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Dear Mr Poels

REGULATION IMPACT STATEMENT (FINAL ASSESSMENT SECOND PASS): *TREASURY LAWS AMENDMENT (BANKING MEASURES N0.1)* ILL 2017 - NON-ADI LENDER RULES

I am writing in relation to the attached Regulation Impact Statement (RIS) prepared for the *Treasury Laws Amendment (Banking Measures No. 1) Bill2017* – Non-ADI Lender Rules.

I am satisfied that the RIS addresses the concerns raised in your letter of 12 September 2017. Specifically:

- further detail has been provided on the sorts of systemic risks that could be posed by the activities of non-ADI lenders;
- there is an expanded discussion of the nature of the Australian non-ADI lending sector's activities, including whether these activities are contributing to risks (the Government is of the view that these activities are not currently materially contributing to risks);
- the 'Costs and benefits' and 'Preferred option' sections have been updated to reflect better this discussion of risks;
- the reference to 'systemically-relevant' has been deleted as it was simply a shorthand way of referring to the entities described under Option 3; and
- further detail is provided on how APRA will likely assess whether a non-ADI lender is materially contributing to risks of instability in the Australian financial system.

I believe the RIS now meets best practice requirements and is consistent with the ten principles for Australian Government policy makers.

What is the problem?

Financial sector stability is critically important to economic performance. It is well established that effective prudential regulation is essential to maintaining financial stability. Should material risks to financial stability arise due to the activities of non-ADI lenders, current regulatory powers may not be sufficient to adequately mitigate these risks.

In Australia, bodies corporate authorised to undertake banking business by APR A under the Banking Act 1959 (Banking Act) are authorised deposit-taking institutions (ADIs). ADIs are subject to APRA's prudential requirements and ongoing supervision. There are a number of entities that engage in the same or similar

lending activities to ADIs, but are not authorised as they do not conduct banking business as it is defined in the Banking Act, or have been exempted from the prohibition against carrying on banking business by APRA. Collectively, these entities can be termed *non-ADI lenders.*

Consistent with its mandate to promote financial stability, APRA has taken actions to reinforce sound residential mortgage lending practices by ADIs. However, APRA does not have the ability to monitor properly or manage risks to financial stability posed by the activities of non-ADI lenders, should such risks arise. This is a problem as non-ADI lenders may be active in the same markets as ADIs and therefore may be a source of the same risks. This leads to a potential regulatory gap in the ability to manage material financial stability risks that might arise from non-ADI lending practices.

Why is government action needed?

International experience demonstrates the importance of having clear regulatory arrangements to deal with financial stability risks before they arise. So while the non-ADI lender sector does not currently represent a material risk to financial stability, it is appropriate to put monitoring and contingency arrangements in place now.

Self-regulation is unlikely to be sufficient to address the policy problem, given non-ADI lenders have little incentive (other than market discipline) to monitor the systemic effect of their lending behaviour and alter lending behaviour accordingly. Government intervention is required to close the potential for there to be a regulatory gap. As APRA's mandate explicitly includes the promotion of stability in the Australian financial system and it has the necessary supervisory capability to monitor the non-ADI sector, APRA is the most appropriate entity to take action. APRA is also accountable for its actions to the Australian people through Parliament and the Government's Statement of Expectations for APRA.

What policy options are being considered?

In the 2017-18 Budget, the Government announced that it would act to ensure APRA is able to respond flexibly to developments that pose a risk to financial stability by providing APRA with new powers in respect of the provision of credit by non-ADI lenders. Consistent with the Budget announcement, the Government's preferred option is to provide APRA with enhanced data collection and rulemaking powers in respect of the provision of finance activities of non-ADI lenders, where these activities materially contribute to financial stability risks (Option 1).

Alternative options include maintaining the status quo, which would require APRA to manage the financial stability risks stemming from the activities of non-ADI lenders using its current powers and functions (Option 2), and to expand APRA's regulatory remit to require non-ADI lenders to be authorised by APRA, thereby subjecting non-ADI lenders to the full range of APRA's prudential requirements (Option 3).

What are the benefits and costs of each option?

Option 1: Provide APRA with monitoring and rulemaking powers over non-ADI lenders
The primary benefit of this option is that it would close the regulatory gap and address the identified policy problem by allowing material financial stability risks to be appropriately monitored and managed by APRA across the entirety of the lending sector. Costs involved with this option are expected to be minimal for two reasons. First, the rulemaking power is a reserve power and would ordinarily lie dormant. Second, as the effect on non-ADI lenders would partly be reversing the impact of inconsistent regulation across entities (both ADIs and non-ADI lenders) engaged in the same activities, it would be largely offset by the effect on ADI lenders. Consequently, the regulatory cost of this option is expected to be minimal - around $1.2 million per annum in total.

<u>Option 2: Maintain the status quo</u>
This option would probably not close the regulatory gap that exists or address the identified policy problem. APRA would not have the power to act when it sees a need do so and this could allow financial stability risks to develop and persist. However, this approach would not result in business or regulatory costs to non-ADI lenders.

<u>Option 3: Require non-ADI lenders to be authorised by APRA</u>
This option would remove the possibility for the non-ADI lenders to contribute to financial stability risks due to a regulatory gap. This option would materially alter the regulatory architecture and subject non-ADI lenders to an unnecessary degree of regulation. It would also impose significant costs on non-ADI lenders and may reduce the size of the sector which provides a competitive balance to the large ADIs. This regulatory costs involved in this option are also large - around $20 million per annum.

The above changes in the regulatory burden on business have been quantified using the Regulatory Burden Measurement framework.

Who will be consulted and how will they be consulted?

Draft legislation to implement the Government's preferred option was exposed for a four week period of public consultation that concluded on 14 August 2017. Treasury and APRA also met with a number of stakeholders as part of the consultation process. Generally, stakeholders expressed support for the data collection component of Option 1 but noted a number of concerns with the design of the rulemaking powers - in particular, that the draft legislation was broader in scope than the Government's Budget announcement. However, stakeholders broadly agreed that it was appropriate for Government to have a role in ensuring lending activities were consistent with financial sector stability.

Support was expressed for Option 2 (as some stakeholders did not see the need for the Government to act) and while Option 3 was not a focus of the consultation - given that it was considered and dismissed by two previous Financial System Inquiries (1997 and 2014) - non-ADI lenders were strongly opposed to this option.

What is the best option from those considered?

The Government's preferred option remains to provide APRA with monitoring and rulemaking powers over non-ADI lenders (Option 1). This option would allow APRA to manage material financial stability risks across the entire market, thereby closing the regulatory gap and addressing the identified policy problem. Further, rules would only be made as necessary, reflecting Government's view that non-ADI lenders are currently not materially contributing to risks of instability in the financial system.

Maintaining the status quo (Option 2) would have a lower cost, but non-ADI lenders would have limited incentive to comply with requests made by APRA and the regulatory gap would remain unaddressed. Furthermore, requiring non-ADI lenders to be authorised as ADIs (Option 3) would address the regulatory, gap, but it would involve significant costs and would impose ongoing regulation, which may be unnecessary given that the risks may be temporary. It would also require a major change to the regulatory architecture.

A number of changes were made to the draft legislation in light of industry's concerns. The draft legislation was amended to make clear that the rulemaking power is a reserve power that would only apply where non-ADI lenders were materially contributing to risks to financial stability. The definition of non-ADI lenders as a class of entities was also refined to ensure that only entities engaged in the ultimate lending or origination activity could be subject to a rule. The explanatory memorandum was updated to include additional detail on the purpose of the rulemaking power and how and when the power would be used. Non-ADI lenders expressed a significant degree of comfort with this approach.

In relation to the minor regulatory costs involved in this option, a regulatory offset has not been identified. However, Treasury is seeking to pursue net reductions in compliance costs and will work with affected stakeholders and across Government to identify regulatory burden reductions where appropriate.

How will the chosen option be implemented and evaluated?

Legislation is required to give effect to the Government's preferred option. While APRA will be able to make rules upon Royal Assent, it is not envisaged it would do so - as APRA would first need to be satisfied that the activity of non-ADI lenders represented a material risk to financial stability. Rather, it is expected that APRA would focus in the first instance on collecting and analysing the additional data on the activity of non-ADI lenders.

Evaluation of the success of this option, once implemented, will occur through three primary channels: assessment by APRA and the Council of Financial Regulators; feedback from non-ADI lenders (in general and to various consultations); and via Parliamentary processes.

I am now satisfied that the RIS now meets best practice requirements consistent with the Australian Government Guide to Regulation.

Yours sincerely

John Lonsdale
Deputy Secretary
Markets Group