prudential Framework</b>	<b>42</b>

# Glossary

ADI	Authorised deposit-taking institution - For the purposes of this paper, 'ADI' refers to a body corporate who holds an ADI licence and is not a foreign ADI or a purchased payment facility provider (PPF).
ADI licence	For the purpose of this paper, an ADI Licence is an authority granted by APRA under section 9 of the Banking Act to permit a body corporate to conduct banking business in Australia with or without conditions, that is not limited by time.
Adjusted assets	Adjusted assets are assets within the meaning given in the Australian Accounting Standards, minus an amount equal to the value of regulatory adjustments to regulatory capital that the Restricted ADI is required to make under Attachment D to <i>Prudential Standard APS 111 Capital Adequacy: Measurement of Capital</i> (APS 111).
APRA	Australian Prudential Regulation Authority.
Banking Executive Accountability Regime (BEAR)	The Banking Executive Accountability Regime (BEAR), set out in Part IIAA of the <i>Banking Act 1959</i> , establishes accountability obligations for ADIs and their senior executives and directors.
Banking Act	<i>Banking Act 1959</i> .
Banking business	Banking business has the meaning in section 5 of the Banking Act.
CET1	Common Equity Tier 1 has the meaning in <i>Prudential Standard APS 001 Definitions</i> (APS 001)
Established ADI	An ADI that has held an ADI licence for a period of time and is subject to APRA's regular approach to applying its prudential and supervisory framework.
FCS	The <a href="#">Financial Claims Scheme</a> is an Australian Government scheme that provides protection to deposits with ADIs and policies with general insurers in the unlikely event that one of these financial institutions fails. In the case of deposits, the FCS only covers deposits in protected accounts held with ADIs that are incorporated in Australia and recorded in Australian currency. The FCS can only be activated by the Australian Government. APRA is responsible for administering the scheme.
Initial capital amount	The minimum amount of regulatory capital an entity needs at the time it is granted an ADI licence.
LCR	Liquidity Coverage Ratio has the meaning in <i>Prudential Standard APS 210 Liquidity</i> (APS 210).
Licensing	Licensing refers to the process by which APRA grants an ADI licence to an entity.
MLH	Minimum liquidity holdings has the meaning in APS 210.

<b>New ADI</b>	An ADI that is not a Restricted ADI, has recently been granted an ADI licence and is subject to an adjusted supervisory approach.
<b>New entrant</b>	A collective term for a Restricted ADI and a new ADI.
<b>NOHC</b>	Non-operating holding company, has the meaning in section 5 of the Banking Act.
<b>PPF</b>	Purchased payment facility, has the meaning in section 7 of the <i>Payment Systems (Regulation) Act 1998</i> .
<b>Protected account</b>	Has the meaning in section 5 of the Banking Act.
<b>Prudential framework</b>	Prudential framework refers to the legislation, as well as prudential and reporting standards plus associated guidance material, which relate to the prudential regulation of ADIs.
<b>Prudential requirements</b>	Includes requirements in the Banking Act, prudential standards made under the Banking Act, reporting standards made under the <i>Financial Sector (Collection of Data) Act 2001</i> , conditions on the ADI's licence and any other requirements imposed by APRA in writing.
<b>Resolution reserve</b>	A reserve to cover potential APRA costs of resolving a Restricted ADI which may, as a last resort, include administration of the FCS if activated by the Australian Government.
<b>Restricted ADI</b>	A body corporate that holds a Restricted ADI licence.
<b>Restricted ADI licence</b>	An authority granted by APRA under section 9 of the Banking Act to permit a body corporate to conduct banking business in Australia, which is for a limited period and is subject to specific requirements and restrictions.
<b>Restricted phase</b>	The period in which a Restricted ADI holds a Restricted ADI licence.
<b>Stored value</b>	The balance of funds represented on PPF devices or PPF accounts held by beneficiaries for the purpose of making payments.

# Executive summary

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The Australian Prudential Regulation Authority's (APRA's) mandate is to protect the Australian community by establishing and enforcing prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by entities it supervises are met within a stable, efficient and competitive financial system.

This information paper sets out APRA's approach to new locally-incorporated entrants (new entrants) to the ADI industry<sup>1</sup>. It forms part of a series of publications that describe APRA's requirements and guidelines for ADIs<sup>2</sup>.

APRA recognises that new ADIs have unique challenges and their risk profiles differ when compared to established ADIs. APRA's approach to new entrant ADIs seeks to strike an appropriate balance between supporting entities to enter and thrive in the banking sector, while ensuring financial system stability and protecting the interests of depositors.

The purpose of this information paper is to set clear expectations for current and prospective new entrants. It outlines APRA's expectations and approach for each step of the new entrant's pathway to sustainability, including:

1. ADI licensing: the two pathways available to obtain an ADI licence and the application process (the restricted pathway and the direct pathway);
2. Restricted ADIs: APRA's prudential and supervisory approach to operating with a Restricted ADI licence (where applicable). This pathway is intended to allow entities time to build resources and capabilities to establish an ADI;
3. New ADIs: following either the restricted or direct pathway to a licence, adjustments to APRA's prudential and supervisory frameworks support the building of a sustainable business; and
4. General information: to guide an entity in setting up a new ADI.

APRA's approach to new entrants covers the progression of an entity through APRA's pre-application engagement stage, the licensing process, and finally the application of APRA's prudential and supervisory framework as a licensed entity, with adjustments in the initial years of being licenced.

All APRA regulated entities are subject to APRA's supervisory and prudential frameworks. Adjustments are made to these frameworks for Restricted ADIs and New ADIs to address the particular risk profiles of these entities. Figure 1 highlights these key adjustments in a side

<sup>1</sup> This Information Paper does not cover the authorisation of new foreign bank branches or new providers of purchase payment facilities.

<sup>2</sup> Refer Figure 2 on page 9.

by side comparison with an Established ADI. Note, ADIs are subject to a wide range of other requirements described in relevant prudential standards, and Restricted ADIs are subject to a modified set of requirements.

**Figure 1. Summary of the key differences in applying APRA’s prudential framework to each category of ADI**

Restricted ADI (where applicable)	New ADI	Established ADI
<b>Key requirements</b> <ul style="list-style-type: none"> <li>• <i>Initial capital</i> - ongoing capital requirement plus 3 months’ operational expenses</li> <li>• <i>Ongoing capital</i> - \$3m plus \$1m resolution reserve</li> <li>• <i>CCB</i> - none</li> <li>• <i>Exit strategy</i> - return of deposits</li> <li>• <i>Deposit limit</i> - \$2m aggregate cap on deposits</li> </ul>	<b>Key requirements</b> <ul style="list-style-type: none"> <li>• <i>Initial capital</i> - higher of \$15m or 9 months’ operational expenses</li> <li>• <i>Ongoing capital</i> - higher of \$10m, rolling 6 months’ operational expenses or percentage of RWAs</li> <li>• <i>CCB</i> - \$2.5m or 25% of 6 months’ rolling operational expenses or 2.5% of RWAs</li> <li>• <i>Exit strategy</i> – likely to be return of deposits option</li> <li>• <i>Deposit limit</i> – may apply some controls on deposit growth</li> </ul>	<b>Key requirements</b> <ul style="list-style-type: none"> <li>• <i>Capital</i> - calculated on a risk weighted basis as per APRA standards</li> <li>• <i>CCB</i> – 2.5% of RWAs</li> <li>• <i>Exit strategy</i> – mature: strategy dependent on resolvability of entity, may include transfer of business</li> <li>• <i>Deposit limit</i> – no limit or controls on deposit growth</li> </ul>

# Background

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## APRA's role

APRA is an independent statutory authority established for the primary purpose of prudential supervision of financial institutions in Australia.

In performing and exercising its functions and powers, APRA is to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, is to promote financial system stability in Australia.

APRA is responsible for protecting the interests of depositors, insurance policyholders and most superannuation fund members<sup>3</sup> – collectively referred to as APRA's beneficiaries. Protecting the financial interests of these beneficiaries lies at the centre of APRA's mandate.

## Authorisation, prudential standards and prudential supervision

Given the important role ADIs play in the provision of financial services to the community as well as their role in the wider economy, these institutions are subject to higher standards than many other sectors of the economy. These include:

- Higher entry standards, such as legislation which requires an entity that wishes to conduct banking business to apply to APRA for a licence authorising it to conduct banking business under the *Banking Act 1959* (the Banking Act). An entity that has been granted a licence under the Banking Act by APRA is referred to as an authorised deposit-taking institution (ADI).
- A prudential framework intended to manage the prudential risks of banking activities. Much of this prudential framework is in the form of prudential standards designed by APRA.
- Ongoing prudential supervision by APRA. This is to identify significant risks to entities and the financial system and ensure these are appropriately addressed in a timely and effective manner.
- This information paper explains APRA's approach for new entrants. It should be read in conjunction with other guidance and material on APRA's approach to ADIs such as *Licensing: Locally incorporated ADIs* which set out APRA's licensing process for ADIs as illustrated in Figure 2.

<sup>3</sup> APRA does not supervise self-managed superannuation funds as these are regulated by the Australian Taxation Office.



**Figure 2. Requirements and guidelines applicable to new entrant**



# Chapter 1 - ADI licensing

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Obtaining an ADI licence requires significant resources and capabilities which can take time to develop. To encourage a wide variety of potential applicants, APRA has two pathways available to become an ADI: the direct pathway and the restricted pathway. The pathway that is suitable will depend on each applicant's circumstances. This chapter describes both pathways and the eligibility for each. Full details of the licensing process, including the need for early engagement with APRA, application requirements and the assessment process are set out in guidelines, *Licensing: Locally incorporated ADIs*, available on the APRA website.

## 1.1 The direct pathway

The direct pathway allows the applicant to conduct its intended banking business from the granting of its licence. The applicant must demonstrate it meets APRA's prudential framework from the point of licence and is ready to commence banking business.

Before authorisation an entity applying directly for an ADI licence will need to:

- achieve a limited launch of at least one income-generating asset product; and
- be operationally ready to launch deposit products shortly after being authorised.

### 1.1.1 Eligibility

Applying directly for an ADI licence is suited to applicants that have the existing resources and capabilities to establish immediately an ADI, especially where the entity is already operating a business. It is also the pathway suited to those who wish to pursue a more complex, non-traditional, higher risk or larger scale business model from the outset.

## 1.2 The restricted pathway

APRA considers the restricted pathway facilitates entry into the banking sector for a wide variety of applicants. The restricted pathway is suitable for applicants that do not have the resources and capabilities to establish an ADI and need time to develop these. This pathway allows applicants to conduct limited banking business as a Restricted ADI before meeting the requirements of the full prudential framework. It can assist applicants in seeking the investment required to operationalise their business, test their business model, progress their compliance with the prudential framework and their application for an ADI licence.

An important part of the restricted phase is the expectation that a Restricted ADI will progress to an ADI licence. As such, the restricted phase is for a maximum period of two years. APRA may consider extending the time limit in some circumstances, though only where APRA assesses that the Restricted ADI is able to transition to an ADI licence in a short timeframe past the two-year limit. The Restricted ADI will either progress to an ADI licence or exit the industry.

The set time period has several outcomes; certainty, transparency and facilitation of exit if needed, as well as mitigating risk of an uneven playing field with competitors, given the concessions to the prudential framework (refer to Appendix B) during the restricted phase.

The Licensing Guidelines set out what an entity applying for a Restricted ADI licence will need. Two key expectations for a Restricted ADI's application are:

- a credible plan to meet the prudential framework for new ADIs within a period of two years; and
- a credible exit plan that can be executed if needed.

### 1.2.1 Eligibility

APRA will determine eligibility for the restricted pathway on a case-by-case basis, given the unique and often innovative nature of individual applications.

Applicants that are part of the corporate group of an existing ADI, foreign bank or any large corporation are unlikely to be eligible for the restricted pathway as these applicants are expected to have sufficient resources and capabilities to apply directly for an ADI licence.

## 1.3 The application process

APRA's licensing process, as with its approach to supervision, is consultative. The application process involves the following steps:

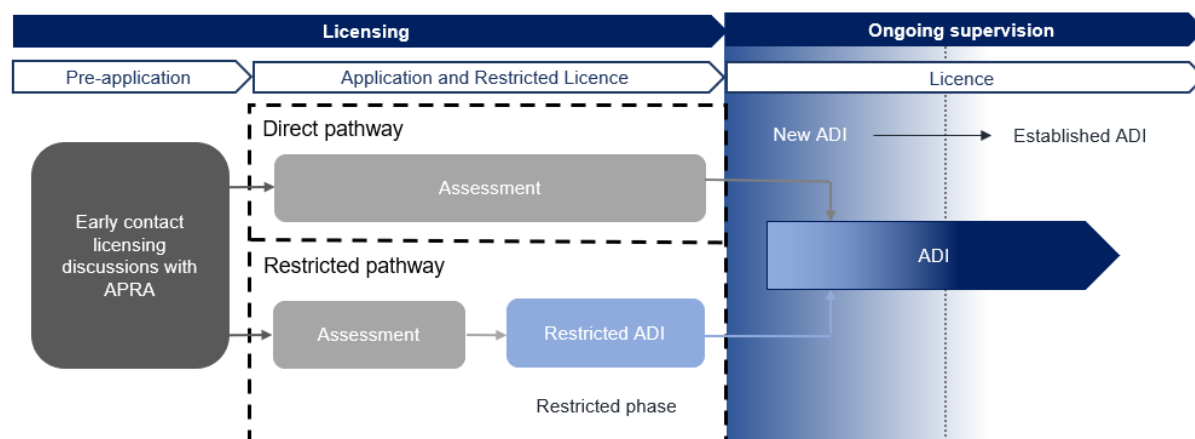
- Initial enquiry – preliminary consultation between APRA and the prospective applicant on its plans to carry on banking business in Australia<sup>4</sup>;
- Pre-application – submission of a developed business plan to APRA for high-level review; and
- Assessment – APRA's review of the application.

The application process may take 9-18 months for a licensing decision depending on the readiness of the applicant and complexity of the business.

Figure 3 shows the licensing process and transition to supervision as a new ADI.

<sup>4</sup> In summary, the Banking Act defines banking business as both making advances and taking deposits. If an entity does not intend to undertake both of those activities it cannot become an ADI.

**Figure 3. APRA's ADI licensing process**



Potential applicants should speak to APRA about the most appropriate licensing pathway for their business. The level of engagement and guidance provided by APRA is the same for either pathway.

# Chapter 2 - Restricted ADIs

The Restricted ADI licence allows an entity time to develop resources and capabilities and to conduct limited, low risk or traditional banking business during its start-up phase. This chapter summarises APRA's prudential and supervisory approach to a Restricted ADI including what happens during the restricted phase, the requirements the entity will need to meet, supervision of the entity, transitioning to an ADI licence and what happens if the entity cannot establish itself as an ADI.

## 2.1 APRA's prudential and supervisory approach to Restricted ADIs

Restricted ADIs are authorised under the Banking Act. They must meet the prudential standards applicable to them (see Appendix B) and the requirements of the Banking Act, which include the Banking Executive Accountability Regime (BEAR).

The following table summarises the requirements that an entity will need to meet during the restricted phase. Further detail on the concessions to the ADI prudential framework for Restricted ADIs is included in Appendix B.

***Table 1. Summary of prudential and supervisory framework for Restricted ADIs***

Restricted ADI requirements	
Prudential standards	APRA modifies application of the prudential standards for a Restricted ADI to be commensurate with the risk during the restricted phase.
Conducting business during the restricted phase	A Restricted ADI will need to achieve a limited launch of at least one income-generating asset product and one deposit product before it can progress to an ADI licence.
Capital	On an ongoing basis, a Restricted ADI will at all times need minimum capital of the higher of: \$3 million plus a resolution reserve (normally set at \$1m); or 20 per cent of adjusted assets.
Liquidity	A Minimum Liquidity Holdings (MLH) requirement to be met at all times.
Deposit limit	Restricted ADIs are subject to a deposit limit of \$2 million on the aggregate balance of all protected accounts and a deposit limit of \$250,000 on the aggregate balance of all protected accounts held by an individual account-holder.
Governance	Acknowledging that some Restricted ADIs may be using the restricted phase to finalise executive appointments and staff recruitment, certain concessions are made to specific governance requirements.
Strategy to full compliance	A credible strategy which details the applicant's plan to meet the prudential framework within the restricted phase is required.

Restricted ADI requirements	
<b>Exit plan</b>	A credible exit plan identifying the avenues it would take to exit its banking business is required. The primary focus should be on a plan for return of deposits. Should the Restricted ADI be unable to fully meet the prudential framework by the end of the restricted phase, it will be required to cease banking business. The Restricted ADI may also decide that its business model is not viable, or it may come under stress and as such may not progress to an ADI licence.
<b>Financial Claims Scheme (FCS)</b>	Prior to a Restricted ADI accepting deposits, it must meet FCS related requirements.
<b>Disclosure</b>	APRA requires a Restricted ADI to take all reasonable steps to ensure that it is clear to all its customers and potential customers that it is operating under a restricted licence and do not yet meet the full prudential framework.
<b>Reporting</b>	The ADI will be required to provide a monthly Restricted ADI specific report to APRA during the restricted phase.

During the restricted phase, Restricted ADIs are expected to be focused on developing their resources and capabilities to meet the full prudential requirements for their intended business. This could include (but is not necessarily limited to) the following:

- fully capitalising the ADI;
- finalising senior management appointments and staff recruitment and training;
- finalising details of products, pricing and the systems they will need to on-board customers;
- developing control functions such as risk and compliance;
- developing, testing and implementing systems and IT infrastructure;
- completing policies and procedures;
- finalising outsourcing arrangements; and
- launching asset and deposit products.

APRA's supervisory oversight of Restricted ADIs will include on-going engagement with the Restricted ADI as it develops its business and progresses towards an ADI licence.

### 2.1.1 Conducting business

Restricted ADIs are not expected to grow significantly beyond a \$100 million balance sheet. Restricted ADI applicants' business plans and financial projections should reflect this at the time of application, as should their operations during the restricted phase.

## Requirement to launch products

To demonstrate they are operationally ready to conduct banking business as an ADI, Restricted ADIs are expected to launch live products, albeit in a limited manner, during the restricted phase. A Restricted ADI will need to have achieved a limited launch of at least one income-generating asset product and one deposit product before it can progress to an ADI licence. Restricted ADIs are able to launch new personal and lower risk banking business products, including deposit products (to a limited number of customers).

Customers offered a new deposit product during the restricted phase are expected to consist of staff of the Restricted ADI and their families and friends<sup>5</sup>. Other members of the general public should not be able to apply for a new release deposit product from a Restricted ADI.

Where a Restricted ADI already offered products when it applied for a licence it will have demonstrated adequate resources and capabilities to manage these as part of the Restricted ADI licensing assessment. Restricted ADIs can continue to offer to the general public these existing (non-deposit) products (for example, pre-paid cards or personal loans) that were established before the entity became a Restricted ADI.

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<sup>5</sup> Where an Restricted ADI's business plan involves taking deposits, but not from individuals, APRA will agree suitable alternative arrangements with that entity.

## ***Box 1 – Launching products***

### **What does APRA mean by ‘launching products’?**

There are three broad types of product launch.

#### **Test launch**

The primary purpose of a test launch is to assess whether systems, processes and procedures function as intended. It involves the creation of dummy positions and transactions. Alternatively, small sums of money funded by the entity may be used to create real positions and transactions.

#### **Limited launch**

The primary purpose of a limited launch is to demonstrate operational readiness for a full public launch. A limited launch involves real products and real customers. Often those customers are staff, their family members or close associates of the entity. Products are not widely marketed to the general public and the dollar amounts involved may be small. However, the full range of regulatory and compliance requirements must be met.

#### **Full public launch**

The primary purpose of a full public launch is to enact plans laid out in the entity’s business strategy. It would include marketing to the general public and competing against incumbents on an ongoing basis.

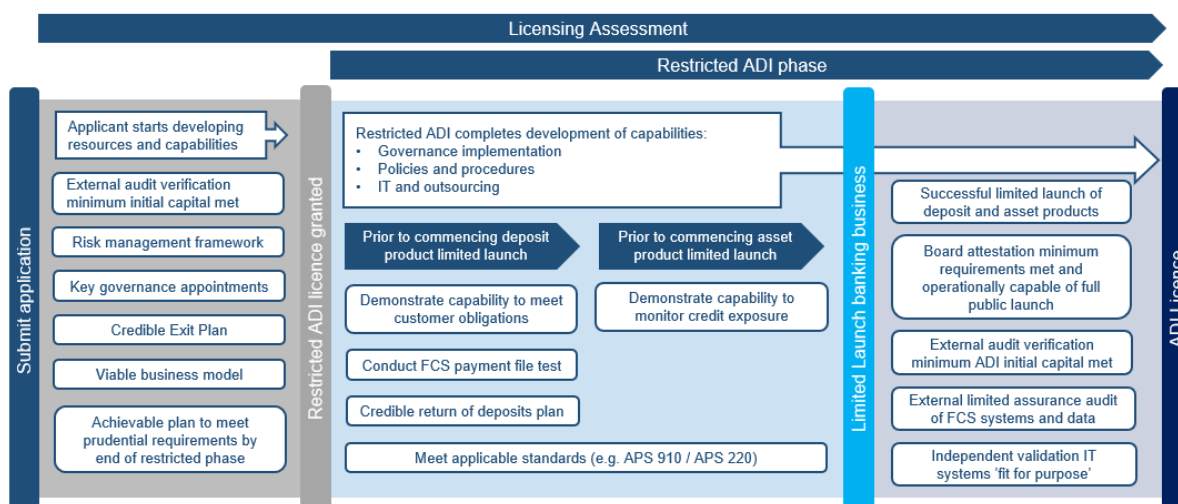
Appropriate systems and controls must be in place prior to the limited launch. Figure 4 summarises APRA’s requirements at different stages of the restricted phase including prior to commencing deposit and asset limited launches.<sup>6</sup>

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<sup>6</sup> Guidance on APRA’s expectation for risk management practices is provided in the guidelines: *Licensing: Locally incorporated ADIs*.



**Figure 4. Requirements applicable in different stages of the restricted phase**



## Deposit limit

Part of APRA's mandate is to ensure that, under all reasonable circumstances, financial promises made by ADIs and Restricted ADIs are met. This is why strict prudential requirements and supervision are in place. Provisions under the Banking Act for the protection of depositors apply to all ADIs in Australia, including Restricted ADIs. As a last resort, the Australian Government protects deposits up to \$250,000 via the Financial Claims Scheme. Given Restricted ADIs do not meet the ADI prudential framework in full, restrictions on the amount of liabilities held in protected accounts will be in place during the restricted phase. To protect depositors further, Restricted ADIs will be subject to a deposit limit of \$2 million on the aggregate balance of all protected accounts and a deposit limit of \$250,000 on the aggregate balance of all protected accounts held by an individual account-holder.

All ADIs and Restricted ADIs must make it very clear to customers where balances, and other funding liabilities, such as pre-paid cards, are not protected under the FCS. In addition, given the intention to ensure regulated entities can meet their financial promises, and, reflective of the fact that Restricted ADIs will not fully meet the ADI prudential framework, Restricted ADIs must not build up material balances in non-protected accounts, such as pre-paid card accounts and foreign currency deposits, during the restricted phase on their own balance sheet.

## Disclosure and marketing

It is important that consumers and other stakeholders know who they are dealing with and understand how dealing with a Restricted ADI may be different to dealing with an ADI. APRA requires that Restricted ADIs take all reasonable steps to ensure that it is clear to all stakeholders, including customers and potential customers, that they are operating under a restricted licence and do not yet meet the ADI prudential framework.

Prior to entering into a customer relationship with a Restricted ADI, a customer (regardless of their relationship to the Restricted ADI) must be provided with a disclosure statement. The

statement must be prominently displayed and written in plain language and must disclose at a minimum, the matters determined by APRA.

Restricted ADIs must make the following further information publicly available:

- an explanation in plain language of the restrictions on its licence, and how the restrictions impact customers;
- the date by which the Restricted ADI must either convert to an ADI or exit the banking industry (i.e. the date two years after the granting of its Restricted ADI licence); and
- any other information regarding the Restricted ADI's status that is relevant to customers considering acquiring an existing product from the Restricted ADI or customers who are considering signing up for a new wait listed product which will be available when the Restricted ADI obtains its ADI licence.

All staff, representatives and employees of the Restricted ADI should be reasonably trained about the restrictions applicable to the Restricted ADI and the conditions under which it operates, including the conditions on its authorisation.

Where a Restricted ADI is offering pre-paid cards, it needs to make clear to customers that these are not protected under the FCS.

A Restricted ADI can actively market its business to the general public in order to develop a wait-list of customers who can be offered products once the Restricted ADI obtains its ADI licence. The Restricted ADI must make clear that those customers will not be eligible to apply for a product until it has gained its ADI licence.

### **2.1.2 Capital requirements**

APRA specifies capital requirements for Restricted ADIs in two parts. Firstly, as a precondition to being granted a Restricted ADI licence, immediately before that date, the applicant will need to hold a minimum initial capital amount specified by APRA. The purpose of the initial capital amount is to reduce a Restricted ADI's reliance on raising additional capital immediately after the grant of licence. Secondly, having obtained a licence the initial capital amount ceases to apply and is replaced by an ongoing Prudential Capital Requirement. These requirements (as well as those for new ADIs) are represented in Figure 5, in Chapter 3 below.

#### **Initial capital amount**

Immediately before being granted an ADI licence, entities will need a minimum initial capital amount of the ongoing minimum capital requirement described below, plus an additional amount equal to the entity's forecast operational expenditure for the following three months.

#### **Prudential capital requirement**

On an ongoing basis, a Restricted ADI will at all times need a minimum capital of the higher of: \$3 million plus a resolution reserve; or 20 per cent of adjusted assets. This is called the Prudential Capital Requirement (PCR).

The resolution reserve is typically set at \$1 million, representing the likely costs of APRA resolving the entity which may, as a last resort, include administration of the FCS if activated by the Australian Government. The actual costs for the business to exit the banking industry may be higher and applicants should consider this when setting their internal capital targets and operating levels. APRA retains discretion to increase the size of the resolution reserve if a Restricted ADI is deemed particularly complex to resolve.

These minimum capital requirements would apply to a Restricted ADI at Level 1 and where applicable, Level 2<sup>7</sup>.

Restricted ADIs must meet their entire prudential capital requirement for the restricted phase with Common Equity Tier 1 (CET1) Capital<sup>8</sup>.

### 2.1.3 Liquidity requirements

A Restricted ADI will need to meet the Minimum Liquidity Holdings (MLH) requirement of liquid assets equal to:

- a) 20 per cent of liabilities<sup>9</sup>;
- b) the total value of protected accounts plus an amount equal to the resolution reserve; or
- c) for Restricted ADIs which are holders of stored value (e.g. pre-paid cards), 100 per cent of the stored value at risk, plus the total value of protected accounts, plus an amount equal to the resolution reserve<sup>10</sup>,

whichever is highest.

The MLH portfolio must comprise liquid assets which are free from encumbrances as outlined by the MLH method in Attachment B to *Prudential Standard APS 210 Liquidity* (APS 210).

The MLH requirement ensures that, under all reasonable circumstances, Restricted ADIs have sufficient liquidity to meet their financial obligations as they fall due.

### 2.1.4 Governance requirements

APRA's governance standards generally apply to Restricted ADIs. However, acknowledging that some Restricted ADIs may be using the restricted phase to finalise executive appointments and staff recruitment, certain concessions are made to specific requirements.

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<sup>7</sup> Level 1 and level 2 are as defined in *Prudential Standard APS 001 Definitions*, referring essentially to the ADI on a stand alone basis (level 1) and the wider banking group (Level 2).

<sup>8</sup> Exceptions may be made for mutually owned Restricted ADIs.

<sup>9</sup> Liabilities as outlined in Attachment B to *Prudential Standard APS 210 Liquidity* (APS 210).

<sup>10</sup> Stored value is defined by the *Payment Systems (Regulation) Act 1998*. *Prudential Standard APS 610* determines stored value at risk.

- Instead of a majority of independent directors, Restricted ADI boards require:
  - a) a minimum of two independent directors at all times; and
  - b) one independent director to be eligible and present to vote at all board meetings.
- A Restricted ADI is not required to have established board committees. The responsibilities of these committees under Prudential Standard CPS 510 Governance is the responsibility of the full board, with the exception of the remuneration committee whose responsibilities are the responsibilities of the non-executive directors.
- A Restricted ADI is not required to have in place a policy for board renewal or procedures for assessing board performance.

### 2.1.5 Exit plan requirements

Restricted ADI applicants must have a credible exit plan identifying the avenues it would take to cease its banking business and exit the banking industry.

The primary focus of the exit plan should be the timely return of deposits to customers without reliance on the FCS, and without impacting financial stability or necessitating use of APRA's crisis management powers. The exit plan should link to the applicant's business plan, key risks, strategy to ADI licence, and risk management framework, ensuring that there are clear trigger points for management actions and exiting the banking industry. Further guidance on APRA's expectation on what should be covered in the exit plan is provided in the guidelines: *Licensing: Locally incorporated ADIs*.

Where a Restricted ADI has an exit strategy that is unusual or involves more complex arrangements, APRA will consider setting a higher resolution reserve requirement. APRA will convey expectations to a Restricted ADI regarding when the exit plan might appropriately be activated. In the event that timely activation of the exit plan by a Restricted ADI did not occur, APRA would consider the use of appropriate powers.

### 2.1.6 APRA's supervisory approach to Restricted ADIs

Prior to licensing, Restricted ADIs are expected to have in place a credible plan to progress to an ADI within two years. This 'strategy to ADI' details the key activities and dependencies necessary for the entity to meet the new ADI framework and progress to an ADI licence.

APRA will use an entity's 'strategy to ADI' during the restricted phase to track the entity's progress towards meeting the prudential framework applicable to new ADIs.

Should the Restricted ADI not be able to demonstrate that it is achieving the key milestones in its strategy to ADI (and there is a risk the entity will not be able to meet the ADI framework and be operationally ready within the two-year timeframe), APRA will consider invoking the Restricted ADI's exit plan.

Further guidance on APRA's expectation on what should be covered in the strategy to ADI is provided in the guidelines - *Licensing: Locally incorporated ADIs*.

## Reporting

Under reporting standards made under the *Financial Sector (Collection of Data) Act 2001*, ADIs are required to provide APRA with data<sup>11</sup>. APRA will exempt a Restricted ADI from the current suite of ADI reporting standards and in place apply a reporting standard for the Restricted ADI. This reporting standard will apply during the restricted phase. Subsequently, as an ADI, the standard range of ADI reporting standards will be applicable.

The Restricted ADI reporting standard includes a common reporting form, a set of instructions, and data that Restricted ADIs are required to provide to APRA. However, APRA may also request Restricted ADIs to provide entity-specific information needed to assist APRA in assessing the Restricted ADI's business model as well as progress towards meeting the prudential framework.

A Restricted ADI will be required to report to APRA on a monthly basis to assist APRA in assessing its compliance with the Restricted ADI prudential requirements and its progress towards fully meeting the prudential framework.

## 2.2 Ending the restricted phase

The restricted phase is for a maximum period of two years. During this time the Restricted ADI will either progress to an ADI licence or exit the industry. Though as stated in section 1.2, APRA may consider extending the time limit in exceptional circumstances.

### 2.2.1 Progression to an ADI licence

Once a Restricted ADI has developed its resources and capabilities, achieved its limited launch and is satisfied it meets the requirements of the new ADI framework it can formally apply to APRA to progress to ADI.

The timing on when a Restricted ADI progresses to an ADI is dependent on the Restricted ADI's business model and its 'strategy to ADI'. Although the formal application will be made near the end of a Restricted ADI's progression, APRA will continually work with Restricted ADIs during the restricted phase, and will assess components of compliance with new ADI framework during the phase.

Regardless of the pathway an applicant takes to become an ADI, the requirements and thresholds to be met are the same. Restricted ADIs are expected to demonstrate they meet the new ADI prudential framework, in the same way that an entity applying via the direct pathway would prior to them progressing to an ADI licence.

### 2.2.2 Exit from industry

There may be instances where a Restricted ADI will not proceed to an ADI licence and will therefore need to exit the industry. This could occur if the Restricted ADI decides that its

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<sup>11</sup> The ADI reporting standards are available at <http://www.apra.gov.au/adi/ReportingFramework/Pages/reporting-forms-and-instructions-adis.aspx>

business is not viable, where it does not wish to proceed to an ADI licence or where it breaches a trigger in its exit plan.

APRA can initiate an exit if it considers that the Restricted ADI will not be successful in transitioning to an ADI licence. An APRA triggered exit could occur if the Restricted ADI is unable to demonstrate to APRA sufficient progress in its development of capabilities and resources to fully meet the requirements of the prudential framework on a proportionate basis within the two-year restricted phase.

There could also be instances where the Restricted ADI has breached its licence requirements or comes under stress. In this instance, APRA would assess the severity and likely continuation of the breach or stress to determine if the Restricted ADI must exit the industry.

Once an exit is triggered, the Restricted ADI would be required to exit the industry in an orderly manner with the interests of depositors given the highest priority. When the Restricted ADI no longer has deposits, APRA would revoke its licence.

# Chapter 3 - New ADIs

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An applicant may be granted an ADI licence either having successfully passed through the restricted phase or having applied for an ADI licence directly. An ADI licence enables entities to begin actively conducting banking business. This chapter discusses a number of adjustments to the application of APRA's prudential and supervisory framework for new ADIs given the nature of their risk profile.

## 3.1 Characteristics of new ADIs

Achieving authorisation is an important milestone. However, having been granted an ADI licence the new entrant should now concentrate on its main objective: growing its business into a sustainable operation. Through this period of growth; in the business, in resourcing needs and in its risk management capabilities, the new ADI will face a period of heightened uncertainty and risk, and a period in which its risks are markedly different to those faced by established ADIs.

General characteristics of new ADIs, when compared with established ADIs, include:

- A period of time before reaching break-even and profitability. For most new ADIs, their business plans forecast an initial period of making losses.
- A reliance on raising additional capital. New ADIs are often reliant on additional capital raising not only to complete development and accommodate planned growth, but also to avoid breaching prudential capital requirements. This creates significant event risk, the impact of which is heightened by a relatively quick speed to capital exhaustion.
- A high reliance on launching new products and the consequent exposure to project delivery risk. Given the capital concerns noted above, any delays in meeting planned product launch dates may have a material impact on reaching sustainability.
- A need to acquire customers swiftly. Given a largely fixed cost base, most new ADIs need to acquire customers both quickly and in sufficient numbers to meet their financial projections.
- A dynamic balance sheet which changes in size and composition very rapidly. As products are launched and traction is gained with customers, new ADIs can experience very rapid changes in their balance sheets.
- A need to make significant ongoing investment in people, technology and risk control frameworks.
- Evolving business plans and strategies. New ADIs are far more likely to make sudden adjustments to their business plans and business strategy as they nimbly react to unfolding events.

Some aspects of APRA's regular approach to applying its prudential and supervisory framework are not well-suited to the special characteristics of new ADIs and the approach is adjusted to target these characteristics.

## **3.2 APRA's prudential and supervisory approach to new ADIs**

APRA's adjusted prudential and supervisory framework applies to all new locally incorporated ADIs. There is no minimum specified time period for a new ADI to be subject to the adjusted prudential and supervisory approach. APRA will transition ADIs to the prudential and supervisory approach for established ADIs as soon as it is appropriate to do so. As such, some ADIs may transition more quickly than others. For example, those with significant financial resources from the outset and with continued access to capital from their parents/owners; those that use systems and procedures with a long operational track record elsewhere; and those with staff with substantial relevant experience may transition more quickly.

Adjustments regarding capital requirements, exit planning, deposit restrictions and supervisory approach are detailed below.

### **3.2.1 Capital requirements**

APRA's expectation in relation to all ADIs is that they maintain appropriate capital resources, both in terms of quantity and quality, commensurate with the risks to which they are exposed. Having enough capital of sufficiently high quality reduces the risk of an entity becoming unable to meet its financial promises, and is crucial for maintaining depositor confidence.

APRA recognises that new ADIs need time to become profitable and that, consequently, new ADIs are typically heavily dependent on external capital support to meet growth targets and to assist in absorbing early losses.

New ADIs must prudently consider potential challenges and ensure that they have sufficient capital to withstand these, including the possibility that profitability takes longer to achieve than expected. The loss or delay of obtaining external capital support may result in the new ADI's business model becoming distressed.

Responsibility for the management of the new ADI's capital position must be clearly defined as part of the ADI's BEAR accountabilities. If APRA observes evidence of ineffective capital planning, supervisory intensity will increase including consideration of whether further enforcement action is warranted.



## Box 2 - Capital

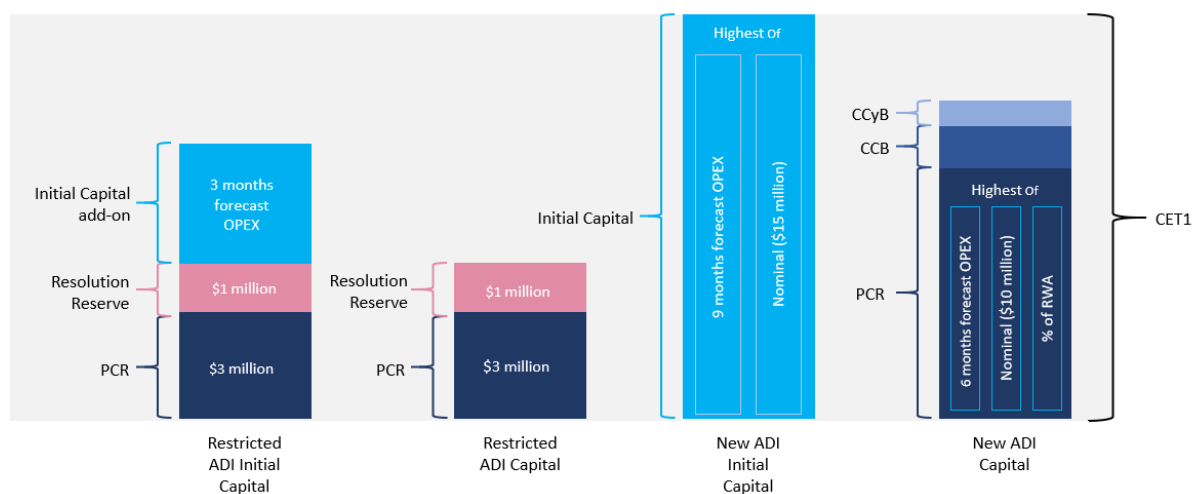
### Capital – what do all these terms mean?

The capital terms used in this paper have the meanings given in APRA's prudential standards. To assist readers with understanding this paper, broad definitions of these terms are provided below. In summary, there are three classes of regulatory capital, three levels at which minimum capital requirements apply and three main elements which comprise minimum capital requirements.

Term	Summary definition
<b>Common Equity Tier 1 capital (CET1)</b>	The highest-quality class of capital. Generally includes paid-up ordinary shares Also a level of capital at which minimum capital requirements apply
<b>Additional Tier 1 capital (AT1)</b>	The next highest-quality class of capital below CET1. Generally includes instruments such as perpetual hybrid securities
<b>Tier 1 capital</b>	A level of capital at which minimum capital requirements apply. Primarily CET1 plus AT1
<b>Tier 2 capital</b>	The lowest-quality class of capital. Generally includes instruments such as long-term subordinated debt securities
<b>Total capital</b>	A level of capital at which minimum capital requirements apply. Defined as Tier 1 plus Tier 2
<b>Prudential capital requirement (PCR)</b>	A minimum capital requirement, set at CET1, Tier 1 and Total capital levels
<b>Capital conservation buffer (CCB)</b>	A CET1 capital buffer over and above CET1 PCR
<b>Countercyclical capital buffer (CCyB)</b>	An incremental increase in CCB, primarily related to systemic risk, set periodically
<b>Risk-Weighted Assets (RWAs)</b>	A method used to assess the exposure to risk in an ADI's business, as a base for capital calculations

APRA specifies capital requirements for new ADIs in two parts. Firstly, as a precondition to being granted an ADI licence, immediately before that date, the applicant will need to hold a minimum initial capital amount specified by APRA. The purpose of the initial capital amount is to reduce an ADI's reliance on raising additional capital immediately after the grant of licence. Secondly, having obtained a licence, the initial capital amount ceases to apply and is replaced by an ongoing Prudential Capital Requirement, plus buffers. These requirements (as well as those for Restricted ADIs) are represented in Figure 5.

**Figure 5. The ‘capital stack’ for Restricted ADIs and new ADIs**



### Initial capital amount

Immediately before being granted an ADI licence, an entity will need a minimum initial capital amount of:

- the ADI’s forecast operational expenditure for the following nine months; or
- \$15 million (to mitigate the possibility of forecasting errors),

whichever is highest.

### Prudential Capital Requirement (PCR)

A new ADI’s ongoing PCR will be:

- the ADI’s forecast operational expenditure for the following six months, recalculated quarterly; or
- \$10 million; or
- a ratio of risk-weighted assets (RWAs) calculated in the normal manner<sup>12</sup>,

whichever is highest.

It is anticipated that in the earlier stages of a new ADI, the forecast operational expenditure or the \$10 million nominal method will derive a PCR greater than the RWA method, whereas

<sup>12</sup> For a new ADI, where appropriate, APRA will specify an alternative methodology for calculating the operational risk capital requirement under the RWA method – to be used instead of the normal methodology outlined in relevant prudential standards.

in the later stages, the RWA method will derive a PCR greater than the operational expenditure method or \$10 million nominal methods.

Certainty and speed of loss-absorbing capacity are important considerations for regulatory capital. Accordingly, new ADIs are expected to meet their prudential capital requirements with capital that consists entirely of Common Equity Tier 1 (CET1)<sup>13</sup>. As such, the PCRs for CET1 Capital, Tier 1 Capital and Total Capital will be identical for new ADIs.

For an established ADI, the major part of PCR is derived as a ratio of RWAs. The method for calculating RWAs is outlined in a range of Prudential Standards. For a new ADI, a total capital amount calculated in this normal manner may be very small in nominal dollar terms. This may occur when the balance sheet is small, or when the ADI has a majority of assets with low risk-weightings (such as placements with other ADIs).

For a new ADI to effect a return of deposits exit plan, that ADI must have sufficient capital to last it through the time period necessary. For this reason, it may be more appropriate in some circumstances for APRA to calibrate a new ADI's PCR in terms of time or a minimum nominal dollar amount, rather than as a ratio of RWAs.

### **Capital Conservation Buffer (CCB)**

As with an established ADI, a new ADI will be required to hold a CCB. A new ADI's CCB will be specified in the following manner:

- Where PCR is derived using the forecast operational expenses method, CCB is set at 25% of that PCR amount. This figure is a proxy for an additional 6 weeks' operational expenditure, and is used for ease of calculation purposes.
- Where PCR is derived using the nominal amount method, CCB is set at \$2.5m.
- Where PCR is derived using the RWA method, CCB is set at 2.5% of RWAs.

The consequences of an ADI having insufficient capital to hold its CCB in full are described in APRA's prudential standards. These primarily relate to constraints on capital distributions such as dividends, share buybacks and discretionary bonus payments to staff. While these constraints will still apply, new ADIs are unlikely to be planning to make such capital distributions. Where a new ADI's capital ratio falls within the CCB range, this will also trigger additional supervisory actions by APRA. These may include pre-positioning actions in preparation for a possible activation of the ADI's exit plan.

### **Countercyclical Capital Buffer (CCyB)**

From time to time APRA may require all ADIs – including new ADIs and established ADIs – to maintain a CCyB. A new ADI's CCyB will be specified in the following manner:

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<sup>13</sup> Exceptions may be made for mutually owned new ADIs.

- Where PCR is derived using the forecast operational expenses method, CCyB is set at percentage of that PCR amount, according to table below.
- Where PCR is derived using the nominal amount method, CCyB is set at a nominal amount, according to the table below.
- Where PCR is derived using the RWA method, CCyB is set as a percentage of RWAs, in the identical manner to that of an established ADI.

**Table 2. Countercyclical capital buffer for new ADIs**

Australian jurisdictional CCyB level as announced by APRA	CCyB per forecast expenditure method	CCyB per nominal method	CCyB per RWA method
0% of RWAs	0% of PCR	\$0	0% of RWAs
0.5% of RWAs	5% of PCR	\$0.5m	0.5% of RWAs
1.0% of RWAs	10% of PCR	\$1.0m	1.0% of RWAs
1.5% of RWAs	15% of PCR	\$1.5m	1.5% of RWAs
2.0% of RWAs	20% of PCR	\$2.0m	2.0% of RWAs
2.5% of RWAs	25% of PCR	\$2.5m	2.5% of RWAs
3.0% of RWAs	30% of PCR	\$3.0m	3.0% of RWAs
3.5% of RWAs	35% of PCR	\$3.5m	3.5% of RWAs

### Box 3- Capital example

#### Capital Example

In the following examples, an ADI has (under the RWA ratio method) a PCR requirement of 12.5 per cent of RWAs and a CCB of 2.5 per cent of RWAs – and there is currently a countercyclical capital buffer applicable of 1 per cent of RWAs.

	Example A	Example B	Example C
6 months' forecast operational expenditure	\$12m	\$8m	\$8m
RWAs	\$40m	\$40m	\$120m
PCR per forecast expenditure method	\$12m	\$8m	\$8m
PCR per nominal method	\$10m	\$10m	\$10m
PCR per RWA method @ 12.5%	\$5m	\$5m	\$15m
PCR applicable	\$12m	\$10m	\$15m
CCB applicable	\$3m	\$2.5m	\$3m
CCyB applicable	\$1.2m	\$1m	\$1.2m

Example A: the forecast operational expenditure method produces the highest result, so PCR is \$12m. CCB is set at 25% of that amount i.e. \$3m. CCyB is set at 10% of that amount i.e. \$1.2m.

Example B: the nominal amount method produces the highest result, so PCR is \$10m. CCB is set at a nominal amount of \$2.5m. CCyB is set at a nominal amount of \$1m.

Example C: the RWA method produces the highest result, so PCR is \$15m. CCB is set at 2.5% of RWAs i.e. \$3m. CCyB is set at 1.0% of RWAs i.e. \$1.2m

#### Excess capital over minimum requirements

The Prudential Capital Requirements (PCRs) are the minimum capital requirements for Restricted ADIs and ADIs.

ADIs should avoid 'just in time' capital planning. Breaching a PCR (i.e. having a lower amount of capital than the minimum requirement) is a serious and significant event. Exact consequences would be determined by APRA given the individual circumstances. However, possible consequences might include the triggering of the entity's exit plan and a revocation of the ADI licence by APRA. As such, APRA expects that entities will seek to operate with capital well above their PCR level so as to make breaches extremely unlikely.

### 3.2.2 APRA's supervisory approach to new ADIs

APRA's supervisory framework has evolved over many years to respond to risks.<sup>14</sup> New ADIs present unique supervisory challenges and a different risk profile and APRA's supervisory framework adapts to target these risks. This includes consistent adjustments and the need for greater supervisory intensity than similar-sized established ADIs. For example, new ADIs:

- have systems, processes, policies and procedures which do not have a track-record of proven effectiveness and which may be evolving quickly;
- may have a board, executive and staff which are inexperienced in overseeing and running an ADI;
- may have novel and untested business models; and
- may have less flexibility in timing or resources available to address issues.

Compared with established ADIs, APRA's supervisory approach to new ADIs is characterised by:

- A higher frequency of engagement between APRA and the new ADI especially regarding matters where there is little or no proven track record.
- More regular/frequent/repeated constructive challenge of the business strategy and key assumptions underpinning it, particularly where a new ADI proposes significant changes to its business strategy. APRA expects that new ADIs are able to articulate assumptions and sensitivities in amended business plans and that these are detailed in downside scenario analysis. Particular attention should be paid to any impact on exit plans. APRA will need time to conduct its own assessment and new ADIs should not assume an immediate (or positive) response to their requests.
- Heightened scrutiny of the product strategy and progress towards meeting planned product launch dates. A new ADI will be expected to achieve a full public launch of products very shortly after being granted a licence. Where a new ADI plans a full public launch of customer liability products (such as customer deposits) before it fully launches customer asset products (such as customer loans), APRA will expect there to be a very short gap between the two launch dates. Where there is a significant delay in launching products APRA may impose additional restrictions or requirements. A failure to launch products as anticipated may trigger an activation of the new ADI's exit plan, or in the most extreme cases cause APRA to revoke the new ADI's banking licence.
- More frequent and specific reporting. Data requested is likely to include items beyond the usual content, format or sub-category breakdowns as outlined in the suite of ADI reporting standards and reporting forms and may include ad hoc reports.

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<sup>14</sup> For example, refer to APRA's 6 October 2020 publications regarding its [supervision risk and intensity](#) model and [supervision philosophy](#).

- A more directive approach. Where time is pressing and an issue is of high prudential importance, it may be appropriate for APRA to convey at an early stage clear, firm and specific expectations for actions to be undertaken by the new ADI. If a new ADI is reluctant to meet those expectations, APRA may take enforcement action.
- Heightened scrutiny of the adequacy of the new ADI's risk control and compliance frameworks. In particular, APRA will need to satisfy itself that new ADIs continue to invest adequate resources into improving these frameworks, and that they remain fit for purpose as the business expands.
- APRA may require a new ADI to commission an independent external review and/ or verification regarding business-critical matters (such as whether the ADI will be operationally ready to launch a product by its planned launch date, or whether the control environment remains fit for purpose). These external engagements will be conducted at the new ADI's expense, and their conclusions will be shared with APRA.

### 3.2.3 Exit Plan

While APRA seeks to reduce the likelihood of an ADI failing, to guarantee that failure will never occur would set undue barriers to entry and the orderly failure of an institution is a natural part of a competitive market. For new entrants the likelihood of failure may be higher during the early years of development so it is important for new ADIs to have credible and comprehensive exit plans to ensure that disruptions, including to depositors, are reduced and minimised should the new entrant fail. An exit plan is triggered when an ADI's board decides, or APRA determines, that it would no longer be prudent or appropriate for the ADI to continue to conduct banking business.

For most (but not all) established ADIs, the first and preferred option in their exit plan is a transfer of business. That is, an entity plans either to merge with another ADI or to solicit purchase by another party. Where the purchasing entity is itself an ADI, that would usually involve transferring the business of the vendor ADI to the purchasing ADI, and subsequently APRA revoking the ADI licence of the vendor ADI. Transfers where the purchasing entity is not itself an ADI (even where it is authorised by APRA in another industry) are possible, but more complicated. This is because there are additional assessment criteria and issues to consider before a non-ADI can purchase an ADI.

For new ADIs there are often significant challenges involved in putting an exit plan into effect. New ADIs are often loss-making, so the speed of capital burn may mean that any exit plan option needs to be effected within a tight timeframe. Arranging a merger with, or sale to, another party can be particularly problematic. In their early stages new ADIs may not have a large balance sheet or many saleable assets, and they may have customer liabilities well in excess of customer assets. Moreover, should a proposed transaction fail there may not be time to arrange an alternative partner.

APRA's expectation for a new ADI is that its exit plan will include a return of deposits option, even if that is one of several options. This option entails the entity repaying depositors from its own financial resources while remaining solvent throughout the depositor repayment period, and without reliance on the FCS. Once all depositors are repaid APRA would revoke the entity's ADI licence, because it is no longer conducting banking business. It may then continue as a going concern (perhaps as a non-bank lender) or enter into liquidation. Entities

should take care not to underestimate the operational complexities involved in a return of deposits option, especially where those deposits have been used to fund long-term assets.

Prior to granting a licence, APRA will explain its expectations regarding the circumstances which would trigger the activation of the exit plan. This is intended to give both parties clarity in advance about critical thresholds, which in turn will assist the board in determining its risk appetite and setting appropriate internal buffers. Should the circumstances outlined by APRA eventuate and the board fails or declines to activate its exit plan, APRA would consider the use of appropriate powers.

### 3.2.4 Deposit restrictions

For a new ADI, APRA must have confidence in its ability to put a return of deposits exit plan strategy into effect, if needed. APRA may require deposit restrictions while an ADI is subject to the adjusted prudential and supervisory approach for new ADIs. The intention is not to impede the prudent growth and development of the business; rather, it is to allow APRA to retain confidence in the likely efficacy of exit plan actions as the entity grows. Restrictions will be set on a case-by-case basis and may be varied at different points.

In determining appropriate deposit restrictions at any one point in time, considerations will include:

- APRA's overall estimation of the credibility of the ADI's exit plan, and of the staff, systems and processes in place to put it into effect.
- Recent trends in – and the current size and composition of – the ADI's balance sheet. Particular attention will be paid to any imbalances between the rate of growth in customer deposit products and customer asset products (such as loans).
- Recent trends in profitability, and any forecast rate of capital burn.
- The current mix between higher-transaction volume deposits (such as everyday banking accounts) and lower-transaction volume deposits (such as online savings accounts or term deposits).
- Interest rates paid on deposit products, and relativities to prevailing market rates.

Quantitative restrictions might include:

- A maximum aggregate amount of deposits, and/ or a maximum on specific deposit products.
- A maximum total number of deposit accounts outstanding, and/ or a maximum on specific deposit products.
- A maximum balance per account or per customer (for example, a limit of \$250,000 per customer would align with the FCS limit).
- A maximum *total customer deposits-to-total customer assets* ratio.



APRA will advise each applicant before the grant of a licence of any likely post-authorisation deposit restrictions. APRA will expect new ADIs to have processes in place, both to monitor adherence to any restrictions, and to take corrective actions to avoid breaching those restrictions.

### **3.3 Transitioning to the prudential and supervisory approach for established ADIs**

Over time, a new ADI will develop its business to a scale and maturity such that APRA determines that it is appropriate for it to be supervised in accordance with APRA's prudential and supervisory framework without adjustments (as for established ADIs).

APRA will use a number of objective benchmarks to guide its judgement on when a new ADI should transition to the prudential and supervision approach for established ADIs. Key considerations will be whether the ADI has established itself as a sustainable enterprise, whether the ADI can reasonably rely upon a transfer of business as a realistic exit plan option, whether its control environment is adequate, and whether it has a proven track record of operational effectiveness. A non-exhaustive list of metrics used would include:

- The range of products launched to-date
- Total balance sheet size, and any other business
- Number of customers with asset products
- Number of customers with liability products
- Cost-to-income ratio
- Surplus capital over PCR
- Projected time to break-even/ profitability (where not already achieved)
- Degree of reliance on additional capital raisings or organic capital generation to fulfil business plans
- Maturity and resourcing of risk management and control functions

# Chapter 4 - General requirements for all new entrants

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This chapter notes additional important matters that are relevant in setting up a new entrant, whether it goes via the restricted pathway or the direct pathway.

## 4.1 When can an entity call itself a 'bank'?

A financial business may not use certain restricted terms, including 'bank', 'banker', 'banking' and 'ADI' in Australia unless it has been granted consent or an exemption by APRA<sup>15</sup> under the Banking Act.

The purpose of restricting terms is to assure the public that a financial business using words like bank, building society, credit union or authorised deposit-taking institution is in fact authorised to carry on banking business. The intention is to limit the use of restricted terms by financial businesses that are not ADIs to very rare and unusual circumstances. The restriction also applies to words of similar meaning to the restricted terms (whether or not in English), and combinations with other words, letters or symbols (e.g. 'neobank').

A financial business is a business which consists of, includes or relates (in whole or in part) to the provision of financial services. If a financial business uses a restricted term without consent or an exemption from APRA, it is committing an offence and, if convicted, the court may impose a fine in respect of each day the business was in violation.

Once APRA has granted the applicant a licence it can use certain restricted terms in reference to its business and will be able to register a previously reserved company name with ASIC and call itself by that name, e.g. 'Applicant Bank Ltd'.

Restricted ADIs, although able to use restricted terms in reference to their business, will still need to make certain disclosures to make it clear to consumers that they are operating on a restricted licence, refer to Appendix B for more information on the specific disclosure requirements.

Related entities of an ADI or Restricted ADI may use restricted terms<sup>16</sup> in relation to the financial business carried on by the licenced entity, provided the terms are not used in a misleading way and it is clear the related entity is not itself licenced.

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<sup>15</sup> Or where a statutory exception applies, e.g. the Reserve Bank of Australia is permitted to use restricted terms without consent or approval from APRA.

<sup>16</sup> Restricted ADIs and ADIs are able to use the restricted terms 'ADI', 'bank', 'banker' and 'banking' without approval from APRA. However if they wish to use the restricted terms 'building society', 'credit union', 'credit society' or 'credit co-operative' in relation to their business they must apply to APRA for approval.

## 4.2 Structural considerations

For all ADIs, there are important factors that impact treatments under the prudential framework in relation to:

- capital structure;
- ownership structure; and
- legal structure (where the applicant is part of a group of companies).

Each of these will be examined in a licensing assessment or where changes are proposed once the ADI is operating.

### 4.2.1 Complexity and opacity

For each – capital, ownership and legal structure – an important consideration for APRA is complexity and opacity. Where any of these are, or are proposed to be, structured in a complex and/ or opaque manner APRA will need to understand the reasons for this. It will also take APRA longer to assess and approve complex or opaque arrangements; it may constitute grounds for the refusal of an application or changes may be requested before any approval will be granted.

Before making decisions regarding these matters, applicants and ADIs should consider whether the proposed level of complexity is necessary to meet their aims, and whether undue opacity can be avoided.

### 4.2.2 Capital structure

Capital is the cornerstone of an ADI's strength and it is important that it is available in times of need. The prudential framework has detailed requirements that ensure this. Entities will have issued capital ahead of obtaining an ADI licence and will usually be raising additional capital as the business grows.

Where this capital is structured without regard to the prudential requirements it can raise impediments to the capital being considered eligible under the prudential framework.

In assessing an applicant's capital structure or additional capital raise by a new entrant, a non-exhaustive list of considerations includes APRA satisfying itself that:

- There are no features which affect the eligibility for the class of capital (such as CET1) intended by the applicant. For example, careful consideration should be given before including features such as a special 'founders' share' tranche of capital or preference shares, which may impact the definition of other tranches of capital; and
- There are no written or verbal agreements, arrangements or understandings – whether included in the constitution/ shareholders agreement/ prospectus or elsewhere – relating to any aspect of the instrument which convey rights or establish expectations that might affect the eligibility for the class of capital intended by the applicant or new ADI; and

- There is either:
  - a) no need for the entity to apply for an exemption/ variation from the relevant prudential standard(s); or
  - b) a compelling justification for the entity to apply for an exemption/ variation from the relevant prudential standard(s), and that granting such an exemption/ variation would not be imprudent or create competitive advantages.

### 4.2.3 Ownership structure

The owners of an ADI can influence its strategy and play a key role in its access to additional capital support. Longstanding legislative frameworks govern requirements on the ownership of ADIs, with concentration requiring specific approval and an assessment under the national interest or a fit and proper test for some small applicants.

In assessing ownership structure, a non-exhaustive list of considerations includes APRA satisfying itself that it is clear:

- who the ultimate beneficial owners of the ADI are;
- that those who control or exert influence over the ADI are fit and proper to do so;
- whether one or more ultimate beneficial owners should be considered as associates under the *Financial Sector (Shareholdings) Act 1998*; and
- what level of reliance the ADI will be able to place on its shareholders for access to additional capital, if needed.

Applicants or new entrants should give careful consideration before creating structures where ownership is held through a cascading series of intermediate companies and/ or trusts, noting especially that it may be challenging to verify information about companies registered in some overseas jurisdictions.

### 4.2.4 Legal structure

The legal structure of a group has important impacts on how the prudential and supervisory framework applies to entities and key activities within the group. It can create impediments to supervision, the use of legal powers or resolution of key activities, or create competitive advantages in relation to how standards are applied.

In assessing an applicant's legal structure, a non-exhaustive list of considerations includes APRA satisfying itself that it does not:

- hinder APRA's ability to perform its role as a prudential supervisor.
- hinder APRA's ability to exercise its powers, including the power to issue Directions in relation to material activities of the business.
- impede APRA's line of sight over key activities.
- create undue dependencies on related-party entities.

- create circumstances where the ADI may need to support other members of the proposed group.
- hinder APRA's ability to resolve the entity if needed.
- seek to gain an unfair competitive advantage, for example through regulatory arbitrage.

APRA may advise an applicant or ADI that the proposed legal structure might be grounds for a refusal of the application, and that alternate structures should be considered. In addition, APRA may determine that it would be appropriate for the applicant or ADI to establish a Non-Operating Holding Company above the applicant / ADI, and make a second application for that Non-Operating Holding Company to be licenced.

# Attachment A: Summary comparison of ADI requirements and expectations

*Table 3. Comparison between requirements and expectations for Restricted ADIs, new ADIs and established ADIs*

Assessment Area	Restricted ADI	New ADI	Established ADI
<b>Business plan-themed</b>			
<b>Balance sheet size</b>	Not expected to grow significantly above \$100m	No specific expectations	No specific expectations
<b>Asset product launch</b>	Needs to achieve a limited launch of an income-generating asset product during the Restricted ADI phase	Needs to have achieved a limited launch of an income-generating asset product before being granted an ADI licence. Needs to achieve a full public launch of an income-generating asset product shortly after being granted an ADI licence	General expectations regarding new product process
<b>Deposit product launch</b>	Needs to achieve a limited launch of a deposit product during the Restricted ADI phase	Needs to achieve a full public launch of a deposit product shortly after being granted an ADI licence	General expectations regarding new product process
<b>Gap between deposit and asset product launches</b>	No specific expectations	Expectation of only a short gap between the full public launch of a deposit product and full public launch of an income-generating asset product	General expectations regarding new product process
<b>Deposit IT requirements</b>	Fit-for-purpose review and FCS file test prior to limited launch of deposits; FCS audit on live data post-launch	Fit-for-purpose review and FCS file test prior to full public launch of deposits; FCS audit on live data post-launch	General expectations regarding new product process
<b>Capital-themed</b>			
<b>Initial Capital</b>	\$3 million plus resolution reserve (typically set at \$1 million), plus Restricted ADI's forecast operational expenditure for the following three months	The higher of: <ul style="list-style-type: none"> <li>\$15 million; or</li> <li>ADI's forecast operational expenditure for the following nine months</li> </ul>	N/A
<b>Capital (PCR)</b>	Required to maintain, at all times:	Required to maintain, at all times, a PCR of: <ul style="list-style-type: none"> <li>\$10 million; or</li> </ul>	Percentage (as determined by APRA) of RWAs calculated in

Assessment Area	Restricted ADI	New ADI	Established ADI
	<ul style="list-style-type: none"> <li>\$3 million plus resolution reserve (typically set at \$1 million); or</li> <li>20 per cent of adjusted assets</li> </ul> <p>whichever is higher</p>	<ul style="list-style-type: none"> <li>ADI's forecast operational expenditure for the following six months, recalculated quarterly; or</li> <li>Percentage (as determined by APRA) of RWAs calculated in accordance with <i>APS 110 Capital Adequacy</i></li> </ul> <p>whichever is highest</p>	<p>accordance with <i>APS 110 Capital Adequacy</i></p>
Capital Conservation Buffer (CCB)	N/A	<ul style="list-style-type: none"> <li>Where PCR derived by operational expenses method, 25% of that amount;</li> <li>Where PCR derived by nominal amount method, \$2.5 million; or</li> <li>Where PCR derived by RWA method, 2.5% of RWAs</li> </ul>	2.5% of RWAs
Countercyclical Capital Buffer (CCyB)	N/A	<ul style="list-style-type: none"> <li>Where PCR derived by operational expenses method, a percentage of that amount depending on general CCyB applicable;</li> <li>Where PCR derived by nominal amount method, a nominal amount depending on general CCyB applicable; or</li> <li>Where PCR derived by RWA method, a percentage of RWAs as for all ADIs</li> </ul>	Percentage of RWAs as for all ADIs
Consequences of dipping into CCB	N/A	<ul style="list-style-type: none"> <li>Constraints on capital distributions</li> <li>Additional supervisory actions, may include pre-positioning actions to prepare for a potential activation of the exit plan</li> </ul>	Constraints on capital distributions

Assessment Area	Restricted ADI	New ADI	Established ADI
Composition of capital	All CET1	All CET1	As per <i>APS 110 Capital Adequacy</i>
Liquidity	Required to maintain, at all times: <ul style="list-style-type: none"> <li>MLH at the higher of 20 per cent of liabilities; or</li> <li>the value of protected accounts and stored value at risk (if applicable) plus an amount equal to the resolution reserve</li> </ul>	Required to maintain, at all times: <ul style="list-style-type: none"> <li>MLH as set by APRA; or</li> <li>Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) in accordance with <i>APS 210 Liquidity</i></li> </ul>	Required to maintain, at all times: <ul style="list-style-type: none"> <li>MLH as set by APRA; or</li> <li>Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) in accordance with <i>APS 210 Liquidity</i></li> </ul>
Exit plan -themed			
Exit plan options	Primary focus on return of deposits	Must include a return of deposits option	Credible strategy agreed with APRA
Exit Plan trigger points	APRA to convey expectations for appropriate trigger points	APRA to convey expectations for appropriate trigger points	General guidance
Deposit restrictions	<ul style="list-style-type: none"> <li>Maximum aggregate amount of \$2m</li> <li>Maximum \$250,000 per customer</li> </ul>	Set case-by-case and variable but may include: <ul style="list-style-type: none"> <li>maximum aggregate deposit amount, and/or maximum amount per deposit product</li> <li>maximum total number of deposit accounts, and or maximum number per deposit product</li> <li>maximum balance per deposit account</li> <li>maximum <i>total customer deposits-to-total customer assets</i> ratio</li> </ul>	On an exceptions basis only
Type of customer	Staff, their families and friends only. Not general public	Any, including general public	Any, including general public
Design features			
Eligibility	<ul style="list-style-type: none"> <li>Not compulsory</li> <li>Not all applicants will be eligible</li> </ul>	All new ADIs will be supervised in this manner, even if only for a short period	N/A
Time limited?	Yes – 2 years	No – but generally 1-5 year period	No



Assessment Area	Restricted ADI	New ADI	Established ADI
Special disclosure requirements?	Yes – must disclose to customers that entity is a Restricted ADI	No	No
Prudential Standards	Met on a modified basis	Met fully, as applicable to business model	Met fully, as applicable to business model
Governance	Minimum two independent directors	Majority independent Board	Majority independent Board
Reporting requirements	<ul style="list-style-type: none"> <li>Exempted from most standard reporting requirements</li> <li>Special reporting requirements apply</li> </ul>	<ul style="list-style-type: none"> <li>Full range of standard reporting requirements</li> <li>Additional specific reporting requirements</li> </ul>	Full range of standard reporting requirements
APRA's supervisory approach	Special supervisory approach	Adjusted supervisory approach to reflect unique characteristics of new ADIs	Regular supervisory approach
Exit thresholds	<ul style="list-style-type: none"> <li>Meets prudential requirements for ADI on a proportionate basis</li> <li>Has achieved a limited launch of an income-generating asset product</li> <li>Has achieved a limited launch of a deposit product</li> </ul>	Determined by APRA, based primarily on an assessment of whether ADI has established itself as a sustainable enterprise	N/A

# Attachment B: Restricted ADI Prudential Framework

This appendix details the concessions to the ADI prudential framework for Restricted ADIs.

## Prudential standards

Table 4: Prudential Standards summarises how APRA's ADI Prudential Standards apply to Restricted ADIs at the point of licensing<sup>17</sup>. APRA will discuss the specific application of the prudential standards with each applicant as they may differ depending on the proposed business model.

Restricted ADI applicants are only expected to comply with certain provisions of modified standards at the point of licensing. Further information is given on how the modified standards apply below, and in the guidelines – Licensing: Locally incorporated ADIs.

As a Restricted ADI progresses through the restricted phase, it will be expected to implement its strategy to transition to an ADI licence in parallel with compliance with the full prudential framework applicable to each milestone. For example, before a Restricted ADI commences a limited launch of deposits it must have demonstrated it meets the requirements of *Prudential Standard APS 910 Financial Claims Scheme*.

**Table 4. Prudential standards**

Prudential Standard	Applies in Full	Modified	Not Applicable <sup>18</sup>
APS 110 Capital Adequacy		✓	
APS 111 Capital Adequacy: Measurement of Capital		✓	
APS 112 Capital Adequacy: Standardised Approach to Credit Risk			✓
APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk			✓
APS 114 Capital Adequacy: Standardised Approach to Operational Risk			✓

<sup>17</sup> While Table 4 is accurate at the date of publication of this information paper, prudential standards may change title or number over time. In addition, new prudential standards may be introduced or existing ones retired. Refer to APRA's website [www.apra.gov.au](http://www.apra.gov.au) for an up-to-date list of applicable prudential standards.

<sup>18</sup> Depending on a Restricted ADI's business model, APRA may decide that a prudential standard is not applicable to the Restricted ADI.

Prudential Standard	Applies in Full	Modified	Not Applicable <sup>19</sup>
APS 115 Capital Adequacy: Advanced Measurement Approaches to Operational Risk			✓
APS 116 Capital Adequacy: Market Risk			✓
APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book			✓
APS 120 Securitisation			✓
APS 180 Capital Adequacy: Counterparty Credit Risk			✓
APS 121 Covered Bonds			✓
APS 210 Liquidity		✓	
APS 220 Credit Quality			✓ <sup>19</sup>
APS 221 Large Exposures		✓	
APS 222 Associations with Related Entities		✓	
CPS 226 Margining and risk mitigation for non-centrally cleared derivatives			✓
APS 310 Audit and Related Matters	✓		
APS 330 Public Disclosure			✓
CPS 220 Risk Management	✓		
CPS 231 Outsourcing		✓	
CPS 232 Business Continuity Management		✓	
CPS 234 Information Security		✓	
CPS 510 Governance		✓	

<sup>19</sup> Assuming the Restricted ADI applicant does not have an existing credit business. Restricted ADIs will be required to meet APS 220 prior to extending credit.

Prudential Standard	Applies in Full	Modified	Not Applicable <sup>8</sup>
CPS 511 Remuneration <sup>20</sup>	✓		
CPS 520 Fit and Proper	✓		
APS 910 Financial Claims Scheme			✓

### APS 110 Capital Adequacy

A Restricted ADI is required to meet a minimum Prudential Capital Requirement of either \$3 million plus resolution reserve (set at \$1 million unless otherwise notified by APRA), or 20 per cent of adjusted assets –whichever is higher.

A Restricted ADI is required to have a capital management plan which is proportionate to its size and complexity and its activities during the restricted phase.

### APS 111 Capital Adequacy: Measurement of Capital

A Restricted ADI must meet its entire capital requirement as Common Equity Tier 1 Capital. A Restricted ADI will be required to make all necessary regulatory adjustments to its capital under Attachment D to APS 111 from its CET1.

APRA will agree the type and ratio of eligible capital for a mutually owned Restricted ADI on a case-by case basis.

### APS 112 Capital Adequacy: Standardised Approach to Credit Risk

A Restricted ADI will calculate its Prudential Capital Requirement as a simple percentage of adjusted assets. The calculation of risk weight-based capital under APS 112 will therefore not be applicable, unless otherwise notified by APRA.

The residential mortgage lending criteria detailed in paragraphs 1-2 of Attachment D to APS 112 will apply to Restricted ADIs conducting mortgage business.

### APS 114 Capital Adequacy: Standardised Approach to Operational Risk

A Restricted ADI will calculate its Prudential Capital Requirement as a simple percentage of adjusted assets. APS 114 will therefore not apply, unless otherwise notified by APRA.

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<sup>20</sup> CPS 511 Remuneration was being consulted on as at the date of this paper.

### **APS 116 Capital Adequacy: Market Risk**

A Restricted ADI will calculate its Prudential Capital Requirement as a simple percentage of adjusted assets. APS 116 will therefore not apply, unless otherwise notified by APRA.

### **APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book**

A Restricted ADI will calculate its Prudential Capital Requirement as a simple percentage of adjusted assets. APS 117 will therefore not apply, unless otherwise notified by APRA.

### **APS 120 Securitisation**

A Restricted ADI is not permitted to undertake any securitisation business during the restricted phase as it is not considered to be a lower risk business. APS 120 will not therefore apply unless otherwise notified by APRA.

### **APS 121 Covered Bonds**

A Restricted ADI is not permitted to issue covered bonds. APS 121 will not therefore apply unless otherwise notified by APRA.

### **APS 180 Capital Adequacy: Counterparty Credit Risk**

A Restricted ADI will calculate its Prudential Capital Requirement as a simple percentage of total adjusted assets. APS 180 will therefore not apply, unless otherwise notified by APRA.

### **APS 210 Liquidity**

A Restricted ADI must meet an MLH requirement of the higher of: 20 per cent of liabilities; or the total value of protected accounts plus 100 percent of stored value at risk (if applicable) plus the resolution reserve of \$1 million (or higher as determined by APRA).

Liabilities and liquid holdings are defined in Attachment B of APS 210. Attachments A and C will not apply to a Restricted ADI.

A Restricted ADI must have a liquidity risk tolerance and a liquidity management strategy proportionate to its business model during the restricted phase.

### **APS 220 Credit Quality**

A Restricted ADI which does not have an existing credit product will not be obliged to meet the requirements of APS 220 prior to licensing. Restricted ADIs which intend to launch a credit product (as part of their limited launch of an income-generating asset product) will be required to meet APS 220 in full prior to the launch.

A Restricted ADI is expected to adhere to the Australian Accounting Standards AASB 9 for recognition of impairment losses on financial assets.

### **APS 221 Large Exposures**

The large exposure limits in APS 221 will apply to a Restricted ADI. However, the limits will be measured against CET1 capital.

The prior consultation requirement for large exposures greater than 10 per cent of the Restricted ADI's CET1 capital will not apply. However, a Restricted ADI must provide notification to APRA no later than one business day after entering into a large exposure of greater than 10 per cent, including demonstration that the exposure has not resulted in excessive risk under all reasonable circumstances.

### **APS 222 Associations with Related Entities**

The related entity exposure limits in APS 222 will apply to a Restricted ADI. However, the limits will be measured against CET1 capital.

Unless otherwise notified by APRA, Attachment A will not apply as APRA will not usually grant an Extended Licensed Entity approval to a Restricted ADI.

### **CPS 226 Margining and risk mitigation for non-centrally cleared derivatives**

A Restricted ADI is not permitted to deal in derivatives. CPS 226 will therefore not apply unless otherwise notified by APRA.

### **APS 310 Audit and Related Matters**

Restricted ADIs are expected to meet and continue to meet on an on-going basis the full requirements of APS 310. External auditors will be expected to provide assurance against a Restricted ADI's compliance with the applicable Restricted ADI reporting and prudential requirements.

### **APS 330 Public Disclosure**

APS 330 will not apply to a Restricted ADI, instead it will need to meet specific disclosures that apply to Restricted ADIs.

### **CPS 220 Risk Management**

A Restricted ADI will be expected to meet CPS 220 on a proportionate basis. The Restricted ADI will be expected to demonstrate that its risk management framework is appropriate and that it has adequate systems and controls in place to monitor and manage the risk it is exposed to during the Restricted ADI phase.

A Restricted ADI must maintain an exit plan and a strategy to ADI licence as part of its risk management framework.

Restricted ADIs will be exempt from the requirement for a comprehensive review of their risk management frameworks by operationally independent persons, however they will be expected to assess whether any amendments or review are necessary where a material change to the size, business mix or complexity of their operations is identified.

### **CPS 231 Outsourcing**

A Restricted ADI must be able to demonstrate to APRA as a minimum that any outsourcing arrangements for material business activities that impact on the strategic plans during the

restricted phase meet the requirements of CPS 231. A restricted ADI must also ensure it manages and monitors each outsourcing relationship at all times.

### **CPS 232 Business Continuity Management**

APRA expects the Restricted ADI to meet customer obligations in the event of a disruption. As a minimum, the Restricted ADI must demonstrate it has considered its exposure to, and has developed response plans for, plausible disruption scenarios to its business operations which are commensurate with the nature, size and complexity of its operations. This may be incorporated in scenario analyses or exit plans.

### **CPS 234 Information Security**

A Restricted ADI must be able to demonstrate to APRA, as a minimum, that the entity maintains information security commensurate with the size and extent of threats to its information assets during the restricted phase.

### **CPS 510 Governance**

CPS 510 will generally apply to Restricted ADIs. However, acknowledging that some Restricted ADIs may be using the restricted phase to finalise executive appointments and staff recruitment, certain concessions will be made to specific requirements.

- Instead of a majority of independent directors, Restricted ADI Boards require:
  - a) a minimum of two independent directors at all times;
  - b) one independent director to be eligible and present to vote at all board meetings.
- A Restricted ADI is not required to have established board committees. The responsibilities of these committees under CPS 510 will be responsibilities of the Board, with the exception of the remuneration committee whose responsibilities will be the responsibilities of the non-executive directors.
- A Restricted ADI is not be required to have in place a policy for Board renewal or procedures for assessing Board performance.

### **CPS 511 Remuneration**

Restricted ADIs are expected to meet, and continue to meet on an on-going basis, the full requirements of CPS 511 Remuneration.

### **CPS 520 Fit and Proper**

Restricted ADIs are expected to meet, and continue to meet on an on-going basis, the full requirements of CPS 520 Fit and Proper.

### **APS 910 Financial Claims Scheme**

Prior to its limited launch of deposit taking products, Restricted ADIs will be required to meet the requirements of APS 910.

Once a Restricted ADI has commenced its limited launch of deposits and has a meaningful number of accounts APRA will use its powers under paragraph 29 of APS 910 to require Restricted ADIs to engage an auditor to undertake a limited assurance engagement of its Single Customer View (SCV) systems and data, and the systems used to generate and transmit FCS payment and reporting information prior to commencing deposit taking activities.





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