Australian Government

The Treasury

SENATE STANDING COMMITTEE ON ECONOMICS

INQUIRY INTO THE BANK FUNDING GUARANTEES

TREASURY SUBMISSION

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CONTENTS

EXECUTIVE SUMMARY

The Australian Government's deposit and wholesale funding guarantees were introduced following the serious deterioration in global financial markets in September and October 2008, and in the context of unprecedented policy actions from authorities around the world. While Australia's financial system was relatively well placed to withstand the turbulence in credit markets, the freezing of global credit flows and the introduction of financial sector guarantees internationally threatened the ability of Australian financial institutions to access funding. This had potentially serious implications for the health of individual financial institutions, the stability of the financial system, the flow of credit to Australian household and business borrowers, and consequently Australia's economic growth.

In response to these developments, the Government announced that it would guarantee deposits and wholesale funding of authorised deposit-taking institutions (ADIs) on 12 October 2008. Deposit balances up to $1 million per depositor, per institution are covered automatically and for free under the Financial Claims Scheme (FCS). Deposit balances above $1 million and eligible wholesale funding instruments may be covered on an opt-in basis and for a fee under the Guarantee Scheme for Large Deposits and Wholesale Funding (Guarantee Scheme).

The Guarantee Scheme fee schedule is based on the credit ratings of the issuing institutions and is set at levels between the prices of ADIs' wholesale debt instruments at the height of the financial turmoil and the prices that had prevailed in more normal market conditions. This approach provides an incentive for ADIs and their investors to cease using the Guarantee Scheme as market conditions normalise, helps to mitigate any impacts of the guarantee on the markets for other financial assets, and ensures that the fee schedule reflects market-based pricing signals and the risks borne by taxpayers.

Around $650 billion of deposits are guaranteed under the FCS. A further $21 billion in large deposits, $15 billion in short-term wholesale funding and $91 billion in long-term wholesale funding are guaranteed under the Guarantee Scheme. The total stock of guaranteed liabilities continues to grow, reflecting growth in deposits and long-term wholesale issuance.

Australia's four major banks have been the largest issuers of government guaranteed long-term funding, consistent with their size and historic reliance on wholesale markets for a larger share of their total funding relative to smaller institutions. However, smaller institutions have also benefited from the guarantees. Non-major Australian banks' deposit bases have grown at a faster rate than the major banks' since the guarantees were introduced, and non-major institutions have increased their share of the wholesale term funding market. In addition, a larger proportion of smaller institutions' funding is guaranteed automatically and for free under the FCS relative to that of the four major banks.

In the aftermath of the collapse of Lehman Brothers, it is likely that low liquidity in financial markets would have resulted in ADIs paying a substantially higher yield on issues on non-guaranteed securities, if they were able to sell them at all. In the absence of the Guarantee Scheme, it is likely that ADIs would have responded to such a high cost of funds by borrowing fewer funds in total, reducing the supply of credit, and passing the higher costs of funds to their new and existing borrowers. That is, the Guarantee Scheme is likely to have put downward pressure on borrowing costs for Australian households and businesses.

Financial institutions that are not ADIs do not have access to the guarantees as they are not permitted to accept deposits and are not subject to prudential regulation. These institutions have also been impacted by the global financial crisis. While it is difficult to disentangle the impact of the events leading up to the introduction of the guarantees on non-ADIs from the impact of the guarantees themselves, it is clear that the difficulties faced by non-ADI institutions had already emerged prior to the introduction of the guarantees and are likely to have persisted in the absence of the guarantees. The outlook for non-ADIs is expected to continue to improve with the recovery in global financial markets.

The FCS and Guarantee Scheme have been carefully designed to minimise the Government's financial exposure. The likelihood of the guarantees being drawn upon is low. ADIs are subject to prudential regulation which is designed to ensure that they have the capacity to meet their financial commitments. In addition, in the unlikely event that a guarantee is called upon, the Commonwealth has the capacity to recover its expenditure through a claim on the relevant institution.

The Australian Government has committed to reviewing the cap on deposits covered by the FCS by 12 October 2011, and removing the guarantee of wholesale funding when markets conditions normalise. The Government is monitoring conditions in wholesale funding markets and supporting multilateral efforts to unwind the wholesale funding guarantee in a timely, well-sequenced and coordinated manner.

THE GLOBAL FINANCIAL CRISIS

Over the course of 2007 and 2008, global financial markets sharply deteriorated. What began as an increase in defaults on United States (US) sub-prime mortgages culminated in widespread weakening of confidence in financial assets and a global repricing of risk. Spreads on most debt securities widened, stockmarkets plummeted, financial markets became more volatile, and funding conditions for financial institutions tightened considerably. Global financial institutions that had inadequate buffers against liquidity shortages and large movements in asset prices suffered heavy losses and became faced with the threat of failure.

The first few weeks of September 2008 saw a dramatic escalation in the global financial crisis, with Fannie Mae and Freddie Mac taken into US Government conservatorship and the bankruptcy of the US investment bank, Lehman Brothers, on 15 September 2008 — at the time the largest bankruptcy in US history. This was shortly followed by the US Government's emergency rescue of American International Group, the sale of Merrill Lynch to the Bank of America, and the collapse of Washington Mutual. By late September 2008, events in the US had spread globally, with the collapse of Belgium's Fortis, Bradford and Bingley in the United Kingdom (UK) and Iceland's Glitnir Bank.

Faced with rising default risk, confidence in financial institutions globally plummeted. Losses on Lehman Brothers debt spilt over into the money market funds sector, and drove one large US fund, the Reserve Primary Fund, to 'break the buck'— its net asset value fell below the value of funds invested. This triggered a run of redemptions on other US money market funds and the withdrawal of investments more generally as investors sought safe havens from the turmoil. As funds sold off assets to meet investor redemptions and banks and other financial institutions sought to further reduce their exposure to risk, asset markets became increasingly distressed and the flow of credit and liquidity in global capital markets virtually froze.

In September and October 2008, authorities in G20 nations including the US, UK and European countries, responded with extraordinary policy measures, including enhanced protections for depositors, guarantees of financial institutions' wholesale fundraising, recapitalisation of major financial institutions, injections of liquidity into financial markets, and coordinated interest rate cuts.

It was in the midst of these events that, on 12 October 2008, the Australian Government announced that it would make arrangements to guarantee the deposits and wholesale funding of ADIs in Australia.

INTRODUCTION OF THE GUARANTEE SCHEMES

Rationale for introducing the guarantee schemes

Australia's financial system was relatively well placed to withstand the turbulence in credit markets as the global financial crisis unfolded. The banking system was, and remains, profitable and well capitalised, with minimal direct exposure to sub-prime assets and failed overseas financial institutions. Up until September 2008, Australian ADIs were able to raise funds to finance their lending growth through a higher level of deposits and wholesale funding, albeit at wider spreads and shorter terms than prior to the crisis.

However, the freezing of global credit flows in September and October 2008 threatened the ability of Australian financial institutions to access funding, with potentially significant implications for liquidity and stability in the financial system. In addition, notwithstanding the relative strength of Australia's financial institutions, the confidence of investors and depositors in Australian ADIs was shaken by the escalation of the global financial crisis. The guarantees were designed to address these serious threats to the health of Australia's financial system by providing certainty to Australian depositors that their deposits were safe and ensuring that ADIs could continue to raise wholesale funds from domestic and international investors.

Concerns about Australian financial institutions' access to global credit markets were also driven by the actions taken by other governments to shore up their financial institutions' access to funds, which would potentially put Australian institutions at a competitive disadvantage to their overseas counterparts. On 30 September 2008, the Irish Government announced that it would guarantee 100 per cent of the deposits and certain types of debts of Ireland's six largest banks. Over the following week Germany, Austria, Denmark and Iceland announced unlimited deposit guarantees, while the US, UK and Hungary significantly increased the amounts guaranteed under their deposit insurance arrangements, and governments such as Denmark, Sweden and the UK announced or foreshadowed guarantees of financial institutions' debt issuance. On the weekend of 11-12 October 2008, the G7 and G20 Finance Ministers agreed to urgent and unprecedented coordinated action to address the credit crisis, including the strengthening of depositor protection and measures to assist financial institutions to raise new funds. In the absence of similar action by the Australian Government, these measures threatened to put Australian financial institutions at a serious disadvantage in raising funds in global capital markets, notwithstanding the relative strength of our banking system.

Another key consideration in the introduction of the guarantees was the impact of global liquidity and credit constraints on the Australian economy. The banking system's access to capital is important, not just for the health of individual institutions and the stability of the financial system, but also to ensure the continued flow of credit to Australian household and business borrowers. Given the fundamental role of credit in supporting household consumption and household and business investment, the freezing of credit flows in September and October 2008 had the potential to restrict Australia's economic growth significantly, with consequential implications for employment and living standards.

Implementation and operation of the guarantee schemes

The detailed design of the guarantee arrangements was based on recommendations to the Government by the Council of Financial Regulators, comprising the Governor of the Reserve Bank of Australia (RBA), the Secretary to the Treasury, and the Chairmen of the Australian Prudential Regulation Authority (APRA) and the Australian Securities and Investments Commission (ASIC). The Council had been examining Australia's financial sector crisis management arrangements since 2004 and had been closely monitoring the impact of the global financial crisis on the Australian financial sector since its emergence in 2007.

The Government announced that it would guarantee deposits and wholesale funding of Australian-incorporated ADIs on 12 October 2008. The Government introduced an interim guarantee of wholesale funding of Australian-incorporated ADIs and foreign bank branches, and certain deposits held by Australian residents with foreign bank branches, on 2 November 2008. The interim guarantee formally expired on 27 November 2008 and was replaced by the final guarantee (below). No guaranteed debt was issued by institutions under the interim guarantee.

Financial Claims Scheme (FCS)

The deposit guarantee is primarily implemented through the FCS. The Government had announced on 2 June 2008 its intention to introduce an FCS with a cap of $20,000 per depositor. In response to the rapidly evolving crisis, on 12 October 2008, the Government brought forward the introduction of the FCS. Legislation establishing the FCS was passed by Parliament on 16 October 2008 and received Royal Assent the following day. On 24 October 2008, on the advice of the Council of Financial Regulators, the Government announced that deposits up to $1 million per depositor per ADI would be covered under the FCS, while deposits above $1 million would be eligible for coverage under the Guarantee Scheme for Large Deposits and Wholesale Funding (Guarantee Scheme).

While introduction of the legislation was swift, development of the FCS had been under active consideration by the Council of Financial Regulators since 2004.[1] This followed the recommendation of the HIH Royal Commission that the Government establish a comprehensive scheme to support insurance policyholders against the failure of insurance companies, and the subsequent Study of Financial System Guarantees, which examined guarantees for financial products more generally. The Council concluded that while existing legislation provided considerable protection to depositors and policyholders, it did not provide for timely payments to be made in the event that an institution failed, which could cause hardship for depositors and policyholders and put pressure on the Government to intervene in an ad hoc manner.

The guarantee of deposits under the FCS covers deposits below $1 million (including the first $1 million of large deposits) with ADIs (except foreign bank branches).[2] A non-exhaustive list of

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[1] Further information on the history of the development of the FCS can be found in the RBA's ***Financial Stability Review*** of September 2004, March 2006, September 2006, March 2008 and September 2008.

[2] There are 189 eligible authorised deposit-taking institutions in Australia, comprised of 14 Australian-owned banks, nine locally-incorporated subsidiaries of foreign-owned banks, 35 foreign bank branches, 11 building societies, 116 credit unions and four other institutions.

deposit products covered by the FCS is set out in the ***Declaration of Covered Financial Products*** made pursuant to subsection 5(8) of the ***Banking Act 1959*** on 27 October 2008. It includes deposits held in savings accounts, call accounts, transaction accounts, cheque accounts, cash management accounts, farm management deposits, pensioner deeming accounts, retirement savings accounts and term deposits.

The FCS does not apply to market-linked investments such as share portfolios or managed funds, as these provide an incentive for investors to pursue higher returns through investments that may involve greater risks, including the risk of making capital losses. Protecting investors in these products from losses while rewarding them for risk could lead to destabilising risk-taking and significantly increase the Commonwealth's liability. The FCS also does not apply to certificates of deposit, debentures and similar instruments, which are types of wholesale debt instrument and which may be eligible for coverage under the Guarantee Scheme.

Foreign bank branches operating in Australia are not eligible for coverage under the FCS, although deposits at these branches are eligible for coverage under the Guarantee Scheme, and may be covered by deposit protection arrangements in the bank's home jurisdiction. Foreign bank branches are not permitted to accept initial deposit balances of less than $250,000 and, while they are subject to prudential regulation by APRA and their home country supervisor, they are not subject to precisely the same requirements in Australia as locally incorporated ADIs.

No fee is payable for access to the FCS and depositors and their financial institutions are not required to apply for coverage. Instead, in the event the FCS is activated by the Treasurer, depositors' entitlements will be calculated and made available to the depositor by APRA, the scheme's administrator, using information provided by the ADI.

The extension of the coverage of the FCS to deposits up to $1 million is a temporary measure to implement the Government's guarantee of deposits during the global financial crisis. The Government has indicated that this cap will be in place until 12 October 2011, at which time the cap will be reviewed. However, the FCS is intended to remain in place as a permanent addition to Australia's depositor protection and crisis management framework.

Guarantee Scheme for Large Deposits and Wholesale Funding

The guarantee of deposits above $1 million is implemented under the Guarantee Scheme. The Guarantee Scheme covers, for a fee and on an opt-in basis, aggregate deposits over $1 million per customer, per institution held with Australian-incorporated ADIs, providing the deposit is at call or with a term of up to 60 months. Special arrangements are in place with respect to the deposits of foreign bank branches (see below).

The inclusion of large deposits in the wholesale funding guarantee, rather than the FCS, reflects the fact that large, sophisticated investors may regard large deposits and wholesale securities as competing investment products. Having consistent arrangements across both types of investment is designed to ensure that the guarantees have the same impact on large deposits and investments in ADI securities, so that they do not distort investment decisions. It also ensures that ADIs that wish to be covered by the guarantee are required to pay for it with respect to all of their wholesale funding, whether it is through large deposits or through issuing securities.

The Guarantee Scheme also encompasses the guarantee of wholesale funding, comprised of a short-term wholesale funding guarantee (for securities with a maturity of up to 15 months) and a long-term funding guarantee (for securities with maturities of 15 months up to 60 months).

The short-term wholesale funding guarantee is available to all ADIs in Australia, including foreign bank branches. The instruments eligible for coverage are restricted to bank bills, certificates of deposit, transferable deposits, certain debentures and commercial paper (for short-term liabilities of up to 15 months in maturity). Foreign bank branches can access the short-term guarantee, subject to certain limits and conditions (see below).

The long-term wholesale funding guarantee is limited to Australian-incorporated ADIs. The guarantee also applies to the foreign branches of eligible Australian-incorporated ADIs but not their foreign subsidiaries. The instruments eligible for coverage are senior bonds, notes and certain debentures, with a term of up to 60 months. The guarantee applies for the full term of the relevant security including in the period following the closure of the scheme to new issuances.

For both the short-term and the long-term guarantee, the Scheme Rules require that guaranteed debt instruments must not be complex. This is intended to ensure that the guarantee is only used in relation to standard, ‘plain vanilla’ securities. The ’not complex’ guidelines reduce the risk to the Government in providing the guarantee.

The Government has indicated that it will withdraw the Guarantee Scheme when market conditions have normalised. Conditions in financial markets and the operation of the scheme are being closely monitored by the Council of Financial Regulators.

Foreign bank branches

On 24 October 2008, the Government announced that it would extend the wholesale funding guarantee to APRA-regulated foreign bank branches, subject to certain restrictions. This decision reflects the important role that the 35 foreign bank branches play in Australia's financial system, particularly with respect to funding the Australian corporate sector, the recognition that they are subject to prudential regulation, and the fact that, unlike Australia, some overseas jurisdictions did not appear to be extending their guarantees to the foreign branches of their domestic banks.

Foreign bank branches are able to seek coverage under the Guarantee Scheme for their short-term domestic liabilities with maturities up to 15 months.[3] As deposits of foreign bank branches are not eligible for coverage under the FCS, foreign bank branches can apply for coverage of deposits below and above $1 million under the Guarantee Scheme up until 31 December 2009.

In addition, foreign branches' access to the Guarantee Scheme is subject to a number of conditions:

- the amount which a branch may guarantee is limited to 110 per cent of the average daily value of short-term wholesale liabilities and deposits held by Australian residents in the 30 days up to and including 24 October 2008;
- branches cannot use the guaranteed liabilities to support directly the foreign ADI outside Australia, or the obligations of the parent or any related entity;
- the guarantee is only available if the liabilities are not guaranteed by the government, or any government agency or authority, of the home jurisdiction of the branch;
- the branch must provide a statement from the chief executive officer (or equivalent) of the parent bank which reaffirms that the parent bank is meeting relevant prudential requirements in its home jurisdiction and that it is not aware of circumstances which would make a future material breach likely; and
- if the parent bank is non-compliant with prudential requirements in its home jurisdiction, the chief executive officer (or equivalent) of the parent bank must provide both a statement describing the matters of non-compliance, and a letter from APRA stating that APRA does not object to the granting of the guarantee.

These limitations and conditions reflect the fact that, while foreign bank branches are prudentially regulated by APRA, they are not subject to the same regulatory requirements in Australia that apply to Australian incorporated banks. In addition, the requirements are designed to ensure that the guaranteed funding is used for Australian operations only and that Australian taxpayer funds are protected.

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[3] Access was initially restricted to securities maturing on or before 31 December 2009. This restriction was amended on 15 May 2009 in recognition of the continuing need for foreign bank branches to access the guarantee with respect to debt of terms up to 15 months.

Non-authorised deposit-taking institutions

Non-authorised deposit-taking institutions are not permitted to hold deposits and are not eligible for the wholesale funding guarantee.

The distinction between authorised deposit-taking institutions and other financial institutions is a fundamental element of Australia's financial system regulatory framework, which dates, in its current form, to the recommendations of the Financial System Inquiry 1997 (the Wallis Inquiry).

The Wallis Inquiry recognised that there is a trade-off between maintaining financial system stability (through prudential regulation and crisis management arrangements) and promoting efficiency and innovation in the financial sector (by minimising Government intervention). The Wallis Inquiry specifically examined whether investors in non-deposit taking institutions such as finance companies and money market corporations should be afforded the same degree of protection as depositors, in the form of prudential regulation. However, it concluded that, unlike deposit-taking institutions, these entities did not pose significant systemic risks, and as such, prudential regulation and associated investor protection arrangements were not warranted.

Investment in instruments issued by non-ADIs provides the opportunity to seek higher returns by taking on higher risks than is possible under prudential regulation, and without the associated compliance burden and costs. Extending the guarantees to institutions outside the prudential regulation framework would protect investors against losses while rewarding them for risk-taking, which could encourage destabilising risk-taking in our financial system, lead to adverse distortions in the financial system, and increase the size and riskiness of the Government's exposure. It would also limit the Government's ability to monitor the nature of its exposures and take regulatory actions to mitigate its risks.

Despite these considerations, a number of other governments have extended guarantees and other support arrangements to entities outside their prudential regulation frameworks. In most cases, this reflects the systemic importance of those financial institutions and local financial and economic conditions. Such moves have also been accommodated by reforms to the financial regulation framework to mitigate these risks. For example, in extending support to investment banks, the US Government moved to subject them to the regulatory frameworks applicable to commercial banks. Similarly, in extending support to its finance company sector, the New Zealand Government announced a new prudential regulation regime for this sector. Australia's situation differs from those of other countries in that non-ADI entities are not systemically important to the financial system and the relative health of our financial system meant that the more significant interventions taken in other jurisdictions were not warranted.

Nonetheless, non-ADI entities that wish to access the Australian Government's guarantees have the option of applying to APRA for authorisation as an ADI, providing that they can demonstrate their ability to comply with relevant prudential requirements and licensing conditions. APRA was provided with additional funding of $45.5 million over four years in October 2008 to enable it to manage the effects of the global financial crisis, including responding to such applications.

Guarantee fee

ADIs pay a fee to access the Guarantee Scheme.

The application of a fee provides an incentive for ADIs and their investors to cease using the Guarantee Scheme as market conditions normalise. It also helps to mitigate any impacts of the guarantee on the markets for other financial assets.

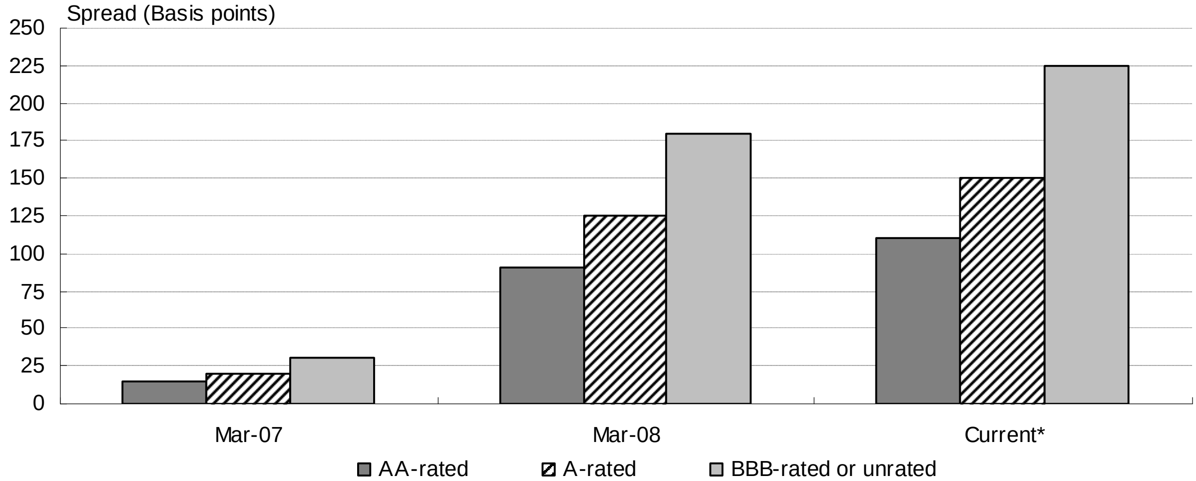
Consistent with the advice of the Council of Financial Regulators, the fee schedule comprises a single rate fee for eligible large deposits and wholesale debt instruments, regardless of their term, with a different rate applying to eligible institutions based on their credit rating (Table 1).

Table 1: Guarantee Scheme fee schedule

Credit rating	Fee per annum
AA- and above	70 bps or 0.7 per cent
A- to A+	100 bps or 1.0 per cent
BBB + or below and unrated	150 bps or 1.5 per cent

The risk-based fees were set with reference to risk spreads observed in financial markets for institutions with different credit ratings (Chart 1). The fees were set at levels between the then current prices of ADIs' wholesale debt instruments (at the height of the financial turmoil) and the prices prevailing over the previous decade, in more normal market conditions. This approach was adopted to ensure the fee schedule reflected market-based pricing signals and the risks borne by taxpayers. It also helps to ensure that ADIs of all ratings have incentives to exit the guarantee arrangements as market conditions normalise.

Chart 1: Indicative cost of funding for Australian ADIs (bps/BBSW)



* includes guarantee fee. Bank Bill Swap Rate (BBSW)
Source: Hogan[4], Reuters, RBA

[4] Hogan, W, P. (2009). 'The Bank Deposit and Wholesale Guarantees of 12 October 2008: An Appraisal' Agenda, Volume 16, Number 2, 2009.

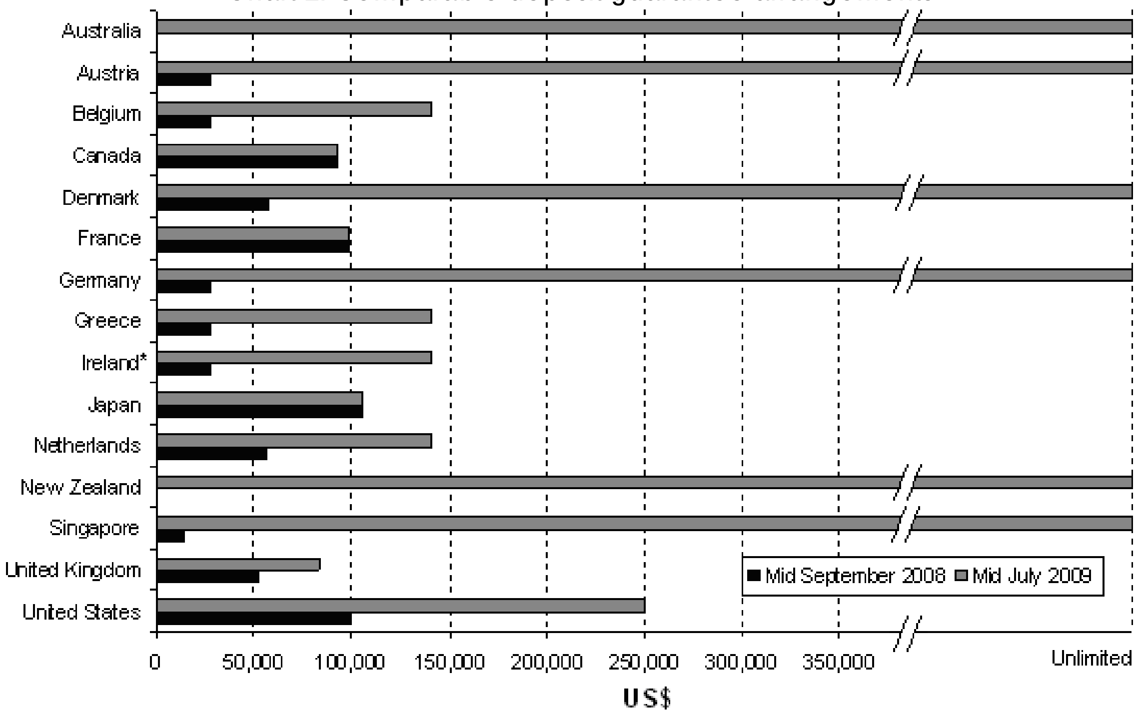
In announcing the fee schedule on 24 October 2008, the Government indicated that it would be reviewed on an ongoing basis and revised if necessary, in light of evolving market conditions.

Comparison with international guarantee arrangements

While most developed nations introduced and/or enhanced arrangements for guaranteeing deposits and wholesale funding liabilities of key financial institutions in the period following the collapse of Lehman Brothers, a variety of approaches have been taken in the design of such arrangements. This largely reflects the different institutional frameworks, financial sector structures, and financial and economic conditions between nations, and the need to move quickly in response to the rapidly evolving crisis. Over time, a number of countries have adjusted their arrangements in order to respond to domestic and international developments, and efforts are being made internationally to coordinate future changes to guarantee arrangements.

Most developed nations have in place deposit guarantee arrangements comparable to Australia's, although the provision of an unlimited guarantee is not as common (Chart 2).

Chart 2: Comparable deposit guarantee arrangements



Sources: Bank for International Settlements (BIS); Bloomberg; RBA; Treasury departments, central banks, debt management offices and guarantee administrators., XE.com.
Coverage limits converted into US dollars using bilateral exchange rates as at 1 August 2009.
* The Irish Government has also provided a 100 per cent guarantee for seven of its credit institutions and subsidiaries.

Details of arrangements to guarantee banks' wholesale debt instruments also vary considerably across countries in terms of structure, fees, debt maturity and termination date of the schemes (Table 2).

Most countries' fee schedules differentiate between institutions on the basis of risk, with more risky institutions paying a higher fee. However, there are different approaches to calculating the fee differential, with countries such as Australia, Canada and New Zealand using credit ratings, while countries such as the UK, France and Germany are using market-based benchmarks such as credit default swaps. The US, Ireland and Korea charge the same fee regardless of the riskiness of the institution. Most nations' fee schedules charge a higher fee for longer-term issuance, whereas Australia's fee schedule does not differentiate between securities with different term structures.

Australia's wholesale funding guarantee fee schedule (which also applies to large deposits) is currently at the lower end of the international spectrum, but is broadly consistent with international arrangements if the cost of swapping debt raised in foreign currencies into Australian dollars is taken into account. These swap costs have been unusually elevated due to the impact of the crisis. Australian ADIs, along with those in New Zealand and the UK, are in the unusual position of issuing the majority of their debt in foreign currencies, and hence incur higher funding costs relative to their counterparts in the US, Europe and parts of Asia.

Table 2: Wholesale debt funding guarantees

Country	Final date for guaranteed issuance	Maximum maturity date	Eligible instruments	Pricing
Australia	Not set	Rolling 5 years	New and existing senior unsecured debt with maturities of up to 60 months	AA- and above rated: 70 bps A- to A+ rated: 100 bps BBB+ or below and unrated: 150 bps
Canada	31/12/09	Duration of guarantee is capped at 3 years from date of issue	New senior unsecured debt with maturity of at least 3 months.	110 bps for institutions rated at or above A- or equivalent (plus 25 bps for others). 20 bps foreign currency surcharge
Germany	31/12/09	31/12/14	Newly issued interbank liabilities and senior unsecured debt.	Charged at a fee (percentage of borrowing amount plus risk premium), to comply with market pricing. No fee amount specified in decree-law; individual percentages to be applied.
Ireland	29/9/2010	All eligible instruments are covered until 29/09/10	New and existing covered bonds, senior unsecured debt and dated subordinated debt (lower Tier 2)	N/A
New Zealand	Not set	Duration of guarantee is capped at 5 years from date of issue	Newly issued senior unsecured debt	AA- or above rated: 70 bps (≤ 1 year); 90 bps (> 1 year) A- to A+ rated: 130 bps (≤ 1 year); 150 bps (> 1 year) BBB- to BBB+ rated: 180 bps (<1 year); 200 bps (>1 year) Reduced rates for foreign currency-denominated securities with maturities greater than 1 year.
UK	31/12/09	09/04/14	New debt with maturities up to 3 years, with some flexibility to rollover.	100 per cent of institution's 12 month median five year CDS spread + 50bps
US	31/10/09	31/12/12	New senior unsecured debt with a term of more than 30 days	50 bps (maturity of 31-180 days); 75 bps (maturity of 181-364 days); and 100 bps (maturity of over 364 days), plus surcharges: • 10 bps payable if insured depositories make up < 50 per cent of consolidated capital. • 10 bps for insured depository institutions (20 bps for other institutions) for instruments with maturity of at least 1 year issued between 1/4/09 and 30/6/09 and maturing on or before 30/6/12. • 25 bps for insured depository institutions (50 bps for other institutions) surcharge for instruments issued between 30/6/09 and 31/10/09, or issued after 1/4/09 with a maturity after 30/6/12.

Sources: BIS; Bloomberg; RBA; Treasury departments, central banks, debt management offices and guarantee administrators.

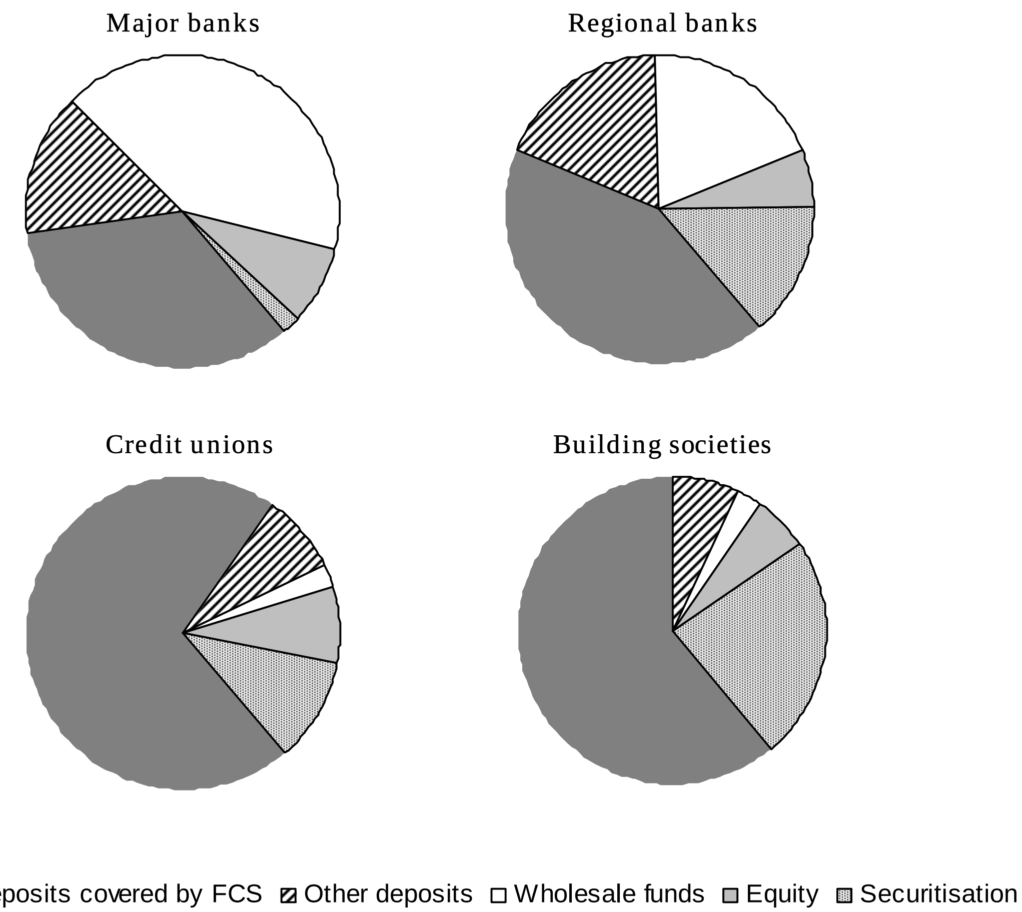
USAGE OF THE GUARANTEES

Financial Claims Scheme

The guarantee of deposits under $1 million through the FCS covers around $650 billion of deposits (as at 31 March 2009). It is estimated that over 70 per cent of all deposits (excluding certificates of deposits), 16.5 million accounts and 99.5 per cent of depositors are covered by the FCS. With aggregate deposits having grown by around 1.4 per cent since March, the deposits covered by the FCS have continued to increase.

The FCS covers a higher proportion of smaller ADIs' liabilities relative to those of larger ADIs (Chart 3). This is because many smaller ADIs such as credit unions and building societies raise the majority of their funding through household and other retail deposits, and relatively little from larger deposits or wholesale funding. This means that a larger proportion of their funding is guaranteed automatically and for free under the FCS.

Chart 3: ADI funding composition as at 31 March 2009



Source: APRA, RBA and Treasury estimates.

Guarantee Scheme for Large Deposit and Wholesale Funding

For the month of June, the average daily value of guaranteed liabilities was $127.3 billion, comprised of $21 billion in large deposits, $15 billion in short-term wholesale funding and $91 billion in long-term wholesale funding (Table 3).

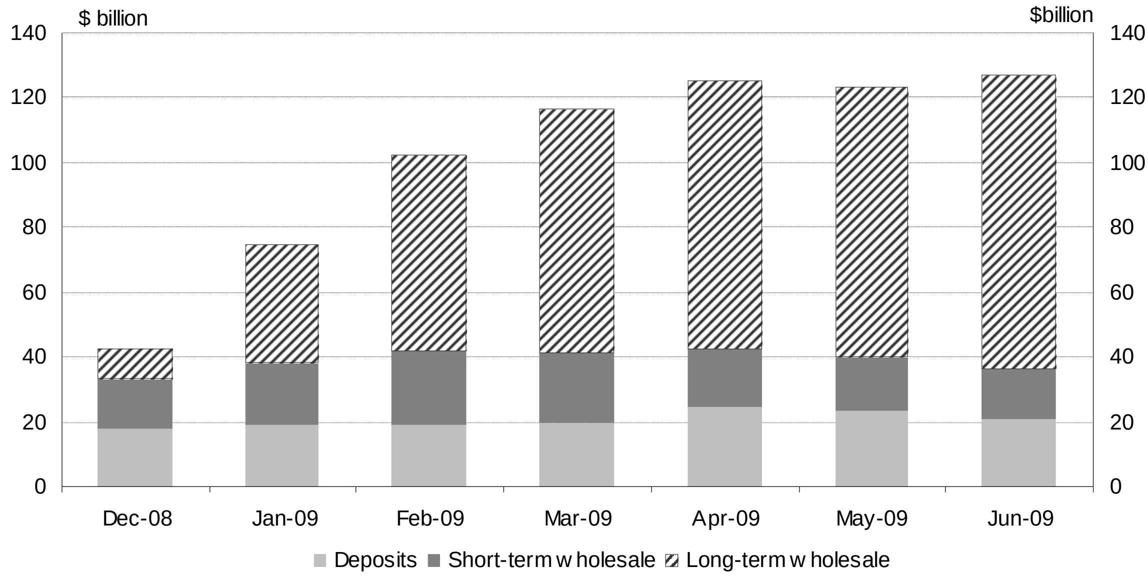
Table 3: Average daily values of Guarantee Scheme guaranteed liabilities - June 2009

Guaranteed liabilities	$b
Deposits	20,997
Short-term wholesale	15,424
Long-term wholesale	90,861
Total	**127,282**

Source: Guarantee Scheme administrator

While the stock of guaranteed long-term wholesale funding continues to grow, the stock of guaranteed large deposits has remained relatively stable for a number of months, and the stock of short-term wholesale funding has fallen slightly since the first few months of the Guarantee Scheme's operation (Chart 4).

Chart 4: Average daily values of Guarantee Scheme



Source: Guarantee Scheme administrator

The Guarantee Scheme covers 2 per cent of ADIs' deposits (in addition to the 70 per cent covered by the FCS). The Guarantee Scheme also covers 1.5 per cent of ADIs' outstanding short-term wholesale funding instruments and 8.6 per cent of their outstanding long-term wholesale funding instruments. In terms of new issuances of wholesale funding, the Guarantee Scheme covers approximately 80 per cent of long-term wholesale funding raised by Australian ADIs since the guarantees were introduced, with ADIs raising $29 billion in non-guaranteed long-term funding since October 2008.

Table 4: Long-term wholesale funding issuance under the Guarantee Scheme (Dec 08 to July 09)

Month	Size* (A$ billion)	% issued in A$	% issued in foreign currencies	Average equivalent spread to BBSW** (bps)	
				3-year floating	5-year floating
Dec-08	23.06	33.31%	66.69%	157	174
Jan-09	28.62	27.91%	72.09%	153	180
Feb-09	18.58	40.50%	59.50%	141	170
Mar-09	12.06	59.09%	40.91%	136	#N/A
Apr-09	5.45	9.91%	90.09%	138	#N/A
May-09	5.26	0.95%	99.05%	137	161
Jun-09	17.05	27.98%	72.02%	115	135
Jul-09	15.90	31.48%	68.52%	112	134
Total	**125.98**	**32.30%**	**67.70%**		

* Currency conversion was based on exchange rates on the day the securities were issued.
**These spreads are based on RBA calculations and are adjusted for the cross-currency basis swap only. These are calculated based on major banks' issuances only and include the 70 basis point guarantee fee.
Source: RBA and Treasury

The AA-rated institutions (comprising Australia's four major banks and one foreign bank subsidiary) have been the largest users of the long-term funding guarantee, accounting for 72 per cent of all guaranteed long-term funding on issue. This is to be expected given the relative size of the major banks and their historic reliance on longer term debt for a larger share of their total funding relative to smaller institutions. Instruments issued under the Guarantee Scheme represent on average around 30 percent of AA-rated institutions' stock of long-term bonds on issue as at September 2008 (prior to the introduction of the guarantees).

A further 26 per cent of guaranteed long-term funding has been raised by A-rated institutions (comprising three non-major Australian banks and one foreign bank subsidiary). Instruments issued under the Guarantee Scheme represent around 190 per cent of these A-rated institutions' stock of long-term bonds on issue as at September 2008.

The remaining 2 per cent of guaranteed long-term funding has been raised by BBB-rated institutions (comprising one non-major Australian bank, one foreign bank subsidiary and one building society). Instruments issued under the Guarantee Scheme represent around 50 per cent of these institutions' stock of long-term bonds on issue as at September 2008.

In short, non-major banks (A-rated and BBB-rated institutions) have raised more guaranteed issuance relative to their September 2008 stock of outstanding bonds than the major banks.

While a significant number of A-rated, BBB-rated and unrated institutions have not raised wholesale funding at all under the guarantee, this is consistent with historical patterns of issuance. That is, most of these institutions did not source their funding via wholesale markets prior to the global financial crisis.

Almost one-third of all guaranteed long-term funding has been raised in Australian dollars, while the remaining two-thirds has been raised in foreign currencies (Table 4). This is also consistent with the historical pattern of issuance. Over half of guaranteed long-term debt is denominated in

US dollars while around 11 per cent is denominated in yen. A further 4.5 per cent is denominated in one of six other Asia-Pacific or European currencies (Table 5).

In contrast, nearly two-thirds of short-term guaranteed funds are denominated in Australian dollars, with the remaining one-third denominated in foreign currencies. Ninety-nine per cent of guaranteed deposits over $1 million are in local currency.

Table 5: Denomination of bonds issued under the Guarantee Scheme (Dec 08 to Jun 09)*

Currency	Size** (A$ billion)	Share (per cent)
US$	65.61	52.08
A$	40.69	32.30
Yen	14.08	11.18
GBP	1.63	1.29
HK$	1.48	1.17
CHF	1.23	0.97
NZ$	0.78	0.62
CAN$	0.36	0.29
SG$	0.13	0.10
Total	**125.98**	100

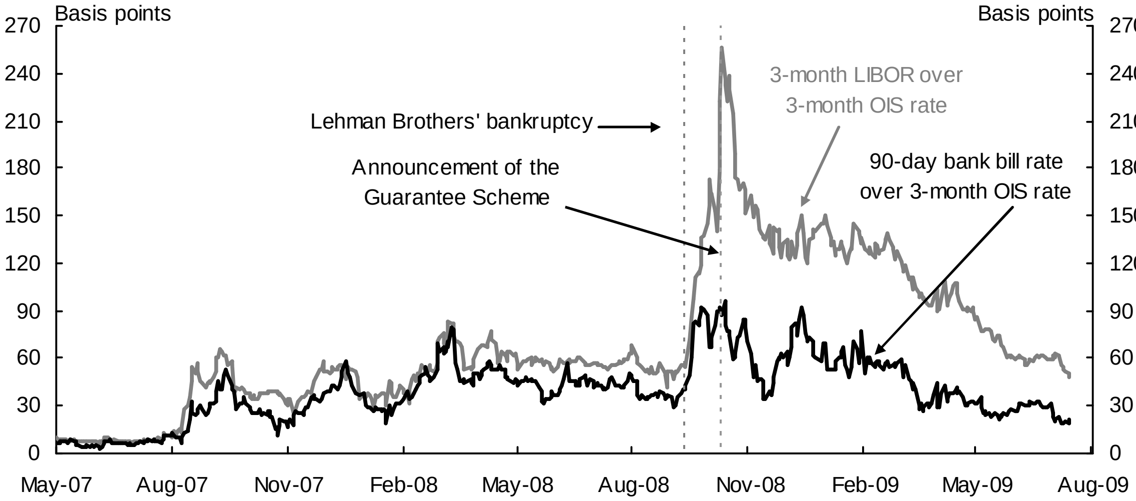
* Denomination of securities may not reflect the market into which they were issued.
** Currency conversion was based on exchange rates on the day the securities were issued.
Source: RBA and Treasury

IMPACT OF THE GUARANTEES

Financial system stability and market confidence

The unprecedented global action in response to the escalation in the financial crisis, including the announcement of the deposit and wholesale funding guarantees by the Australian Government, had an immediate favourable impact on confidence and financial system stability. Key credit spreads, which had skyrocketed after the collapse of Lehman Brothers in September 2008, have continued to narrow following these announcements (Chart 5). Similarly, survey data indicated an improvement in depositors' confidence in ADIs, with households' view of deposits as the preferred place for savings rising to historically high levels.

Chart 5: Key credit spreads in Australia



Sources: Bloomberg and RBA

After a period of gradual decline at the beginning of 2009, key credit spreads have fallen more rapidly over the past few months, in many cases returning to levels last experienced prior to the Lehman Brothers bankruptcy (Chart 5). Similarly, measures of household and business confidence have shown signs of significant improvement. The Westpac-Melbourne Institute Consumer Sentiment Index has increased by close to 40 per cent since July 2008.[5]

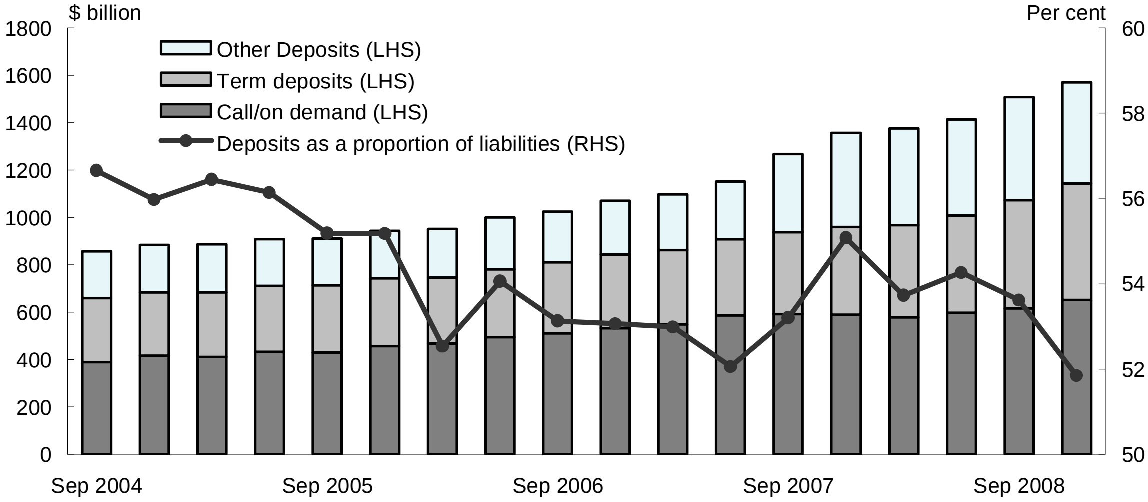
The impact of Australia's guarantee arrangements on confidence, financial stability and economic growth has been recognised internationally. For example, the International Monetary Fund noted that the Government's ADI guarantees have bolstered confidence in the financial system and allowed credit to continue to flow to the economy during the global financial crisis.[6]

[5] The Westpac-Melbourne Institute Consumer Sentiment Index – increase from 79.0 per cent in July 2008 to 109.4 per cent in July 2009.
[6] Australia—2009 Article IV Consultation, Concluding Statement, 23 June 2009.

Deposits

Deposits as a proportion of total bank liabilities were in long-term decline prior to the global financial crisis as depositors substituted higher-yielding investments for deposits and banks relied increasingly on cheap wholesale funding to sustain lending growth (Chart 6).

Chart 6: Deposits as a proportion of Australian bank liabilities

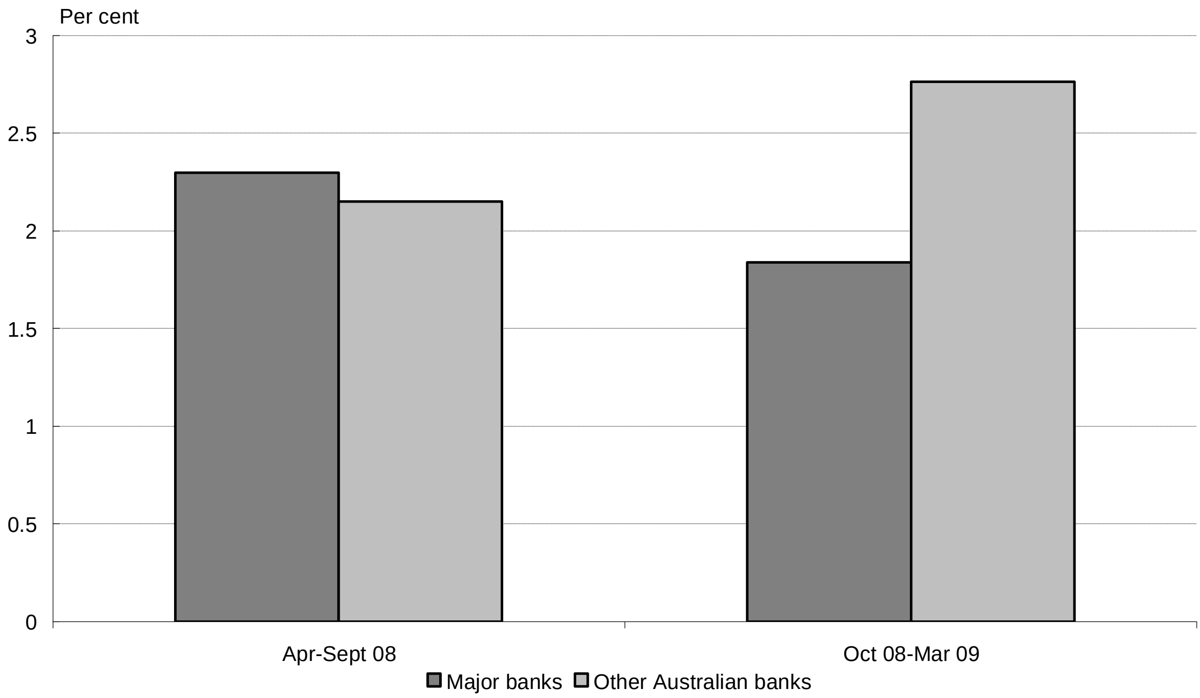


Source: APRA Quarterly Bank Performance Statistics

With the onset of the crisis, this pattern reversed. Banks experienced strong growth in deposits, particularly from May 2008, as investors sought refuge from the volatility in investment markets. Growth in deposits (excluding certificates of deposit) held at banks increased sharply over the second half of 2008 and accelerated in October 2008 (rising by 5.7 per cent in the month). This 'flight to quality' also manifested in movements of deposits from some smaller institutions to the major banks, potentially impacting on smaller institutions' ability to finance their lending activities.

The introduction of the Government guarantee on deposits immediately stemmed these outflows of deposits from certain smaller institutions, and is likely to have contributed to strong aggregate deposit growth in the fourth quarter of 2008. Deposits grew by an average of 2.4 per cent per month in the December quarter 2008, before falling to a level of 0.7 per cent per month over 2009 to date. Moreover, deposit growth has been more broad-based across the ADI sector since the guarantee was introduced, with deposits at non-major banks growing at a faster rate than those at the major banks (Chart 7).

Chart 7: Average growth rate of deposits (excluding certificates of deposit)



Source: APRA

Wholesale funding

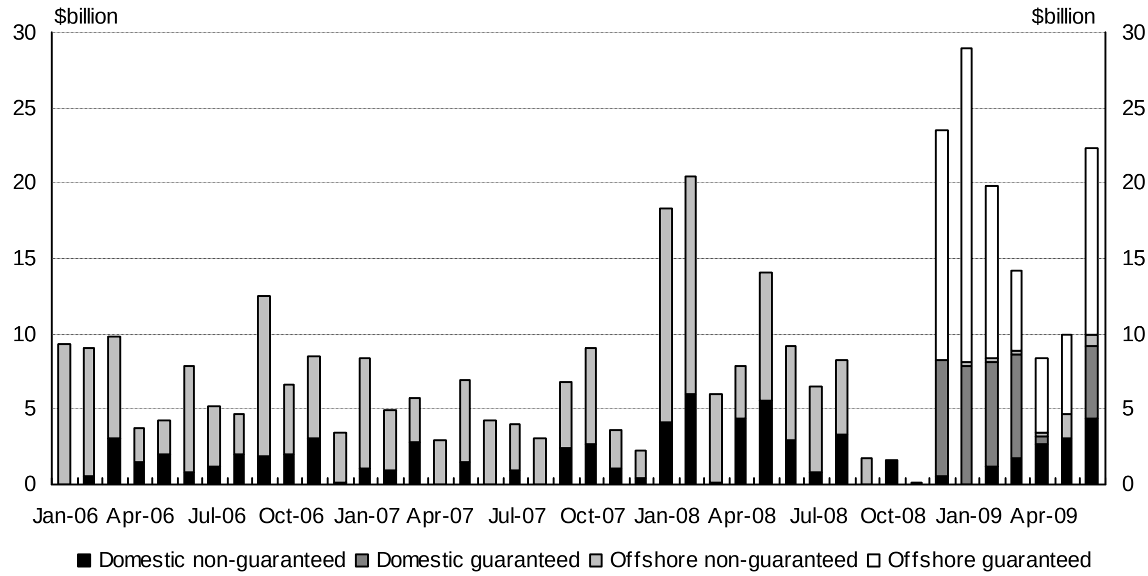
As noted above, in the decade prior to the global financial crisis, many ADIs, including Australia's four major banks, had become increasingly reliant on wholesale funding to finance their lending growth. However, the onset of the crisis made wholesale funding more expensive and difficult to obtain, and caused Australian ADIs to become more reliant on short-term wholesale markets and deposits, potentially increasing their exposure to liquidity and rollover risks. As the crisis deepened and long-term wholesale funding markets seized up in September and October 2008, Australian ADIs all but stopped offshore and domestic issuances (Chart 8).

Under such extreme distress, the Guarantee Scheme has played a critical role in assisting Australian ADIs to re-enter the global credit market. Aided by the Guarantee Scheme, Australian ADIs raised long-term wholesale funds in nine different currencies at generally narrowing spreads between December 2008 and June 2009. Based on past experience, it appears that the major banks are now well advanced on their 2009-10 funding task, which is likely to be in excess of $100 billion.

Moreover, banks have been able to issue bonds in larger amounts and with longer maturities than had been possible since mid-2007, both in Australia and abroad. The average term of guaranteed debt has been approximately four years, around one year longer than during the months leading up to the crisis.

Chart 8: Banks' bond issuance

A$ equivalent; monthly



Source: Guarantee Scheme Administrator

As market conditions have improved, the major banks have been able to successfully issue non-guaranteed bonds both domestically and offshore (Table 6). Since the start of April 2009 the major banks have issued around $14 billion in term funding without the Government's guarantee, up from $6 billion over the previous six months. Moreover, the pricing differential between non-guaranteed and equivalent guaranteed instruments is narrowing.

Table 6: Non-guaranteed bond issuances over A$100 million by the major Australian banks since April 2009

	Issue Date	Issuer	Currency	Size (AUD million)	Term (years)	Spread	Benchmark
Domestic	1/04/2009	ANZ	AUD	125	2	na	na
	6/04/2009	CBA	AUD	1200	3	130	BBSW
	29/04/2009	NAB	AUD	1500	3	130	BBSW
	5/05/2009	ANZ	AUD	1,000	3	128	BBSW
	19/05/2009	NAB	AUD	175	3	128	BBSW
	26/05/2009	WBC	AUD	1,700	3	120	BBSW
	5/06/2009	WBC	AUD	300	3	120	BBSW
	18/06/2009	NAB	AUD	1,300	3	115	BBSW
	7/07/2009	CBA	AUD	2,000	5	145	BBSW
Offshore	21/05/2009	NAB	STG	1,000	5	285	Gilts*
	29/05/2009	CBA	THB	140	4/7	140/158	Tgov^
	10/07/2009	NAB	EUR	1,705	7	158	Mid-swap

*UK Government bonds. ^Thai Government bonds.
Source: Reuters

Funding costs and interest rates in Australia

The impact of the bank deposit and wholesale funding guarantees on interest rates in Australia depends on what banks' costs of funds would have been in the absence of the guarantees, and what this would have implied for the level of lending rates: in other words, the extent to which the increase in costs of funds would have been passed on to consumers, in the absence of the Guarantee Scheme.

Impact through wholesale funding

One way of assessing what the banks' costs of funds would have been in the absence of the guarantees is to look at the yield on existing (non-guaranteed) debt on the secondary market. The difference between the secondary market yield for non-guaranteed securities and that on new issuances of guaranteed securities (including the guarantee fee) can be thought of as a cost saving to the ADI from the Guarantee Scheme, which could be translated into downward pressure on lending rates to consumers. It is reasonable to conclude that, in its initial months, the Guarantee Scheme enabled ADIs to raise wholesale funds at a considerably lower cost than would have been possible without the guarantee.

Where the secondary market for securities is deep and liquid, the prevailing yield could be expected to be a good guide for the cost of new (primary) securities. However, particularly in the immediate aftermath of the collapse of Lehman Brothers, the low liquidity in financial markets meant that secondary market yields would not have been a good representation of the cost of new funds. In fact, it is likely that ADIs would have been required to pay a substantially higher yield on issues of non-guaranteed securities in this period than indicated by secondary market yields, if they were able to sell them at all.

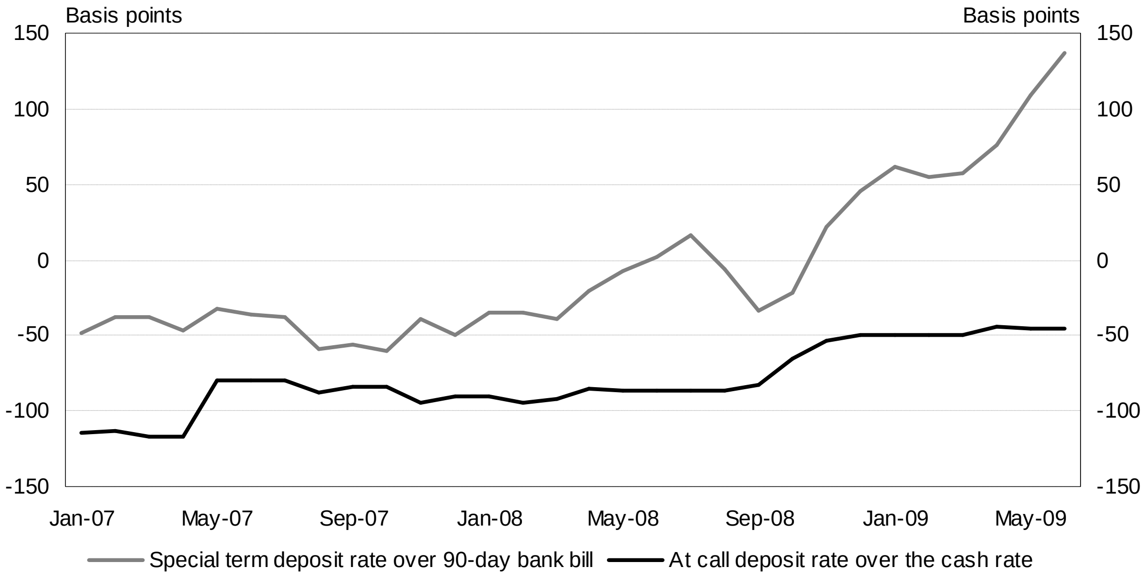
Further, it is also reasonable to conclude that in such circumstances ADIs would be likely to respond to such a high cost of funds by borrowing fewer funds in total, reducing the supply of credit (by tightening lending conditions and increasing interest rates), and passing on the higher cost of funds to their new and existing borrowers. That is, the Guarantee Scheme is likely to have put downward pressure on borrowing costs for consumers.

In recent months, Australia's major banks have been able to issue significant volumes of non-guaranteed securities, many of which were priced at spreads similar to those for guaranteed bonds of comparable terms (allowing for the guarantee fee) (Table 6). As the gap between the cost of funds for guaranteed and non-guaranteed securities has narrowed, the impact of the Guarantee Scheme on banks' wholesale funding costs, and therefore their lending rates, has also declined.

Impact through the pricing of deposits

While ADIs raised significant additional deposit funds following the introduction of the guarantees, the strong competition for deposits has resulted in spreads between major banks' key deposit rates and relevant benchmark rates rising to record levels (Chart 9). While this development is likely to have benefited Australians who hold net savings in the form of deposits, it has increased the cost of this source of funding to ADIs, partially offsetting the impact of the guarantees in putting downward pressure on funding costs.

Chart 9: Spreads of major banks' deposit rates over market rates



Source: RBA

Non-ADI financial institutions and intermediaries

Non-ADI financial institutions have also been impacted by the global financial crisis. However, as noted on page 10, these institutions do not have access to the guarantees as they are not permitted to accept deposits and are not subject to prudential regulation.

It is difficult to disentangle the impact of the events leading up to the introduction of the guarantees on non-ADIs from the impact of the guarantees themselves. However, it appears that the trends adversely affecting these entities in the last few months of 2008 had already emerged prior to the introduction of the guarantees. It is likely that these trends would have continued even in the absence of the guarantees, as nervous investors sought to move their funds to less risky investments.

This section outlines the experiences of key non-ADI financial institutions.

Mortgage trusts

Mortgage trusts are generally unit trusts that pool investors' funds and invest them in residential, commercial and industrial property mortgages, usually for terms of three to five years and offering a variable rate of return. Prior to the Government's announcement of the deposit and wholesale funding guarantees, at least 10 (of a total of around 80) mortgage trusts had frozen redemptions, in response to falling asset liquidity and increasing demand for withdrawals from unitholders. By the end of October 2008, most mortgage trusts had frozen redemptions, although these funds are generally continuing to pay regular income distributions.

Since December 2008, more than 75 per cent of mortgage funds have made periodic withdrawal offers to unit holders, usually on a quarterly basis, but in at least one case redemption offers are now being made on a monthly basis. To date, these redemption offers have only been able to meet withdrawal requests partially, given a combination of abnormally high requests for redemptions and limited availability of liquid funds.

In the longer term, as financial conditions improve and confidence returns in global financial markets, it is expected that investors will be able to access their investments more readily. At the same time, improvements in the performance and liquidity of financial markets and investors' appetite for risk can be expected to reduce unitholders' demand for redemptions.

Cash management trusts

Cash management trusts (CMTs) are generally trusts that operate by pooling investors' money into high-yielding money-market instruments. CMTs' assets had fallen in the months leading up to the announcement of the guarantee, from $47.4 billion in June 2008 to $45.3 billion at the end of September 2008. Since that time, total assets of cash management trusts have remained largely unchanged and unaffected by the Government's guarantees. At the end of the March quarter 2009, the total unconsolidated assets of the CMTs stood at $45.3 billion.

However, since the announcement of the guarantee, cash management trusts have moved most, if not all of their assets into Government-guaranteed deposits and wholesale debt instruments. This has impacted on the liquidity in the short-term non-guaranteed commercial paper market and contributed to the difficulties faced by non-ADI issuers of wholesale debt instruments in attracting investors.

Finance companies

There is considerable variety in the size and type of entities in this sector. Some entities are 'captive' financiers, others may specialise in the provision of finance for agricultural operations, equipment leasing or consumer credit. Many are part of local or overseas financial groups.

According to RBA data, the volume of funding that financing companies obtained from debentures and other non-financial institution sources fell by approximately 5 per cent from $54.5 billion in September 2007 to $52.0 billion in September 2008. In addition, finance companies' aggregate assets were falling relative to ADI assets, from around 10.8 per cent in September 2007 to 10.1 per cent in September 2008.

Some finance companies have suggested that the guarantee arrangements contributed to their difficulties in raising funds following the events of September 2008. These include some larger corporations that fund themselves through the wholesale markets and some smaller entities that fund themselves primarily through the issue of debentures to retail investors. Other finance companies reported difficulties for other reasons such as creditor default or difficulties affecting the overseas parent.

However, investors' reduced appetite for instruments issued by finance companies was already evident prior to the introduction of the guarantees, as a result of the broader financial crisis. Moreover, this trend is likely to have continued in the absence of the guarantees, given the reduction in investor confidence following the collapse of Lehman Brothers.

In 2009, there are indications that finance companies have been able to access funding from retail and wholesale sources, albeit at more modest levels compared to previous years. Finance companies that rely on retail debentures have reported improved ability to rollover existing funds and increased inflows of new funds. Other finance companies have been recently successful in issuing corporate bonds in domestic and overseas markets.

Securitisation markets

Securitisation has been a growing source of funding for Australian ADIs since the early 1990s and, for smaller regional banks and non-bank financial institutions, has become a major method for funding lending growth, particularly in the residential mortgage market (Chart 10). These lenders had taken advantage of low spreads on residential mortgage-backed securities (RMBS) issuances prior to the global financial crisis to compete strongly on price with the established major banks, garnering substantial market share as a result.

The dislocation in global securitisation markets was an early symptom of the global financial crisis and began in early 2007, well before the introduction of the Government's deposit and wholesale funding guarantees. What started as an increase in defaults on US sub-prime mortgages soon manifested as losses and credit rating downgrades in securities backed by such loans, leading to widespread deterioration in investor appetite for mortgage-backed securities and other structured debt products.[7]

The marked deterioration in global investor demand for asset-backed securities flowed through to the Australian RMBS market, which had previously relied on foreign investors to fund around three-quarters of total new issuance. Secondary market spreads increased from 14.0 basis points in March 2007, to 98.8 basis points in March 2008, to over 154.4 basis points in September 2008 (Chart 10). At this level, RMBS ceased to be a commercially viable source of funding for mortgage lenders. Issuance of RMBS fell sharply, from $25 billion in the June 2007 quarter to $2.1 billion in the September 2007 quarter, and an average of $2.6 billion per quarter over the following year.

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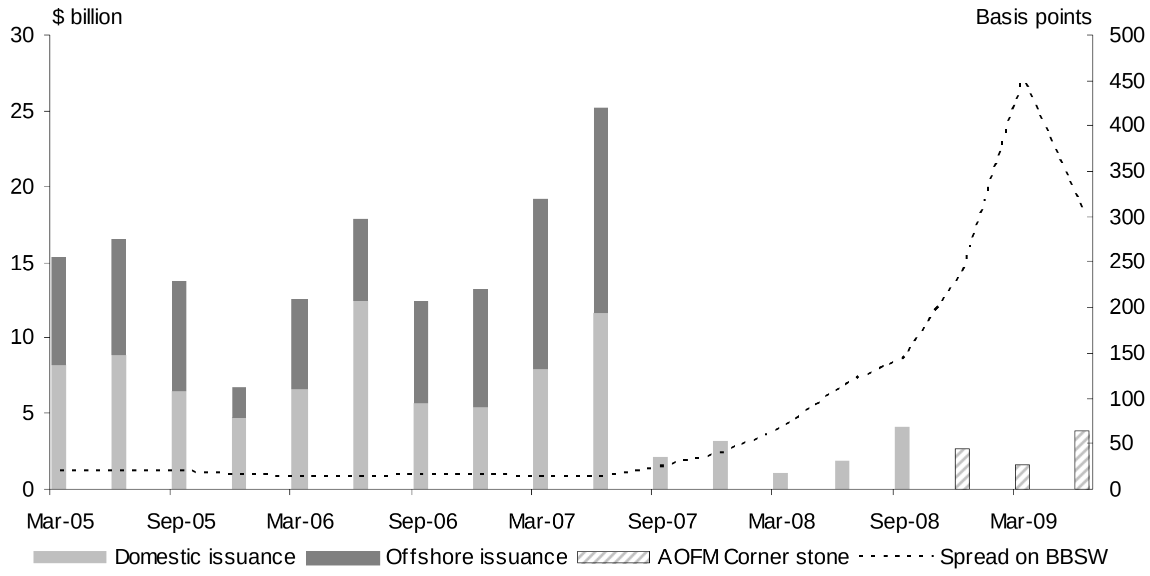
[7] Further information on the evolution of the US sub-prime lending crisis and its impact on securitisation markets can be found in the RBA's ***Financial Stability Review*** of September 2007 and March 2008.

Chart 10: RMBS Issuances and secondary market pricing



Source: Market participants, RBA

By the time the Government's deposit and wholesale funding guarantees were introduced in October 2008, offshore markets had effectively been closed to Australian RMBS issuance, and domestic issuance had been muted, for over a year. The events of September 2008, including the conservatorship of Freddie Mac and Fannie Mae, major US Government issuers of mortgage-backed securities, further impacted on market sentiment towards asset-backed securities and the availability of funds for investment in such securities. Against this backdrop of significant shocks to global securitisation markets, the introduction of the deposit and wholesale funding guarantees had only a marginal immediate impact on the RMBS market, if any.

Although there have been no new issuances of RMBS other than those sponsored by the Australian Office of Financial Management (AOFM)[8], conditions in the RMBS market have improved since the height of the global financial crisis. The number of active investors in the secondary RMBS market has increased, the number of distressed sellers has fallen, and secondary market spreads have fallen from more than 400 basis points to around 200 basis points. The actions taken by governments globally in September and October 2008 to restore confidence in financial markets, including the Australian Government's wholesale funding and deposit guarantees and the Australian Government's investment in RMBS, have contributed to this improvement in general market conditions.

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[8] On 26 September and 12 October 2008, the Government announced it would direct the AOFM to invest up to $8 billion in RMBS to support continued competition from smaller ADIs and non-ADI lenders throughout the global financial crisis, of which at least $4 billion is directed towards non-ADI lenders.

Competition in banking

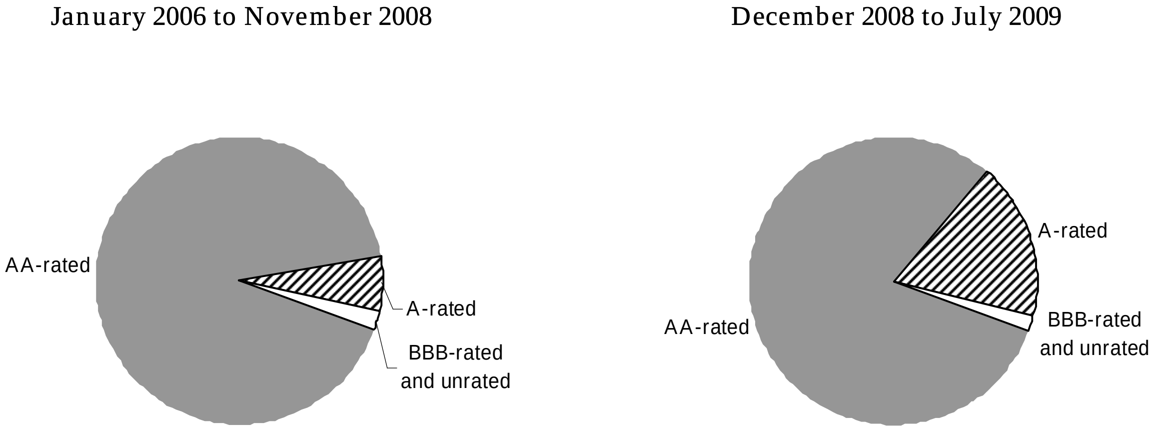
The global financial crisis has impacted on the competitive dynamics of the banking system. Financial system participants whose business models relied on the cheap and ready availability of wholesale credit faced difficulties raising funds at commercially viable rates of interest when the credit cycle turned. As a result, from mid-2007, a number of financial institutions were forced to exit the market, merge with stronger entities, or relinquish market share to entities with more diversified sources of funding.

While the shift in competitive dynamics and market share began well before the introduction of the guarantees, concerns have been raised that the guarantees primarily benefit Australia's major banks, in part reflecting their high usage of the guarantees when measured in absolute terms. At the other end of the spectrum, concerns have also been raised that the guarantees have reduced the ability of non-ADI financial institutions to compete as they are not eligible for the guarantee arrangements.

The Government's deposit and wholesale funding guarantees are available to all 189 eligible Australian ADIs. By providing broad coverage, the guarantees benefit a significant number of financial institutions that, collectively, represent the bulk of the banking services industry, thus supporting competition among a wide range of participants.

Australia's major banks account for a significant proportion of total liabilities covered by the guarantees, reflecting the size of their balance sheets relative to smaller ADIs. For example, the four major banks account for 69 per cent of guaranteed long-term wholesale funding and 60 per cent of total guaranteed liabilities raised. However, the major banks' share of total wholesale term funding (government-guaranteed and non-guaranteed) by ADIs has fallen from 94.7 per cent between the start of 2006 and the introduction of the Guarantee Scheme to 80 per cent in the period since the scheme was introduced. Over the same period, the share of wholesale term funding raised by A-rated institutions increased from 6 per cent to 18 per cent, while the share of term funding issued by BBB institutions remained constant at 2 per cent. That is, access to the Guarantee Scheme has enabled the non-major banks to increase their share of wholesale debt issuance (Chart 11).

Chart 11: Estimated share of bonds issued by ADIs



Source: Bloomberg

In relation to non-ADI financial institutions, the financial system regulatory framework has long distinguished between ADIs and non-ADIs, in relation to both the protections afforded investors and the regulatory imposts on the institutions. While extending the guarantees to non-ADIs would arguably assist them to compete, it would also provide such entities with an unfair and distortive competitive advantage relative to prudentially regulated institutions, because they are not subject to the same regulatory restrictions and compliance burdens as those which are prudentially regulated.

MANAGING RISKS

The FCS and Guarantee Scheme have been carefully designed to minimise the Government's financial exposure and avoid creating inappropriate incentives for investors and financial institutions to take excessive risks. This section outlines some of the key mechanisms that have been adopted or utilised to manage the risks associated with the guarantees.

The likelihood of the guarantees being drawn upon is low. ADIs are subject to prudential regulation by APRA in accordance with international standards, which are designed to ensure that financial institutions have the capacity to meet their financial promises. Government expenditure would arise under the guarantee only in the unlikely event that an institution fails to meet its obligations with respect to a commitment that is subject to a guarantee and the guarantee is called upon. In such circumstances, the Commonwealth is likely to be able to recover any such expenditure through a claim on the relevant institution.

Institutional coverage and prudential regulation

As discussed on page 8, eligibility for the guarantees is limited to ADIs. This ensures that the guarantee arrangements are targeted towards institutions that are systemically important to the financial system. It also minimises the risks of the arrangements to the Commonwealth and the financial system by ensuring all participating institutions are subject to prudential regulation.

Prudential regulation mitigates the inherent risks associated with ADIs' activities by requiring them to maintain appropriate risk management systems and a risk-based buffer of regulatory capital, and subjecting them to APRA's oversight and direction, including its crisis management powers.

Product coverage

As discussed on page 7, the deposit guarantee is limited to traditional deposit products and does not cover market-linked investments. Similarly, the wholesale funding guarantee is limited to standard 'plain vanilla' bonds, which reduces the risk to the Australian Government as guarantor of the securities. Limiting the guarantees to these products ensures that ADIs can continue to raise funds using standard products, while helping to prevent the guarantee from being used in a manner that contributes to systemic risks.

Limited period of application

The guarantee arrangements are designed to be temporary. The Guarantee Scheme will be withdrawn when market conditions normalise and the cap on the FCS will be revised by 12 October 2011. This limits incentives for ADIs and investors to become reliant on the guarantees or modify their risk-taking behaviour in response to it.

In addition, the term of deposits and wholesale instruments guaranteed under the scheme is limited to 60 months, which minimises the longer term impacts of the arrangements on the financial system.

Approval process

While institutions are not required to apply for coverage under the FCS, they are required to apply for coverage under the Guarantee Scheme. A separate application must be lodged for each particular wholesale debt program or deposit product. Applicants are obliged to demonstrate that they have complied with all prudential requirements at the time of their application. If APRA or the RBA finds the letter of prudential compliance incomplete or incorrect, the application is treated as not having been made.

In addition, the Australian Government has discretion regarding whether to approve an application. The Government can also close the scheme to new applications for any reason, including if it considered that the scheme was not operating as intended (although it could not repeal guarantees and eligibility certificates that have previously been approved).

Mechanisms to recover the cost of claims

In the event the FCS is activated, the Government can recover amounts paid to depositors from the assets of the relevant ADI. The ***Banking Act 1959*** requires Australian ADIs to hold assets at least equal to their deposit liabilities. In the unlikely event that the assets of the ADI were insufficient to meet the Government's claim in liquidation, the Government can introduce a levy to recover any shortfall.

Similarly, applicants for coverage under the Guarantee Scheme must enter into a counter-indemnity deed with the Commonwealth. The counter-indemnity is a commitment by the ADI which protects the Commonwealth from harm resulting from its role as guarantor. Among other things, the counter-indemnity ensures that the Commonwealth has rights to recover expenses (including interest and costs) it incurs through providing the guarantee from the institution. This protects the Commonwealth from financial losses and provides strong incentives for ADIs not to default on their guaranteed liabilities.

Monitoring and reporting

Regular reporting by ADIs allows the Government to monitor the growth in guaranteed liabilities and be alert to emerging trends. Institutions are required to report monthly to the RBA the average daily value of guaranteed liabilities on issue. The Guarantee Scheme arrangements provide the Commonwealth with additional audit rights over the information held by both ADIs and the Guarantee Scheme Administrator (the RBA). In addition, APRA has comprehensive powers to obtain information from ADIs relating to their prudential soundness or system stability.

The Government has committed to six-monthly reporting on the Guarantee Scheme to Parliament. In addition, the guarantee arrangements are reported in the Government's budget documents and audited financial statements in accordance with relevant accounting standards.

WITHDRAWAL STRATEGY

It is generally accepted that it is in the long-term interest of Australian ADIs and the financial sector as a whole for institutions to rely on their own credit rating for funding purposes, without reliance on government guarantees.

However, while there are some positive signs that the dislocation in global credit markets is easing, markets continue to be affected by liquidity constraints and investors' reduced appetite for risk, and confidence remains vulnerable to setbacks. To date, all non-guaranteed ADI securities have been issued by the AAA or AA-rated ADIs. This demand for non-guaranteed debt is likely to be insufficient to keep pace with the demand for credit in the banking system in coming months.

In addition, the removal of guarantee arrangements in Australia will need to take into account the timing of the removal of similar arrangements overseas, to ensure that Australia's ADIs are not placed at a competitive disadvantage to their foreign counterparts when raising funds. The Council of Financial Regulators is closely monitoring conditions in financial markets and

Australian agencies are working towards reaching multilateral agreement to unwind emergency interventions in a timely, well-sequenced and coordinated manner. The matter is expected to be discussed at the G20 Leaders' meeting in Pittsburgh in late September 2009.