Conversion to a Bank in Australia

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1. Introduction

This memorandum briefly outlines the significant issues that would need to be addressed by an existing financial entity (**Company**) should it seek to convert to a bank in Australia. Please note that this is a general overview of the regulatory environment in Australia and is not tailored to the particular circumstances of any particular entity.

The Company will require authorisation from the Australian Prudential Regulation Authority (**APRA**) to become a bank in Australia. APRA is the body empowered to grant authorisation to conduct any banking business in Australia.

Another regulatory body that is important in the regulation of authorised deposit-taking institution is the Australian Securities and Investments Commission (**ASIC**), particularly in relation to the Company obtaining an Australian Financial Services License. This memorandum does not deal with all the above matters in detail, however is a good guide to thinking about the key issues at play when proposing to convert to a bank in Australia.

This memorandum:

(a) assumes that the Company is not a subsidiary of a non-operating holding company. If this is not correct, then certain other requirements will need to be complied with;

(b) does not consider any potential application of the *Foreign Acquisitions and Takeovers Act 1975* (Cth).

If any further information in respect of any of the points raised in this memorandum or other matters is required, please do not hesitate to contact us.

2. BECOMING A BANK

Under the *Banking Act 1959* (Cth) (**Banking Act**), it is an offence to conduct a banking business in Australia without an Authorised Deposit-taking Institution (**ADI**) licence from APRA, giving it authority to do so. A 'banking business' includes the business of taking of money on deposit and making advances of money. To become a bank in Australia, the Company must apply to APRA for an authority to carry on a banking business. An entity authorised to carry on a banking business in Australia is called an ADI.

The basic requirements that the Company would be required to meet when seeking authorisation from APRA are set out below. APRA encourages potential ADI licence applicants to contact APRA at an early stage to discuss their intentions to apply for an authorisation prior to

filing a formal application, to give APRA an opportunity understand the institution's proposals as well as raise potential issues or concerns at an early stage. This will also help the applicant to understand APRA's expectations and the licensing process.

APRA may review and comment on drafts of an application through the various stages of its development.

2.1 Application to use restricted words and expressions

The words 'bank', 'banker', 'banking', 'building society', 'credit union' or 'credit society' are restricted under the *Banking Act*, and the Company will need to obtain consent from APRA under section 66 of the Banking Act to use such terms or similar terms in its name.

The purpose of the restriction is to protect the public and ensure that customers are not misled into believing that an institution meets the prudential requirements that apply to ADIs, when in fact it may not be the case. Consent would only be granted if APRA is satisfied that allowing the institution to use the restricted words would not defeat the purpose of the restriction. APRA may also impose conditions on an institution's use of the restricted words.

2.2 Criteria for ADI Authority

Only corporations (and not partnerships or other unincorporated entities) can apply to APRA for an ADI authority. If this has not already been done, a prospective applicant must register a company with ASIC under the *Corporations Act 2001* (Cth) (**Corporations Act**) prior to seeking an ADI authority.

An applicant is not required to offer a full range of banking services on authorisation but must have the expertise in its selected area of operation. APRA expects that where an applicant does not have an existing operation in Australia it will establish its capacity during the authorisation process so that it is ready to commence business when it is granted the authorisation. See also paragraph 2.6 which outlines the new restricted ADI licenses regime which APRA is proposing to introduce in the future.

The requirements for applicants may vary on a case by case basis. APRA has, however, issued updated guidelines called "Guidelines on Authorisation of ADIs" dated April 2008 (Authorisation Guidelines), which, amongst other things, prescribe the minimum criteria that a locally incorporated ADI will be required to meet in order to be eligible to apply for a branch banking authority. Under the Authorisation Guidelines to apply for banking authority from APRA, the Company will need to meet certain minimum criteria including the following:

(c) have the capacity and commitment to conduct banking business with integrity, prudence and competence on a continuing basis;

(d) adhere to all prudential requirements set down by APRA. Higher prudential requirements may be set on a case by case basis (e.g. a newly authorised ADI);

(e) demonstrate a wide spread of shareholdings unless exempted under the *Financial Sector (Shareholdings) Act 1998* (Cth);

(f) satisfy APRA that from the commencement of operations its risk management and internal control systems are adequate and appropriate to monitor and limit risk exposures;

(g) satisfy APRA that its compliance processes and systems are adequate and appropriate to ensure compliance with APRA prudential standards and all other Australian regulatory and legal requirements;

(h) satisfy APRA that its information and accounting systems are capable of producing all required statutory and prudential information in an accurate and timely fashion from the commencement of its banking operations;

(i) have in place arrangements with an external auditor to report to APRA on:

(i) the observance of prudential standards;

(ii) compliance with statutory requirements as well as any conditions on its ADI authorisation;

(iii) the reliability of information supplied to APRA;

(iv) whether the external auditor has become aware of any matter which in its opinion may have the potential to materially prejudice the interests of depositors; and

(v) any other matters agreed between the bank, the external auditor and APRA, and

(j) submit to APRA an acceptable 3-year business plan.

In addition, where an applicant is a foreign bank seeking to establish an Australian branch, APRA will require further minimum criteria, including that the applicant be incorporated and recognised as a bank under the law of its home country, consent be received from the home country supervisor for the establishment of a branch in Australia, that adequate reporting arrangements are in place to the parent or head office, and that the applicant is subject to adequate standards of prudential supervision in its home country (including as to capital adequacy) and that it is supervised on a consolidated basis consistent with the provisions of the Basel Concordat.

2.3 Documents to be provided

The Company's final application must be accompanied by the supporting information which includes:

(a) (**ownership and management**) ownership and management details of the Company including a brief history, outline of its operations, substantial shareholders and their respective shareholdings, directors and senior management, financial information of the Company for the last three years, and if applicable, an outline of the proposed branch framework and proposed reporting lines to the head office;

(b) (**3-year business plan**) a 3-year business plan including an outline of proposed activities, details of proposed borrowing and lending activities, principal Australian office location, estimate staff numbers, proposed commencement date and projections of financial projections (detailed balance sheet, cash flows and earnings and key financial and prudential ratios);

(c) (**systems and controls**) details of risk management systems and procedures, information and accounting systems, internal audit arrangements, business continuity plan (including disaster recovery), evidence that information and other systems will be capable of producing all required statutory and prudential returns accurately and in a timely fashion;

(d) (**subsidiaries**) details of existing or proposed subsidiaries and associates, the nature and scale of business and their proposed business relationship with the proposed ADI, as well as any plans to transfer assets from any subsidiaries or associates to the proposed ADI;

(e) (**other**) the certificate of incorporation and constitution of the proposed corporate vehicle, and an external auditor's certificate verifying the level of capital and capital ratios of the applicant.

(f) (**APRA prudential supervision**) an undertaking to adhere to APRA prudential requirements at all times, consult APRA and be guided by it on prudential matters, provide APRA with any information it may require for the prudential supervision of the proposed branch and evidence that arrangements are in place for the external auditors of the bank to report to APRA as required.

If the applicant is a foreign bank looking to establish a branch in Australia, further documentation is required from APRA, including from the applicant's parent or head office.

2.4 Timing for obtaining authorisation

The Authorisation Guidelines state that the APRA licensing process can take between 3 to 12 months. The delays usually experienced in obtaining authorisation relate to applicants providing incomplete information or delay in responding to APRA requests. The approval may also be contingent on other approvals, such as from the Foreign Investment Review Board or in relation to Australian Financial Services Licences, as discussed below.

APRA will also assign a responsible staff member as a point of contact for each applicant for the authorisation process.

2.5 Retail Banking

Locally incorporated banks are subject to legislative and prudential requirements, such as those in relation to capital adequacy and depositor protection provisions in the Banking Act. As with all ADI applicants (other than a foreign bank branch), a locally incorporated ADI will need to hold a minimum of A$50 million in Tier 1 capital. Otherwise, there is no set amount of capital that is required for an authority to carry on banking business in Australia.

At all times, the locally incorporated ADI will also need to maintain a prudential capital ratio of 8% of the total risk-weighted assets, of which at least half must be made up of Tier 1 capital (i.e. a minimum Tier 1 capital ratio of 4%). Newly established ADIs may be subject to a higher minimum capital ratio in their formative years depending on the risk profile of the proposed operations.

2.6 Proposed Amendments to Banking Legislation

On 19 October 2017, the *Treasury Laws Amendment (Banking Measures No. 1) Bill 2017* (Cth) (**Bill**) was introduced, with the primary objectives of improving the stability of the financial sector by increasing the regulatory burden of non-ADI lenders, removing restrictions on the use of term 'bank', and modernising the objects of the Banking Act. Whether the Bill will pass into law is yet to be seen and Ash Street will continue to monitor this space.

We summarise the key proposed amendments below:

(a) Regulation of non-ADI Lenders

Currently, APRA has regulatory oversight of all ADIs, however has little power over other providers of finance who are not considered to be conducting a 'banking business' (e.g. because they do not take deposits). The Bill will, if passed, give APRA the power to make rules which apply to non-ADI lenders, although this power is still more narrow than APRA's powers in relation to ADIs and limited to those issues which pose a material risk to the stability of Australia's financial system.

(b) Removing restrictions on the use of the term 'bank'

Under the proposed new section 66 of the Banking Act, it will no longer be an offence for an ADI to use the words 'bank', 'banker' or 'banking' in relation to its financial business, as long as APRA has not issued a determination prohibiting its use. While APRA currently permits only ADIs with a Tier 1 capital of over A$50 million from using such term the Explanatory Statement of the Bill states that the intention here is to "*create a more level playing field in the banking sector*" by allowing smaller ADIs to label themselves as a bank. Nevertheless, APRA will retain a discretion to make determinations as to whether specific ADIs will be able to use these terms, particularly where the ADI does not have the ordinary characteristics of a bank.

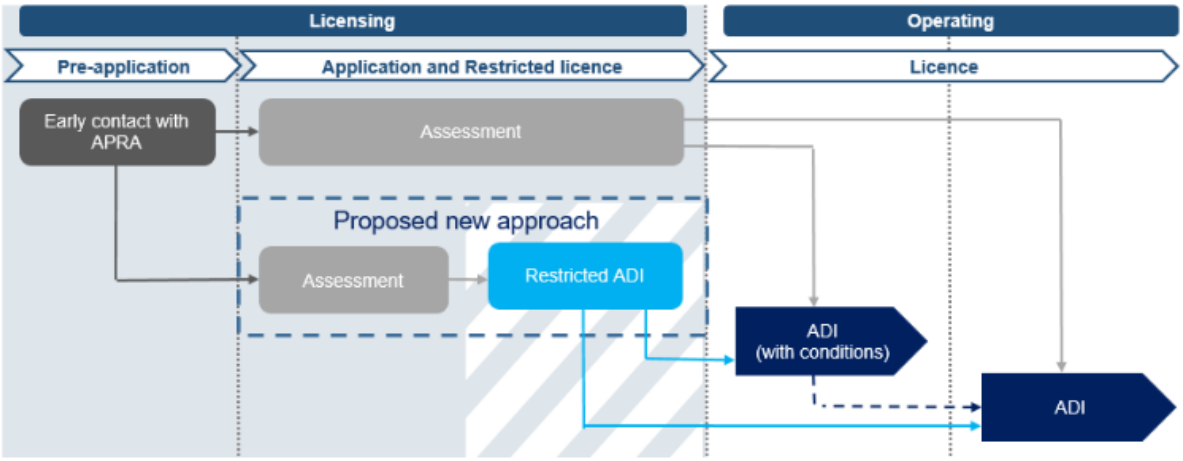
(c) Modernising the objects of the Banking Act

The Bill proposes to insert a number of objects to set out the purpose of the Banking Act. In particular, it signals the wide powers of APRA to regulate the Australian financial system, hold banking executives accountable, manage the operations of ADIs (including where an ADI fails or threatens to fail in complying with its obligations) as well as administer the FCS. Nevertheless, the primary purpose of protecting the interests of depositors has not changed.

2.7 Application for a Restricted ADI Licence

On 15 August 2017, APRA released a discussion paper in relation to their proposed introduction of a phased approach to granting ADI licences, by introducing the "Restricted ADI licence" for certain applicants seeking to become ADIs to reduce barriers for new entrants with limited financial resources, particularly those with innovative or non-traditional business models or those leveraging greater use of technology, to allow them time to develop their business to meet APRA's prudential framework.

The proposed licensing model is aimed at facilitating new entrants and encouraging innovation in the banking industry, particularly small institutions in their formative years. Well established corporations or prudentially-regulated institutions (e.g. financial institutions with adequate resources and capabilities) are less likely to be considered for restricted ADI licences.



Source: APRA Discussion Paper, Licensing: A phased approach to authorising new entrants to the banking industry. 15 August 2017, page 4.

The new proposed approach introduces a 3-step approach to licensing:

(a) **Restricted ADI Licence** – A temporary licence for institutions which require time to build resources and capabilities. Restricted ADIs will not be required to comply with the full set of prudential requirements, however due to the inherently riskier nature of restricted ADIs, APRA will impose alternative restrictions to ensure that the public is adequately protected, including imposing maximum deposits from single depositors to A$250,000, maximum aggregate deposits of A$2 million, as well as restricting the product and service offerings of the restricted ADI. Minimum capital adequacy and liquid holdings may also apply and will be reviewed by APRA on a case-by-case basis. Applicants are required to hold a minimum of A$3 million plus wind-up costs in start-up capital, and directors and senior management must meet APRA's fit and proper standards.

A restricted ADI licence has a maximum period of 2 years, during which the applicant will be expected to develop its capabilities to fully meet the prudential framework and transition into an ADI licence with conditions, or a full ADI licence. If the institution fails to do so within the time frame, APRA will require the ADI to exit the banking industry.

(b) **ADI Licence with conditions –** This licence would allow an ADI to operate within certain conditions, and would be particularly appropriate for ADIs with a limited or niche business model.

(c) **ADI Licence –** the appropriate licence for applicants with resources and capabilities to offer broad banking services.

The supporting information that is required is less substantive than the set of documents required in a full ADI licence application. APRA will require information as to the applicant's structure, ownership, governance and business plan. In addition, a strategy will have to be provided which shows the institution's plan to fully meet the prudential framework within the required time frame, as well as an exit plan should the strategy be unsuccessful.

Due to the nature and risk of a restricted ADI, the institution will have to demonstrate the capability to provide information necessary for the Financial Claims Scheme (**FCS**), which is a safety net operated by APRA to protect depositors and can be activated by the Australian Government if an ADI fails. Depositors are protected up to a limit of $250,000 at each bank, building society and credit union that is incorporated in Australia and authorised by APRA. If the FCS is activated following the failure of an ADI, APRA will endeavour to pay account holders, or enable them to access, their FCS payments within seven calendar days.

APRA expects to be able to grant restricted ADI licences more quickly than a full ADI licence.

APRA is inviting written submissions on its proposal for the phased licensing approach, which should be sent to APRA by 30 November 2017.

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3. AUSTRALIAN FINANCIAL SERVICES LICENCE

3.1 Requirement to hold an AFSL

The Company will need to apply for an AFSL if it wishes to carry on a "financial services' business in Australia. A person provides a "financial service" if it:

(a) **provides financial product advice** (e.g. advice on the purchase and sale of shares);

(b) **deals in a financial product** (e.g. an ADI providing a deposit-taking facility);

(c) **makes a market for a financial product** (e.g. a market for the purchase and sale of shares);

(d) **operates a registered scheme** (e.g. manages a registered managed investment scheme); or

(e) **provides a custodial or depository service** (e.g. holds shares on behalf of clients).

A "financial product" includes securities, derivatives and deposit-taking facilities made available by ADIs. If the Company will provide deposit-taking facilities as an ADI, it is likely that the Company will require an AFSL. If the Company carries on different financial services, it will be required to hold an AFSL in respect of each type of financial service that it provides.

AFSLs are issued to protect the public by ensuring that licensees have the appropriate skill, financial resources and compliance systems. ASIC maintains a register of licensees (as well as authorised representatives and declared professional bodies).

3.2 Applying for an AFSL

Applications for an AFSL must be lodged with ASIC by lodging the necessary form (which must be completed online), together with the supporting documents and application fee.

Prior to lodging an application, it is important for the Company to consider what financial services or products it wishes to provide or deal with in Australia. This is because the AFSL is only granted with respect to the products or services the Company specifies in its application. ASIC may impose licence conditions to ensure that a licensee complies with its ongoing obligations.

At a minimum, ASIC requires a business description of the applicant, details as to its organisational competence, financial resource statements and documents in relation to each nominated responsible manager. Where the proposed financial services or products are more complex, ASIC may require additional proof documents and further information to prove that the applicant can meet its obligations as the holder of an AFSL.

3.3 Timing

The obtaining of an AFSL will require a significant undertaking on the part of the Company. In terms of timing it can take at least between three to four months and this depends to a large extent on the type of financial services business the Company may wish to carry on, the identification of employees with the requisite experience upfront and the completeness of the information provided by the Company.

3.4 Obligations of an Australian Financial Service Provider

Financial service licensees are subject to a number of statutory obligations, including:

(a) ensuring its financial services are provided **efficiently, honestly and fairly**;

(b) having adequate arrangement to manage **conflicts of interest**;

(c) complying with any **conditions** on the license imposed by ASIC;

(d) complying (including ensuring its representatives comply) with **financial service laws**;

(e) having **adequate resources** to provide the financial services;

(f) **maintain competence** (including by ensuring its representatives are adequately trained);

(g) having adequate **risk management systems**; and

(h) if financial services are provided to retail clients, having a **dispute resolution system**.

A financial services licensee must also notify ASIC as soon as practicable (and in any case within 10 business days) upon it becoming aware of any significant breach or likely significant breach of its obligations. Failure to do so is a civil penalty provision.

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4. MONEY LAUNDERING AND TERRORISM FINANCING

4.1 *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (Cth) Framework

The *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (Cth) (**AMLCTFA**) places obligations in certain "reporting entities" to take certain steps in relation to the prevention of money laundering and terrorism financing. This Act implements the international standards established by the Financial Action Task Force on Money Laundering.

A reporting entity is an entity which provides a "designated service". A "designated service" is defined broadly and in relation to ADIs and banks, includes the opening of an account, accepting money on deposit, allowing a transaction to be conducted and making a loan. These obligations also extend to building societies and credit unions.

4.2 Obligations of Reporting Entities

Under the AMLCTFA and associated regulations, banks have a number of obligations, including:

(a) enrolling or registering the business with AUSTRAC;

(b) carrying out customer identification and verification procedures prior to providing a designated service (such as opening an account);

(c) carrying out ongoing due diligence on customers;

(d) creating an anti-money laundering and counter terrorism financing program to help identify money-laundering risks and manage them;

(e) reporting suspicious transactions;

(f) reporting of transactions over A$10,000.

4.3 Enforcement

Banks that do not comply with these requirements could be subject to pecuniary penalties and injunctions. A company or individual may also have criminal proceedings brought against if they are in breach of their obligations to:

(a) report certain movements of physical currency in and out of Australia (s 53 of the AMLCTFA);

(b) report certain movements of bearer negotiable instruments in and out of Australia (s 59(3));

(c) not provide remittance services while being unregistered (s 74 of the AMLCTFA).

Reporting entities must also keep certain records for 7 years to allow AUSTRAC to easily monitor and enforce the regime under the AMLCTFA.

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5. PRUDENTIAL REGULATION

5.1 Basel III Framework

APRA has published a number of Prudential Standards which implements the international banking regulation formulated by the Basel Committee on Bank Supervision. By way of introduction, Basel I was the first regulatory accord which provided a framework for regulatory review, as well as disclosure requirements for assessment of capital adequacy of banks. Australian began implementing Basel II in November 2004, which expanded the rules for minimum capital requirements by requiring banks to maintain minimum capital ratios of regulatory capital over risk-weighted assets, as well as further improvements and requirements such as regulatory supervision and market discipline.

Basel III was then developed in response to the global financial crisis of 2007-2008 to strengthen capital requirements. Australia began implementing Basel III on November 2012 and it is now reflected in the latest amendments to APRA's Prudential Standards 110 to 120, as well as the reporting requirements in ARS 111. ADIs must be compliant with the Basel III liquidity cover ratio rules and net stable funding ratio rules, including that an ADI must:

(a) hold enough liquidity to undertake a 30-day stress test;

(b) maintain a common equity tier 1 capital ratio of 4.5% (increased from 2%);

(c) maintain a tier 1 capital ratio of 6% (increased from 4%);

(d) maintain a total capital ratio of 8%; and

(e) hold a capital conservation buffer of 2.5% of the ADI's total risk-weighted assets.

5.2 Notification of Breach

ADIs are required to adhere to these prudential standards, and must report any significant actual or potential breaches to APRA as soon as practicable, failure of which may result in a fine of 200 penalty units (A$42,000).

If APRA suspects that an ADI has breached or may breach a standard, it may issue a direction that the ADI comply with the standard. Refusing to comply with this direction carries a fine of 50 penalty units (A$10,500).

Ash Street Partners Pty Limited

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