Submission on the APRA Discussion Paper on Licensing: A Phased Approach to Authorising New Entrants to the Banking Industry

By Dr Katharine Kemp, Dr Anton Didenko, Ms Louise Malady and Prof Ross Buckley,
UNSW Sydney, Digital Financial Services Research Project

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Summary

We support the proposal of the Australian Prudential Regulation Authority (APRA) to introduce a Restricted Authorised Deposit-Taking Institution (ADI) licence for certain new entrants to the banking industry for the following reasons:

1. Facilitating new competition by Financial Technology companies ('FinTechs') is likely to improve dynamic efficiency in the banking industry and there is growing recognition that dynamic efficiency is the most important benefit from competition.

2. The introduction of a phased licence is a much-needed next step in achieving the Australian government's stated objective that '[o]ur policies and regulations will … help promote Australia's FinTech capability by supporting the evolution of our FinTech start-ups and innovators to develop, test and globally launch their innovative products and services'.[1]

[1] The Treasury, Commonwealth of Australia, 'Backing Australian FinTech' (2016) 18 <http://fintech.treasury.gov.au/files/2016/03/Fintech-March-2016-v3.pdf>.

3. The introduction of such a licence is consistent with the international trend of financial regulators reducing barriers to entry for FinTechs by increasingly making use of restricted, conditional or tailored licences. The proposed restrictions on the Australian licence represent a cautious approach to opening the financial system to greater competition while preserving stability in it.

We elaborate on our reasons below and raise several issues APRA may wish to consider.

Our Reasons for Supporting APRA's Proposal

1. **The Importance of Dynamic Competition from FinTechs**

Following the Global Financial Crisis of 2008 (GFC), concentration in the financial sector increased significantly in many markets, including in Australia.[2] While this was partly the result of consolidation following the failure or financial distress of numerous institutions, concentration levels have been increased by the substantial step up in financial regulation triggered by the GFC.[3] High thresholds for obtaining a banking licence increase the cost of entry to the disadvantage of new entrants, while high compliance costs may impose disproportionate operational burdens on small institutions.[4]

Vigorous competition has in the past been considered a threat to stability in financial systems.[5] However, policymakers now recognise that effective competition is vital to ensure

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[2] Elena Carletti and Agnieszka Smolenska, Competition Committee, Directorate for Financial and Enterprise Affairs, Organisation for Economic Co-operation and Development (OECD), '10 Years on from the Financial Crisis: Co-operation between Competition Agencies and Regulators in the Financial Sector' (Note, DAF/COMP/WP2(2017)8, 4 December 2017) 17, 27 ('*OECD Note on Co-operation between Competition Agencies and Regulators in Financial Sector*'); Reserve Bank of Australia, Submission to the Productivity Commission Inquiry, 'Competition in the Financial System' (Submission, September 2017) 2, 4 <https://www.rba.gov.au/publications/submissions/financial-sector/competition-in-the-financial-system/submission-to-productivity-commission-september-2017.pdf>; Daniel Morgan, Director of Policy and Regulation, Innovate Finance, 'UK Neo Banking – A Case Study' (undated) 7.

[3] See *OECD Note on Co-operation between Competition Agencies and Regulators in Financial Sector*, above n 2, 7–10, 17.

[4] See *OECD Note on Co-operation between Competition Agencies and Regulators in Financial Sector*, above n 2, 17, noting also that some regulators have accordingly reduced the compliance burden for small institutions. See also Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, 'One Size Fits All? Applying Basel III to Small Banks and Savings Banks in Germany' (Speech delivered at the Handelsblatt Conference on Future Strategies for Savings Banks and Landesbanken, Berlin, Germany, 2 February 2017).

[5] See *OECD Note on Co-operation between Competition Agencies and Regulators in Financial Sector*, above n 2, 9–10, regarding the interaction between competition and stability objectives in the

the financial sector is served by the most efficient institutions, and stability is enhanced by institutions of diverse sizes and business models.[6] Robust competition drives firms to respond to consumer needs, to adapt to changing circumstances, to be agile in innovation, to drive down costs, and to improve the quality of their offering.[7]

Competition policy has for many years tended to focus on the benefits of competition in increasing output and driving down prices (increasing 'allocative efficiency'), and in pushing firms to reduce their production costs to make the most efficient use of society's resources (increasing 'productive efficiency'). However, scholars and courts increasingly recognise that the most important benefit of competition may be improved dynamic efficiency, that is, the rate and spread of innovation.[8] While increases in allocative and productive efficiencies may improve the efficient use of resources in a static market setting, improvements in dynamic efficiency may create entirely new markets and serve needs that have not previously been met, 'leapfrogging' incremental developments in existing markets.[9]

New FinTech entrants in the banking industry offer the prospect of more vigorous dynamic competition, particularly in offering services via new technological channels and using technology to adapt services to the needs of consumers, including those who have been under-served by the traditional banking models.[10] Relative to traditional banks, FinTechs escape the burden of legacy systems; benefit from newer IT systems; have specialised skills and experience with new technologies, networks and big data analysis; enjoy lower cost

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banking industry; Michael C Keeley, 'Deposit Insurance, Risk and Market Power in Banking' (1990) 80 *American Economic Review* 1183, 1185–6.

[6] See, eg, Dombret, above n 4; Office of the Comptroller of the Currency, United States (OCC), 'OCC Summary of Comments and Explanatory Statement: Special Purpose National Bank Charters for Financial Technology Companies' (Explanatory Statement, March 2017) 3.

[7] See Eleanor M Fox, 'Against Goals' (2013) 81 *Fordham Law Review* 2157, 2159–60.

[8] See J Gregory Sidak and David J Teece, 'Dynamic Competition in Antitrust Law' (2009) 5 *Journal of Competition Law and Economics* 581, 600-1. See also Maria Ana Barata and Agnieszka Smolenska, 'EU Competition Policy in the European Banking Union – Are the Good Old Policies Good Enough?' (Policy Paper, European University Institute, 16 November 2017); Wolfgang Kerber, 'Should Competition Law Promote Efficiency? Some Reflections of an Economist on the Normative Foundations of Competition Law' in Josef Drexl et al (eds), *Economic Theory and Competition Law* (Edward Elgar, 2009) 98; Jonathan B Baker, 'Beyond Schumpeter Versus Arrow: How Antitrust Fosters Innovation' (2007) 74 *Antitrust Law Journal* 575, 583–6.

[9] See Sidak and Teece, above n 8, 600–1.

[10] See also Office of the Comptroller of the Currency (OCC), 'Supporting Responsible Innovation in the Federal Banking System: An OCC Perspective' (White Paper, March 2016) 2, 8, regarding the use of fintech to advance financial inclusion and serve the under-served.

structures, particularly where they have no bricks-and-mortar infrastructure; and move more quickly to grasp competitive opportunities.[11] FinTechs may also increase transparency in the market; reduce switching costs between providers; and especially serve the needs of the large number of 'millennials', who have recently entered the financial marketplace with a clear desire for technology-driven financial solutions.[12]

2. **Phased Licensing as a Much-Needed Next Step in Encouraging Fintech Entry**

Regulators in Australia are being actively encouraged to adopt changes to regulations which may be acting as barriers to innovation and competition. ASIC's regulatory sandbox, while a welcome advance towards encouraging more FinTechs to enter Australia's financial system, provides limited practical support upon entry given its tightly limited parameters.

APRA's proposal, in contrast, represents a more concrete approach to providing practical support for new market entrants. It enables FinTechs to establish themselves with more certainty as to their regulatory future. A restricted licence should provide them with time to hire key personnel, establish policies and IT systems, attract capital, build infrastructure and commit to third-party suppliers, all with the certainty of a restricted licence from the prudential regulator.[13] This should allow new entrants to build the capacity necessary to meet the prudential requirements for an ADI licence, before being legally required to do so.

3. **Consistency with International Trends in Restricted Licences for FinTechs**

Internationally, a number of regulators have recently introduced, or are considering the possibility of introducing, a restricted or conditional licence for new entrants or a licence specifically designed for FinTechs. APRA's proposed Restricted ADI licence is consistent with this trend. ***Annex A*** of this submission canvasses a number of international examples.

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[11] See also OCC, 'Supporting Responsible Innovation in the Federal Banking System: An OCC Perspective' (White Paper, March 2016) 4. See also HM Treasury, 'Regulatory Innovation Plan' (April 2017) 5.

[12] See Reserve Bank of Australia, Submission to the Productivity Commission Inquiry, 'Competition in the Financial System' (Submission, September 2017) 2 <https://www.rba.gov.au/publications/submissions/financial-sector/competition-in-the-financial-system/submission-to-productivity-commission-september-2017.pdf>. See also Office of the Comptroller of the Currency (OCC), 'Exploring Special Purpose National Bank Charters for Fintech Companies' (White Paper, December 2016) 1.

[13] See Prudential Regulation Authority (PRA), Bank of England, 'New Bank Start-up Unit: What You Need to Know from the UK's Financial Regulators' (Guide, March 2017) 11.

Additional Issues APRA May Wish to Consider

1. At the end of the two-year period in which an entity is allowed to have a Restricted ADI licence, APRA may place a number of conditions on the entity's new ADI licence rather than force the entity to close its business. There could, foreseeably, be a situation where many new, conditional ADI licences are issued, such that the value of an ADI licence is undermined because its meaning for any one institution becomes inextricably linked with the conditions placed on that ADI licence. Making the conditions on each licence publicly known would ameliorate this concern – but it is something for APRA to consider.

2. We note that a separate team has been established within APRA for the purposes of managing new licences. We agree this should increase efficiency and standardisation of processing applications. However, APRA may want to carefully consider how it now partners with frontline supervisors and risk specialists as part of the application process to ensure that frontline supervisors are fully aware of the nature of the Restricted ADI licence and the complete history behind any conditions which may, in the end, be attached to the entity's ADI licence after the two-year period. A strong level of collaboration between the new licensing team and APRA's frontline supervisors will be important for the success of this new initiative and a positive in terms of Knowledge Management.

3. While we agree in general with the assumption that the proposed phased approach to licensing ADIs is likely to increase competition in the banking industry, the effect of the new rules is difficult to assess without a dedicated ex ante impact (eg social and economic) analysis. Such an analysis would give APRA and the market stakeholders a greater understanding of the existing demand for the new rules and allow APRA to better assess the potential implications. To be effective, such impact analysis should assess quantitatively (rather than in a purely qualitative manner) not only the expected micro- and macroeconomic benefits, but also the costs of transition to the new licensing regime. The results of an impact analysis might affect the relevance of some of our observations (particularly in points 4 and 5 below). We appreciate that data availability might be limited at an early stage. Therefore, should APRA decide to proceed with the development of the phased approach to licensing ADIs, we propose a further follow-up (ex post) impact study at the end of the first year of operation of

the new rules. The results of such study could be made public. They would, in our view, form a solid basis for any further adjustments of the licensing regime, for example, by flagging any emerging systemic effects and allowing APRA to better allocate its resources.

4. The proposed licensing approach is – at least in its current form – innovation-neutral: eligibility for the new Restricted ADI licence does not depend on the degree of novelty or technological advancement employed by the new market entrants. This increases the potential impact of the new approach, but could also invite start-ups that do not innovate and wish to use the phased licensing regime simply as a testing facility in the run-up to the full (or conditional) ADI licence. Such applicants might limit the perceived benefits of dynamic competition in the banking sector, while at the same time requiring the regulator to divert additional resources to the review of applications. Should APRA proceed with implementing the new licensing approach, it might wish to analyse the application numbers and applicants' profiles at the end of the first year and tighten the eligibility requirements as necessary.

5. The less stringent requirements imposed on entities with a Restricted ADI licence are likely to increase the overall failure rate of the new market entrants. As a result, the new rules must ensure adequate protection of depositors and prevent abuse. Depending on the actual impact of the new licensing regime and the number of businesses with a Restricted ADI licence (see point 3 above), the proposed eligibility criteria and protective instruments may not adequately address the possible negative effects of failure (especially in case of mass withdrawals from the market) of the Restricted ADIs, including their impact on the public trust and perception. In the proposed scheme, the capital requirements act as a buffer to recoup potential losses, which – in the case of depositors – are limited to AUD 2,000,000 (the aggregate deposit cap). High quality (Tier 1) capital can indeed provide an effective safety net in cases of mass failures of Restricted ADIs, especially when coupled with the proposed exit arrangements. At the same time, market exit may take time, leaving depositors of failing Restricted ADIs unable to withdraw their money and creating negative publicity for the new licensing regime. APRA might consider a number of solutions. First, it could publish more details on what an 'exit plan' would include, including how customers can recover deposits in case of the failure of Restricted ADIs, given

the announced intention to avoid reliance on the Financial Claims Scheme (FCS). Second, APRA could prioritise reduction of failure rates in the first place by imposing stricter prudential requirements or limiting the types of permitted operations (eg by further restricting lending, in addition to the capital adequacy and liquidity requirements). Third, the negative impact of possible failure of Restricted ADIs may be reduced by limiting the types of customers from which they can accept deposits (eg only legal entities and natural persons who are also shareholders of such Restricted ADIs).

6. We understand that the Restricted ADI licences target primarily start-ups with limited financial resources and a simple product set. These businesses may lack the sophistication necessary for full compliance with the existing ADI licensing regime, at least initially. As a result, they are likely to require simple, clear and predictable rules, as well as regulator's assistance and a point of contact. Unclear and ambiguous licensing requirements may be misinterpreted as allowing the regulator to choose arbitrarily which businesses qualify for the new regime and could discourage potential applicants. At the same time, it appears that APRA 'does not intend to apply strict criteria to identify institutions which may qualify for a Restricted ADI licence'.[14] We stress the importance of clearly conveying to the target businesses (ie start-ups) the objectives and selection criteria, to ensure the new rules are not perceived as giving unfair advantage to businesses arbitrarily selected by the regulator.

7. As the new rules target primarily start-ups, we note that institutions which 'possess the resources and capability to apply for an ADI licence' will not be eligible for the new Restricted ADI licence.[15] Businesses considered 'well-resourced and established'[16] will thus be expected to apply for the 'full' ADI licence. In line with our comments in point 6 above, we emphasise the importance of ensuring a degree of certainty in applying the selection criteria. APRA might wish to develop criteria to separate businesses that are only eligible for a 'full' ADI licence. These criteria should be objective and, if met by a Restricted ADI, would trigger a duty to apply for

[14] APRA, 'Licensing: A Phased Approach to Authorising New Entrants to the Banking Industry' (Discussion Paper, 15 August 2017) 19.

[15] Ibid.

[16] Ibid 8.

an ADI license (conditional or unconditional). Another issue that could be considered is the remoteness of connection of start-up companies with the incumbent financial institutions: the former might be legally separate entities, but possess close ties with the latter. APRA could make it a requirement to disclose any such connections as part of the application disclosure. In addition to (or in place of) the negative eligibility criteria precluding the issuance of a Restricted ADI licence, APRA might consider introducing a new positive criterion – the genuine need for a transitional period to qualify for an ADI licence. This would be in line with some international examples of eligibility criteria for a regulatory sandbox.[17]

Conclusion

The introduction of a phased licence regime for ADIs is highly likely to serve the development of the FinTech sector in Australia, and enhance competition, particularly dynamic competition, in the provision of financial services, to the benefit of Australian consumers and the overall economy.

In implementing such a phased licence regime, we recommend APRA give consideration to how it might handle conditions imposed upon ADI licences granted at the end of the initial two-year period, how it might engage responsible supervisors early in the licensing process and how to properly formulate and convey to the prospective applicants the relevant eligibility criteria. We also invite APRA to perform a corresponding impact analysis of the new regime, on ex ante and ex post basis, to better inform the contents of the initial rules and their subsequent revision (if required).

[17] See eg Financial Conduct Authority, 'Sandbox Eligibility Criteria' <https://www.fca.org.uk/publication/documents/sandbox-eligibility-criteria.pdf> accessed 29 November 2017.

Annex A -- Emerging International Trends in Restricted FinTech Licences

United Kingdom

The United Kingdom (UK) government has stated its vision 'for UK financial services to be the most competitive and innovative in the world, supplementing existing services with greater choice and value for consumers', having 'firmly embedded competition and innovation objectives in the regulatory landscape for financial services through the main regulators' objectives and remits'.[18]

As APRA notes in the Discussion Paper, in the UK, the Prudential Regulation Authority (PRA), together with the Financial Conduct Authority (FCA), has introduced a phased authorisation option. Since 2016, the PRA and the FCA have permitted applicants for authorisation as a new bank to choose the 'mobilisation' option (sometimes called the two-stage 'Option B' authorisation process),[19] which allows the applicant a period of 12 months of restricted authorisation to build capacity, while meeting reduced prudential requirements. An institution granted the restricted authorisation under the 'mobilisation' option may not trade fully during this period, but is typically limited to receiving deposits of GBP 50,000.[20] The PRA and the FCA have also established a 'New Bank Start-Up Unit' to advise new and smaller entrants.[21]

Early reports are that, while entry remains challenging, the introduction of the 'mobilisation' option, and related initiatives supporting FinTech entry, has led to a substantial increase in entry by FinTechs in the UK.[22]

United States

In December 2016, the United States Office of the Comptroller of the Currency (OCC) published a White Paper on 'Exploring Special Purpose National Bank Charters for Fintech

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[18] HM Treasury, 'Regulatory Innovation Plan' (April 2017) 5.

[19] Morgan, above n 2, 9.

[20] Prudential Regulation Authority (PRA), Bank of England, 'New Bank Start-up Unit: What You Need to Know from the UK's Financial Regulators' (Guide, March 2017) 25.

[21] Ibid 4.

[22] See HM Treasury, 'Regulatory Innovation Plan' (April 2017) 13; Morgan, above n 2.

Companies'.[23] The OCC proposed to use its powers under the National Banking Act to grant special purpose national bank charters ('SPNB charters') to FinTechs wishing to conduct a banking business, as it has done in the past for 'trust banks' and 'credit card banks'.[24] However, the grantee of the proposed SPNB charter would generally be subject to the same regulatory requirements as national banks and federal savings associations,[25] with the OCC noting that 'applying a bank regulatory framework to fintech companies will help ensure that these companies operate in a safe and sound manner so that they can effectively serve the needs of customers, businesses, and communities, just as banks do that operate under full-service charters'.[26] The OCC has emphasised that there would be 'no "light-touch" supervision of companies that have an SPNB charter'.[27]

However, as for other charter applications, a FinTech applying for an SPNB charter would benefit from the three phases of the decision stage of the application process. These phases are:

- the preliminary conditional approval phase (during which the OCC may impose standard requirements as well as additional conditions relevant to the FinTech's particular business model and risk profile, while potentially adapting capital requirements);

- the organisation phase (when the bank raises capital and prepares for opening, and the OCC conducts a preopening examination); and

- the final approval stage (when the OCC decides whether the bank has met the requirements for opening).[28]

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[23] OCC, 'Exploring Special Purpose National Bank Charters for Fintech Companies' (White Paper, December 2016).

[24] Ibid 3; OCC, 'OCC to Consider Fintech Charter Applications' (Press Release) <https://occ.gov/news-issuances/news-releases/2016/nr-occ-2016-152.html>.

[25] OCC, 'Exploring Special Purpose National Bank Charters for Fintech Companies' (White Paper, December 2016) 2, 5.

[26] Ibid 2.

[27] OCC, 'OCC Summary of Comments and Explanatory Statement: Special Purpose National Bank Charters for Financial Technology Companies' (Explanatory Statement, March 2017) 3.

[28] OCC, 'Exploring Special Purpose National Bank Charters for Fintech Companies' (White Paper, December 2016) 14.

In March 2017, the OCC released a 'Draft Supplement' to its Licensing Manual, detailing the proposed application process for an institution seeking such a charter.[29] However, the OCC's proposal appears to have been derailed, at least for the time being, as a result of legal actions brought by the Conference of State Bank Supervisors and the New York Department of Financial Services, challenging the OCC's power to grant the proposed charters.[30]

Switzerland

In 2016, the Swiss government announced its intention to introduce a 'fintech licence' which would represent a 'business-type-neutral approach to facilitate regulation of institutions that do not conduct typical banking business' and permit deposits up to CHF 100 million.[31] Implementation will require an amendment of the Swiss Federal Banking Ordinance by the Swiss Parliament, which is shortly to be debated.[32]

Dubai

In 2017, the Dubai Financial Services Authority (DFSA) announced that it will permit FinTechs to apply for a new class of restricted financial services licence, referred to as an 'Innovation Testing Licence', which will permit the FinTech to test an innovative product or service in the Dubai International Financial Centre (DIFC) without complying with all of the normal regulatory requirements for a period of 6 to 12 months, which may be extended in exceptional circumstances.[33] The DFSA may impose restrictions on the business the FinTech may carry on; the number and type of customers it can serve; and the period of the licence. If the FinTech meets the outcomes listed in the detailed test plan submitted with the licence application, and it can meet full DFSA authorisation requirements, it will migrate to full

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[29] OCC, 'Comptroller's Licensing Manual Draft Supplement: Evaluating Charter Applications from Financial Technology Companies' (Draft Supplement, March 2017) <https://www2.occ.gov/publications/publications-by-type/licensing-manuals/file-pub-lm-fintech-licensing-manual-supplement.pdf>.

[30] See Chris Capurso, 'The OCC Fintech Charter: Status Report' (November 2017) *American Bar Association (Business Law Section) Consumer Financial Services Committee Newsletter*.

[31] Switzerland Global Enterprise, 'Fintech Switzerland' (Fact Sheet, 2017) <https://www.s-ge.com/sites/default/files/cserver/publication/free/factsheet-fintech-switzerland-s-ge.pdf >.

[32] Bär & Karrer, 'FinTech – First Part of New Regulation Enacted' (Briefing, July 2017) 2 <https://www.baerkarrer.ch/publications/BK-briefing-fintech-E-170705.pdf >.

[33] Dubai Financial Services Authority (DFSA), 'DFSA Launches Innovation Testing Licence for FinTech Firms' (24 May 2017) < https://www.dfsa.ae/MediaRelease/News/DFSA-launches-Innovation-Testing-Licence-for-FinTe>; DFSA, 'Gen 13: Facilitating FinTech Innovation' <http://dfsa.complinet.com/en/display/display_main.html?rbid=1547&element_id=23455>.

authorisation. Otherwise, the FinTech will be required to cease carrying on activities which require regulation in the DIFC.

European Central Bank

In contrast to these examples, in September 2017, the European Central Bank (ECB) published the 'Guide to Assessments of Fintech Credit Institution Licence Applications' (the ECB Fintech Guide).[34] The ECB states that its intention in publishing the ECB Fintech Guide is to create transparency for FinTechs applying for a banking licence regarding the criteria the ECB will apply, but at the same time it 'seeks to neither support nor discourage the entrance of FinTech banks as market participants, compared with banks with other types of business model'.[35] In fact, some believe that the ECB Fintech Guide indicates that the ECB may impose additional liquidity and capital requirements on FinTech entrants relative to other applicants.[36]

[34] Banking Supervision, European Central Bank, 'Guide to Assessments of Fintech Credit Institution Licence Applications' (Guide, September 2017).

[35] Ibid 2.

[36] See Carmen Alvarez, 'ECB: Banking Charters for Fintech Companies' (BBVA, 16 October 2017).