KING&WOOD MALLESONS

Level 61
Governor Phillip Tower
1 Farrer Place
Sydney NSW 2000
Australia

T +61 2 9296 2000
F +61 2 9296 3999

www.kwm.com

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To The Manager
Banking, Insurance and Capital Markets Unit
Financial System Division
The Treasury
Langton Crescent
Parkes ACT 2600
lenderrules@treasury.gov.au

Submission in response to draft *Treasury Laws Amendment (Non-ADI Lender Rules) Bill 2017*

We refer to the draft *Treasury Laws Amendment (Non-ADI Lender Rules) Bill 2017* (the **Draft Bill**) released on 17 July 2017 and the request by the Treasury for submissions on the proposals made under the Draft Bill.

We welcome the opportunity to make a submission.

We recognise the fundamental importance of promoting financial stability and that financial stability can be affected by activities conducted outside the bank sector. Further, we recognise that the registration of entities which provide finance, and the collection of data are essential steps in understanding what forces are at play in the financial system and what rules are best devised to promote financial stability.

That said, in our view it is important to recognise that there is an equally fundamental distinction between non-bank lenders and ADIs. Non-ADI lenders have no depositors to protect. They do not play the same role in the payments system. It is hard for a citizen not to deal with an ADI but there is not the same practical compulsion for a citizen to deal with a non-ADI. It is also important in the interests of competition and choice that there be non-ADI lenders and that what they provide is different from what is available from an ADI, and that the markets in which they operate (and the capital markets upon which they rely) are not adversely affected by any uncertainty or unintended consequences that further regulation of non-ADI lenders may bring.

It follows that any regulation of non-ADI lenders cannot have the same prudential character as the regulation of ADIs. It should be limited to exceptional circumstances where the extent or nature of the non-ADI lending activity is threatening the stability of the financial system. Further, as with any regulation, it should be clear to which entities it applies and how they may be affected.

In that regard, we consider that the following changes to the Draft Bill would provide clarity in respect of the powers given to APRA and the obligations on non-ADI lenders, and better reflect the Government's policy objectives:

- The test for 'registrable corporation' under FSCODA should be amended to 'the corporation undertakes the provision of finance in the course of carrying on business in Australia';
- The definition of 'non-ADI lender' in the Banking Act should be narrowed to ensure that a 'dollar of finance' is caught only once (and does not catch intra group chains of finance or multiple types of

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finance for the same property purpose). For this purpose, the scope of 'lending finance' should be limited to a narrower range of activities within the meaning of 'provision of finance' under FSCODA.

- APRA's rule-making power should be limited to lending finance activities that materially contribute to the risk of instability in the Australian financial system. There should also be specific areas where APRA may not make a rule;
- The Draft Bill should be amended to provide for a consultative approach to rule-making under the Banking Act;
- The Draft Bill should include a power to rescind a rule and also a duty to rescind it when the circumstances giving rise to the occasion to make the rules have passed;
- The scope of APRA's determinations under section 38E of the Banking Act should extend only to address the specific activities of lending finance that give rise to a material risk of financial instability;
- Further clarity should be provided around how penalties for breach of the Banking Act will be assessed, imposed and potentially challenged by a non-ADI lender;
- The Draft Bill should contain a transitional period in the Banking Act for after a rule is made by APRA;
- The new exemption under section 7(2A) of FSCODA should be amended in order to provide relief to foreign entities with a very limited connection to Australia;
- The assessment of value under the Debts Due Test and the Loans Value Test in FSCODA should be done at the same time;
- The meaning of 'financial year' in FSCODA should be clarified;
- The definition of 'related corporations' in FSCODA should be amended in light of the new test for 'registrable corporations';
- The proposed amendments to FSCODA should include a transitional period before APRA's rule-making powers become effective, and preferably only enliven, at the time of Royal Assent, the amendments that give rise to the registration and data collection requirements of FSCODA; any enlivening of the rule-making power should only occur after the 'transitional period' has lapsed and if and only when APRA believes that a material risk to financial stability has occurred;
- The Draft Bill should include transitional provisions for corporations that have received from APRA exemptions from the reporting obligations in FSCODA (even though they are registered under FSCODA); and
- Further clarity should be provided regarding the meaning of 'provision of finance' under FSCODA in the context of the bond market.

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1 Scope and meaning of 'registrable corporation'

1.1 Recommendation 1: The test for registrable corporation under FSCODA should be amended to 'the corporation undertakes the provision of finance in the course of carrying on business in Australia.'

Under the Draft Bill, a 'non-ADI lender' means a 'registrable corporation' as defined under the *Financial Sector (Collection of Data) Act 2001* (Cth) (**FSCODA**), and the definition of a 'registrable corporation' has been expanded. A corporation is a registrable corporation if 'the business activities in Australia of the corporation include the provision of finance' (**Business Activities Test**) or if APRA makes a determination that the corporation is a registrable corporation. In our view, this test for a 'registrable corporation' is problematic because its meaning is unclear and its scope is too broad. We recommend that the test be amended to 'the corporation undertakes the provision of finance in the course of carrying on business in Australia' (**Carrying on Business Test**).

There is uncertainty around the meaning and scope of the Business Activities Test proposed in the Draft Bill, in particular the required level of connection to Australia and the requirement for repetition (i.e. whether one-off indirect activities in Australia meet the Business Activities Test) or where there are a number of intra-group transactions or a 'chain of financiers' each of which results in a final act of 'lending finance' which is the subject of the reporting requirement under FSCODA. We propose that the Draft Bill be amended to instead use the Carrying on Business Test to take advantage of an existing body of case law that can be used to provide clarity around the meaning of a 'registrable corporation'.

APRA still has the power to make determinations under section 7(1A) of FSCODA to include a particular corporation or classes of corporations within the scope of 'registrable corporations'. Given this discretion, in our view the better approach to defining 'registrable corporation' is to use the Carrying on Business Test that has a more precise meaning rather than the excessively broad and uncertain Business Activities Test.

2 Scope and meaning of 'non-ADI lender' and 'lending finance'

2.1 Recommendation 2: The definition of 'non-ADI lender' in the Banking Act should be narrowed to ensure that a 'dollar of finance' is caught only once (and does not catch intra group chains of finance or multiple types of finance for the same property purpose). For this purpose, the scope of 'lending finance' should be limited to a narrower range of activities within the meaning of 'provision of finance' under FSCODA.

The proposed definition of 'non-ADI lender' under the Banking Act is a 'registrable corporation' within the meaning of FSCODA. This definition of non-ADI lender catches a wide range of entities that raise money and provide finance whether for retail or wholesale purposes (including domestic and offshore investors). In our view, while this may be appropriate in the context of the collection of data under FSCODA,[1] it is unintentionally wide in scope and beyond the stated intent of the Government's proposed regulatory framework in the context of APRA's proposed rule-making power under the Banking Act. Initial government announcements in the Budget Papers foreshadowed the use of a 'reserve power' to target macro-prudential concerns. The Explanatory Memorandum to the Draft Bill

[1] In the context of APRA's powers to make determinations under section 7(1A) of FSCODA, paragraph 1.26 of the Explanatory Memorandum provides that 'such a determination will enable any corporations which are not captured by the widening of the class of registrable corporations in section 7 of FSCODA to be specified by APRA. Full coverage of the non-ADI lending market is the intended consequence of these amendments.'

suggests that policy objective is to strengthen APRA's ability to respond to developments in non-ADI lending that pose a risk to financial stability, particularly in residential mortgage lending. For these reasons we recommend that the definition of 'non-ADI lender' is narrower than the meaning of 'registrable corporation' (using the Carrying on Business Test suggested above) and is limited to reporting a 'dollar of finance' only once, and not through a series of transactions or where finance is provided at an initial (wholesale or development) phase and then a subsequent (retail or acquisition) phase.

The current proposed definition of non-ADI lender does not take into account the broad range of lenders in the non-ADI sector and potentially catches many other intermediary entities that are involved in passing on what is the same quantum of credit. In our view, to meet the stated policy objective, the only lending entity that needs to be caught is the entity that provides lending finance to the final borrower.

For this purpose 'lending finance' should be narrowed in scope and defined as the 'provision of finance' (within the meaning of FSCODA) *excluding* paragraphs (g) (Commonwealth debt securities) and (h) to the extent the debentures are quoted on a prescribed financial market or are issued outside Australia. 'Lending finance' should also exclude the 'provision of finance' to an entity outside of Australia and, for the avoidance of doubt, the entry into a derivative (within the meaning of the Corporations Act) transaction. The current proposed definition of lending finance is too broad and gives APRA a very broad rule-making power that in our view does not align with the Government's policy objective. Further, in some situations it is unclear the scope of activities that are included in the proposed definition of 'lending finance'. Part (b) of the test[2] is particularly broad and may suggest that if a person subscribes for securities, be they equity or debt, in a bank or finance company, the person has engaged in 'lending finance' as loans will result from it. If a developer builds a block of flats for sale and the indirect result is that loans will be made to fund the purchases of those flats, is the developer engaged in lending finance? Further along, is the builder then also engaged in lending finance? In our opinion, our suggested amendments to the definition of 'lending finance' provide clarity around its meaning and appropriately narrows the scope of entities that are subject to APRA's non-ADI lending rules, so that only the entity that provides lending finance to the final borrower is caught.

3 Scope of APRA's rule-making power

The proposed section 38C of the Banking Act provides the critical gateway to APRA's rule-making power. We recommend the following changes to section 38C and we explain our reasons for these changes below.

(1) If APRA considers that an activity or activities engaged in by one or more non-ADI lenders ~~in relation to~~ of lending finance materially contribute to risks of instability in the Australian financial system, APRA may, in writing, determine rules in relation to ~~matters relating to~~ that activity or those activities of lending finance, to be complied with by:

(a) all non-ADI lenders; or

(b) a specified class of non-ADI lenders; or

(c) one or more specified non-ADI lenders~~-~~,

[2] Lending finance means (a) the lending of money, with or without security; (b) the carrying out of activities, whether directly or indirectly that result in the funding or originating of loans or other financing: proposed section 5(1) of the Banking Act.

which activity or activities in each case, materially contribute to those risks of instability.

(2) A rule may impose different requirements to be complied with in different situations or in respect of different activities in respect of that activity of lending finance.

(3) APRA may not determine a rule in relation to:

(a) any matter that is the subject of a prudential standard issued by APRA in respect of an ADI;

(b) the way the business affairs, operations or activities of a non-ADI lender are to be conducted or not conduced, other than in respect of the activity of lending finance that is the subject of the rule under sub-section (1).

3.1 Recommendation 3: APRA's rule making power should be limited to lending finance activities *that materially contribute to the risk of instability in the Australian financial system.* To provide greater certainty about the operation of APRA's rule-making power, there should also be specific areas where APRA may *not* make a rule.

Under the Draft Bill APRA may determine rules in relation to matters relating to lending finance. Although APRA's rule-making powers are not triggered until the activity materially contributes to the risk of financial instability in the Australian financial system, the same requirement is not made with respect to the subject matter of APRA's rules. The only requirement is that they are with respect to 'lending finance'.

We request that the scope of APRA's rule-making power be narrowed. We recommend that the APRA rule or determination must directly relate to lending finance that materially contributes to the risk of instability in the Australian financial system. This will help align the scope of APRA's powers with the objective of addressing specific macro-prudential issues. The powers should not be used to subject non-ADI lenders to ongoing prudential supervision by APRA in a manner similar to ADIs especially in relation to aspects of their business (including fund-raising and capitalisation) that are not 'lending finance'.

We think this submission is consistent with Government policy. The draft Explanatory Memorandum states that the Draft Bill is not intended to subject non-ADI lenders to ongoing prudential regulation and supervision as it does to ADIs.

Further, we recommend that the Draft Bill be amended to include an express statement that the APRA rules be appropriate to the object of mitigating the risk of instability so that they do not encompass general prudential regulation of non-ADIs.

4 Process for rule-making

4.1 Recommendation 4: The Draft Bill should be amended to provide for a consultative approach to rule-making

The Draft Bill should set out a clear process for rule-making and the implementation of rules. Although APRA is required to consult with ASIC before making, varying or revoking a rule,[3] there is no requirement for APRA to consult with non-ADI lenders regarding a proposed rule. We recommend that

[3] Proposed section 38C(9) of FSCODA.

the Draft Bill explicitly provide that APRA must engage in detailed consultation with the affected non-ADI lenders before it makes any rule in relation to them.

4.2 Recommendation 5: The Draft Bill should include a power to rescind a rule and also a duty to rescind it when the circumstances giving rise to the occasion to make the rules have passed

In our opinion, the Draft Bill should include:

(a) a power to rescind an APRA rule once the Government is satisfied that the 'risk of instability to the Australia financial system' has ceased; and

(b) a provision *requiring* APRA to, in writing, revoke a rule once it considers that the lending activities that were the basis for that rule no longer materially contribute to the risk of instability in the Australian financial system.

5 Consequences of breaching a non-ADI lender rule

5.1 Recommendation 6: The scope of APRA's determinations under section 38E of the Banking Act should extend only to address activities that give rise to a material risk of financial instability.

The Draft Bill allows APRA to make a direction that requires the non-ADI lender to 'comply with a rule', 'refrain from lending money', and/or 'refrain from carrying out activities, whether directly or directly, that result in the funding or originating of loans or other financing', if APRA has reason to believe that the non-ADI lender has contravened or is *likely* to contravene a non-ADI lender rule.[4] The current drafting of the determination gives APRA scope to make determinations that could extend to the entire business of a non-ADI lender and are, in our opinion, beyond the stated policy objective. We recommend that the determination under section 38E be narrowed to address the non-ADI lender's activities of 'lending finance' that have given rise to the material risk of financial instability and not extend to any other activities of the non-ADI lender.

5.2 Recommendation 7: Further clarity should be provided around how penalties for breach will be assessed, imposed and potentially challenged by a non-ADI lender

Under the Draft Bill, the only sanction available to APRA is to make a determination for breach of a non-ADI lender rule. In respect of managing the actions of ADIs, APRA has other prudential and capital actions that it can take. In our view, given the consequences for a non-ADI lender may be comparatively more severe, we recommend that:

(a) further clarity should be provided around how penalties for breach will be assessed, including a provision that provides a non-ADI with the right to challenge directions given by APRA;

(b) there is a grace period to allow a non-ADI to address APRA's concerns; and

(c) APRA must have reason to believe that the non-ADI has contravened (as opposed to the non-ADI being 'likely' to contravene) a non-ADI lender rule in order to suspend a non-ADI's lending practices under section 38E(3)(b)-(c).

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[4] Proposed section 38E(1), (3) of FSCODA.

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6 Transitional Provisions under the Banking Act

6.1 Recommendation 8: The Banking Act amendments should include a transitional period after a rule is made by APRA

The scope of APRA's rule-making powers under the Draft Bill may impact the availability and cost of finance to borrowers. The proposed laws should aim to provide certainty as to when a rule could be made that will impact the business of a non-ADI lender. We recommend that the Draft Bill include a transitional period after a rule is made by APRA. This period will provide non-ADI lenders with the ability to alter their lending activities to their customers so as to comply with the rule. This is particularly important in light of the significant consequences of non-compliance outlined in section 5.

7 The new exemption under section 7(2A) of FSCODA

7.1 Recommendation 9: The exemption should be amended in order to provide relief to foreign entities with a very limited connection to Australia.

A corporation will *not* be a registrable corporation under FSCODA if the corporation's assets in Australia that are debts due to the entity from the provision of finance do not exceed $50 million ('**Debts Due Test**') *and* the value of the principal amounts outstanding on the loans that arose in the previous financial year do not exceed $50 million ('**Loan Value Test**').[5] Whilst the Debts Due Test requires a geographical link (the assets must in Australia), the Loan Value Test does not – it includes all loans regardless of their connection with Australia. This means that a corporation may pass the Debts Due Test but fail the Loan Value Test because of the size of their loan book *outside* Australia. Therefore a corporation with a small connection with Australia that carries the bulk of its business offshore would not be able to seek relief from section 7(2A). The Draft Bill is designed to address the risk of financial instability *in Australia* and in our view the exemption under section 7(2A) should be amended to provide relief to lenders with a very limited connection to Australia.

7.2 Recommendation 10: The assessment of value under the Debts Due Test and the Loans Value Test should be done at the same time.

The assessment of value under the Debts Due Test and the Loans Value Test is done at different times. The Debts Due Test looks at the value of assets in the last audited balance sheet (or if there is not one, the value as shown in the accounting records of the corporation).[6] The Loans Value Test looks at the value of loans that 'arose' in the preceding financial year. We recommend that the Draft Bill be amended to have one date of assessment.

8 The meaning of 'financial year'

8.1 Recommendation 11: The meaning of 'financial year' in FSCODA should be clarified

The calculation of the value of loans or other financing (see 7.2 above) is to be done on a financial year basis. The meaning of 'financial year' is unclear in the Draft Bill. The draft Explanatory Memorandum suggests that the financial year ends 30 June.[7] Corporations will operate according to

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[5] Proposed section 7(2A) of FSCODA.

[6] FSCODA section 33(2).

[7] See paragraph 1.31 which states, 'The calculation of the value of loans or other financing is to be done on a financial year basis. SO in determining whether a corporation is a registrable corporation, if that corporation had less than $50M in loans outstanding on 30

different financial years. We recommend that the Explanatory Memorandum and Draft Bill be amended to explicitly provide that the meaning of financial year accommodates different financial year periods.

9 The definition of 'related corporations'

9.1 Recommendation 12: The definition of 'related corporations' in FSCODA should be amended in light of the new test for 'registrable corporations'

The Draft Bill applies the current section 7 test of 'registrable corporation' in defining 'related corporations' in section 34(2). We recommend that the meaning of 'related corporations' should be updated in light of the new 'registrable corporations' test. This will enable other provisions in the draft bill (specifically section 7(2AD)) to operate as intended.

10 Transitional Provisions under FSCODA

10.1 Recommendation 13: The proposed amendments to FSCODA should include a transitional period before APRA's rule-making powers become effective.

The current Draft Bill does not include any transitional provisions under FSCODA. It is unclear if this means that current registered corporations must make their own assessment as to whether they remain registrable and ask APRA under section 10(c) to have their name removed from the register if required. We recommend that the proposed amendments to FSCODA should include a transitional period before APRA's rule-making powers become effective, and preferably only enliven, at the time of Royal Assent, the amendments that give rise to the registration and data collection requirements of FSCODA; any enlivening of the rule-making power should only occur after the 'transitional period' has lapsed and if and only when APRA believes that a material risk to financial stability has occurred.

10.2 Recommendation 14: The Draft Bill should include transitional provisions for corporations that have received from APRA exemptions from the reporting obligations in FSCODA (even though they are registered under FSCODA).

Where entities have satisfied the current 'registrable corporations' test, APRA has provided *reporting* exemptions to some entities on the basis that they do not have any 'domestic books' and therefore would be providing APRA a 'nil' return on APRA's Reporting Standards. We recommend that the Draft Bill include transitional provisions for such entities so that their reporting exemptions survive these proposed changes to FSCODA.

11 Scope and meaning of 'provision of finance'

11.1 Recommendation 15: Further clarity should be provided regarding the meaning of 'provision of finance' in the context of the bond market.

The definition of 'provision of finance' under FSCODA goes to the registrability of a corporation under FSCODA. The term includes 'the purchase of debentures or other securities (other than shares)

June in the relevant year and less than $50M in assets consisting of debts due to the corporation as a result of transactions entered into in the course of provision of finance, that corporation is not a registrable corporation for the purposes of FSCODA'.

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issued by a corporation'.[8] We seek clarification from the Government regarding its policy with respect to:

(a) the intent of FSCODA to be collecting data from bond market investors generally; and

(b) the intent of FSCODA to be collecting data from bond market investors overseas who do not carry on business in Australia.

If the Government intends not to capture (a), then we recommend the exclusion of debentures quoted on a prescribed financial market, and those lodged in a licensed clearing and settlement facility (or its equivalent outside Australia). The Government may even consider excluding any bond issued outside Australia.

If the Government intends not to capture (b), then the position of the foreign bondholder could be dealt with by our changes proposed to section 7(1)(a) of FSCODA coupled with adopting the Carrying on Business test proposed in Recommendation 1.

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We are making these submissions on behalf of our firm, and the views expressed are our own and not those of any of our clients. We would welcome the opportunity to discuss these submissions with the Treasury.

Yours sincerely

King & Wood Mallesons

Contact
Stuart Fuller | Partner
King & Wood Mallesons
T +61 2 9296 2155 | M +61 418 254 550
stuart.fuller@au.kwm.com

Kate Jackson-Maynes | Partner
King & Wood Mallesons
T +61 2 9296 2358 | M +61 438 487 126
kate.jackson-maynes@au.kwm.com

[8] FSCODA section 32(1)(h).