Response to APRA's Discussion Paper: Phased Licensing for Authorised Deposit Taking Institutions

30th November 2017

Opening Comments

APRA's initiative on the provision of phased licensing for Authorised Deposit taking Institutions (ADI's) is a unique and timely opportunity to create meaningful and sustainable competition in the Australian Financial System. These policy changes must however facilitate the emergence of genuine alternatives, that better support Australian businesses, their opportunities for growth and innovation, and in so doing underpin the strength of the Australian economy. For this to be achieved the phased licensing process needs to accommodate the full spectrum of possible business models (e.g. smaller niche fintech's to new mainstream challenger banks) that are collectively required to challenge the dominant market share of the incumbents. These policy changes must equally provide a clear and systematic approach to registration that facilitates the capital raising process, overcoming the paradox of seeking investment in the pre-revenue stage of an ADI business model, without the certainty that that ADI will be obtained and/or how much investment might be required as part of the application process. By way of example, many global private equity firms looking to invest in Australian Challenger banks pre-revenue, will be familiar with the now well tested process in the UK that has seen over 30 banking licences granted since 2010 and as such will want the same degree of comfort afforded by a clear set of processes and milestones that lend themselves to confirmatory due-diligence and the resulting assurance that an ADI licence will be forthcoming.

There is no doubt we have a dire need for genuine competition in the Australian banking system, especially the underserved Small-to-Medium Enterprise (SME) sector. SMEs are hugely reliant on banks generally and the major banks particularly who account for ~85% of all SME lending. The absence of meaningful competition in the SME banking sector has seen the banks move away from providing the quality and consistency of service the SME sector would naturally expect and deserve. Consequently, SME satisfaction with the big four banks has deteriorated to a 30-year low and many predict it will never recover. The economic cost of a banking system that is unsupportive of SMEs is evidenced by the estimated 'credit gap' in unmet SME credit demand in Australia of c. \$50-\$70bn[1] leaving SMEs now largely reliant upon their own capital to fund business growth. Alternatives outside of this have seen an increase in the shadow banking sector to fill this gap, however their continued growth could potentially have a destabilising effect on the financial system due to the unregulated nature of their business models. Fin-tech and working capital cash-flow lenders are some other new entrants that have been welcomed and supported by recent regulatory changes, but typically their business models and restricted product range do not enable them to offer a meaningful solution to the significant funding needs of SMEs and thus do not represent genuine competition to the incumbent banks.

[1] Computer Says Yes – Macquarie Research 2015

As a new *"Challenger"* to the Australian banking market whose specialist relationship driven customer focussed service proposition has been purpose-built to focus solely on SMEs, Judo is supportive of APRA's intent to enable more competition to the incumbent banks. However, we believe the changes to date do not fully cater to the breadth of business models coming to market and therefore do not achieve the goal of providing genuine alternatives to the incumbent banks. Outlined below are three key areas we have addressed for your consideration, that if adopted would positively impact the outcomes of this important initiative:

1. One size *does not* fit all - applicants are not a homogenous group
2. Reduce the disparity in capital treatment
3. Improve regulatory proportionality and reduce complexity

1. One size *does not* fit all

Judo acknowledges the primary objectives that APRA has defined in its discussion paper, particularly noting the competitive neutrality goal where it is stated that "*The proposed phased approach to licensing is targeted at a specific contingent of potential applicants – specifically those who need time to build resources and capabilities"*, however Judo believes that this aspect potentially overlooks the diversity of the applicants, and assumes they face similar market dynamics. The proposed changes do not address the fact that applicants may be applying at different stages of business maturity and with different financial model, and most importantly with substantially different capitalisation and markedly different ability to access further equity capital.

As with the experience of the "*Challenger banks*" in the UK, it is expected that as the Australian market responds to these initiatives we will notice a similar level of diversity. It is expected that the Australian "*Challengers"* will have different models, offerings, strategies, and aspirations, with a common goal to supply specific products and services to carefully targeted segments and under-serviced parts of the market. We will see digital-only banks built on innovative technology platforms, specialised banks targeting very specific market segments, and non-bank brands with parent companies that are strong in other industries.

The proposed changes appear to favour those business models that are based around innovative technology platforms as the foundation of their approach to the market, and those that are at a very early stage of development in their operating model who require an extended period to build out their prudential frameworks and meet all the capital hurdles. The requirement to hold 12 months operating expenses as part of capital for an applicant's exit strategy would seem to be orientated to new start-ups who are not actively conducting business and have a modest expense base. This may be overly harsh for well capitalised more substantial operating business if applied strictly.

The proposed approach does not appear to cater to those business models that are more advanced in their stage of business maturity or have a stronger capital base, or are currently operating in the financial services sector. It does not acknowledge that their systems, capabilities and resourcing may be more advanced in their development and therefore capable of operating with a higher threshold for deposits (i.e. >$2M) or reduced capital and liquidity requirements below the 20% hurdle proposed during the restricted phase.

A potential solution would be to provide multiple conditions or classes of restricted licences to reflect the diversity of applicants, the different stages of business maturity, or varying levels of capital, or access to capital. Whilst this may impact the goal of competitive neutrality, it would also encourage those applying for a licence to seek higher levels of capital than the minimum of $3M.

The table below, details a possible approach to enable new bank entrants to fully maximise the restricted ADI process, with consideration to their size and operational readiness.

Potential Categories for Restricted Licence Phase

Categories	Stage	Policy Response
New Start-up	Capital <$10M and/or systems, policy and process low level of maturity	Higher levels of Liquidity and Capital and constraints on deposits in line with recommendations in discussion paper
Advanced Start-up	Capital>$50M and/or systems, policy and processes medium level of maturity	Lower levels of Liquidity and capital and higher level of deposits than new start up
Existing Business	Those currently fully operational and with capital>$50M systems, policy and processes with high level of maturity	Capital and Liquidity requirements approaching those of full ADI and higher level of deposits than advanced start up

2. Reducing the disparity in treatment of capital

The lack of access to finance for SME's to fund business growth has been a trend since the GFC as the Banking sector has sought to de-risk their portfolios. The potential economic ramifications of this trend have been discussed by the Reserve Bank who have expressed concerns around overly restrictive lending practices to this segment. Guy Debrelle has recently been quoted saying "While finance is readily available for large companies, either through the banking system or capital markets, our liaison with smaller enterprises indicates the availability of finance is a much more binding constraint." [2] He also added that "Banks reluctance to back small firms that wanted to expand had major economic implications because small business account for a pretty large chunk of overall investment spending in the economy." [3]

In the main, Judo is supportive of the ongoing requirements and restrictions that need to be complied with whilst holding a restricted licence, and expects to maintain appropriate capital resources, to ensure stability and to match our risk profile. However as noted above the proposed 20% leverage ratio to calculate capital penalises those applicants with a higher asset base at the time of application e.g. $2m of deposits on a $3M capital base is 66% as opposed to 2% on a base of $100M. The simplicity of this approach is appreciated; however, this also potentially limits the growth for those businesses that are actively trading in other aspects of financial services whilst in the restricted phase, as capital requirements will continue to grow as the asset base/lending book grows, however liabilities will remain stagnant during this period.

[2] Guy Debrelle Deputy Governor Reserve Bank of Australia

[3] AFR "Scott Morrison misses his chance to force the big four to do more for small business" 27/11/17

Noting that the 20% capital requirement is all to be held as CET 1, this is a significant disparity to the average CET1 capital held by smaller ADIs in Australia, and above total capital ratios, which are noted in the table below:

Pillar 3 Capital Disclosures Regional Australian Banks

Bank	Date	CET1 Ratio	Total Capital
Auswide	30 June 17	12.1%	14.4%
Members Equity	30 June 17	10.1%	14%
MyState Bank	31 March 17	11.1%	13.1%
Heritage Bank	30 June 17	12%	13.4%

Judo understands it is important to establish a minimum capital base and is supportive of a minimum of $3M (plus wind-up costs) to ensure the ongoing financial safety and depositors are protected, however we would like to recommend changes to the simple leverage calculation to reflect the capital base, the business and systems maturity and current level of business activity.

Judo would recommend this simple leverage ratio, during the restricted phase be a range from a minimum of 15% to 18% to reduce the capital disparity and to reflect it is held against total assets not RWAs. This amount is still higher than both the CET1 and total capital held by the above-mentioned institutions. However, we acknowledge the policy objective to set the higher minimum is reflective of the increased risk for applicants during the restricted phase. The assessment of the amount would be at APRAs discretion and would reflect, amongst other things, the capital base of the applicant, the size of the new applicant, the maturity of their systems and capabilities and that they are unlikely to be of systemic importance, having regard to the fact the new restricted licence holders are of a limited size. This would also provide APRA with the financial safety it desires during the restricted phase, as well as competitive neutrality.

Judo supports the creation of greater competition whilst protecting the integrity of the banking system and believes this is an 'AND" not an OR' proposition. i.e. greater competition and a strong banking system.

3. <u>Improve regulatory proportionality and reduce complexity</u>

The proposed phased approach will allow operations under a simplified regulatory framework, however to obtain an unrestricted ADI an applicant must be able to comply with the full regulatory framework (on a proportionate basis) by the end of the restricted phase or within the timeframe of 2 years. The current documents do not provide clarity as to the extent of the proportionate requirements and which areas will be adjusted for new entrants to enable the applicant to build the appropriate scaled frameworks during this period.

The regulatory environment across Australia's 3 main regulatory bodies remains diverse and complex, and even the incumbent organisations, who have had over 100 years and significantly more resources can find the environment overwhelming. Ken Henry, the Chairman of National Australis Bank and former Head of Treasury has recently commented on the increasing levels of regulation and the impact of Boards and directors. His view was that levels of regulation were continuing to increase.[4]

Judo is not advocating for a lowering of regulatory or prudential standards, but to allow greater flexibility in approach for smaller and newer entrants who are not considered to be systemic, have a sound risk management framework and have an approved exit strategy.

During the restricted phase the capital and liquidity frameworks have a simplified approach and Judo would recommend that this approach be continued for a transition period for a minimum of 12 months.

Judo would also recommend that as an organisation transitions from restricted to full ADI, APRA should consider transitionary capital arrangements to allow the newly authorised entity to avail of some capital concessions for another 2-year period. This may take the form of an extended period to build the Capital Conservation Buffer e.g. 1 % in first 12 months building to 2.5% by year 2. This would be independently assessed by APRA based on the systemic importance of the entity and their comfort that in the event of an exit being required, this could be resolved in an orderly manner. It is expected that APRA would impose restrictions on the entity during this period which could include a dividend restriction.

Judo would also recommend a reduction in proposed MLH of 20% to 16-17% depending on APRA's assessment of the applicant, the proposed exit strategy and ongoing business model. This range is more reflective of MLH holdings by other institutions in Australia excluding those on LCR, and is substantially higher that APRA's minimum requirement of 9%.

Liquidity Holdings MLH Institutions[5]	June 16	June 17
Other Domestic Banks	15.2%	15.2%
Banks	15.5%	15.6%
ADIs	15.4%	16%

Judo recommends a simplified and proportionate framework using size and complexity of entity to set thresholds. This would provide greater clarity for potential new entrants and investors.

Concluding remarks

Wayne Byres in a recent speech to COBA raised the challenges for regulators in meeting competing demands. He noted "…a desire for a regulatory framework that appropriately differentiates across the diversity of ADIs, and (simultaneously) a desire to avoid differences in regulation creating competitive inequalities when different classes of ADIs compete against each

[4] The Australian "Regulation Overwhelming Bank Boards" November 2017

[5] Quarterly Authorised Deposit Taking Institution Performance June 2017

other. Put more simply, there are few advocates for a 'one size fits all' approach, but equally everyone wants a level playing field." [6]

This challenge will extend to the implementation of the framework for a phased approach to licensing. APRA needs to fine tune the objectives of balancing financial safety and stability and meeting other objectives, including playing a role in the broader economy by easing the navigation of the licensing process to increase competition.

It is critical that new entrants are not constrained from growing their businesses during the restricted phase and to achieve this it is important that this new approach does not operate a zero-failure regime, but rather, noting that restricted licence holders will be closely monitored, should ensure that exit plans are well defined, and any failures are managed in an orderly manner. In this way APRA will achieve the balance in the mandate that they are seeking.

The banking system in Australia has transitioned to one with a bias on property-based lending, rather than the core functions of a bank to intermediate capital to sectors of the economy to finance expansion in productive assets and economic activity. Given the challenges this presents for SME's there is an opportunity in following economist John Kay's advice to the British government on its banking sector: "perhaps the most useful initial role of government is to promote the creation of new financial institutions directed to providing the mix of loan and equity finance and advice to help SMEs grow."

There are times when active government intervention to facilitate greater competition is a legitimate policy response, and it is encouraging to new entrants such as Judo, that the proposed regulatory changes have opened the door for the emergence of genuine competition to better support Australian businesses. These regulatory changes must be real, clear and applicable to all business models (not just fintech's) to generate genuine competition to the stranglehold the banks have on the entire market. Genuine competition for the core activity of lending to SMEs with the breadth of facilities they require available to them is the only meaningful intervention that will deliver the full impact that SME businesses in Australia deserve.

About Judo Capital – 'Banking as it used to be; banking as it should be'

Built by some of Australia's most experienced bankers and modelled in part on the UK Challenger Banks (Aldermore www.aldermore.co.uk, Shawbrook www.shawbrook.co.uk and Oaknorth www.oaknorth.co.uk) Judo Capital is a *purpose-built Challenger* (not a Fintech) focussed solely on the SMEs, that has come to market to address the growing dissatisfaction with, and the gaps inherent in the offerings of the incumbent banks. It is Judo Capital's intention to apply for a restricted banking licence in 2018. Details on Judo Capital can be found at www.judocapital.com.au.

[6] Individual Challenges and Mutual Opportunities – Wayne Byres Key Note Address at COBA 2017-Customer Owned Banking Association convention October 2017