Xinja's Response to the APRA Discussion Paper "Licensing: A phased approach to authorising new entrants to the banking industry".

Submitted via licensing@apra.gov.au

November 2017

Introduction

Xinja welcomes the opportunity to respond to the *"Licensing: A phased approach to authorising new entrants to the banking industry"* APRA Discussion Paper. Xinja commends APRA for meeting with a number of industry stakeholders, including Xinja and the open nature of those initial conversations.

Xinja acknowledges APRA is an independent statutory authority established for the purposes of prudential supervision of financial institutions and for promoting financial system stability in Australia. In performing this role, APRA is responsible for, in particular, protecting the interests of depositors, insurance policyholders and most superannuation fund members – collectively referred to as APRA's beneficiaries. Protecting the financial interests of these beneficiaries lies at the centre of APRA's mission.

Xinja is building Australia's first neobank, designed to be 100% digital and made entirely for mobile, from the ground up with customer interests at heart. We are not a bank yet, but we want to be. Xinja is hoping to work in partnership with APRA and ASIC to become a bank and obtain an AFSL, ACL and banking licence. This will enable Xinja to provide a full range of retail banking products and services (eg. prepaid debit card, savings accounts and home loans). Having recently completed our Seed Funding Round and now in our Series B funding round, we are keen to share our experience of becoming a new entrant to the Australian banking system.

Xinja was created with the belief that it's time for Australians to enjoy the benefits of banking competition, innovation and quality of service already enjoyed by customers in other parts of the world. Despite Australia's high level of mobile technology adoption, Australians haven't been able to fully embrace the possibilities of innovations such as real time payments, digital wallets, big data, open APIs, artificial intelligence and machine learning. While consumers in the US and UK are already benefiting from new capabilities brought by neobanks and digital challenger banks, Australian customers have told us they still struggle with even the simplest of banking needs. It is our belief that a more competitive banking sector will encourage investment in new entrants and make much more possible for Australian consumers and businesses when it comes to dealing with their banking and their money.

Financial institutions that take customer deposits and conduct banking business occupy a unique position of trust within the community. The financial safety of these institutions is key to the financial stability and economic well-being of the community and, as a result, these institutions are subject to higher standards than in many other sectors of the economy. This includes higher entry standards to the industry, such as legislation which requires APRA to license an institution before it can conduct business in a prudentially-regulated sector.

Xinja respects this sacred position in the community and intends to strengthen the financial services sector and will never forget that banking is all about dealing in units of trust. Trust is hard to earn and easily lost.

Xinja appreciates the delicate balance between APRA allowing new entrants into the banking industry whilst maintaining the standards that have made Australia a renowned economy with robust regulation around the world.

APRA consultation questions:
Introduction of a phased approach for ADIs
Should APRA establish a phased approach to licensing applicants in the banking industry?

Xinja strongly supports APRA establishing a phased approach to licensing applicants in the banking industry. This will foster increased competition, exciting innovation, better customer outcomes - all whilst maintaining the strength and stability of the Australian financial sector.

Balance of APRA's mandate
Do the proposals strike an appropriate balance between financial safety and considerations such as those relating to efficiency, competition, contestability and competitive neutrality?

Xinja believes the proposals generally do strike an appropriate balance, although there are some elements that could be further refined as outlined in this submission.

The ability to be able to conduct banking business in the Australian market is an honour and a privilege. With privilege comes responsibility. Xinja takes this very seriously and so should others who choose to apply to become a Restricted ADI. APRA has outlined a proposed process that strikes the equilibrium and balance between efficiency, competition, contestability and competitive neutrality. The measures are not easy to satisfy, and nor should they be. Australians have been arguably let down in recent years by the incumbent banks. This is not good enough and consumers deserve better. APRA should make applicants justify their business case and organisational competence. New applicants should be endeavouring to raise the bar in banking, actively contribute to making banking better again for customers.

Eligibility
Are the proposed eligibility criteria appropriate for new entrants to the banking industry under a Restricted ADI licence?

APRA have proposed initial eligibility criteria around Governance, a Business Plan, an approach to meet the full prudential framework, Capital, Fit & Proper requirements, Risk Management, an Exit Plan, Financial Claims Scheme (FCS) systems & reporting and other requirements including documenting procedures and audit requirements - these all make sense and are fundamental elements of running a sustainable banking business.

In terms of **Governance**, in particular, the 'tone from the top' that the Board sets is the foundation of establishing a culture of active risk management and ethical conduct. Reporting is another element that should be in place to help ensure Management have a firm control of their operations and are not putting the interests of customers at jeopardy.

A **Business Plan** demonstrates that the applicant has thought through their proposed operations and has adequate systems and processes in place to run the business. A Business Plan would naturally contain market analysis, customer needs being addressed by the applicant, key risks & mitigants and future aspirations to give APRA comfort of the ongoing viability of the applicant.

An approach to meet the full prudential framework, is important to restore competitive neutrality so that new participants are not seen to be unfairly benefited in the eyes of consumers and competitors. This will need to be on a case by case basis as every organisation is different.

A bank's **Capital** standing and ongoing management is a core competence of being able to run a bank. Although it will be initially challenging to raise adequate capital, new participants should be aspiring to be 'unquestionably strong' to help ensure the long term financial stability of the sector. This of course will take time. Further detail is outlined in the question below.

Fit & Proper requirements need to be maintained so that applicants maintain ethical standards and the integrity of the industry. People make a business and the people in a bank are entrusted to maintain operating competence at all times. It is noted that those applying for a Restricted ADI would generally also be applying to ASIC for and AFSL and ACL, so although there may be some duplication between requirements from regulators, a more is better approach to this important area should be maintained.

Naturally, **Risk Management** and embracing the APRA CPS 220 Standard are crucial to a successful business. New applicants must maintain adequate resourcing and systems in all material risk categories and compliance. Initially it may be challenging to meet every single requirement of the Risk Management Standard, but within a few years of operations all new Restricted ADIs / Conditional ADIs / full ADIs should openly embrace CPS 220. It has been the view of the Xinja Chief Risk Officer, since its inception, that CPS 220 is one of the best and most practical Standards written by APRA. CPS 220 not only helps with Risk Management principles, but also business practices. In a post GFC financial services sector, Risk Management has never been more important. New innovation also creates an opportunity to enhance risk management. There is more data available than ever before, systems should be seamlessly interconnected and decision making processes more robust to actively analyse the risk vs reward equation. The risk management culture of a new entrant is also something that can be shaped and become a competitive advantage. There is no excuse not to build a team that understands the risks they are taking, asks the rights questions and walks the walk on risk culture.

An **Exit Plan** or 'Plan B' helps to limit the potential system risk, customer impact and international reputational damage should a Restricted ADI fail (or show strong signs that it may). A 'menu of options', whether that be simply giving back depositor money or merging (or being acquired) by an existing ADI should all form part of this Plan. In reality, at least in the early stages, an Exit Plan should be relatively straight forward. If a Restricted ADI is only able to take $250,000 from an Individual and $2 million in aggregate, the exposure is limited. Applicants for a Restricted ADI would naturally be discussing their business (and Exit Plan) with existing players who would no doubt be keen to take on additional customers should a Restricted ADI fail. Also, as the businesses applying to become a Restricted ADI would typically be small in the early stages, Management should know exactly the state of their business and be able to take swift action from the 'menu of options' to remedy the situation, whether that be by giving back depositor money or merging with an existing ADI.

Financial Claim Scheme (FCS) systems and reporting - should be theoretically quite easy to maintain for a new applicant as there would be no legacy customer data to cleanse and a Single Customer View (SCV), at least in the early stages, would be a simple output from most Customer Relationship Management (CRM) or core banking systems. APRA has made the FCS requirements very accessible and new (and existing) core banking systems can generally produce this output with minimum effort. The FCS SCV output may need to be extracted simply in excel format but should be accessible.

Other requirements, such a Policies & Procedures will be important to help ensure staff with an applicant are aware of their Compliance and business requirements. Financial reporting and associated auditing is standard for financial institutions and strengthens culture from an early stage. Naturally Policies and Procedures will take time to develop and embed into the business.

Restricted ADI Licence phase

Is two years an appropriate time for an ADI to be allowed to operate in a restricted fashion without fully meeting the prudential framework? Is two years a sufficient period of time for a Restricted ADI to demonstrate it fully meets the prudential framework?

Xinja would obviously endeavour to move off a Restricted ADI as soon as possible, but having modelled this in detail, a 2 year time period would increase risk on Xinja to grow quite rapidly in the first years of operations when it would much prefer to target sustainable growth over a slightly longer period.

Xinja has taken APRA through its detailed financial model to show the 3 year Business Plan.

Applicants should outline a detailed schedule of when they expect to move away from a Restricted ADI to full ADI status.

Of important consideration is the potential impact of putting a hard deadline on a Restricted ADI to move to limited and then unlimited, as the challenge this presents when raising additional funds from investors. If there is a hard deadline, with no flexibility, this potentially puts the Restricted ADI in a weaker negotiating position when it is determining the terms and price to raise additional funds. Xinja feels a 3 years time period, or 2 year with an opportunity to apply for an extension can obtain the balance between ensuring business do not remain as Restricted ADIs indefinitely but allows adequate time to establish their operations.

Furthermore, APRA needs to carefully consider what is the expectation after moving off a Restricted ADI. At the time of writing this submission, the legislation removing the $50m Capital was yet to receive Royal Assent. Assuming the existing $50m Capital requirement is maintained to be called a bank (under Section 66 of the Banking Act), then it is a significant step from the proposed $3m to $50m. Xinja notes that this is currently being reviewed in Parliament. Further detail around Capital is outlined below and Xinja again extends an invitation to APRA to be taken through the detail Xinja Capital Model - that was provided as part of the Restricted ADI application.

Minimum requirements

Are the proposed minimum requirements appropriate for potential new entrants to the banking industry? Are there alternative requirements APRA should consider?

Xinja notes APRA has proposed Initial and then Ongoing Requirements.

Xinja supports the $3m minimum requirement for the Restricted ADI as we believe it is the principal impediment to new entry to the market.

Xinja however does not believe that a minimum capital of 20% of Net Assets is achievable when developing a true banking model. If the start up bank has more than $150m loans on their balance sheet than the bank will be through the $3m minimum requirement. Xinja estimates it will need a mortgage pool of greater than $1.5billion before it reaches profitability.

Xinja would prefer that the minimum was 20% of Risk Weighted Assets rather Net assets.

Xinja notes the following regarding the current Capital requirements to use the word 'bank', although this is under review:

The current competitive landscape for new banking entrants

Australia's major banks currently benefit from a historic accumulation of capital meaning that regulatory capital requirements have become barriers to entry for new players. These barriers not only impact smaller ADIs, they also impact the commercial realities of being a startup bank seeking funding in Australia. It is not surprising that the growth in innovation and competition in Australia's financial services sector has not been in banking, but in specific niche areas of financial services with lower capital and regulatory hurdles to be able to offer a service in the market: peer to peer lending, investing, mortgages, and small business lending are good examples. None of these specific areas require a $50m capital hurdle to simply offer a product to market. However, when an organisation is seeking to take deposits, and wishes to call itself a bank, the $50m hurdle applies. As a result, we have seen at best limited innovation and competition in the form of the rebranding of existing ADIs, acquisitions of 'online only' banks, traditional banks 'digitising' their services and offerings and slowly improving their mobile distribution channels. What Australians have not seen yet is a genuinely new, full service retail bank entering the market, as has happened in most other developed banking markets. Xinja and Neobanks in general are focussed on providing new digital customer experiences accessible anytime, anywhere a customer has a mobile handset - with the security consumers have come to expect from banks.

Building a startup bank in Australia has its unique challenges. In the principles of lean startup, the fastest least risky path to growth is to be able to start with a minimum viable product (MVP) on a small scale to validate the product as market fit, and to learn and iterate from that until you are ready to scale. In the context of banking in Australia, there is no real opportunity to start lean with a MVP in market as you require authorisation before you can offer a banking service, so your first banking customer will already cost you in excess of $50m. This leaves only two other alternatives for those wishing to enter the banking sector in Australia, outside of applying for your own authorisation as an ADI. The second option is to partner with an existing ADI, which in and of itself creates complexity in terms of commercial arrangements, how funds are reported, how customers are managed and how innovation and competitive offers can be brought to market. The third option is to buy a smaller ADI, however that in and of itself does not enable a startup to call itself a 'bank', which again limits how you can engage with customers.

The pathways to starting a new bank in Australia are therefore a choice of three problems:

1. Raise over $50m in capital,
2. Be dependent on and constrained by your competitors, or
3. Raise less capital and operate like a bank without calling yourself a bank.

None of these are particularly commercially attractive, market competitive, or market attractive. In fact, a branch of a foreign bank would most likely find it easier to enter the Australian market, than a local startup under the current regulatory framework.

In addition to these capital barriers to entry, existing major banks also enjoy competitive advantages in terms of their access to comparatively lower cost of funds and higher volume of funds, compared to their smaller counterparts and any new entrant. This makes it difficult for new entrants to be genuinely price competitive (at least in the immediate and short run), even for those who do overcome the $50m hurdle. Over and above the $50m, new entrants then need to source funds to lend out, further adding to the total amount of funds needed to start a new bank in Australia.

The landscape for raising $50m in startup funding in Australia

For those who take on the $50m challenge, the real cost of starting a bank will be well in excess of $50m. There is the cost of the licensing process itself, the cost of building the bank's core systems and processes, the cost of wholesale funding, the operating costs of running the bank, as well as the costs of customer acquisition and compliance.

The primary options for such startup funding in Australia (outside of family and friends) are accelerators, grants, business loans, and equity financing through angel investors, venture capital and early stage venture capital partnerships (crowdfunding is still yet to become available for privately held companies - yet that is how most startups begin in Australia)[1]. None of these standard pathways are straightforward in and of themselves, let alone particularly suitable for funding a startup bank. Government grants for an excess of $50m don't exist. Applying for a 'business loan' from a bank to start a bank would be akin to a startup asking its competitor to fund it, whilst handing over your business plan for how you will compete. Then if we look at equity funding for anyone who is at pre-revenue, pre-customer traction and pre-ADI, it gets even harder. Series A funding in Australia might typically raise $3m to $7m[2]. By comparison, a startup bank in Australia would need from 8x to more than 16x this to reach the $50m capital requirement alone. The $50m hurdle also represents 10x the estimated $5m cost of a core banking platform itself, according to EY[3], and creates a disproportionate barrier to startups being being able to take full advantage of falling technology costs for core banking platforms to bring new alternatives to the market. While the cost of a core banking platform is not the only cost involved in starting a bank, by comparison, the $50m regulatory barrier significantly changes the economics and commercial proposition for starting

[1] http://www.pollenizer.com/2016/08/09/funding-options-available-startups-australia/
[2] http://mashable.com/2016/06/15/guide-startup-funding-australia/
[3] http://www.afr.com/business/banking-and-finance/financial-services/new-breed-of-uk-startup-banks-force-licensing-rethink-20170424-gvr8ah

a bank. Raising funds for a startup, and raising funds for a startup bank, are two very different challenges.

Despite the general interest in innovation in financial services, and the interest in increasing competition in the banking sector, the actual interest in funding a startup bank is a very different reality - especially if you are looking for funding from outside the major banks themselves, and looking for funding from those without existing strategic relationships with the major banks.

Therefore we believe it is important to review not only the entry requirements for the new restricted ADI license, but what happens during and at the end of that period to a neo-banks capital requirements. Failure to link capital requirements to risk in a neo bank generates a significant risk of new entrants “hitting the $50m wall” and failing.

Licence restrictions

Are the proposed licence restrictions appropriate for an ADI on a Restricted ADI licence? Are there alternative or other restrictions APRA should consider?

Generally we consider the restrictions appropriate, however we would urge APRA to consider two points:

Firstly Xinja would request that APRA give special consideration to the words:

“*APRA … expects that a Restricted ADI will not be actively conducting banking business.*”

We believe that is it essential that Restricted ADI’s (RADIs) be allowed to actively conduct banking business, of a restricted nature and under a strict set of conditions and guidelines.

Our reasons for this are fourfold:

1) **It is essential for a start up bank to attract investment capital and generate income.** To do this they must be allowed to offer their services to market. Investors will not invest the substantial capital required to scale a bank if there is no proven product/market fit and proof of revenue generation.

2) **An ADI must be allowed access to the market to be able to test, refine and improve its products, services and risk systems.** The most effective, valuable feedback for both Xinja and APRA will come from our interactions with everyday Australians using our banking services.

3) **The two year restricted ADI period must not be a competitive advantage to the current incumbent banks.**
If RADI banks were not allowed to conduct banking business, the restricted ADI period will give existing competitors two years to observe, copy and implement the RADI bank's technology, processes and products.
Unable to defend itself by attracting capital, offering new products and constantly innovating, the RADI bank would be an easy target for the hugely advantaged incumbent banks.

4) **To protect the security of the financial infrastructure of Australia, it is important that the less regulated "shadow banking" system within our economy is minimised.**
Requiring a potential new bank entrant to operate under a RADI scheme which prevented them from actively conduct banking business, would create such a high investment hurdle that the business would mostly likely be re-engineered to avoid the need for an ADI. This is a poor outcome for the consumer, for APRA and for the economy as a whole.
In our own case at Xinja, the financial business case for becoming a highly regulated, highly transparent bank, as opposed to a lightly regulated shadow "bank" was a very close call. We chose to progress down the bank path due to substantial ethical and societal factors that we chose to take account of.

> It is vital that the commercial hardship of starting a bank is not made too great forcing potential entrants to take a less regulated path.

To be clear, Xinja is not advocating that Restricted ADI banks should be allowed to operate without substantial restrictions.

Xinja supports the limits outlined such as $2m in deposits and no single deposit greater than $250k, and all the other restrictions outlined in APRA's excellent paper. However within these guidelines RADI banks should absolutely be allowed to actively conduct banking business.

What better test for Xinja than to start with 200 customers holding $5,000 each with us, and us offering them a range of closely APRA monitored banking services?

Whilst it is likely that both APRA and Xinja's thinking is closely aligned on this matter as other areas of the discussion paper such as 4.3.5 do say that RADIs will be permitted to carry out a limited level of banking business to enable them to test their capabilities, we feel it is important to clearly set out that RADIs will be allowed to conduct business with potentially a few thousand people before being required to progress to a full ADI.

Indeed we are aware that parties are already briefing in the market that RADIs will not be allowed to take deposits at all and are therefore not worth supporting or investing in. Clear communication from APRA that this is a commercially viable path to take for new entrants is important if the goals of new competition in the market are to be met.

Secondly we would ask APRA to consider articulating a process that allows a gradual easing of restrictions over the two year period (and then post) in line with Tier One capital held, and proven success with systems, products and risk management

Obviously a situation where a neo bank holds a RADI and is restricted to $2m in deposits and holds $3m in Tier 1 capital for two years, and then the day after is expected to have $50m and be let loose with a full ADI with restrictions is not practical or useful!

It presents considerable risk for both the regulator and the bank.

Once a RADI holder such as Xinja has proven our capabilities to manage risk, service our customers and hold an appropriate amount of Tier 1 capital, we would seek to have those limits raised a little, then a little more and so on, until both we and APRA were comfortable to move to a full ADI with restrictions and into the standard licensing regime. There might be potentially 5 or 6 of these “upgrades” across the life of the RADI scheme. Progression should, of course, be at the discretion of APRA.

The final step off the RADI scheme and onto an ADI with restrictions should simply be another small step with incremental increases in Tier 1 capital, customer numbers, and risk. We believe this is important to manage the risk of new entrants, and minimise the impact on freshly approved neo banks.

This is the pathway followed to great effect by other regulators in the Uk, Europe and the US. These conditions have allowed great value challenger banks such as Monzo, Starling, Atom, N26, Clearly and Simple to thrive bringing competition, value and positive change to retail banking.

Financial Claims Scheme

Are the proposals appropriate in the context of the last resort protection afforded to depositors under the Financial Claims Scheme?

Xinja believes they are.

Further refinement
Are there other refinements to the licensing process APRA should consider?

Comparing to the UK experience

Australia's $50m capital requirement for new banks (although currently under review) is particularly onerous compared to lower minimum capital requirements in the UK since 2013, which have now been reduced to €1 million or £1 million[4] (whichever is higher), plus a capital planning buffer. Even though UK customers and banks suffered more than Australians from the GFC, the UK was faster to embrace banking innovation and competition[5], providing a clear roadmap for startups to 'grow up' into becoming fully authorised banks in a scalable, commercially viable way[6]. We support initiatives such as the current proposed amendments, which we expect will open up the banking sector and create similar opportunities for Australian consumers.

Since the introduction of these regulatory changes, there has been significant growth in new startup banks in the UK including Monzo, Atom, Starling and Tandem. Many of our customers have already experienced the banking services available in the UK via these digital mobile challengers and have been asking why it isn't happening in Australia. We hope the proposed amendments to the Banking Act, in addition to the wider budget changes, will give Australians access to similar standards of innovation and competition. In line with the creation of the UK's dedicated new bank startup unit to specifically address the licensing needs for new bank startups, Xinja is pleased to be working directly with APRA's newly established licensing unit. We look forward to continuing to work collaboratively and in partnership with regulators to ensure customer deposits are safe and secure whilst providing

[4] http://www.bankofengland.co.uk/pra/Documents/publications/reports/2014/barriers2014.pdf
[5] http://www.bankofengland.co.uk/publications/Documents/joint/barriers.pdf
[6] http://www.bankofengland.co.uk/pra/nbsu/Pages/default.aspx

sufficient room to build, grow and scale in an appropriately customer centric, risk managed and commercially viable way.

Thank You

We thank APRA for the opportunity to respond to this Discussion Paper and encourage APRA to continue to engage both informally and formally, with the broader startup and financial services community. We would welcome the opportunity to meet to discuss our response further, especially in the broader context of opening up competition in the Australian banking sector. We believe Australia could be a global leader in innovation in banking and financial services industry and look forward to the APRA's continued leadership role in this area. With the proposed regulations due to come into effect in early 2018, we hope this will provide further room for APRA to authorise new entrants to become ADIs under less restrictive capital requirements, with a phased approach to licensing that will enable new entrants to bring new banking services and experiences to Australians sooner rather than later.

We don't expect APRA to be providing unrestricted licenses in the first instance. However we do expect that new entrants should be given the opportunity to demonstrate their capacity and capabilities over time and in line with the increasing scope and scale of their customer operations and deposits. We believe it is possible to bring competition into the sector in a safe, scalable and commercially viable way, keeping customers' interests at the centre of what we do. We believe it's time Australians experienced banking as it could be, and we value the opportunity to make that happen.

Regards,

David Nichols
Chief Risk Officer

Eric Wilson
Chief Executive Officer