



Regulation Impact Statement

Banking exemption order for religious charitable development funds

(OBPR ID: 2013/15019)

Introduction

1. This Regulation Impact Statement (RIS) has been prepared by the Australian Prudential Regulation Authority (APRA). Its purpose is to assist APRA in making a decision on proposed changes to *Banking exemption No. 2 of 2015* (the Exemption Order) designed to more clearly delineate the boundary between the prudentially-regulated banking sector and entities not prudentially-regulated, and to reduce the risk that a retail investor in an religious charitable development fund (RCDF) would confuse such an investment with an authorised deposit-taking institution (ADI) deposit or transactional ADI product. RCDFs are a type of shadow banking entity that engage in credit intermediation, in part by receiving funds from retail investors who wish to support the work of their church denomination and making loans to church parishes that require capital to build/extend schools, aged care facilities, church facilities and the like. The proposals, if adopted, would impose limitations on products offered by RCDFs to ensure RCDFs are not mistakenly associated with prudentially-regulated financial institutions, and would require enhanced disclosure to assist retail investors to better understand the risk profile of the products they are investing in. The proposals have been developed in conjunction with similar reforms to the regulatory framework for Registered Financial Corporations (RFCs).

Background

2. APRA's mandate is to balance the objectives of financial safety and efficiency,

competition, contestability and competitive neutrality of prudentially-regulated financial institutions so that they can meet their financial promises to depositors, policyholders and superannuation fund members within an efficient and competitive financial system. In so doing, APRA is required to promote financial system stability in Australia. APRA carries out its mandate through a multi-layered prudential framework that encompasses licensing and supervision of regulated financial institutions.

3. Under section 9 of the *Banking Act 1959* (the Banking Act), a body corporate that wishes to carry on banking business in Australia may only do so if APRA has granted an authority to do so. Banking business for the purposes of the Banking Act is held to be the taking of money on deposit and making advances of money. Once authorised by APRA to undertake banking business, the body corporate is an ADI and is subject to APRA's prudential requirements and ongoing supervision.
4. Under section 11 of the Banking Act, APRA may determine that certain or specified provisions of the Banking Act do not apply to entities while the determination is in force.
5. RCDFs are a class of entity whose activities fall within the definition of banking business but that have been granted an exemption by APRA from the need to be authorised as ADIs. RCDFs were established for the purpose of borrowing and using money for religious and charitable purposes. These fundraising and lending activities meet the definition of 'banking business' in the Banking Act. To date, RCDFs have been granted an exemption from the need to be authorised under the Banking Act. The exemption applied to such funds is historical in nature with some of the original exemption orders dating back to the 1960s. APRA has continued to exempt RCDFs from the need to be authorised, subject to certain conditions. These conditions include that an RCDF:
 - exists for a religious and charitable purpose;
 - is operated as not-for-profit;
 - does not offer transactional banking facilities including EFTPOS, ATM and cheque accounts (the latter can be offered to affiliates of the RCDF);
 - discloses that it is not prudentially supervised by APRA; and
 - provides a disclosure to an investor stating that it is not prudentially supervised by

APRA nor covered by the depositor protection provisions in section 13A of the Banking Act.

6. In order to ensure a consistent and uniform approach is applied in the granting of such orders, APRA made a single class order, with common conditions (as noted above), in 2006 that applied to all RCDFs listed on that Order (the 2006 Exemption Order). The 2006 Exemption Order was made for a period of five years. In 2011, APRA renewed the 2006 Exemption Order for a further period of two years (the 2011 Exemption Order) and notified RCDFs that it would review the operation of the Order and the conditions attaching to it prior to its expiration in 2013. APRA commenced a review of the 2011 Exemption Order in April 2013 with the release of a discussion paper, *Banking Act exemptions and section 66 guidelines*. The 2011 Exemption Order was remade unchanged in June 2013 to allow for the continued consultation on proposed changes. APRA released revised proposed conditions to the Exemption Order in August 2013 in a response paper, *Response to Submissions Religious charitable development funds*, but subsequently placed its proposed reforms on hold following the Government's announcement of the Financial System Inquiry (FSI).
7. APRA has continued to remake the Exemption Order without change pending finalisation of the FSI and the Government's response.
8. Recommendation 35 of the Final Report of the FSI stated, with respect to investment products:

'Clearly differentiate the investment products that finance companies and similar entities offer retail consumers from authorised deposit-taking institution deposits'.
9. The Government's response to the Final Report of the FSI of October 20 2015 noted in relation to recommendation 35:

'The Government agrees with the need to clearly differentiate financial products. We support APRA improving product differentiation for retail consumers while at the same time noting that the sensitivities of potential adjustments for particular sectors will need to be considered'.
10. The FSI's recommendation on investment products, and the Government's response, are relevant to investment products offered by RCDFs.
11. With the release of the Government's response to the Final Report of the FSI, APRA now

proposes to finalise its review of the Exemption Order. APRA has therefore extended the Exemption Order unchanged for a further 12 months, until 31 December 2016, in order to provide certainty to RCDFs while APRA finalises its proposals on the future operation of the Exemption Order, details of which will be released in early 2016.

Problem

12. There are a number of developments that necessitated a review of the operation of the Exemption Order, including:

- the reliance on retail funding, and particularly funding sourced through products with a high degree of similarity to retail transactional product offerings of ADIs, has blurred the distinction between RDCFs and ADIs such that investors in RDCFs may mistakenly believe they have bank-like products with associated depositor protections;
- the existence of unregulated entities offering bank-like products to retail investors means that Australia's arrangements do not wholly conform with global principles defining the permissible activities of banking institutions; and
- instances, both domestically and internationally, of financial problems within charitable institutions indicates that such entities are not without risk to retail investors.

Blurring of distinction between RCDFs and ADIs

13. In Australia, the term 'shadow banking' encompasses a broad range of entities including RCDFs, RFCs, hedge funds and structured investment vehicles. While it is recognised that shadow banking entities have a role to play in financial intermediation, such entities undertake the same (or similar) activities as prudentially-regulated entities but without the rigorous scrutiny that applies to the prudentially-regulated sector. This allows bank-like institutions to raise deposit-like funding to make bank-like loans. While some shadow banks (such as RCDFs) may operate as not-for-profit, their investors are still exposed to potential significant losses should they fail. In addition, the size of shadow banking systems can also pose systemic risks in some jurisdictions, albeit not in Australia. For these reasons, global policymakers have been promoting a clearer boundary between the regulated and unregulated banking systems and greater oversight of shadow banking

sectors that pose systemic risks. While the shadow banking system in Australia is relatively small, the risks to individual investors are the same.

14. As previously noted, RCDFs are currently provided an exemption from the need to be authorised as ADIs, hence they are not subject to APRA's prudential regulation and supervision. The foundation for this type of exemption was to allow religious organisations to pool resources from affiliated bodies such that funding could be directed where needed to support the functions of an RCDF. However, many RCDFs also accept funds from retail investors who have a connection with the RCDF, generally based on religious affiliation; in some cases a person without such an association may also invest their funds with an RCDF.
15. Reviews of the operation of RCDFs have shown that despite the existing conditions on RCDFs, the product offerings of many such funds, and the way they describe and market their products, are in many ways indistinguishable from ADI transactional banking products, especially at the smaller end of the market. This means there is no clear difference between the nature of products offered by RCDFs and those offered by ADIs.
16. A related prudential concern is the acceptance of funds from retail investors. Currently, RCDFs are able to accept funds from retail investors through their conduct of banking business but without the safeguards under the Banking Act that retail investors who place deposits with ADIs are entitled to. Based on data provided in June 2013, funding of RCDFs attributable to retail investors amounted to approximately \$1.3 billion.¹ APRA considers that the continued existence of exemptions to entities that conduct banking business but that are not required to ensure that there are safeguards akin to those in the Banking Act for retail investors in those entities is inappropriate. The not-for-profit structure of RCDFs does not, in APRA's view, alter this situation (indeed, many ADIs under the Banking Act operate as mutual, not-for-profit organisations).
17. In some cases, RCDFs have a larger retail investor base than some smaller ADIs. Some RCDFs offer online facilities, and this technology is broadly available, so geographic barriers to business have been reduced. Given RCDFs are engaged in banking-like

¹ APRA does not regulate RCDFs nor does it routinely collect data from them. This is the most recent data that was made available to APRA in 2013, prior to this matter being put on hold during the FSI.

business it may be that RCDFs are, in some instances, operating in the same market as ADIs and can be considered as competitors to ADIs. APRA's continued provision of an exemption to RCDFs allows them to conduct banking-like business without the authorisation and ongoing regulatory and supervision requirements that ADIs are subject to. This also means they are provided an inappropriate competitive advantage vis-à-vis ADIs. This issue has become more relevant as RCDFs increasingly operate in the retail banking sector.

Conformance with global principles

18. The global principle governing the permissible activities of banking institutions is set out in the Basel Committee on Banking Supervision's (Basel Committee's) *Core Principles for Effective Banking Supervision* (Core Principles).² The relevant principle requires, *inter alia*, that the taking of deposits from the public be reserved for institutions that are authorised and prudentially supervised as banking institutions.

19. In 2012, the International Monetary Fund (IMF) conducted a review of Australia's observance of the Core Principles, as part of its Financial Sector Assessment Program (FSAP), and noted:

‘Australian law permits the existence of non-authorised and non-supervised deposit-taking institutions. The number of such institutions is small and the scale of their activities is predominantly *de minimis*, however there are major global institutions benefitting from this exemption within the Australian market and deposit-like facilities are being offered to the public.’³ The IMF recommended that APRA:

‘Revise the conditions for exemption from section 11 of the Banking Act for Registered Financial Corporations to ensure, at a minimum, that such exemptions be limited to institutions reliant wholly on wholesale funding.’

This recommendation is relevant in the context of many RCDFs who, like some registered financial corporations, are reliant on retail funding.

² Basel Committee on Banking Supervision, *Core Principles for Effective Banking Supervision* at <http://www.bis.org/publ/bcbs230.htm>.

³ Australia, *Basel Core Principles for Effective Banking Supervision: Detailed Assessment of Observance*, 21 November 2012 at <http://www.apra.gov.au/AboutAPRA/Publications/Pages/default.aspx>

20. The IMF's recommendation can be put into a global context. The shadow banking system is defined as a system of entities and activities outside the regulated banking system that provides credit intermediation. Globally, policymakers and regulators have stepped up their focus on 'shadow banks' in the wake of the global financial crisis, which saw considerable stress in both banking and shadow banking systems. Indeed the Australian Government has already indicated its commitment to improving oversight of the shadow banking sector, by making it a priority of its G20 leadership agenda.⁴

Evidence of failure

21. While the purpose of RCDFs is both a charitable and not for-profit purpose, which is different to that of ADIs⁵, it is the case that RCDFs offer retail products which are similar or the same as the banking products of ADIs. While to date there has been no failure in the RCDF sector in Australia, there have been cases of material losses recorded by religious bodies, including at least one RCDF. In addition, there have been collapses of religious bodies in overseas jurisdictions.

22. On the domestic front, one diocese lost \$160 million from falls on global share markets at the height of the global financial crisis. These losses had a material impact on the charitable activities of the diocese in question. More recently, a Victorian church suffered significant losses as a result of a failed school development programme, with the church in question to divest itself of a number of church properties in order to fund the \$46 million loss. While these were not RCDFs, and retail investors lost no funds, these examples serve to illustrate that charitable and not-for-profit bodies face risks, investment and otherwise, and do lose money from time to time.

23. There are also examples of failures on the international front. In 2008, the Presbyterian Mutual Society in Northern Ireland, whose investors consisted of the local laity, were left exposed after the Society collapsed when it suffered a run on withdrawals during the global financial crisis. Another international example of financial failure involves the Catholic Archdiocese of Maribor in Slovenia which has been effectively bankrupted due to bad investments, funded by parishioners and augmented by debt. Losses are unclear

⁴ G20 2014: Overview of Australia's Presidency, December 2013 - https://www.g20.org/sites/default/files/g20_resources/library/G20Australia2014conceptpaper.pdf

⁵ Note, however that Australia has a significant ADI sector which also operates on a not-for profit basis.

but have been estimated at €500 million.

24. In addition, there have been collapses amongst other types of shadow banking entities in Australia, including most recently that of Banksia Securities Limited which was offering products that were the same or very similar to ADI products and not dissimilar to product offerings of many RCDFs.

Objectives of APRA's proposals

25. APRA is proposing amendments to the Exemption Order aimed at more clearly delineating the boundary between the prudentially-regulated banking sector and entities that are not prudentially regulated thereby reducing the risk that a retail investor in an RCDF would confuse such an investment with an ADI deposit or transactional ADI product.

26. The proposed amendments to better distinguish RCDF banking products from those of ADIs are:

- to prohibit the use of the words 'deposit' and 'at-call', and derivatives of those words, by RCDFs by including additional conditions on the Exemption Order;
- to require that retail funding has a minimum term or call period of 31 days. An investor would not be able to redeem, and an RCDF would not be able to repay, any funds for a minimum of 31 days from the date they are invested, except in cases of demonstrated hardship;
- to prohibit RCDFs from providing BPAY transactional facilities to retail investors (other than as a BPAY payee). RCDFs are already prohibited from offering ATM, EFTPOS and cheque account facilities; and
- enhance the prudential warning, including a statement that investors in an RCDF are not covered by the Financial Claims Scheme (FCS).

27. The objective of APRA's proposals is to ensure the continued appropriateness of the conditions under which exemptions from the need to be authorised under the Banking Act are provided. Specifically, in this case, the objective is to ensure that retail investors understand that their investment in an RCDF is not equivalent to a deposit with an ADI.

28. APRA's proposals would result in a clearer regulatory boundary between the prudentially-regulated ADI sector and RCDFs engaged in banking-like business. The proposals seek to minimise any potential misunderstanding on the part of retail investors as to whether an entity in which they are investing is regulated and supervised in a similar manner to an ADI. APRA's proposals do not seek to prevent RCDFs from offering products to retail investors but would require RCDFs to ensure the products they offer are not essentially transactional banking facilities akin to those offered by ADIs. RCDFs will still be able to avail themselves of the Exemption Order provided they meet the conditions attaching to the Order on an ongoing basis.
29. APRA's proposed approach recognises that strengthening disclosure requirements will not itself be sufficient to achieve the stated objectives. Whilst expanded disclosure may place more information in front of investors, ASIC noted in its Report 230 on *Financial literacy and behavioural change*, that 'people (including investors) are often overwhelmed by the volume and complexity of information available to them, including disclosure material such as Product Disclosure Statements, prospectuses and annual reports.'⁶ The Report further found that 'investors (across different comparison groups) chose not to read the prospectus or ignored the information in it.'⁷
30. These findings reinforce other survey results about the limited community understanding of Australia's financial regulatory arrangements. A survey conducted in 2006 by Roy Morgan Research for the Reserve Bank of Australia found, *inter alia*, that few people could correctly identify the prudential supervisor of banks, building societies and credit unions from a multiple choice list.⁸ The most common answer was 'other/can't say' (36 per cent) followed by 'Reserve Bank' (28 per cent). Only 14 per cent correctly identified APRA. These findings were supported by a subsequent (unpublished) Roy Morgan Research survey for APRA in 2011. This survey concluded that 'awareness and understanding of the regulations that apply to financial institutions generally and whether or not regulations apply to banks, building societies and credit unions were at low levels. Similarly, awareness of APRA and its regulatory role regarding financial institutions was

⁶ Australian Securities and Investments Commission, *Report 230: Financial literacy and behavioural change*, March 2011, p. 22.

⁷ *op. cit.*, p. 38.

⁸ Reserve Bank of Australia, *Financial Stability Review*, March 2006, pp.45-46.

also at a low level’.

31. In view of these findings on disclosure and financial literacy, and the particular experience of the Banksia Securities Limited failure, APRA considers that the potential for investor misunderstanding can be more effectively addressed through restrictions on the types of products offered to retail investors. If a non-prudentially regulated entity is able to offer ADI-like products and use ADI-like terms to describe those products, it is perhaps unsurprising that retail investors may misunderstand the nature of the entity with which they are investing. Even in the presence of disclaimers and disclosures, retail investors in such products may not understand the nature and risks of the product.

Options

32. APRA has identified three possible options that may meet its objectives:

1. maintain the existing exemption order unchanged;
2. fully implement the proposals for RCDFs as consulted on in August 2013; or
3. discontinue the exemption order.

Impact analysis

Assessment of costs and benefits

33. As part of the 2013 consultation process, APRA specifically requested submissions on the cost-benefit impact of implementing the proposals, and invited respondents to use the OBPR’s (then) Business Cost Calculator to estimate costs. A few submissions provided quantitative data on the likely cost impact of the proposals and, where relevant, that data has been included in this Regulation Impact Statement.

34. The benefits that will arise should the proposals be adopted are not easily quantifiable. They include the reduced likelihood of retail investors suffering losses because they were unaware that they were investing in a non-prudentially regulated entity with a potentially higher risk profile than an ADI. They also include the enhancement to Australia’s international reputation from APRA’s greater conformity with relevant global principles in this area and with emerging best practice on regulatory approaches to shadow banking systems.

35. In each option, the stakeholders that would be affected include RCDFs, retail investors in

RCDF products, APRA and Government.

Option 1 — Maintain the exemption order unchanged

36. Under this option the Exemption Order would continue to be remade without change.
37. The continued operation of the Exemption Order unchanged beyond 31 December 2016 would mean that RCDFs would continue to offer banking-like products, particularly transactional deposit accounts, without the need to meet prudential requirements and investors in those products would not have the benefits of depositor protections available to ADI depositors. RCDFs would therefore continue to operate as ‘advantaged competitors’ to ADIs, especially smaller ADIs. RCDFs would not incur any additional costs under this option. These costs are represented in the Regulatory Burden Estimate (RBE) table below.

Table 1 - Average annual regulatory costs (from business as usual)				
Change in costs (\$ million)	Business	Community organisations	Individuals	Total change in costs
Total, by sector	\$0	\$0	\$0	\$0

38. For retail investors, in addition to not benefiting from prudential safeguards in relation to their investments, the potential for uncertainty, given the commonality of some product offerings of RCDFs and ADIs, would continue. For example, investors in RCDFs, in some cases, may continue to invest believing they have the benefit of protection, including that offered by the Financial Claims Scheme (FCS), when in fact this is not the case.
39. For APRA and the Government, this option would mean that Australia would continue to be non-compliant with the *Core Principles* regarding limiting the exemption under section 11 of the Banking Act. Australia would also be in contradiction of its stated priority as part of its former G20 presidency to improve oversight of the shadow banking sector.⁹ There may also be a contingent cost through the possibility of the need for a

⁹ G20 2014: *Overview of Australia's Presidency*, December 2013

government bail-out to support retail investors in an RCDF should an RCDF become insolvent.

Option 2 — Fully implement the proposals

40. Under this option, APRA would implement the proposals for RCDFs as consulted on in August 2013. This would mean that from the effective date of the revised order, RCDFs would continue to be able to accept funds from wholesale investors and retail investments from affiliates (including staff and clergy but no other natural persons) as is currently the case. However, the following new conditions would apply with respect to retail investor funding:

- the use of the words ‘deposit’ and ‘at-call’, and derivatives of those words would be prohibited;
- such funding to have a minimum term or call period of 31 days. An investor would not be able to redeem, and an RCDF would not be able to repay, any funds for a minimum of 31 days from the date they are invested except in cases of exceptional circumstances that led to demonstrated hardship;
- prohibition on RCDFs providing BPAY transactional facilities to retail investors. RCDFs are already prohibited from offering ATM, EFTPOS and cheque account facilities; and
- an enhanced prudential warning that notes investors in an RCDF are not covered under the Financial Claims Scheme.

41. Under this option, in the absence of definite data, APRA has assumed that all RCDFs would be affected, which assumes they all have retail investors. The actual number of RCDFs actually affected could be materially less.

42. RCDFs with retail investors would be impacted in several ways: firstly, there would be compliance costs associated with changing future product offerings and seeking to move existing retail at-call investors into new products; there would also be additional interest expenses associated with 31-day versus at-call products; and, some existing retail investors when faced with the new product offering may choose to place their funds with another institution, for example with an ADI. In order to assist RCDFs in this transition, Option 2 would include a 12-month transition period after expiry of the existing Exemption Order on 31 December 2016 for business in place at that date.

43. The size of these impacts would be a function of the extent of retail investor funding in an RCDF's total funding base. In aggregate, based on a sample of data collected by APRA in 2013, retail investor funding constituted approximately 17 per cent of total funding of RCDFs of which approximately 50-60 per cent appeared to be invested in at-call products. In dollar terms, at the upper boundary of 60 per cent, this represented \$830 million in retail at-call products. Of this amount approximately \$645 million was held by three RCDFs. The remaining \$185 million was spread amongst the remaining 56 RCDFs (assuming all had retail at-call business). Assuming that a typical at-call product would offer a zero per cent interest rate, and a typical 31-day term product an interest rate of two per cent, this equates to an overall additional interest cost across 56 RCDFs of \$3.7 million per annum or an average of \$66,000 per RCDF per annum. For the three largest funds the equivalent figures are \$12.9 million per annum or \$4.3 million per fund per annum. As the figures show, a very significant proportion of at-call retail funding is concentrated within a very small number of large RCDFs; for the majority of RCDFs the cost impact of moving from at-call to a 31-day term for retail deposits will be less than the cost estimates provided here. APRA understands that some RCDFs also provide investors the opportunity to forgo interest in order to further assist the charitable works of an RCDF. Further, for about half of the RCDFs with retail funding, that funding comprised less than 10 per cent of their total funding.
44. In order to mitigate some of these costs, it is proposed to further refine the proposed definition of affiliates as set out in the August 2013 Response to Submissions paper to remove the exclusion which prevented retail investors from being deemed affiliates, and to also allow natural persons who are staff of an RCDF or its affiliates and clergy to be deemed to be affiliates. This will likely serve to reduce somewhat the extent of the proposed restrictions and the associated costs.
45. In addition, the loss of at-call access may mean that some RCDFs experience an outflow of funds from investors who do not wish to invest their money for a 31-day term. While RCDFs have indicated this may be a potential impact of the proposal to restrict retail investor funding, it is difficult to estimate the extent of any such outflows. Such outflows would be expected to be reasonably limited if it is the case that monies are being invested with RCDFs for the purpose of furthering the works of the RCDF rather than for the purpose of conducting transactional banking business. APRA has also made clear that

RCDFs will be able to release funds at any time in the event of an investor suffering hardship which makes necessary their immediate access to their funds. RCDFs will be free to develop their own procedures to manage such circumstances and to allow ready access by an investor in such circumstances.

46. APRA’s estimate of the compliance costs of this proposal, based on a sample of data provided by four RCDFs, which provide a representative sample of a range of RCDFs from small to large RCDFs, is an overall estimated cost of \$4.39m across 59 RCDFs. The actual cost impact may be less as not all RCDFs have retail investor business. On-going compliance costs are likely to be immaterial as it is expected that compliance costs would be incurred during the initial transition to the new requirements. Using the Government’s standard methodology for stating compliance costs, the average annual compliance cost is estimated to be \$439,675 in total, or \$7,452 per affected RCDF. Compliance costs are expected to be a function of various factors, including the size of the RCDF’s retail funding; the number of staff in the RCDF; and the number of existing retail at-call investors and products. The key cost driver is expected to be the number of existing retail at-call investors as this will impact on the cost of withdrawing existing products and encouraging existing investors into new product offerings. Compliance costs to update disclosure and marketing material and in relation to staff training would also be incurred. These costs are represented in the Regulatory Burden Estimate (RBE) table below.

Table 2 - Average annual regulatory costs (from business as usual)				
Change in costs (\$ million)	Business	Community organisations	Individuals	Total change in costs
Total, by sector	\$0	\$0.440	\$0	\$0.440

47. The second category of impact, the potential loss of retail investors, is inherently difficult to quantify as it is an opportunity cost, contingent on the effectiveness of the transition undertaken by an RCDF. In this respect, APRA proposes to offer a significant transition, with the proposals not taking effect for existing business in force at 31 December 2016, until 1 January 2018.

48. It is important to recognise that RCDFs could continue to accept at-call retail investments by restructuring their operation as an ADI or a managed investment scheme should they

so desire. There would be costs associated with any such restructuring. Based on industry consultation to date, expects that only a small number of RCDFs, if any, to pursue such a path.

49. Withdrawing the opportunity for RCDFs to provide at-call deposits may involve costs for those retail investors who currently use RCDF products for their transactional banking needs, and do not already have an ADI transactional account. These investors would need to make alternative arrangements if they wish to retain the convenience of at-call access to their funds. However, such investors would benefit from the depositor protections of the Banking Act or other safeguards provided by investing in products that are subject to regulation. In any event, RCDF products are not intended to operate as transactional banking accounts.
50. For APRA, this option would involve costs relating to staff for re-making the legislative instrument to incorporate the proposals. These costs are relatively modest comprising approximately one week of one full-time staff member's workload each year. The benefit of this option is that it is the most aligned with APRA's mandate but without the significant costs of Option 3. Thus there would be a clearer regulatory boundary between RCDFs and ADIs, and therefore a reduced possibility that retail investors would confuse investments in RCDFs with those offered by ADIs.
51. It would also mean that the favourable treatment provided to entities with an exemption, vis-à-vis ADIs, would be limited. This would be consistent with the approach adopted for other entities (i.e. RFCs) with an exemption as implemented in 2015.
52. For the Government, these changes would mean that Australia would more closely comply with the IMF Recommendation that such exemptions only be offered to institutions that are solely reliant on wholesale funding. Australia would also be meeting its stated priority as part of its previous G20 presidency to improve oversight of the shadow banking sector. Material costs are not anticipated to be incurred by the Government if this option was adopted.

Option 3 — Discontinue the exemption order

53. Under this option the Exemption Order would not be renewed. This would mean that RCDFs would need to discontinue their existing banking-like business. Alternatively, they would need to restructure using one of the other regulatory paths currently available

to them should they wish to continue to accept funding from investors, whether wholesale or retail.

54. This option would impose additional compliance costs on RCDFs as they would be forced to restructure should they wish to continue to conduct banking business. Given the reliance of RCDFs on funding raised through the conduct of banking business it is assumed that most, if not all, RCDFs would restructure as an ADI, an RFC or operate a managed investment scheme. The actual cost to an RCDF would be a function of the structure under which it chose to operate and the cost of converting its operations to an alternative structure. Under this option, RCDFs that did seek to continue to operate a banking business would also face material ongoing costs associated with their new structure. Approximate cost estimates suggest that to become an ADI would involve initial and ongoing regulatory and compliance costs of \$426,000 per entity per year. In addition, an ADI is required to meet APRA’s capital, liquidity and governance standards which would impose business costs in addition to the estimated compliance costs. To become an RFC would also involve substantial costs, but less than seeking to be licensed as an ADI. The initial and ongoing costs are estimated at \$205,000 per entity per year. The MIS option would also have costs similar to that for seeking to become an RFC and are estimated at \$160,000 per entity per year. Given the relative costs, for the purposes of APRA’s regulatory analysis, it has been assumed that only 2 RCDFs would seek to become an ADI, 5 entities would seek to become RFCs and the remaining 52 would choose the MIS alternative. Applying these numbers to the assumed costs could result in industry-wide costs over 10 years of \$102 million or \$10.2 million per year. These costs are summarised in the Regulatory Burden estimate table below.

Table 3 - Average annual regulatory costs (from business as usual)				
Change in costs (\$ million)	Business	Community organisations	Individuals	Total change in costs
Total, by sector	\$0	\$10.2	\$0	\$10.2

55. For retail investors with RCDFs which choose not to restructure, this option would mean that they would need to move their funds elsewhere. For retail investors with RCDFs which choose to restructure, the cost and other impacts will depend on which alternate

regulatory option is pursued by the RCDF.

56. Arguably the key disadvantage for retail investors would be the loss of their ability to assist their chosen RCDF and the charitable work it undertakes by conducting banking business with the RCDF, if the RCDF chose not to restructure. However, these investors could continue to support the charitable work by making donations.
57. For APRA, the discontinuation of the Exemption Order would result in some modest reduction in costs, particularly those associated with the ongoing review and maintenance of the Exemption Order.
58. For the Government the key benefit would be that there would be a reduced possibility of it being called on to bail-out retail investors in the event of the failure of one or more RCDFs, noting that RCDFs do not attract any explicit form of Government guarantee or support. The major cost of this option would be that the Government may need to step in and provide certain social services and funding that were previously provided by RCDFs, whether it be in the form of direct assistance for those in need or through increased funding of schools, hospitals and aged care facilities, amongst other services.

Consultation

59. APRA released a discussion paper, *Banking Act exemptions and section 66 guidelines*, setting out details of the proposals on 19 April 2013. Written submissions were requested by 24 May 2013. In addition, APRA has met with representatives from industry and responded to various requests for information and clarification.

Submissions received

60. APRA received 22 submissions on its April 2013 proposals in relation to RDCFs. Submissions on the proposals were made by RCDFs as well as denominational advisory bodies with an affiliation with RCDFs. The following table provides a summary of key issues raised in relation to each of APRA's original proposals and APRA's response to submissions made.

Table – Submissions and APRA’s responses

Proposal	Comments received	APRA’s response
<p>Retail funding – RCDFs would no longer be able to accept retail investor business.</p>	<p>Generally, submissions were not supportive of this proposal. Concerns centred around the impact of the proposal on the religious and charitable work undertaken by RCDFs using retail funding. Submissions argued that requiring RCDFs to operate under an alternative regulatory regime would have a detrimental impact on the provision of services including schools, hospitals, aged care and social welfare programmes, amongst others. They argued that alternative regimes — seeking authorisation to become an ADI, register as an RFC or operate a registered MIS — would be administratively burdensome and the associated costs would impede the religious and charitable works of RCDFs.</p>	<p>APRA undertook further analysis including seeking additional information from RCDFs in respect of the proposed banning of retail investments. Additional information from RCDFs has shown that the administrative costs and lost net interest income associated with APRA’s original proposal would be higher than APRA had presumed. Accordingly, APRA decided to revise its original proposal, in a way that would materially reduce the administrative and lost interest income costs for RCDFs without compromising APRA’s objective.</p> <p>Under the revised proposal, APRA would not require RCDFs wishing to offer products to retail investors to operate under an alternative regulatory</p>

Proposal	Comments received	APRA's response
	<p>Some submissions suggested they be allowed to continue to accept funds from retail investors but with additional conditions on the RCDF Exemption Order, such as requiring an investor to provide a signed declaration stating that they understand that their investment is not equivalent to a deposit with an ADI and does not enjoy the benefit of depositor protection.</p>	<p>regime. APRA also modified its proposal such that RCDFs will continue to be able to raise funds from retail investors, but on a term or minimum call basis.</p> <p>The proposed additional conditions would require that any account offered to a retail investor lacking a stated maturity date have at least a 31-day notice period prior to any withdrawal. Any term investment would need to commence with a stated term of at least 31 days. On maturity of a term investment, an RCDF could, where the investor has requested repayment, repay the funds via cash, cheque or direct credit to an account at an ADI. Where the investor has not requested repayment, the funds would have to be rolled over into a new investment with a minimum term of 31 days.</p> <p>Notwithstanding the</p>

Proposal	Comments received	APRA's response
		<p>minimum term, RCDFs would not be precluded from releasing funds from retail investments in cases of an investor's exceptional circumstances that may lead to hardship. RCDFs will need to develop their own procedures for determining genuine investor hardship.</p> <p>These proposed conditions would not relate to funding from wholesale investors. RCDFs may continue to offer at-call products to wholesale investors.</p>
<p>RCDFs are able to use of the terms 'deposit' and 'at-call' without restriction. In the April discussion paper, APRA proposed restricting the use of these terms.</p>	<p>Generally submissions supported this proposal.</p>	<p>Propose to proceed with proposal as originally proposed.</p>
<p>In the April discussion paper, APRA proposed to restrict RCDFs from offering BPAY facilities. This was in addition to existing restrictions under</p>	<p>RCDFs were generally not supportive of the proposal and questioned whether it also covered the use of BPAY between affiliates of an RCDF.</p>	<p>On remaking the RCDF Exemption Order, APRA proposed to restrict RCDFs from offering BPAY payment functionality in relation to products offered</p>

Proposal	Comments received	APRA's response
<p>the RCDF Exemption Order that prevents RCDFs from offering ATM, EFTPOS and cheque account facilities, other than to affiliates of the RCDF.</p>		<p>to retail investors, as such facilities are associated with ADI transaction accounts. This approach is consistent with the current Exemption Order, which does not allow ATM, EFTPOS and cheque functionality to be offered for RCDF retail accounts. However, RCDFs themselves will be able to continue to make or receive payments, including new retail investments, via BPAY. An RCDF will also be able to continue to use BPAY to transact between affiliates of the RCDF.</p>
<p>Currently, RCDFs must ensure that advertising and marketing material of the RCDF contains clear and prominent disclosures to the effect that:</p> <ul style="list-style-type: none"> • neither the controlling entity or the Fund is prudentially supervised by APRA; • contributions to the 	<p>No submissions raised concerns with this proposal.</p>	<p>Proposed to seek to expand disclosures to include reference to the Financial Claims Scheme.</p>

Proposal	Comments received	APRA's response
<p>RCDF do not obtain the benefit of the depositor protection provisions of the Banking Act; and</p> <ul style="list-style-type: none"> • the Fund is designed for investors who wish to promote the charitable purposes of the Fund. <p>As part of its review of the RCDF Exemption Order, APRA has noted instances where RCDFs are putting such disclosures in the fine print of documents or in other places where it is questionable that the disclosure is clear and prominent to a person considering investing in the RCDF. APRA reiterates that all such disclosures must be in a clear and prominent place on all advertising and marketing material. In addition, APRA is proposing that the existing disclosure be expanded to include a statement to the effect that an investment in an RCDF is not covered by</p>		

Proposal	Comments received	APRA's response
the Financial Claims Scheme.		

61. As the summary table of submissions from RCDFs shows, RCDFs were generally not supportive of the key proposal in APRA's original proposals in relation to the RCDF Exemption Order, notably with respect to the proposal to completely prevent RCDFs from accepting funds from retail investors. In addition, submissions expressed concerns about the proposed restrictions on BPAY functionality. Some submissions gave qualified support to APRA's proposals in that they understood the general objectives, and in some cases agreed that where an RCDF had different purposes to its original religious and charitable purpose then it should not be accorded an exemption. A number of proposals suggested alternatives for the future operation of the RCDF Exemption Order, including imposing capital and liquidity requirements, additional audit requirements and seeking specific attestations from investors that they understood the nature of the investment they were undertaking and that it was not the same as an investment in an ADI. Most submissions argued that APRA's proposals would impact on their future religious and charitable work such as funding to schools, hospitals, aged care facilities and other programmes that RCDFs support.

62. As discussed previously, RCDFs are currently exempt from the need to meet the stringent requirements imposed by APRA on ADIs, which include capital, liquidity, audit and behavioural requirements amongst others. Some RCDFs suggested that the imposition of some form of capital and liquidity requirement would be a possible alternative. This alternative is embodied in APRA's licensing requirements as covered by Option 3. The alternative of requiring individual investors to attest the nature of the investment they are undertaking places the onus on the individual investor but provides no additional security or protection to investors or their investments. As noted, at paragraph 29, strengthening disclosure requirements will not itself be sufficient to achieve the stated objectives, and it can equally be argued that requiring a retail investor to sign a declaration, in itself, would not be a sufficient mechanism to enhance understanding or remove the risks that attach to products that have the appearance of similar products offered by banking institutions but

without the same prudential oversight and safeguards. As further noted at paragraph 31, disclosures are in and of themselves not sufficient to remove the risk that retail investors may misunderstand the nature and risks of the product(s) they are investing in.

63. After consideration of the arguments made in submissions by RCDFs, and the gathering of further information about the business models of RCDFs, APRA significantly revised its original proposals. In particular, APRA proposed not to proceed with the blanket restriction on RCDFs accepting retail investments. This change would allow RCDFs to accept retail investor funding without the need to restructure their operations, but with additional restrictions on offering certain products with features and characteristics clearly associated with product offerings of ADIs. In particular, RCDFs would still be able to offer products to retail investors provided such products had a 31-day minimum term or call before they could be redeemed. APRA consulted on this option in August 2013, receiving eight submissions in response. Submissions generally supported APRA's modified proposals notably that APRA was no longer proposing to ban RCDFs from accepting retail investor funding, but submissions, whilst acknowledging the concessions, did not support the imposition of a minimum 31-day term on retail investments. It was also noted that the proposed restriction with respect to staff of RCDFs and clergy was not desirable as such persons have a clear affiliation with the RCDF and should not be captured by the proposals.
64. The other key issue for RCDFs concerned BPAY functionality. While not supportive of the proposal generally, RCDFs were particularly concerned that the proposal could affect the use of BPAY amongst affiliates of an RCDF. This was not APRA's intention and APRA clarified the intention of its original proposal in its August 2013 Response to Submissions paper.
65. In light of the submissions received in response to the second consultation, APRA proposes to make further modifications to the proposals to address the concerns raised by RCDFs but that still allow for APRA to meet the key objectives of its proposals concerning improved protection for retail investors and aligning exemptions with IMF recommendations and Australia's G20 commitments. It is proposed that the definition of affiliates be broadened such that it does not exclude non-natural persons who are retail investors, nor natural persons who are staff of an RCDF or clergy from being deemed affiliates. In effect, this will mean that the proposed restrictions on at-call funding and

BPAY functionality will not apply to these persons. In addition, it is proposed that APRA provide a significant transition period to allow RCDFs time to move to any new requirements. That is, new requirements would not apply to retail business on an RCDF's books at 31 December 2016 until 1 January 2018. New business would need to comply with the new requirements from 1 January 2017. The transition would give RCDFs time to amend marketing and disclosure materials and to engage with retail investors and transition funding from an at-call basis to term business.

Conclusion and recommended option

66. The table below provides a summary of the costs and benefits of each option against the key criteria discussed in this RIS.

Table: Summary of the net benefits of each option

	Option 1: status quo	Option 2: Implement additional conditions on exemption	Option 3: Remove exemption
Compliance costs and indirect costs (indicative)	No change	Low to significant for individual RCDFs. Moderate costs across the sector	Significant costs
Leads to improved protection for retail investors	Does not meet this criteria	Partially meets this criteria	Meets this criteria
Consistent with IMF recommendations and Australia's G20 commitments	Does not meet this criteria	Partially meets this criteria	Meets this criteria

	Option 1: status quo	Option 2: Implement additional conditions on exemption	Option 3: Remove exemption
Summary:			
Compliance and indirect costs	Nil	Moderate	Significant
Prudential benefit	Nil	Moderate	Strong
Overall	No change	Moderate net benefit	Marginal net benefit

67. Option 1 confers no additional costs on RCDFs but also means that retail investors may continue to invest in RCDFs without distinguishing RCDFs and their product offerings from those of ADIs. Under Option 1, APRA would allow RCDFs to continue to operate without added safeguards designed to minimise risks that retail investors in RCDFs are under the impression that an RCDF is the same as an ADI, and that the products it offers have the same protections as an ADI product. The current blurring of distinctions between the regulated banking system and this aspect of the shadow banking system would not be addressed, leaving Australia at variance with global principles in this area.

68. Under Option 2, RCDFs that rely on retail at-call funding would incur additional costs. The impact on individual RCDFs would vary, depending on their current reliance on at-call retail funding. Overall, as stated in this RIS the compliance costs are estimated at \$4.39 million across all RCDFs. The expected benefits to RCDF investors and the community in general, in the form of greater transparency and clarity about RCDFs and their product offerings, are harder to quantify, being essentially future opportunity

benefits that are contingent in nature. Given that overall investor funds held by RCDFs amount to more than \$1 billion, then the compliance cost is reasonably low relative to the benefits that will flow to investors (on this basis, compliance costs would be less than 0.4 per cent of total investor funds). In APRA's view, the overall public policy benefits of a better protected and informed retail investor community with a clearer distinction between RCDFs and ADIs clearly outweigh the costs involved. The clearer distinction will also bring Australia more into conformance with global standards and with emerging international best practice and its G20 commitment on regulatory approaches to shadow banks.

69. Under Option 3, the Exemption Order would be discontinued meaning that RCDFs would have no choice but to restructure should they wish to continue to conduct banking business. This option would impose significant costs on all RCDFs as they would need to close their operations if they did not wish to restructure. Closing their operations would result in the loss or reduction of services maintained by RCDFs including in relation to schools, hospitals and aged care facilities. For investors, the impacts would depend on the path chosen by the RCDF, although investors would have the simple option to move their funds to an ADI. For Government, the removal of the Exemption Order would be consistent with the IMF's recommendation that such Exemption Orders be limited to entities reliant wholly on wholesale funding.
70. Option 3 would impose significant costs on RCDFs. Option 2 as originally proposed would impose lower but still material costs for some RCDFs. Option 2 as modified to allow RCDFs to continue to accept retail funding with a minimum 31-day term provides a compromise to the extent that it results in a clearer distinction between products offered by ADIs and those of RCDFs and enhanced disclosure requirements will assist further in ensuring that retail investors understand that RCDF products do not receive the same protections as those provided to depositors of ADIs. While the costs of this option would vary across RCDFs depending on their funding profile, compliance costs estimated using the Government's standard methodology are \$439,675 per year in total across all RCDFs over a 10 year time horizon, or approximately \$7,452 per affected RCDF. In addition, business costs due to the potential change in interest expense incurred by RCDFs on at-call business being moved to a minimum 31-day term would be a function of the size of an individual RCDF's at-call business and the interest differential between term and at-

call funds. This change will potentially impose a substantial cost on three RCDFs with significant retail at-call deposits and may result in reduced services by some RCDFs.

71. While on the basis of the analysis in this RIS Option 1 results in the lowest compliance costs, Option 2 provides the most appropriate balance between achieving the objectives of APRA's proposals while acknowledging the impacts on the charitable works of RCDFs. While the costs of Option 2 will be significant for three RCDFs and impose moderate costs for the remainder, APRA is of the view that the potential for losses to individual investors and the broader impact of the potential failure of one or more RCDFs is sufficient, from a risk assessment perspective, to outweigh the quantifiable costs associated with this option. As noted in APRA's 2015 Annual Report 'despite the overall health of the financial sector, APRA must always stay alert to a range of risks and vulnerabilities that inevitably exist with a dynamic financial system.'¹⁰ APRA in fulfilling its mission and objectives takes a pro-active approach to regulation and seeks to ensure there is an appropriate balance between financial safety and efficiency and competition. In the context of entities that are exempt from being authorised and prudentially regulated by APRA, the conditions under which exemptions from authorisation are provided need to remain appropriate, reflect the changing environment in which such entities operate, and clearly delineate the boundary between the prudentially regulated and non-prudential sectors.

72. On balance, it is therefore recommended that Option 2 be adopted with effect from 1 January 2017 and an additional transition period of 12 months be provided to allow RCDFs time to ensure their arrangements with regard to existing retail investors comply with the proposed changes to the Exemption Order.

Implementation and review

73. APRA's requirements will be reviewed as necessary to ensure they continue to reflect good practice and remain relevant and effective.

¹⁰ APRA Annual Report 2015, page 7.

Compliance with Best Practice Regulation Handbook

74. As consultation for these proposals commenced before the 8 July 2013 implementation of the revised Best Practice Regulation Handbook, APRA has opted to complete a single-stage RIS.

75. Offsets will be found for 2016 from the Treasury portfolio.