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24 July 2009

Mr John Hawkins
Committee Secretary
Senate Economics Reference Committee
Parliament House
CANBERRA ACT 2600

Dear Mr Hawkins

Inquiry into Bank Funding Guarantees

Challenger wishes to make the following submission to the Inquiry into Bank Funding Guarantees.

Challenger has three businesses which have been affected by the bank deposit and wholesale funding guarantees.

Challenger Mortgage Management is Australia's largest non-bank mortgage lender and mortgage broking aggregator. It comprises two businesses, one providing Broker Platform (Aggregation) services and the other multi-branded lending for residential and commercial loans. At 31 March 2009, Challenger Mortgage Management had A$18.9 billion in residential and commercial mortgages under management within the lending business (that is, loans managed or serviced by Challenger) and a further A$100 billion in mortgages under administration within the Broker Platform business (that is, third party loans arranged by brokers). As a non-bank lender with no access to the wholesale funding guarantee Challenger Mortgage Management has been at a very significant funding disadvantage relative to the major banks.

Challenger Funds Management is the responsible entity for the Howard Mortgage Fund which has operated for more than 24 years and is the largest mortgage fund in Australia. It had more than $2.9 billion in funds under management when it was forced to restrict redemptions following the introduction of the bank deposit guarantee. Challenger Funds Management is also the responsible entity for the Challenger High Yield Fund which was also forced to restrict redemptions following the introduction of the deposit guarantee.

Challenger Life Limited is the largest provider of retail annuities in Australia with assets of $6 billion as of March 2009. The company serves the retirement income market, with APRA regulated guaranteed short and long-term income streams including some lifetime annuities. Challenger Life did not suffer major adverse effects on its business as a result of not having access to either the deposit guarantee or wholesale funding guarantee despite it being regulated by APRA in a very similar way to a bank. However, Challenger Life competes directly with bank term deposits and has been at a competitive disadvantage in that market as a result of its lack of access to a deposit guarantee.

(a) The circumstances and basis of the decision to introduce an unlimited bank deposit guarantee and of subsequent decisions to change or define the guarantee.

Challenger is not a bank and was not experiencing events that could have been addressed by the guarantee on bank deposits at the time it was introduced.

(b) The circumstances and basis of the decision to introduce an unlimited wholesale bank funding guarantee and of subsequent decisions to change or define the guarantee.

World credit markets were effectively frozen in August 2007 when the US sub-prime crisis crystallised. The consequences were fear among major institutions about the risk of counterparty default resulting in reluctance to participate in inter-bank lending and a severe contraction in liquidity as these institutions began to hoard cash.

RMBS (residential mortgage backed securities) lost acceptance in capital markets irrespective of the country of origin or credit quality of the collateral. Quality instruments such as high grade Australian RMBS began trading at values substantially below their economic value.

As a consequence of requirements for many institutions to mark to market under IFRS (International Financial Reporting Standards), the continuing volatility of these securities rendered them un-tradeable by most institutions because of the continuing risk of mark downs.

Non-bank lenders lend at a margin to the match funded price for pools of mortgages. They were forced to rely on their existing warehouse facilities to fund new lending. These facilities are finite and small relative to the annual volume of mortgages that were previously being written and securitised.

Without access to a plentiful supply of funding non-bank lenders had to constrain new lending and with average costs rising a large number have exited the market, including ones which previously had significant scale, such as GE and Macquarie (Puma). The remaining non-bank lenders were only able to operate at a fraction of their former capacity. As a consequence the major banks made major inroads into the non-bank lenders' market share, predominantly funded using short term finance.

Some of the regional banks were predominantly dependent on capital markets to fund their mortgage books through securitisation. The effect of the credit crisis on these institutions has been very similar to the effect on NBFIs (non-bank financial intermediaries). As a result there has been major consolidation (takeover activity) in the banking sector (eg. Adelaide/Bendigo, St George/Westpac, and BankWest/CBA). The Chairman of the ACCC (Australian Competition and Consumer Commission) has recently raised serious concerns about the negative implications of this consolidation for future competition.

In normal credit market conditions the major banks rely for their funding on a combination of long and short term securities issued to capital markets including some RMBS, their deposit base, and access to short term liquidity through inter-bank lending and the open market operations of the RBA. The credit crisis resulted in less access to and more expensive funding through the capital and inter-bank markets, competition for available funds pushed up deposit rates, and there was, until the government guarantee was introduced, much greater than normal reliance on access to short term liquidity through the RBA's open market operations. The major banks were also able to do large internal securitisations, which were taken directly to the RBA repo window to obtain short term liquidity.

The credit crisis forced the banks to raise mortgage rates relative to the RBA cash rate, but those increases did not reflected the full cost of matched long-term funding from capital markets for new mortgage lending.

The profile of liquidity risk within the global financial system has been a central issue as those institutions that have ignored the true cost of financing have learnt to their detriment. Global risk free government yield curves are more often than not normally shaped which means the cost of longer term finance is higher than short term finance. The cost of money for riskier institutions will also have an even higher cost in the long term than the short term.

As a result there is always a propensity to lend for longer terms and borrow for shorter terms at lower rates than would be required to match fund a transaction. The price of liquidity to term is the long term borrowing cost of an institution. If that institution decides to borrow shorter and take the risk that rates might rise in the future the institution is taking liquidity risk.

Because the major banks had access to the RBA's repo window they were able to take liquidity risk at an out of market level which they were not required to mark to market in their books.

Non-bank mortgage lenders are much more constrained in their ability to tolerate liquidity risk. They can only lend with any scale at prices which closely reflect the true market cost of funding their assets to the term of those assets.

As a result of the credit crisis, until the wholesale funding guarantee was introduced, the major banks had to rely much more heavily on RBA open market operations to obtain the liquidity that they needed to fund lending. The cost of such borrowing is determined by the bidding process which is used by the RBA to maintain the overnight cash rate as close as possible to its target rate. Access to liquidity through RBA open market operations gives the banks a pricing advantage and underpins a significant part of their profitability.

Extensive use of the RBA's repurchase arrangements therefore gave the banks two advantages relative to their non-bank competitors:

1. Access to liquidity; and
2. A pricing advantage.

Banks also provide the warehouses for non-banks, but the pricing now charged for these warehouses does not reflect either the price at which the banks are originating mortgages on their own books, or the value that they receive from taking similar pools of securities to the RBA repo window, which both make non-banks less competitive.

As a result of the freeze in credit markets, most primary issues of RMBS were by way of private placements. The issues that went to market were at spreads above the level at which it was possible to break even on the full long term costs of a new loan at prevailing mortgage rates. In the middle of 2008 the price of RMBS deals was between 110 and 180 basis points above BBSW (the bank bill swap rate).

The cost of this term funding of fully priced RMBS can be compared with the price of liquidity then being obtained on a short term basis from the RBA by the major banks using equivalent securities as collateral. In mid 2008 RMBS repurchase agreements with the RBA were being done at spreads ranging from 1 basis point above BBSW to 73 points below BBSW.

To the extent that the Future Fund also found bank paper a more attractive short term repository for the cash transferred to it from government surpluses than leaving it on deposit with the RBA at the cash rate, the banks also enjoyed that as another source of short term funding during the credit crisis.

In May 2008 the Treasurer announced that the AOFM would issue additional CGS (Commonwealth Government Securities) to support the effective operation of the Australian financial system. On 22 July 2008 the AOFM indicated that the proceeds of this new issuance would be invested in Australian dollar denominated debt securities issued by Australian, State and Territory government guaranteed entities and AAA rated sovereigns, supranationals and financial institutions.

The AOFM also announced that it would invest some of the Australian Government's short term cash balances in A1+ and A1 rated bank accepted bills and certificates of deposit issued by ADI's (banks), and A1+ rated ABCP (asset backed commercial paper). This provided the banks with a further source of short term funding.

While the RBA's expanded open market operations, the Future Fund's investments with the banks, and AOFM's prospective involvement in bank ABCP were for good public policy purposes and were not undertaken with the intention of giving the banks a competitive advantage in the mortgage market, they all had that effect.

There was no argument for denying banks access to these facilities. However the government needed to consider any indirect negative effects these operations were having on competition and whether a policy response was appropriate to provide for the maintenance of a competitive mortgage market in the face of the credit crisis induced consolidation.

On the 26th of September 2008 the Treasurer announced that the AOFM (Australian Office of Financial Management) would purchase Australian RMBS (residential mortgage-backed securities); *"as part of the Government's commitment to strong and effective competition in Australia's mortgage markets…with a wide range of financial products at competitive prices."*

The Treasurer noted that the RMBS market has provided an important source of funding for new and smaller mortgage lenders to compete with the major banks and that Australian RMBS are of high quality, and continue to experience low rates of arrears. However, despite this solid credit performance the dislocation of international capital markets had reduced issuance, thus weakening the capacity to compete of mortgage lenders reliant on the primary RMBS market.

The AOFM would be directed to invest in AAA rated RMBS in two initial tranches of $2 billion each to reinvigorate the Australian RMBS market. This was a temporary measure and the RMBS purchased by the AOFM would be held until redeemed or sold into secondary markets as and when market conditions normalise.

The Direction to the AOFM issued by the Treasurer on 3 October 2009 set out the Government's objective in making this investment — *"to support competition from a diverse range of lenders during the present market dislocation."*

The AOFM investments were intended to be the cornerstones of much larger deals which, with the government's participation, would encourage a much wider group of participating investors. At the time the AOFM program was conceived there was evidence that the securitisation market was starting to recover. For example, Challenger did a $441 million RMBS deal on 29 September 2008. It was anticipated that this modest government intervention would help accelerate the recovery of investor confidence.

Unfortunately those expectations were to be quickly overtaken by an event that had an extreme impact on capital markets - the collapse of Lehman Brothers. As a result, on 12 October 2008 the Government announced that it would guarantee all term wholesale funding by Australian banks operating in international credit markets to make sure that they have the best possible access to global capital in the future. This was a response to similar measures being implemented by other governments to support their banks' international credit raising arrangements, which the Australian Prime Minister correctly said would make their weaker banks more competitive in the market than Australia's stronger banks.

The Prime Minister also announced that the Government would guarantee all deposits in Australian ADIs (authorised deposit taking institutions) - banks, building societies, credit unions – and that the guarantee would be reviewed in three years.

The Prime Minister also announced that the AOFM would purchase an additional $4 billion in RMBS from non-ADI lenders to "ensure that this sector of the lending market has access to funding for their future operations."

By 28 November 2008 the government had the major elements of all these arrangements in place. The guarantee applied automatically to deposits of up to $1 million at no direct cost to the account holder. The guarantee was optional for deposits over $1 million with the same fee scale applying as for the wholesale funding guarantee for banks. From that date a tiered fee structure based on the institution's credit rating was applied for the wholesale funding guarantee. AA rated banks could have access to a guarantee on new wholesale funding for a fee of 70 basis points, A rated banks for 100 basis points, and BBB or unrated ADIs for 150 basis points.

(c) The effect that the initial announcement of, and subsequent changes to, an unlimited bank deposit guarantee had on operations of the Australian financial sector, including for entities not regulated by the Australian Prudential Regulation Authority (APRA).

The bank deposit guarantee removed the risk of a run on any ADI. However, as the Governor of the Reserve Bank noted on 17 October 2008 in an email to the Secretary to the Treasury (which was subsequently leaked and appeared on the front page of the Australian):

> *"The problem we face is that the sudden (and substantially irrational) surge in demand for guaranteed instruments is creating - or is about to create - serious dislocation in the financial system. People with up to $5 million will be looking to shift out of securities cmts etc into deposits."*

That was certainly the experience with the Challenger Howard Mortgage Fund. It had operated for almost a quarter of a century, including through other periods of financial turmoil, providing daily redemptions without interuption. But like its competitors, with the announcement of the deposit guarantee, it immediately came under extreme pressure with respect to its liquidity as many unit holders sought the certainty of a government guarantee.

On the 20 October 2008 the asset consultant Lonsec initiated action on the entire Australian mortgage trust sector:

> *"The recent Government guarantee on bank deposits does not extend to mortgage trusts and, therefore, presents a significant challenge to the competitiveness of the sector. As a result of this development Lonsec has decided to issue a **'Hold'** rating to all funds in the 'Mortgage – Commercial' and 'Mortgage High Yield' sectors. Lonsec hopes that once markets normalise, the environment for this sector will improve, but it is unclear how long these conditions will persist and, therefore, how long the current ratings action will be in place. Lonsec will continue to monitor these risks going forward. Importantly, Lonsec does not believe that investor's capital is at risk given the underlying assets of the funds. Lonsec reiterates this is a 'Hold' recommendation and not a recommendation to redeem from these funds".*

Despite the explicit statement that this was *"not a recommendation to redeem from these funds"* news of this ratings action did nothing to stem the outflow of funds. With demands for redemptions close to exceeding available liquidity Challenger issued a statement on 21 October 2008 which said:

> *"21 October 2008, Sydney - Challenger today acknowledged that while the recent initiatives by the Federal Government are intended to provide stability in the financial system, the*

implementation of the unlimited bank deposit guarantee had created concerns amongst some investors about the security of income investments not covered by this guarantee.

Challenger has been monitoring the impact of the government initiative on its market leading and long standing mortgage fund, the Challenger Howard Mortgage Fund (the Fund), which has experienced an elevated number of inquiries and redemption requests following the Government announcement.

As a result the redemption policy for this Fund, along with Challenger's other mortgage funds, will be temporarily amended. This amendment will mean the volume of redemptions processed will be matched against the liquidity generated by maturing of the Fund's loan assets. The payment of monthly distributions is not affected by this decision.

Rob Adams, Chief Executive Funds Management, commenting on behalf of the Responsible Entity for the Fund said: "This decision is a necessary and prudent response to a material increase in redemption requests following the Government's announcements. This temporary change in redemption policy has been designed to protect the interests of all unit holders.

"Importantly, the quality of the Fund's assets remains sound and the portfolio continues to perform strongly, particularly when compared against similar investment vehicles. The Fund's assets remain invested in commercial mortgages secured by a diversified portfolio of quality properties. Mortgage investments in the Fund have been and continue to be selected based on conservative lending criteria."

Mr Adams said: "We believe we are seeing unintended consequences of the Government's initiative in relation to supporting the banking system. We will keep a close watch on the situation and review the policy when conditions normalise."

Challenger's associated commercial lending operations will continue by accessing other funding sources."

By the nature of its various investments the Challenger High Yield Fund was highly exposed to the dislocation then occurring in the capital markets, including increased redemption requests. As its responsible entity Challenger was forced to amend its withdrawal policy:

"16 October 2008, Sydney – Challenger today announced that in response to the continuing global credit crisis and conditions in the domestic credit market, it considered it was prudent to temporarily amend the withdrawal policy for the Challenger High Yield Fund offered by its Funds Management business.

The responsible entity for the fund, Challenger Managed Investments Limited (CMIL), believes that amending the withdrawal process is the best course of action to protect the interests of investors given continued dislocation in credit markets. There are indications that this dislocation has further accelerated in recent days following a number of developments – including similar decisions by other participants within the sector.

Under the amended policy, it is intended that redemptions will be offered quarterly as investments in the fund are sold or as they mature. The level of redemptions offered will be subject to prevailing market conditions. The distribution policy of the fund is not affected by this announcement.

CMIL will constantly monitor market conditions and expects the fund to return to the previous withdrawal process as conditions allow it to do so.

CMIL remains confident that the fund will meet its performance objectives over the medium to long term and that the decision is the right course of action to preserve value and is therefore in the best interests of all unit holders."

(d) The effect that the initial announcement of, and subsequent changes to, an unlimited wholesale bank funding guarantee had on the operations of the Australian financial sector, including for entities not regulated by APRA.

The Australian Government has not acted in isolation in giving ADIs access to government guarantees. Many other governments have provided various forms of guarantees and support to their financial sectors.

Capital markets are global and there is now no shortage of government guaranteed paper which has been preferred by many investors because it represents a silver bullet solution to credit, counterparty and liquidity risks. Many banks also prefer to buy paper which is government guaranteed because of the favourable treatment it receives for regulatory capital purposes. As a result regional ADIs and NBFIs which previously relied on global markets to fund the securitisations that enabled them to provide effective competition for the major banks in the Australian mortgage market have effectively been left without access to these investors.

While regional ADIs have access to the wholesale funding guarantee they have found that the 150 basis point guarantee fee is too high to permit them to economically fund a significant volume of new lending. NBFIs have no access to the government guarantee and therefore very limited access to funding from international investors in the current market.

(e) The estimated effect of the bank deposit and wholesale funding guarantees on interest rates in Australia.

Prior to 1990 the margin between the mortgage rate and the bank bill rate was often negative so there was little or no room for housing lending on any scale by anyone other than banks, building societies and credit unions. [1]

In the early 1990's a combination of financial deregulation and lower inflation substantially reduced the gap between the bank bill rate and the deposit rate allowing non-bank mortgage providers to enter the market.[2]

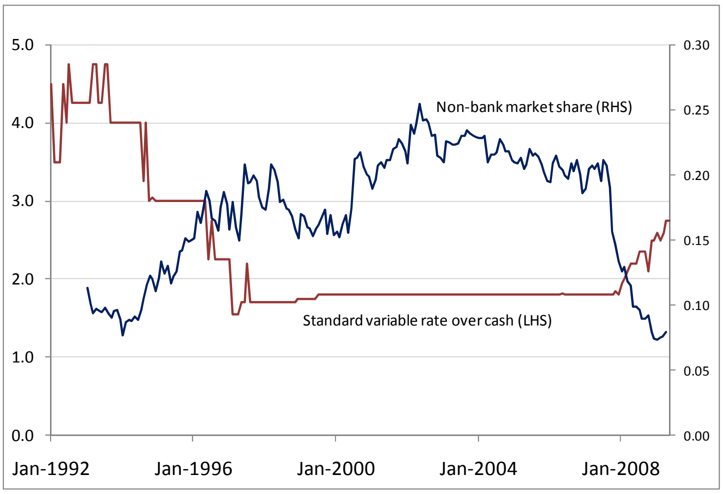
Because the banks had far larger mortgage books than the mortgage managers and wanted to maintain their traditional average margins they were reluctant to cut their mortgage pricing. The mortgage managers were able to borrow at around the bill rate and undercut the banks' mortgage lending rates.[3]

In 1994 official interest rates were raised by 2.75% creating the conditions for competition to intensify between non-bank mortgage providers and the banks. The non-banks offered a significant reduction in the margin between mortgage lending rates and the official cash rate and undercut the banks' mortgage pricing. This rapidly increased the non-banks' share of housing lending from around 2% to 8% of total approvals. To protect their market share the banks were forced to reduce their lending rates to meet this new competition from non-bank lenders.

The result was a reduction of more than 2% in the margin on mortgage lending over the cash rate. Non-bank mortgage providers, while only providing a minority of home loans, have had a profound effect on the interest rates paid by all home loan borrowers. This continued unbroken for a decade until the dislocation of credit markets and resulting consolidation of the mortgage market.

[1] The Evolution of the Housing Loan Market in Australia, Reserve Bank of Australia Bulletin, June 1996. page 1.
[2] Ibid page 2
[3] Ibid page 3

SPREADS ON MORTGAGE RATES AND THE MARKET SHARE OF NON-BANK LENDERS



Source: RBA, ABS

Since the market share of non-bank lenders began to fall precipitously the SVR (standard variable rate) has risen by over 0.9% relative to the benchmark RBA cash rate.

(f) How Australia's deposit guarantee and wholesale funding guarantee schemes compare with guarantees offered in other countries and the way in which these schemes were introduced and changed in major overseas countries.

There is an essential difference between the market support arrangements that have been put in place by the Australian Government and those that have been put in place by many other developed countries. The Australian measures were to maintain public confidence in the banking sector and to ensure the competitiveness of Australian banks seeking funding in global markets. In other jurisdictions deposit guarantees had to be put in place to deal with an actual loss of public confidence in specific institutions (banks like Northern Rock in the UK that were actually failing) and the measures that were put in place to support wholesale capital markets were to deal with the consequences of actual credit defaults occasioned in the first instance by widespread malpractice in sub-prime lending in the USA.

This suggests that there are important qualitative differences between Australia and other jurisdictions not only in terms of the measures that were implemented to deal with what was essentially contagion from the global financial crisis, but also in respect of both industry practices and regulatory arrangements.

Challenger would like to bring to the Committee's attention to three important precedents in terms of other countries' interventions:

- The UK government's decision to offer a choice of either a government guarantee on credit or the liquidity of RMBS;
- Canada's pre-existing arrangements for the government to guarantee RMBS and now for the government to purchase RMBS; and
- Canada's decision to make a government guarantee available to life offices.

Attachment 1 to this submission is a table which summarises market support mechanisms in OECD jurisdictions prepared from a report by the law firm Shearman & Sterling LLP.

(g) The interaction between the deposit guarantee scheme and other recent measures implemented by the Government since September 2008, including the wholesale funding guarantee and the purchases of residential mortgage backed securities.

When it was conceived the AOFM RMBS program was intended to provide cornerstone investments for a series of primary issues of securities that would attract much broader investor support and accelerate recovery of the RMBS market. As evidence of that recovery, Challenger had on 29 September 2008 done a deal for $441 million without AOFM support. However the reaction in capital markets to the Lehman Brothers collapse was a major set back and dashed any expectation of an early recovery. As Australian RMBS did not carry a government guarantee it was uncompetitive in a market which was hungry for paper with sovereign guarantees. This was a global phenomena, so the effect on Australian primary RMBS issuance would have been the same even if the Australian Government had not provided a government guarantee to Australian ADIs' wholesale funding.

In these circumstances the AOFM program became an extremely timely and vital support for regional ADIs and NBFIs that, respectively, did not have effective (because of the 150 basis point fee) or any access to the government guarantee of wholesale funding. The AOFM program was extremely successful in providing sufficient funding to keep a critical mass of second tier lenders operating under very difficult circumstances and ready to provide effective competition for the major banks when more normal market conditions return.

(h) The nature of the financial and economic distortions that the unlimited deposit guarantee scheme has created vis-à-vis savings products that are not covered by the guarantee scheme.

The Australian Government has restricted its guarantee arrangements to ADIs. They were not made available to other APRA regulated entities with similar regulatory capital requirements such as life offices because the purpose of the guarantees was narrowly defined as ensuring the stability of the Australian banking system.

Challenger Life would have benefited where it competes directly with bank term deposits if competitive neutrality had been maintained by providing access to the government guarantees for fixed term life products. Some retirees whose confidence in equity markets had been shaken by the extreme period of volatility took their superannuation benefits as lump sums and sought the security of a government guaranteed term deposit. By doing this many retirees would have taken their retirement savings outside the superannuation system where they would no longer enjoy the tax exempt status of pension phase earnings and benefits. Some of these retirees might have behaved differently if they had access to a government guaranteed fixed term annuity which would have kept their retirement savings inside the superannuation system.

Notwithstanding this, Challenger has been pleased that the normal guarantees provided by life offices under APRA regulation have continued through this period of capital market dislocation to be sufficient to attract the normal ongoing flow of funding associated with Challenger's retiree clientele.

(i) The optimal cap, if any, for the deposit guarantee in the light of international experience.

The primary purpose of deposit insurance is to alleviate immediate hardship resulting from an actual bank failure. That would suggest that the optimal cap would be relatively small, intended to provide depositors with reasonable living expenses while the regulator dealt with a failed bank's future ownership and management. As a practical reality, depositors' access to their money has not been constrained in any Australian bank failure that has occurred in the last several decades.

The events of October 2008 have demonstrated that large guarantees provide an opportunity for investors to seek a safe harbour for riskier non-bank assets. This behaviour results not only in various market distortions but also funding difficulties in the non-bank sector which are systemic in nature, for example closure of the entire mortgage fund sector, despite the fact that the underlying assets continued to perform.

The Governor of the RBA was accurate in his assessment of this behaviour as *"substantially irrational"* and creating *"serious dislocation in the financial system"* since it resulted in those moving their funds receiving significantly lower yields and the funds they were moved from not being able to undertake further lending to classes of borrowers not necessarily well served by banks. This ocurred not because of any likely non-performance of either the funds or prospective borrowers, but because of the unusual demands for liquidity precipitated by this investor behaviour.

(j) Recommendations for ameliorating the moral hazard associated with the deposit guarantee and wholesale funding guarantees.

There are two moral hazards generally associated with deposit guarantees. The first is that depositors will have no incentive to consider the relative safety of competing institutions and will seek the highest return without regard for the strength of the institution. The second is that some bankers will be less careful in their business decisions if their customers are insulated from adverse consequences. Both are arguments for minimal or no deposit guarantees.

There are three moral hazards associated with the wholesale funding guarantee. The first is that that the funds will be invested recklessly. The second is that the funds will be used for purposes other than those for which the guarantee was provided. The third is that the funding advantage resulting from the guarantee will be used for anti-competitive purposes.

The first hazard is effectively controlled by recourse to the assets of the guaranteed entity. Unless the government chooses to intervene in the running of the business - which is a moral hazard in itself - the second and third hazards are harder to control.

(k) Recommendations for timelines and for policies to credibly remove the wholesale funding guarantee and to reduce the deposit guarantee to any recommended optimal cap.

As confidence returns to the capital markets spreads will reduce and most investors will prefer to receive a higher yield without having to pay the guarantee fee. At that point the option of a guarantee on new issues can be removed without affecting the banks' access to funding. Existing guarantees will simply run off.

Given that funding of the Australian banking system is largely dependent on the condition of global capital markets, which could still experience significant volatility, there is a strong argument for international co-ordination of the removal of guarantees.

As the Australian banking system is stable the government probably has more room for discretion in the removal or reduction of the deposit guarantee.

(l) The effects of the bank deposit guarantee and wholesale funding guarantee on competition within the financial sector.

In general, a combination of the capital markets dislocation and the availability of government guarantees to ADIs, has increased the level of competition between banks for deposits and reduced the effective level of competition in lending markets between major banks on one hand and regional banks and NBFIs on the other.

(m) The effects of the announcement of the unlimited bank deposit guarantee and unlimited wholesale funding guarantee on consumer and business confidence.

It needs to be borne in mind that the government implemented both the deposit and wholesale funding guarantees to ensure public confidence in, the stability of, and access to competitive global finance, for the Australian banking system. The ongoing achievement of those key objectives has been highly beneficial for both business and consumer confidence. To consider the significance of that confidence it is only necessary to contemplate what would have been the case if the opposite set of outcomes had come about.

However, it is also important to recognise that when a national government says that it stands behind certain financial institutions and not others, that that will necessarily have a cost, at least for some time, in terms of public confidence in those other institutions that were not guaranteed. This occurs regardless of the actual relative strengths of the guaranteed and non-guaranteed institutions.

(n) The broader economic and social consequences of these distortions.

There have been many broad social and economic consequences but they have resulted more from the dislocation of credit markets and its consequent impact on economic activity than from the distortions in markets which are an inevitable consequence of any government intervention.

Given that the most significant distortion resulting from intervention - sovereign guarantees and funding of private banks - is much more a global than a national issue, and given that most countries financial systems are in much worse shape than Australia's those interventions will unfortunately continue for some time.

The widespread availability of government guaranteed paper is likely to continue to hinder demand for paper which does not carry a government guarantee. Critical in this category in the Australian context is RMBS. The re-emergence of competition in the Australian mortgage market is dependent on the revitalisation of the market for Australian RMBS. There is now universal support amongst regional banks and remaining large NBFIs for a government guarantee of RMBS to achieve this.

(o) The size and nature of the contingent liability that the unlimited deposit guarantee has created for Australian taxpayers.

Since the wholesale funding guarantee was implemented it has assisted the major banks in raising more than $120 billion.

During the same period the AOFM RMBS program has assisted the regional banks and NBFIs to raise about $10 billion.

(p) Other matters relevant to the bank deposit guarantee and wholesale funding guarantee that the committee considers appropriate.

Maintaining competitive neutrality should be a high priority when implementing any government intervention in a market. With government guarantees expected to be a feature of bank wholesale funding for some time it is appropriate for the government to consider the provision of guarantees to both regional banks and NBFIs. These should be in a form which will regenerate competition and provide funding capacity for a wider range of lenders, particularly to assist regional and small business borrowers who are not being adequately serviced by the major banks.

Attachment 2 to this submission is a proposal for a government guarantee of both RMBS and ABCP which would allow regional banks and NBFIs to closely replicate the funding costs of the major banks and so return competition to the Australian mortgage market. The proposal meets the competitive neutrality test because it would also be available to the major banks.

In summary the proposal is to guarantee AAA rated RMBS at the trust level with the same guarantee fee (30 basis points) as is available for AAA rated semi-government securities issued by the States. Issuers would be able to use government guaranteed short-term (30 or 90 day) ABCP, with its lower funding cost to achieve a similar average funding cost as the banks with their current mix of short and long term funding.

The advantage of guaranteeing RMBS at the trust level is that all guaranteed funding would only be available for its intended purpose - lending for Australian residential mortgages - and could not be used for other purposes (such as buying back sub-debt, international M&A activity or even paying dividends), as is the case with guarantees of wholesale funding for institutions.

Unlike the UK government guarantee on RMBS, both credit and liquidity would be guaranteed. Credit risk is not a major issue for investors in AAA rated Australian RMBS which in the course of the global financial crisis has suffered no losses. The more important issue to investors is liquidity risk and their need to be assured that they will be able to sell the security at a time that is relevant to their investment mandate without suffering a capital loss. This issue would be dealt with by the government guaranteeing the clean-up call, which takes effect when the securities have paid down to 10% of their issue value, which is typically within 5 years.

As these guarantees would apply only to AAA rated RMBS, which carry minimal credit risk, the contingent liabilities to be carried by the government would effectively be limited to a maximum of 10% of the issue value. The arrangements would include penalties sufficient to ensure that the issuer exercised the call. In the event the issuer was unable to exercise the call the government would buy the AAA rated securities and would receive a premium yield.

These arrangements would re-open the Australian RMBS market, revitalise competition in the mortgage market, and limit the government's effective contingent liability to only a small fraction of the funding actually raised. The option to guarantee new issues of RMBS and ABCP would be removed at the same time that the current guarantees on wholesale funding are withdrawn.

Challenger requests an opportunity to appear before the Committee to discuss this proposal and the other issues detailed in this submission.

Yours faithfully

Dominic Stevens
Chief Executive Officer

ATTACHMENT 1

SUMMARY OF GOVERNMENT ASSISTANCE TO FINANCIAL SECTOR ACROSS 23 OECD COUNTRIES
Source: Shearman & Sterling LLP

AUSTRALIA

Guarantee bank debt	Deposit guarantee	Central Bank Assist	Recapitalisation measures	Purchases of troubled assets	Other measures
Guaranteed for a fee based on institution's credit rating	Deposit insurance	nil	nil	nil	AOFM SPV ABIP

AUSTRIA

Guarantee bank debt	Deposit guarantee	Central Bank Assist	Recapitalisation measures	Purchases of troubled assets	Other measures
€75 billion Guarantee facility	Guar to Dec 31/09	nil	€15 billion facility for equity support	nil	One bank taken over by state

BELGIUM

Guarantee bank debt	Deposit guarantee	Central Bank Assist	Recapitalisation measures	Purchases of troubled assets	Other measures
Guarantee to 31/10/11 Systemic banks inter-bank lending guaranteed	€100,000 deposit guarantee	nil	nil	Fortis BNP Paribas Dexia S.A.	Capital injections

CANADA

Guarantee bank debt	**Deposit guarantee**	**Central Bank Assist**	**Recapitalisation measures**	**Purchases of troubled assets**	**Other measures**
Eligible debt instruments of up to 3 years Fee reduced from 135 bps to 110 bps for competition reasons	Canada Deposit Insurance Corp	Cut rates Increased liquidity	Framework for capital injections	Purchase of $25 b of govt insured RMBS for liquidity purposes	Debt covered by Canadian Lenders Insurance Facility treated as sovereign for capital requirements purposes C$3.5-C$4.5 Senior funding facility for non-bank RMBS C$13b funding for export finance Finance of C$12b for equipment and vehicles Established Canadian Life Insurers Assurance Facility to guarantee wholesale term borrowings by life insurers

DENMARK

Guarantee bank debt	Deposit guarantee	Central Bank Assist	Recapitalisation measures	Purchases of troubled assets	Other measures
Bank Aid Package to guarantee creditors	Bank Aid Package to guarantee depositors	Official rate increase to support Krone Subsequent cuts followed ECB with 1% differential DKK 60b bond issue to support pension funds	Bad bank Bank Aid Package 2 provides DKK75b to banks and DKK25b to the mortgage credit sector as hybrid core capital requiring a 10% return	Social pension fund has mandate to purchase DKK 22b property mortgage bonds Healthy parts of Roskilde Bank taken over	Temporary provision of core capital by central bank proposed as an alternate to a 25% cut in lending

FINLAND

Guarantee bank debt	Deposit guarantee	Central Bank Assist	Recapitalisation measures	Purchases of troubled assets	Other measures
Guarantees subject to market rates up to €50b until end 2009	Deposit guarantee doubled to €50,000	nil	State offering sub debt as Tier 1 capital	nil	SME finance support Export finance support

FRANCE

Guarantee bank debt	Deposit guarantee	Central Bank Assist	Recapitalisation measures	Purchases of troubled assets	Other measures
Funding not guarantee (SFEF) Guarantee only in exceptional cases at commercial rates	Deposits guaranteed to €70,000	nil	Ad hoc vehicle (SPPE) provides recapitalization as sub-debt, hybrids and preference shares	nil	Banks with commercial paper listed on a regulated market are eligible for short-term refinancing operations French authorities have issued a joint recommendation on fair value of instruments affected by turbulence Government appointed credit mediator for persons and companies seeking refinance

GERMANY

Guarantee bank debt	Deposit guarantee	Central Bank Assist	Recapitalisation measures	Purchases of troubled assets	Other measures
€500b financial stabilization fund to recapitalize financial sector companies, guarantees of instruments to facilitate refinancing, and purchase of selected assets.	Guarantee of deposits progressively raised to €100,000		Recapitalisation in the form of equity participation. Modifications to takeover law to facilitate recapitalisation	Recapitalisation measures for various banks. An ABS investment portfolio will be covered with €6b including a guarantee of €4.8b from the State of Bavaria	Purchase of selected assets from financial sector companies Right for government to expropriate financial sector companies

GREECE

Guarantee bank debt	Deposit guarantee	Central Bank Assist	Recapitalisation measures	Purchases of troubled assets	Other measures
Guarantees, subject to fees and collateral, up to €15b	Deposits guaranteed to €100,000	Issue of €8b bonds to be lent to banks to provide competitive lending to small business and for housing	Purchase of €5b of preference shares redeemable within 5 years at cost	nil	Program of loans to provide small business with working capital

HUNGARY

Guarantee bank debt	Deposit guarantee	Central Bank Assist	Recapitalisation measures	Purchases of troubled assets	Other measures
€2b bank bail out package providing debt guarantees, recapitalization financed from IMF	Deposit guarantee up to €45,000	Widened scope of eligible collateral from A to BBB	Provision for forced recapitalization measures	nil	Facilities from IMF and EIB Fiscal measures include increase in VAT

ICELAND

Guarantee bank debt	Deposit guarantee	Central Bank Assist	Recapitalisation measures	Purchases of troubled assets	Other measures
nil	Press release that deposits are safe	Outflow restrictions imposed and revoked IMF required official rate increased to 18% Seeking extra funding from the US Fed	nil	Nationalization of banks	IMF stabilization program

IRELAND

Guarantee bank debt	Deposit guarantee	Central Bank Assist	Recapitalisation measures	Purchases of troubled assets	Other measures
Financial Support Scheme guarantees covered liabilities and institutions	Deposit guarantee increased to €100,000	nil	Government will invest €3.5b of Tier 1 capital in designated banks funded from the National Pension Reserve in the form preference shares with the right for the government to purchase up to 25%of the ordinary shares. The Financial Regulator has published statutory codes of practice on business lending and mortgage arrears.	Nationalised the Anglo Irish Bank Corporation plc Government said the bank was solvent An assessor will be appointed to determine compensation, if any, for the nationalization.	Financial Support Scheme Act provides wide powers.

ITALY

Guarantee bank debt	**Deposit guarantee**	**Central Bank Assist**	**Recapitalisation measures**	**Purchases of troubled assets**	**Other measures**
Guarantee on market terms transactions of Italian banks to obtain securities eligible for refinancing within the Eurosystem	Deposits guaranteed for 36 months	Facility to guarantee loans from Bank of Italy to Italian banks Reduced thresholds for refinancing and temporary exchange program	Facility for Ministry of Economy to recapitalize banks after 9 Oct 2008 using non-voting preference shares Government hasa nnounced a special fund to issue sub-debt as Tier 1 capital	nil	Subscribe to bank instruments convertible to ordinary shares, redeemable by issuer, yield subject to profits, economically sound, aimed at improving flow of finance to business, issuer must undertake to ensure adequate levels of financing to business, dividend policies consistent with capital requirements, code of conduct relating to remuneration and golden parachutes, 30% must be subscribed by private persons (20% with current shareholdings < 2%), amount available 2% of total assets, issuer must act in a way that does not represent an abuse of assistance

JAPAN

Guarantee bank debt	Deposit guarantee	Central Bank Assist	Recapitalisation measures	Purchases of troubled assets	Other measures
Government announced it would support banks with public funds to ensure small and medium businesses would not struggle to access credit.	Guarantee of US$100,000	Increased repos including ABS Uncollateralized o'nite call rate of 0.3% Outright purchase of commercial paper	Japan, China, South Korea developing $80b reserve pool for region	nil	A range of BoJ liquidity measures Jan 22, BoJ purchased 3 trillion yen of commercial paper and asset-backed commercial paper rated a-1 and above with residual maturity up to 3 months, with certain restrictions.

THE NETHERLANDS

Guarantee bank debt	Deposit guarantee	Central Bank Assist	Recapitalisation measures	Purchases of troubled assets	Other measures
€200b facility to purchase non-complex senior unsecured loans	€100,000 deposit guarantee	Special credit to individual institutions against adequate collateral	€20b recapitalization fund using preference shares	ING issued non-voting Tier 1 securities to Government Risk transfer to Government of 80% of ING's Alt-A mortgage securities	

NEW ZEALAND

Guarantee bank debt	Deposit guarantee	Central Bank Assist	Recapitalisation measures	Purchases of troubled assets	Other measures
Wholesale funding guarantee	NZ$1m guarantee of deposits Institutions with deposits of more than $5b charged 10bps Includes non-bank finance companies	Official rate cuts	nil	nil	Additional liquidity facilities by the Reserve Bank of NZ

NORWAY

Guarantee bank debt	Deposit guarantee	Central Bank Assist	Recapitalisation measures	Purchases of troubled assets	Other measures
nil	NOK2m per person	2 year fixed rate loans to banks of NOK1b 3 month fixed rate loans of NOK10m and 6 months NOK1b	nil	Swaps of government securities for covered bonds And other collateral for periods up to 3 years	Jan 26 government announced addition measures would be forthcoming

PORTUGAL

Guarantee bank debt	Deposit guarantee	Central Bank Assist	Recapitalisation measures	Purchases of troubled assets	Other measures
Government will guarantee institutions at its discretion to €20b	Deposit guarantee of €100,000	Bond portfolio gains and losses only to be accounted for if impaired Regulation to soften calculation of pension fund losses by banks to improve solvency. Extension of eligible collateral in Eurosystem Operations	€4b program for recapitalisation	Nationalisation of BPN Guarantee of small private bank against advice of the Governor of the Bank of Portugal	Doubling of Tier 1 capital requirements to 8% Bank of Portugal required to approve advertising complex products

SPAIN

Guarantee bank debt	Deposit guarantee	Central Bank Assist	Recapitalisation measures	Purchases of troubled assets	Other measures
€100b available to guarantee issuances of debt traded on official Spanish secondary markets.	€100,000 deposit guarantee	nil	Facility for government to acquire securities, preferred shares and similar capital	€30-€50 program financed through government bonds to purchase quality assets backed by new transactions originated on or after October 7, 2008.	Temporary mortgage moratorium for unemployed

SWEDEN

Guarantee bank debt	Deposit guarantee	Central Bank Assist	Recapitalisation measures	Purchases of troubled assets	Other measures
Guarantee of medium term financing with a limit of SEK1,500b	Deposit guarantee of SEK500,000	nil	Fund to recapitalize banks using preference shares Changes to Tier 1 requirements to facilitate lending	Several banks have utilized guarantee scheme	National Housing Guarantee Board is drafting a program to protect house owners against falls in value causing a lending bank to call loans by the government guaranteeing the loans.

SWITZERLAND

Guarantee bank debt	Deposit guarantee	Central Bank Assist	Recapitalisation measures	Purchases of troubled assets	Other measures
Indicated action would be taken if necessary	CHF100,000 deposit guarantee	Auction of Swiss francs to Eurosystem institutions	Recapitalisation of Credit Suisse Group and UBS AG	Transfer of US$60b in illiquid securities from UBS	Fiscal stimulus through infrastructure projects

UNITED KINGDOM

Guarantee bank debt	**Deposit guarantee**	**Central Bank Assist**	**Recapitalisation measures**	**Purchases of troubled assets**	**Other measures**
Guarantee, for a fee, of short and medium term debt Fee is 100% of institution's median five-year CDS spread plus 50bps	Deposit guarantee of £50,000	Operational Standing Lending Facility rates are 25bps above and below Bank Rate Asset Purchase Facility authorizes purchase of £50b of high quality investment grade assets including asset backed securities. Source of funds is newly created reserves ie quantitative easing DWF (Discount Window Facility) provides liquidity for up to 364 days Term auctions to provide funds at 3 months maturity against wider collateral including UK mortgages	£25b facility to provide Tier 1 capital in the form of equity or preference shares. A further £25b is available for ordinary equity raisings. RBS, HBOS & Lloyds TSB have used these facilities.	Northern Rock Bradford & Bingley	Guarantee Scheme for Asset Backed Securities On Jan 19, 2009 the government announced it would provide full or partial guarantees to eligible AAA rated ABS, including mortgages and corporate and consumer debt. UK banks and building socities will be eligible. The scheme will commence in April 2009 subject to state aid approval.

		Special Liquidity Scheme provides banks and building societies access to BoE standing facilities to temporarily exchange high quality assets including RMBS Extension of Eligible Collateral to include AAA rated RMBS			

UNITED STATES OF AMERICA

Guarantee bank debt	Deposit Guarantees	Central Bank Assist	Recapitalisation measures	Purchases of troubled assets	Other measures
TLGP (Temporary Liquidity Guarantee Program) guarantees newly issued senior unsecured debt of banks, thrifts and holding companies. Fees are determined by duration: <180 days 50bps 181-364 days 75bps 365days>100bps	Deposit insurance US$250,000 Fee 10bps for non-interest bearing accounts Institutions will be charged standard guarantee fee for interest bearing accounts	TALF (Term Asset Backed Securities Lending Facility) up to US$1trillion to reduce credit spreads and restart securitization market Collateral to include newly issued AAA rated asset backed securities funded from TARP CAP (Capital Assistance Program) stress tests major institutions to determine new capital requirements. If needed supplied by Treasury as preference shares. Banks will be able to exchange TARP for CAP. PPIF (public Private Investment Fund) uses $500b-$1tril of public and private	TARP (Troubled Asset Relief Program) provides for direct equity investments in institutions under the Economic Emergency Stabilisation Act. Total is US$700b in three tranches. Troubled assets are either mortgage related or anything else Treasury thinks money should be spent on, which includes shares or preference shares in about 400 banks.	Mortgage Backed Securities Purchase Program Treasury Dept will purchase up tp US$700b of distressed mortgage backed securities and other assets for subsequent resale to investors. Henry Paulson determined mortgage backed securities were not the best use of all this money.	Government loan to auto industry of US$630b JP Morgan Chase and Co purchase of Bear Stearns required US$29b from the Fed AIG Fed provided a revolving credit facility of US$85b and a further US$37.8b to buy investment grade securities from AIG subsidiaries. Fannie and Freddie Government seized control and provided US$100b to each. Fed subsequently initiated purchase of direct obligations of Fannie, Freddie and Ginnie at a cost of US$600b Citigroup Treasury and

		money to acquire real estate related legacy assets. CPFF (Commercial Paper Funding Facility) will purchase through SPV 3 month unsecured and asset backed commercial paper (ABCP) all issuers eligible Liquidity Fund Is a 1 year program for banks to purchase ABCP from mutuals MMIFF (Money Market Investor Funding Facility) provides back up liquidity for money market investors.			Federal Deposit Insurance Corporation provided protection against unusual losses for a US$306b of loans and asset backed securities. Treasury invested US$20b in Citigroup from TARP TIP (Targeted Investment Program) Citigroup received US$20b Bank of America Treasury and Federal Deposit Insurance Corporation protected against losses on US$118b pool of loans and ABS mostly acquired from Merrill Lynch. Treasury provided US$20b from TARP for preferred stock.

ATTACHMENT 2

Proposal for a Government Guarantee of Residential Mortgage Backed Securities

Table of Contents

1. Introduction

The purpose of this paper is to outline a proposal for the introduction of a guarantee by the Australian government of residential mortgage backed securities (RMBS). The proposal will allow for the guarantee to operate in both the asset backed commercial paper (ABCP) market as well as the term RMBS market.

Residential mortgage backed securitisation should continue to play a role in the provision of credit to households on a competitive basis. The Global Financial Crisis (GFC) and the introduction of the government guarantee of wholesale funding for ADIs has significantly affected the liquidity and depth of the market for RMBS. While the Australian Office of Financial Management (AOFM) securitisation program has provided some liquidity, the normal functioning of the RMBS market has not returned. In addition, ADIs have a substantial benefit of being able to supplement liquidity and funding on a short term basis through the inter-bank markets and the RBA's open market operations. When the cost and availability of term funding is challenged, this becomes a substantial competitive advantage. Consequently, any effective guarantee must also be extended to short term residential mortgage backed ABCP funding.

The objective of any government guarantee of RMBS and ABCP should be to level the competitive playing field between the 4 major banks and those non-bank financial institutions, regional ADIs, credit unions and building societies seeking to participate in the mortgage funding market. In order to satisfy this objective, the guarantee must be priced at a level that reflects the relative risk as determined by rating levels and be available on both a short term and long term funding basis to improve liquidity across the capital structure and to provide the foundation for improved mortgage pricing to households.

2. The Proposed Guarantee Scheme

2.1. Introduction

It is proposed that the Australian Government (the "Guarantor") make available a guarantee facility in respect of securities, both short and long term, backed by Australian residential mortgage loans (the "Guarantee Facility"). The Guarantee Facility will be available until 3 years from the anniversary of its introduction.

Eligible Institutions can apply to access the Guarantee Facility provided the securities proposed to be issued meet the Eligible Securities Criteria, the Eligible Mortgage Criteria and following payment of the applicable Guarantee Fee.

Applications will be made to the AOFM who will be responsible for the issue of appropriate guarantee documentation and for the ongoing administration of the guarantee program. It is expected that the program will be self-funding, and ultimately profitable for the Australian Government given the low risk nature of the obligations being guaranteed.

2.2 Eligible Institutions

Eligible Institutions that can apply to access the Guarantee are:

1. Authorised deposit taking institutions authorised under the Banking Act 1959;
2. Non-bank financial institutions, which in the view of the Guarantor, have a substantial Australian mortgage lending business; and

3. In the case of institutions wishing to apply for a Guarantee of complying ABCP, the institution must make the Sponsor Capital Contribution to the relevant special purpose vehicle (SPV) responsible for issuing the ABCP.

2.3 Eligible Securities Criteria

Eligible Securities must fulfil each of the following conditions:

- In the case of securities with a legal final maturity greater than 1 year (RMBS), they must, upon issue, be rated AAA (or the equivalent) by at least two rating agencies. In the case of securities with a legal final maturity of less than 1 year (ABCP), they must, upon issue, be rated A-1+ (or the equivalent) by at least two rating agencies. In each case, they must be so rated on the basis that they do not carry a guarantee;
- They must be denominated in one of Australian dollars, US Dollars or Euro or such other currency as may be approved by the Guarantor;
- In the case of RMBS, the securities must have a clean-up call that can be exercised when the face value of securities falls to 10% of the original face value of the securities issued (the “Clean-up Call”);
- In the case of ABCP, the securities must be issued by an SPV that has certified that it holds the Sponsor Capital Contribution as part of the underlying credit enhancement for the series of securities issued on behalf of that Sponsor.

2.4 Eligible Mortgage Criteria

Each mortgage which backs the Eligible Securities to be issued with a Guarantee must be a mortgage loan and its related security. The pool of mortgage loans backing either the ABCP or RMBS must satisfy the following criteria:

- Each mortgage loan must be secured by a valid first-ranking mortgage over residential property located in Australia;
- Each mortgage loan must carry a mortgage insurance policy issued by an APRA regulated and approved mortgage insurer that covers the full amount of principal and interest in respect of the loan;
- The loan-to-value ratio of each mortgage loan must not exceed 95%;
- At least one full payment in respect of each mortgage loan must have been made;
- The mortgage loan must not be in arrears at the time of sale to the SPV;
- The seller of the mortgage loans must be an Eligible Institution.

2.5 Guarantee Fee

The Guarantor will determine, and be entitled to charge, the amount of the Guarantee Fee for the issue of a Guarantee in respect of any Eligible Securities.

The Guarantee Fee will vary depending upon the nature of the security issued.

The Guarantee Fee applicable for ABCP will be [20] basis points per annum.

The Guarantee Fee applicable for RMBS will be [30] basis points per annum.

The Guarantee Fee will be payable in Australian dollars from the cashflows of the SPV and will rank ahead of the coupon payable on the AAA rated securities. It will accrue on an actual/365 basis over the period commencing on (and including) the date of issue of the Eligible Security and ending on the date that is the earlier of (i) the date on which the Eligible Security is redeemed in full and (ii) the date on which the Clean-up Call is exercised.

2.6 Capital Contribution for ABCP

In order for an issue of ABCP to be considered an Eligible Security, the Sponsor must contribute [1]% of the face value of the ABCP as an additional credit enhancement to be retained by the issuing SPV (Sponsor Capital Contribution). The ratings of the ABCP must be A-1+ (or their equivalent) without taking into consideration the Sponsor Capital Contribution.

The Sponsor Capital Contribution enhances the credit of the ABCP while at the same time ensuring that the Sponsor has an incentive to refinance the mortgage collateral underlying the ABCP into term RMBS. Accordingly, the Guarantee Fee for ABCP can be less than for RMBS to reflect its shorter term, lower credit risk and the fact that there is a cost to the Sponsor of the Sponsor Capital Contribution.

Term RMBS will not require a Sponsor Capital Contribution.

The Sponsor Capital Contribution will also assist the Guarantor in understanding the creditworthiness of unregulated institutions seeking to access the Guarantee Facility.

Sponsors will be restricted in the proportion of their overall funding that can be represented by ABCP. The proportion of each individual Sponsor's securitised funding from the date of the implementation of the Guarantee Scheme that is represented by ABCP cannot exceed [75%] of the total securitised funding of that Sponsor at any time. Sponsors' pre-existing stock of securitised funding prior to the introduction of the Guarantee Scheme will not be included in the calculation above.

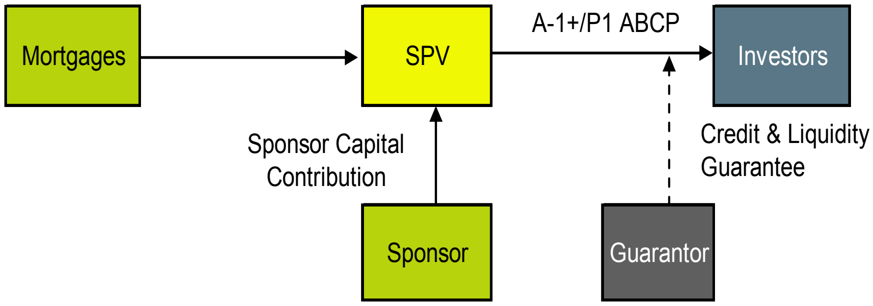
Credit & Liquidity Guarantee

The Guarantee will provide protection to investors both in respect of credit and liquidity risk for both ABCP and RMBS.

ABCP

The Guarantee of ABCP will be expressed to insure investors from any credit losses (after exhaustion of all other credit enhancements (including the Sponsor Capital Contribution)) and will protect investors from any liquidity failures in the market.

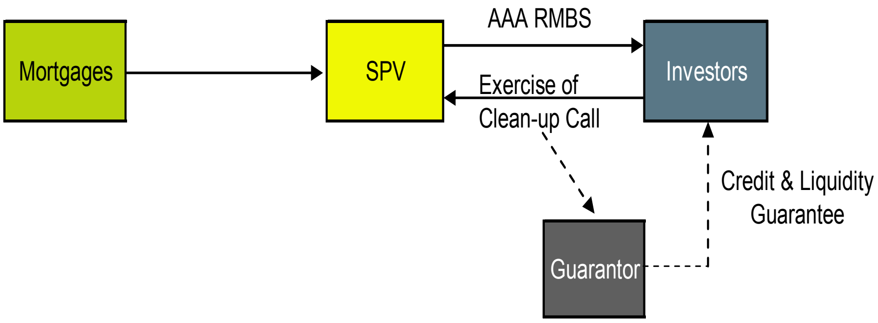
At the maturity of any issue of ABCP carrying a Guarantee, the ABCP will either be reissued to investors or redeemed either in part or whole. In the event that the ABCP was not able to be reissued to investors (either in part or whole) due to market failure, the Guarantor will be obliged to purchase the outstanding affected balance of ABCP for a period of the Guarantor's determination. At the conclusion of this period, the Guarantor can offer the ABCP for sale to the market on terms determined by the Guarantor.



RMBS

The issuer of the RMBS will grant a 10% Clean-up Call as part of the Eligible Security structure. When the face value of the RMBS falls to 10% of the original face value issued, the issuer may exercise its option to call the outstanding face value of RMBS at par. If the issuer is unable to exercise the Clean-up Call, the Guarantor will be obliged to purchase the remaining face value of RMBS at par.

The issuer may elect to include a date-based call as part of its security structure. Any date-based call occurring before the Clean-up Call will only be met by the issuer. The Guarantor will only be obliged to exercise the Clean-up Call in the event that the issuer was unable to meet it.



3.1 The need for a guarantee of short term funding

The most significant change in the global capital markets since the beginning of the GFC has been the change in the price of liquidity. The cost of long term finance has increased substantially while the cost of short term finance has not escalated to anywhere near the same degree. Consequently, there is an incentive for institutions to lend for a longer term and borrow for a shorter term and at cheaper rates than would be the case if the lending and borrowing were match funded.

ADIs with access to the central bank window have a mechanism by which they can manage this liquidity risk, and as the cost of long term debt has increased and its availability has been challenged, ADIs have relied increasingly on issuing short term debt or repoing securities with the RBA.

Non-bank mortgage lenders are more constrained in their ability to tolerate liquidity risk and can generally only lend with any scale at prices which closely reflect the true market cost of funding their assets for the term of those assets. In addition, non-bank mortgage lenders typically rely on bank provided warehouse facilities to pool mortgage loans ahead of issuing match funded RMBS. Banks have increased the cost of these warehouse facilities to a level that does not reflect the short term nature of the liquidity and credit risk being taken. This has also materially affected non-bank mortgage lenders' ability to originate competitively priced mortgage loans.

A guarantee of both the credit and liquidity risk associated with the issue of short term ABCP backed by residential mortgage loans will have the effect of giving non-bank and bank lenders alike equal access to the benefit of the current pricing for liquidity risk. This will neutralise or eliminate the current pricing disadvantage in warehouse facilities and facilitate more competitive mortgage loan origination.

Consideration for lower rated tranches

While the above proposal only extends to a guarantee of the AAA rated or A-1+ rated tranches of any RMBS or ABCP issue, consideration should be given to extending the guarantee to include all tranches of the capital structure rated AA- or better.

Since the GFC, the market dislocation has resulted in there being little to no interest from investors in the subordinated tranches of RMBS structures. Accordingly, in order to successfully place the higher-rated tranches many Sponsors are forced to purchase and hold the lower rated tranches on their own balance sheet. For smaller ADIs and non-bank mortgage lenders, this is a significant cost and competitive disadvantage.

Government consideration could be given to guaranteeing all tranches rated AA- or better of each issue and charging a differential fee for the guarantee based on the risk profile of those securities. In this fashion, the guarantee would work in a similar fashion to the current wholesale funding guarantee of ADIs where pricing is tiered based on the rating of the ADI applying to use the guarantee.

3.3 Benefits to Investors

- High quality alternative government guaranteed investment
- Expected to have an attractive yield similar to current ADI government guaranteed wholesale funding
- For risk-weighted investors, the investment will carry the sovereign risk weight (0%)
- Marketability – will promote a liquid secondary market in government guaranteed RMBS

- Liquidity – secondary market liquidity as well as insulation from extension risk via the liquidity guarantee at the Clean-up Call

3.4 Benefits to the Issuers

- Access to a deep and liquid source of funds that has been unavailable since the beginning of the GFC
- Access to both short and long term funds on a competitive basis
- Provides liquidity to balance sheets and warehouses and enables competitive lending to be restarted
- Reduces cost of funds enabling cheaper mortgage pricing
- Potential release of capital improving return on equity and return on capital ratios
- Improved profitability

3.5 Benefits to the Economy

- Restarts the Australian residential mortgage backed securities market and provides a source of funds for residential mortgage lending that has been lost since the beginning of the GFC
- Promotes competition in the mortgage finance market by levelling the playing field for all mortgage providers – major banks, regional banks, credit unions, building societies, credit unions and non-bank financial institutions
- Enables more competitive mortgage pricing
- Provides greater choice for Australian consumers
- Limited risk for Australian taxpayers in providing the guarantee with substantial longer term benefits

3.6 Benefits to the Government

- Simple and effective solution to the promotion of competition in the mortgage finance market
- No infrastructure required to establish the scheme. Issuance of guarantees and ongoing monitoring of program can be performed by the Australian Office of Financial Management with existing resources that have been dedicated to the AOFM's RMBS purchase program
- The scheme will be self-funding and will most likely be profitable for the government over the long term
- The usage of the scheme and its ultimate withdrawal can be managed easily and effectively by adjusting the pricing applicable to the issuance of guarantees