Australian Government

The Treasury

Senate Standing Committee on Economics

Inquiry into the Australian Business Investment Partnership Bill 2009 and the Australian Business Investment Partnership (Consequential Amendment) Bill 2009

The views expressed in this submission are those of the Australian Treasury and do not necessarily reflect the views of the Treasurer or the Australian Government.

April 2009

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Overview

The Treasury's submission to this inquiry focuses on the context and public policy rationale for the development of the Australian Business Investment Partnership (ABIP) initiative as well as describing the key features of ABIP both in terms of how these features work in practice, and the principles underpinning their integration into the ABIP initiative.

ABIP is an incorporated joint venture between the Commonwealth of Australia and Australia's four major domestic banks[1] to address a potential 'funding gap' that may emerge in commercial property financing as a result of the global financial crisis.

The global credit contraction that is unfolding as part of the global financial crisis creates a risk that financiers, particularly foreign banks, may scale back their lending to financially viable Australian commercial property assets. The precise likelihood and extent of this occurring is difficult to judge, but it is clear that there has been a tightening in the market for commercial property financing, and the events of the past 18 months suggest that financial market conditions can change quickly and unpredictably.

While the major domestic banks are well capitalised, they face constraints in terms of the extent to which they could offset a significant and sudden withdrawal of finance from other financiers.

The possible shortage of finance for financially viable commercial property assets could have adverse consequences for the ongoing operations of these assets, as well as broader macroeconomic consequences. If borrowers believe there are risks they will not be able to refinance assets, they may de-leverage by selling property, which can then sharpen price falls, and trigger further sales.

It is against this backdrop that the Government decided to establish ABIP as a temporary, contingency vehicle to ensure that Australia's financial system can respond appropriately in the event that existing financiers scale back lending to viable commercial property assets. ABIP is designed to mitigate the negative effects of such a withdrawal, including by providing confidence that viable assets will be able to be refinanced. This includes providing confidence more generally to the commercial property market as it goes through a process of consolidating its overall debt and equity exposures.

The remainder of this overview maps the design details of ABIP against its policy rationale.

[1] Australia and New Zealand Banking Group Ltd (ANZ), Commonwealth Bank of Australia (CBA), National Australia Bank Ltd (NAB) and Westpac Banking Corporation (Westpac).

Targeted response

ABIP is a targeted response to specific market failure – namely the potential inability of the private sector to provide liquidity for financially viable assets. Accordingly, ABIP will not provide refinancing to assets that were, but are no longer, considered creditworthy.

ABIP's robust credit assessment architecture will assist in ensuring that all ABIP loans are to entities genuinely experiencing liquidity problems (not issues of creditworthiness).

The direct financial interest and exposure of the four major banks will provide a pecuniary incentive for the major banks to ensure the quality of ABIP's loan portfolio. Moreover, the major banks' financial interest in ABIP will provide an incentive for them to discourage foreign banks from seeking to use ABIP as an 'easy exit' strategy from their existing commercial property exposures, as such exposures would be passed, at least in part, to the major banks via ABIP. This interest and exposure remain even after loans of the initial $4 billion contribution have been made.

ABIP is a lender of 'last recourse'. It will be required to assure itself that the market has failed before it can lend, ie. that financing to creditworthy applicants is not available[2]. ABIP will not operate where financing is available in the market.

If market conditions normalise, and the commercial property financing markets function normally, ABIP will not need to write any further loans.

Foreign banks may decide to cut back or withdraw from the Australian market whether or not ABIP exists. If they withdraw from a borrowing that ABIP ultimately refinances, they will miss out on providing finance to a creditworthy borrower paying market price. In other words, they will withdraw on liquidity or strategic grounds, not risk or price.

Temporary response

The duration of ABIP's possible lending activities has been deliberately limited to two years to ensure that ABIP does not operate longer than necessary. If credit markets improve so that ABIP is no longer required, the Government will seek to wind it up as soon as possible. The two-year limit also ensures that borrowers are not reliant on long-term funding from ABIP. Loans made during the two-year lending period may remain outstanding for a further period of three years after the end of the lending period.

Further, ABIP is to operate as a lender of last recourse. Borrowers from ABIP will have incentives to source alternative financing arrangements, given ABIP's loans will be priced at a small premium above the prevailing market.

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[2] The ABIP Board will need to determine on a case-by-case basis if finance relating to the relevant assets is/is not available from commercial providers. In considering whether such finance is/is not available, the ABIP Board will need to have regard to the terms and conditions applying to any alternative finance for the assets, which may be offered by other commercial providers. It will need to form a view as to whether or not these terms and conditions are such as to impose an onerous and commercially unrealistic burden on the loan recipient so as as to significantly impact on the financial viability of the project. This involves the exercise of some judgment by the ABIP Board. However, the intention is that generally speaking, ABIP would operate as a lender of last recourse.

Timeliness

Market intelligence from analysts, commentators and participants in syndicated loans indicate that there is a real possibility that a 'funding gap' may emerge in the commercial property sector over the course of 2009 and 2010.

Given the significant amount of preparatory work involved in developing an appropriate policy response, ABIP has been designed to be in place ahead of these circumstances emerging.

ABIP is a prudent contingency measure. As market conditions can change rapidly, it is important to have a contingency measure such as ABIP in place, and able to respond immediately if necessary. As noted above, having ABIP in place provides a confidence boost about refinancing conditions, and this in itself can help stabilise the market.

Flexibility

The flexibility of ABIP to potentially participate in other areas of commercial lending recognises that the global credit contraction may evolve in ways that are unforeseen.

However, ABIP's ability to provide funding in areas other than commercial property would require the unanimous agreement of ABIP's shareholders. Neither the Government nor the banks have agreed that, at this stage, it is necessary for ABIP to lend to sectors beyond commercial property.

Lending beyond commercial property involves different considerations of risk and return which would need to be carefully assessed, including prudential regulatory consequences for the four major banks. Furthermore, it would need to be determined if ABIP, as a specifically designed vehicle, was the appropriate avenue to address other liquidity problems. However, neither the four major banks nor the Government will support ABIP extending lending beyond commercial property on less than fully commercial terms.

Safeguards to minimise risk to taxpayers funds

Providing finance to the commercial property sector is not without risk, and this sector can be particularly vulnerable in a downturn in the economic cycle. In that context, ABIP contains a number of safeguards to minimise the risk to taxpayers funds, including, but not limited to:

- ABIP's lending criteria, which will be consistent with the lending criteria of the four major banks, particularly in determining financial viability;
- appropriate conservative provisioning within ABIP for bad and doubtful debts;
- the requirement for unanimity of all decisions of the ABIP Board, including entering into any financing arrangement:
  - this excludes any decision to take enforcement action against an ABIP borrower. In the case of enforcement action, four out of five ABIP directors, one of whom

must be the Commonwealth director, must agree to take such enforcement action; and

- the requirement that if any of the four major domestic banks is an existing lender to a proposed borrower from ABIP, it must remain in a syndicate at least at its current proportionate participation:
  - this provides an important safeguard that the proposal remains commercially viable.

The safeguards serve to minimise the risk to taxpayers of the Commonwealth's involvement in ABIP, whilst recognising that such risk cannot be eliminated.

Governance arrangements

ABIP will be established under the ***Corporations Act 2001*** (Corporations Act), as a public company limited by shares. This ensures that the directors of ABIP are bound by the directors duties as set out in the Corporations Act, including the duty to act in the best interests of the company.

These duties extend to all the functions performed by the Board members, including in relation to entering into loan arrangements.

Further, the requirement of unanimity of decision making (except in relation to commencing enforcement processes), protects all shareholders by ensuring that commercial property assets are only refinanced where all directors consider that the asset is financially viable.

Accountability and transparency

ABIP will have a high degree of accountability and transparency, proportionate to the significant Commonwealth investment in the entity. In particular, certain arrangements will ensure that the efficiency and effectiveness of ABIP's operations are subject to Parliamentary and public scrutiny, including:

- ABIP's auditor will be the Auditor-General, and the directors of ABIP will be required to establish and maintain an audit committee that must be constituted consistently with the arrangements for audit committees of wholly-owned Commonwealth companies;

- the directors of ABIP will be required to give the Minister a copy of ABIP's financial report, directors' report and auditor's report for each financial year, which will be required to be tabled in each House of the Parliament; and

- ABIP will be obliged to provide its shareholders (including the Government) with any information the shareholder may reasonably require.

Appropriate return for risk

The financial arrangements for ABIP are underpinned by the objective that there is a direct relationship between the risk that the Commonwealth and the four major banks are assuming and the return that each party receives. This is specifically manifested in three key areas:

- initial shareholder loan contributions;
- Government guarantee on any debt ABIP may issue above the initial $4 billion provided to ABIP by the Commonwealth and the four major banks, if unanimously approved by ABIP's directors; and
- the return to Government for guaranteeing a small proportion of ABIP's debt that may be subordinated to the debt provided to ABIP by the Commonwealth and the four major banks, as discussed in section 3.4.3.

In determining the details attaching to each characteristic of the financing structure of ABIP (discussed in more detail in the body of this submission), the parties have had specific regard to the risk that each party will bear, and the appropriate compensation for bearing that risk. In particular, as the Commonwealth would bear (in some circumstances) more risk in order to achieve ABIP's policy intent, it would receive a commensurately higher expected return.

1. INTRODUCTION

On 24 January 2009, the Prime Minister and the Treasurer announced that the Commonwealth of Australia (Commonwealth) and Australia's four major domestic banks[3] would establish the Australian Business Investment Partnership (ABIP) as a temporary, contingency measure to provide liquidity support for financially viable commercial property assets in Australia where finance relating to those assets is not available from other financiers[4].

The Prime Minister provided background for the Government's announcement in a speech of the same day[5], outlining the possibility that as a result of the global financial crisis, financiers, and in particular foreign banks, may reduce their financing commitments to otherwise viable Australian businesses.

The Prime Minister outlined the possible adverse macroeconomic consequences that such a retreat or withdrawal of funding may have on the Australian economy, as well as outlining ABIP's funding and lending arrangements.

ABIP is a contingency measure, to be in place if a 'funding gap' for financially viable commercial property assets emerges. Further, ABIP has the flexibility to provide financing in other areas of commercial lending, should the need arise and the Government and four major banks jointly agree. While the major Australian banks are well capitalised, they may be unable to provide sufficient additional liquidity to offset a significant withdrawal of foreign bank financing. In the current global financial environment, market conditions can evolve rapidly, and market participants can quickly change their positions and intentions.

Consequently, it is important to have ABIP operational as soon as practicable so it is able to respond if necessary in a timely way, as market circumstances develop.

Bills to facilitate the establishment and operations of ABIP were introduced into the Parliament on 12 March 2009, along with a draft Shareholders' Agreement detailing the proposed nature and scope of the relationship between ABIP's shareholders.

Treasury's submission to this inquiry provides background on the market environment (including expected debt market conditions) and policy considerations that led to the development of the ABIP initiative, as well as detail on the key design features of ABIP's structure and operations.

Section 2 deals with the rationale for the establishment of ABIP, including the level of foreign bank participation and possibility of withdrawal. It includes a consideration of the domestic banks' ability to fill a 'funding gap', and the potential consequences if this is not possible.

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[3] Australia and New Zealand Banking Group Ltd (ANZ), Commonwealth Bank of Australia (CBA), National Australia Bank Ltd (NAB) and Westpac Banking Corporation (Westpac).

[4] Media Release: Prime Minister, 24 January 2009, ***Building Australia's future - a $4 billion Australian Business Investment Partnership to support Australian jobs***. http://www.pm.gov.au/media/Release/2009/media_release_0771.cfm

[5] Speech: Prime Minister, 24 January 2009, ***Australia Day Address – Perth***, http://www.pm.gov.au/media/Speech/2009/speech_0767.cfm

Section 3 outlines the specifics of the ABIP initiative, including legal structure, funding, nature, scope and duration of lending activities, and pricing. Budget implications, governance, market effects and other issues are also considered.

2. RATIONALE FOR THE AUSTRALIAN BUSINESS INVESTMENT PARTNERSHIP (ABIP)

As noted by the Reserve Bank of Australia (RBA) in its latest ***Financial Stability Review***[6]:

> The global financial system has continued to experience significant stress. Confidence in many large global financial institutions has been fragile, investors have been highly risk averse, and banks, businesses and households have been looking to reduce their leverage and restructure their balance sheets.

Further, the RBA noted that the effects of credit contraction caused by the global financial crisis are not limited to financial systems, but extend to the real economy[7]:

> While some tightening of credit conditions is to be expected given the deterioration in prospects for the world economy, the current difficulties in the global financial system have significantly increased the risk of a damaging feedback loop taking hold between the financial system and the real economy.

In particular, the RBA has cited some characteristics of the current global economic environment that are contributing to global economic instability, including that[8]:

- many major economies are contracting;
- confidence in many large global financial institutions has been fragile;
- investors have been highly risk averse;
- banks, businesses and households have been looking to reduce their leverage and restructure their balance sheets;
- credit growth has slowed; and
- lending standards have been tightened significantly in many countries.

It is likely that such market characteristics will continue throughout 2009 and global financial markets will continue to have a high degree of instability.

2.1 Foreign bank participation in Australian debt markets

Foreign banks play an important role in the Australian financial system. Of the 56 banks operating in Australia[9], 35 are foreign bank branches and 9 are foreign bank subsidiaries[10].

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[6] RBA 2009, p. 1
[7] RBA 2009, p. 3
[8] RBA 2009, p. 1

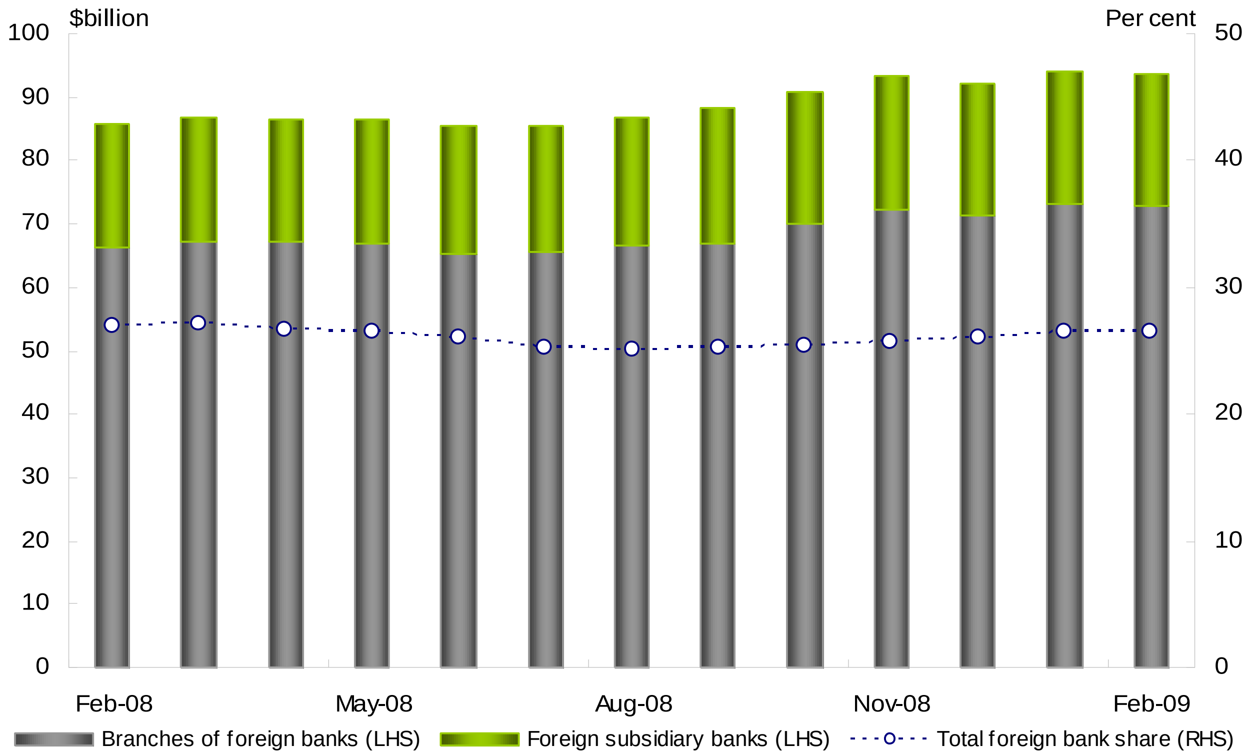
These banks provide an important source of funding in the Australian debt market, both in terms of business lending in general and commercial property lending in particular.

2.1.1 Business lending

As at February 2009, foreign banks held $94 billion or 26.5 per cent of the stock of outstanding bank business loans in the Australian market (Figure 1). The contribution of foreign banks as a proportion of total bank business loans has been broadly stable over the past year.

Foreign banks also play a particularly important role in syndicated credit facilities. It is estimated that in 2006-07, foreign banks were participants in syndicates totalling $75 billion, which declined to $68 billion in 2007-08[11].

Figure 1 Business loans outstanding in Australia ($ billion) – February 2009[12]



Data Source: APRA data.

[9] Excluding wholly-owned subsidiaries of other banks operating in Australia, and other non-bank deposit-taking institutions such as building societies.

[10] APRA, 2009.

[11] Macquarie Research Economics, 2009.

[12] BankWest has been excluded from the data to prevent data distortion from CBA's purchase of BankWest.

2.1.2 Commercial property lending

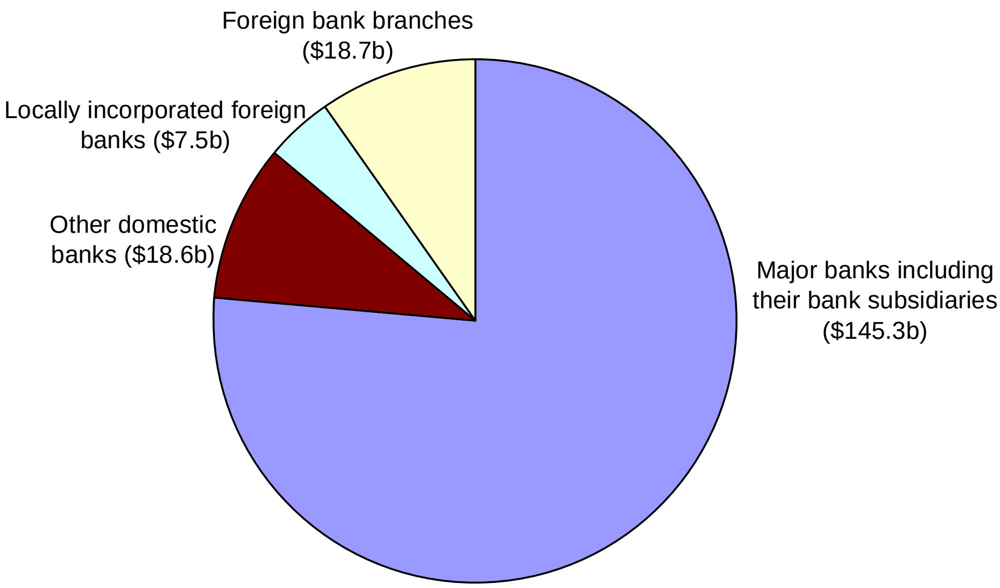
As at December 2008, banks held $190.1 billion of exposure to Australian commercial property in total. Of this, $26.2 billion, or 14 per cent, was held by foreign banks (Figure 2).

A substantial proportion of commercial property assets are financed through the use of syndicated facilities, in which foreign banks are particularly active.

The four major domestic banks have advised that around $70 billion of debt for commercial property is expected to be refinanced over the next two years. Of this $70 billion, an estimated $50 billion is in syndicated loan facilities, with the remaining $20 billion part of other debt financing arrangements.

The refinancing of these syndicated loans can be placed at risk through the withdrawal of a single syndicate member.

Figure 2 Total commercial property exposures ($ billion) – December 2008



Data Source: APRA, unpublished data.

2.2 Possible foreign bank retreat / withdrawal from Australian debt markets

There are a myriad of factors that may impact on the decision of foreign banks to exit the Australian market, including, for example, the fact that some banks are owned or controlled by foreign governments whose decisions may not be wholly influenced by the dynamics of the Australian market.

Many foreign banks are facing difficult circumstances in their home economies, and have been under pressure to reduce their lending commitments and exposures generally, and in particular to pull liquidity back into their home markets. This could create a liquidity shortage, or a 'funding gap', in the Australian economy and the commercial property sector in particular.

The outlook for these banks continues to remain most uncertain given the stress under which global financial markets continue to operate, with risks remaining clearly on the downside.

2.2.1 Data on foreign bank lending activity

There is generally a time lag between data on foreign bank lending activity and current market conditions. While the data describes past lending activities it does not give an indication of future lending intentions.

The RBA's ***Financial Stability Review*** (March 2009) indicates that since the end of June 2008, the commercial property sector has had $5.3 billion in new syndicated loans approved. However, credit market conditions can evolve quickly and there is no guarantee that this situation will endure in 2009 and 2010.

While both the RBA and the Australian Prudential Regulation Authority (APRA) have indicated that lending to the commercial property sector by foreign banks did not decline in 2008, refinancing conditions for commercial property have tightened. In its ***Financial Stability Review***, the RBA observed that[13]:

> Information from the syndicated loan market also suggests that most property companies that had large refinancing requirements during 2008 were generally able to rollover their debt, albeit on less accommodating terms than in the recent past.

In this regard, it is important to note that ABIP is a forward looking, contingency measure to safeguard against the possibility of adverse circumstances developing over the next two years.

2.2.2 Views of market commentators

Market analysts advise that some foreign banks are tightening their credit availability and reassessing their exposures, including to the commercial property sector.

- Analysis by Merrill Lynch in November 2008 suggests that over the next two years, $17 billion in syndicated loans are at risk due to foreign bank withdrawals. This will particularly affect the commercial property sector.

- Macquarie Research Economics has identified the existence of a potential gap in access to credit because[14]:

> … several large US, UK and European banks have had to be rescued by their respective governments, while others are de-leveraging at a rapid pace.

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[13] RBA 2009, pp. 32-33

[14] Macquarie Research Economics 2009, p. 1

- Goldman Sachs JB Were (GSJBW) reported on 24 November 2008 that a lack of liquidity in the commercial property sector meant there was a risk prices could decline below fair values.

- On 5 February 2009, GSJBW analysis suggested that in the next three years foreign banks could withdraw $33-37 billion, or 27-28 per cent, of total foreign bank syndicated loans. They estimate this could increase to as much as $46 billion if credit markets do not improve.

2.2.3 Views of market participants

In the development of the ABIP initiative, Treasury officials held discussions with a range of foreign banks. These banks were unable to give any guarantees that they would be in a position to retain their current exposures to the Australian economy in general, or to the commercial property sector specifically.

- It is important to note that if foreign banks review their exposures or undertake credit rationing, it will not necessarily result in them completely withdrawing from the Australian market.

Additionally, various market participants and representative organisations have recently made a number of observations regarding credit and liquidity issues in the commercial property sector, particularly noting that some foreign banks have been looking to reassess their level and quality of exposure. For example, the Property Council of Australia has also announced that its members had reported that over 20 foreign banks have signalled plans to reduce their exposure to Australian commercial property funding, or have already withdrawn funding[15].

It should be noted, however, that some foreign banks have indicated that they are not scaling back or withdrawing from the commercial property sector.

2.3 Capacity of domestic banks to offset a withdrawal

If foreign banks do retreat or withdraw from the Australian debt financing market, any gap in financing will need to be sourced from elsewhere (such as from Australia's four major domestic banks) in order to maintain liquidity and continue financing. While the major domestic banks are well capitalised, they face constraints in terms of the extent to which they could offset a significant and sudden withdrawal of finance from other financiers. In particular, the ability of the major banks to expand their commercial property lending is constrained due to their prudential limits and concentration limits to this sector.

These limitations are not confined to the major domestic banks, but extend to second tier banks. For example, Suncorp, on 24 February 2009 when releasing its 2009 half year results, stated that[16] "… the Bank has ceased lending to new customers in the non-core businesses of corporate banking, corporate property and lease finance and will work with

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[15] Property Council of Australia 2009

[16] Suncorp 2009, p. 9.

existing customers to reduce outstanding receivables balances on these portfolios over time."

GSJBW has also observed in relation to commercial property financing, that some Australian banks are already at, or are very close to reaching their industry concentration lending limits, and that this would make it difficult to upscale existing loans or take on new positions in this sector.[17]

2.4 Consequences of a liquidity shortage

A liquidity shortage in the commercial property sector would have consequences extending beyond commercial property into the wider economy, leading to adverse macroeconomic consequences.

Commercial property plays an important role in the Australian economy in terms of business and employment opportunities during the development phase and after projects are completed, including in the retail, manufacturing, hospitality and corporate sectors.

Commercial property also provides important investment opportunities for everyday Australians, including through superannuation funds and Real Estate Investment Trusts.

The generally highly leveraged nature of commercial property assets makes this sector particularly vulnerable to a liquidity shortage.

Withdrawal of finance from viable commercial property assets may force businesses to sell assets in a distressed sale, which could lead to a more rapid and disorderly fall in prices than would otherwise occur, resulting in prices falling below their underlying values.

The direct losses from such a fall in prices would accrue not only to property holders, but also to other investors in the commercial property sector, including through superannuation funds.

This may also lead to breaches in debt covenants for other commercial property assets and reduce the ability of owners and developers to source continued financing.

For example, the RBA noted in its ***Financial Stability Review*** that a downturn in commercial property prices in the United Kingdom has led to[18]:

> … capital values … around 40 per cent below the peak. This, in turn, is reinforcing the adverse credit supply loop, by reducing collateral values against which borrowers can secure their loans.

That is, withdrawal of finance from viable commercial property projects may have adverse effects on employment and investment in other sectors of the economy.

The commercial property sector employs about 150,000 people in Australia.

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[17] GSJBW 2009

[18] RBA 2009, p. 15

Based on the cyclical behaviour of activity and employment in the commercial property sector in previous severe economic downturns of the 1980s and 1990s, without action, a combination of weak demand and tight credit market conditions could see economic activity in the commercial property sector decline by around one third with consequent job losses of up to 50,000. This expected weakness makes the sector particularly vulnerable to any sudden withdrawal of finance by external financiers.

3 SPECIFICS OF THE ABIP PROPOSAL

It is in the context of the current and prospective market environment that the Government and the four major domestic banks will establish ABIP. This section outlines the key design features of ABIP, including the structure of the entity, its accountability and transparency regime and the nature and scope of ABIP's operations.

3.1 Legal structure

ABIP will be established under the Corporations Act and will be a public company limited by shares.

The members (shareholders) of ABIP will be the Commonwealth of Australia (Commonwealth) and Australia's four major domestic banks: ANZ, CBA, NAB and Westpac.

The shareholders of ABIP will enter into a Shareholders' Agreement which will outline, among other things, the operation, control, management and funding of ABIP. Any amendments to the Shareholders' Agreement will be made public as soon as practicable after they are agreed.

The draft Shareholders' Agreement was tabled in Parliament as part of the introduction of the ABIP Bills. A summary of the key features of the draft Shareholders' Agreement is provided at Appendix 1[19].

ABIP is not subject to ministerial direction and is not an entity under the ***Commonwealth Authorities and Corporations Act 1997***. Accordingly, the Government cannot direct ABIP to lend to particular projects.

3.2 Nature, scope and duration of ABIP lending activities

The primary focus of ABIP is the refinancing of commercial property. ABIP may potentially provide finance in other particular circumstances, but only where all shareholders jointly agree (see 3.2.2).

ABIP will lend the funding provided by the Government and the four major domestic banks (as well as any additional financing ABIP acquires by issuing debt) to commercial property assets that meet ABIP's lending criteria, determined by its shareholders.

[19] The complete draft Shareholders' Agreement is available at http://www.treasury.gov.au/contentitem.asp?NavId=&ContentID=1506

These lending criteria will be consistent with the lending criteria of the four major banks and will ensure that ABIP only provides funding for commercial property where the underlying assets, and the income streams from those assets, are financially viable.

ABIP is not intended to compete with other financiers, but to act as a lender of last recourse. The lending criteria will reflect this, and ABIP will price at a slight premium above the prevailing market.

Providing liquidity support for commercial property assets that are not financially viable represents an unacceptable risk to both the Commonwealth and the four major banks: ABIP is designed to address a potential liquidity shortage, not to provide funding for all commercial property assets. Neither the major banks nor the Government will risk losing their funding to ABIP by supporting loans on less than fully commercial terms.

It is also important to highlight that ABIP's participation in providing finance to commercial property is only temporary. It can only enter into new financing arrangements for up to two years from the date of Royal Assent of the ABIP Bill, with a further three years in which to run down ABIP's lending portfolio.

This timing limitation provides a clear signal to the market of ABIP's temporary nature as well as a defined end date for its financing activities. If debt markets allow financially viable commercial property assets to continue to be refinanced, it is possible that ABIP will not participate in any lending activity.

3.2.1 Commercial property Lending Criteria

The draft Shareholders' Agreement provides that:

- an application to ABIP to provide financial accommodation to any person will be assessed by ABIP in accordance with the Lending Criteria in effect from time to time (clause 2.3a);
- the ABIP Board may only approve applications to ABIP as authorised by the Lending Criteria and otherwise in accordance with the ***Australian Business Investment Partnership Act 2009*** (clause 2.3b); and that
- the Lending Criteria require, among other things, that:
  - if a borrower has a shareholder of ABIP (or more than one shareholder of ABIP) participating in a financing arrangement in respect of which they have made an application to ABIP ('Participating Shareholder'), ABIP must not lend to that borrower unless each Participating Shareholder maintains at least its proportionate participation in the relevant financing arrangement;
  - ABIP will only provide loans in respect of commercial property assets in Australia; and
  - ABIP will not provide equity funding (clause 2.3c).

Commercial property assets are assets that typically require high levels of investment and are institutionally owned, managed or maintained by listed or unlisted managed investment schemes, stapled securities groups, superannuation funds, investment trusts or property syndicates.

In that context, the types of commercial property assets where ABIP may provide financing include, but are not limited to, retail shopping centres, commercial office buildings and industrial property. ABIP will focus principally on completed commercial property investments and partly completed development assets with secured pre-commitments.

To provide further clarity, examples of assets that would fall outside the scope of ABIP's lending criteria are property located outside Australia, land banks, speculative development assets and rural property.

The requirement that a major bank must remain in a syndicate at least at its current proportionate participation provides an important safeguard in terms of the proposal remaining commercially viable.

Further detail on the lending criteria are available at Appendix 2.

3.2.2 Other areas of commercial lending

The Prime Minister's announcement of the ABIP initiative (24 January 2009) outlined that ABIP would be structured to allow sufficient flexibility to provide financing in other areas of commercial lending, should the need arise and the Government and four major banks jointly agree.

This provision is included in the ABIP Bill and highlighted in the ABIP Bill Explanatory Memorandum, which notes that ABIP would be able to provide such funding if circumstances necessitate and provided those arrangements are agreed unanimously by the members of ABIP.

Whilst ABIP has been established as a targeted response to a specific problem in commercial property financing, the inclusion of this provision allows ABIP to provide funding beyond the commercial property sector should the need arise, and removes any doubt in relation to the legal validity of any such transaction where ABIP provides financing.

It is important to note that neither the Government nor the four major banks have agreed that it is necessary, at this stage, for ABIP's financing to be expanded beyond the commercial property sector.

If ABIP's shareholders were to consider providing financing in other areas of commercial lending (ie. beyond commercial property), such financing arrangements would require extensive shareholder discussions on the basis, terms and conditions of such financing. This would include, but not be limited to: the nature and scope of any such lending; developing appropriate lending criteria; provisioning arrangements; the expected return to shareholders; and prudential regulatory consequences for the four major banks.

However, neither the four major banks nor the Government will support ABIP extending lending beyond commercial property on less than fully commercial terms.

3.3 Governance

ABIP will be subject to the governance arrangements under the Corporations Act, as well as other special arrangements under the ABIP Bill. These will ensure that ABIP is properly accountable, operates within Constitutional limitations, has an appropriate legal structure and is subject to appropriate governance and reporting arrangements.

3.3.1 ABIP Board

The ABIP Board will consist of five directors, with each of ABIP's shareholders (the Commonwealth, ANZ, CBA, NAB and Westpac) having the right to appoint one director. The Commonwealth's nominee director will be the Chair of ABIP[20].

Board resolutions, apart from resolutions to commence enforcement processes in relation to the property of a borrower, must be unanimous (Shareholders' Agreement clause 6.2a).

This provision protects all shareholders by ensuring that commercial property assets are only supported where all directors consider that the asset is financially viable.

Resolutions to commence enforcement processes may be passed by four of the five directors. The director nominated by the Commonwealth (or alternate) must be one of the directors supporting the resolution (Shareholders' Agreement clause 6.2b).

The Commonwealth's nominee director will not only receive advice from ABIP management, but will also have access to independent expert advice to assist them in meeting their responsibilities.

3.3.2 Reporting and auditing

The reporting and auditing arrangements for ABIP ensure that the Commonwealth's participation in ABIP is undertaken in an accountable and transparent manner.

The arrangements also provide an important mechanism to ensure that reliable information is available to the public on ABIP's financing arrangements and performance.

The directors of ABIP will be required to give the responsible Minister (the Treasurer) a copy of ABIP's financial report, directors' report and auditor's report for each financial year. The Minister will then have to table these reports in each House of the Parliament.

Further, the ABIP Bill provides that ABIP's auditor will be the Auditor-General and that the directors of ABIP will be required to establish and maintain an audit committee, that must be constituted consistently with the arrangements for audit committees of wholly-owned Commonwealth companies.

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[20] The Government is yet to announce who will be its nominee director (and therefore the ABIP Chair).

It is important to note that there are a range of aspects of ABIP's operations that will be commercial-in-confidence, including information on loan applications and financing arrangements. To ensure that ABIP is able to operate effectively, it is important that the confidential nature of these transactions (or applications) is not compromised.

3.4 ABIP funding

3.4.1 Initial shareholder funding

The Government and the four major domestic banks will provide initial loan funding to ABIP and an amount for working capital. The Government will provide $2 billion and the four major banks will provide $500 million each.

Accordingly, on its establishment, ABIP will have access to $4 billion in available financing, less an amount for working capital, expected to be $4 million. The financing provided by the major banks will not be Government guaranteed.

The amount for working capital will be contributed by the shareholders in proportion to their funding of ABIP, with the Commonwealth contributing $2 million, and the four major banks each contributing $0.5 million (Shareholders' Agreement section 4.2).

3.4.2 Further debt funding

If additional financing is required beyond the initial funding, ABIP will be able to issue up to $26 billion in debt, subject to the unanimous agreement of shareholders (Shareholders' Agreement section 4.4). This could provide ABIP with up to $30 billion in available financing. Any debt issued by ABIP will be Government guaranteed.

To give effect to the guarantee of ABIP's debt, a Deed of Guarantee will be executed after the enactment of the ABIP legislation. This Deed of Guarantee will not be operative until such time as ABIP is in existence and issues debt.

Debt will only be issued when the initial loan facility provided by the Government and the four major domestic banks has been exhausted and only if additional financing is required beyond the initial loan funding provided by shareholders, and all shareholders unanimously agree.

As debt issued by ABIP above the initial $4 billion provided by the Commonwealth and the four major banks will be guaranteed by the Government, the Government will earn an appropriate fee.

The level and timing of the fee will be agreed by shareholders, having regard to risk and liquidity factors and general market conditions at the time any such debt is issued. In this context, the fee will be on a sliding scale, increasing up to 150 basis points.

3.4.3 Subordinated debt

Under Australia's prudential framework, as ABIP issues debt the banks' contributions could be increasingly treated as equity capital by APRA, impacting on the banks' own lending more generally.

The initial shareholder loans of $4 billion will be subordinated to the Government guaranteed debt issued to the market, with the following exception. The Government will guarantee a small proportion of debt which is subordinated to the initial shareholder loans (up to around 5 percent) (Shareholders' Agreement clause 4.4c). That is, the majority of the Government guaranteed debt will be senior to (rank ahead of) the shareholder loans, but a small proportion of the Government guaranteed debt will be subordinated to the shareholder loans.

If it were not for this subordination, the APRA prudential framework would treat the initial $500 million contribution of each bank as becoming increasingly leveraged, and therefore risky, as ABIP's size grew beyond $4 billion. The capital requirement to support this risk would eventually increase to the point of it being treated as equity capital. That is, it would be a $500 million deduction from each bank's Tier One capital. The banks would therefore need to each raise an additional $500 million of capital, or alternatively cut their lending by around $10-15 billion each. This would be counter productive to the intent of ABIP to elsewhere assist in facilitating the flow of credit to the economy.

The Commonwealth will receive an appropriately substantial equity-like return on the amount of Government guaranteed debt which has a lower (ie. subordinated) claim on ABIP's assets than the shareholders' initial loan funds, reflecting higher risk (Shareholders' Agreement clause 4.4c).

3.4.4 Provisions for bad and doubtful debts

As part of ABIP's prudent lending arrangements, ABIP will put in place provisions for any bad and doubtful debts it may incur on its portfolio. The draft Shareholders' Agreement outlines the provisioning arrangements that will be adopted. This will be a cash flow provisioning policy, reflecting an appropriate (but conservative) approach, being:

- until an aggregate of $500 million has been borrowed from ABIP, a cash flow provision of 50 basis points will be applied; and

- once more than $500 million has been borrowed from ABIP, a dynamic provisioning policy will be adopted to take into account economic conditions and risks at the time (Shareholders' Agreement clause 10c(iv)).

3.4.5 Risk, return and loss sharing

Lending to commercial property inherently involves some risk. ABIP has been carefully designed to limit the risks to shareholders, through a range of safeguards, including prudent lending criteria. Nevertheless, some risks remain, including the risk of losses.

Under ABIP's financial structure, any 'first loss' will always be to ABIP's equity, principally the provisions for bad and doubtful debts.

After that the following arrangements apply:

- if ABIP issues no debt, any subsequent losses will be borne by the four major domestic banks and the Commonwealth, proportionate with their initial contributions.
- if ABIP issues debt (up to $26 billion, all of which will be Government guaranteed), after equity, the order of any loss is as follows:
  - the Government, to the amount of any subordinated guaranteed debt;
  - the shareholders' initial loan contribution; then the
  - the Government, to the amount of non-subordinated guaranteed debt (Shareholders' Agreement clause 4.4c).

It is important to note that equity and debt contributions from the four major banks are still at risk beyond the issuing of the initial $4 billion, providing an incentive to the banks to only support loans on fully commercial terms.

A graphical representation of these arrangements is provided at Appendix 3.

ABIP's financial structure and pricing ensures that returns to the Government and the major banks properly reflect risks borne. Returns comprise interest and principal payable on shareholders' funds lent to ABIP, the amounts payable by ABIP with respect to the Government guarantee (of both the subordinated debt and non-subordinated debt) and dividends. In circumstances where the Government assumes greater risk than the major banks (ie. where ABIP issues debt to the market and in particular when and if any guaranteed debt is subordinated), the expected return to Government is appropriately higher than for the four major banks.

3.5 Pricing

It is envisaged that ABIP's pricing would be at a small premium above the prevailing market. It should be noted that the prevailing market is pricing risk significantly higher than was the case 12-18 months ago.

3.6 Budget implications

The $1.998 billion loan and the $2 million equity contribution to ABIP constitute an investment, and will therefore have no effect on the underlying cash balance. However, interest received on the loan facility and dividends on the equity contribution will improve the underlying cash balance, and these will partially offset interest costs paid on financing the loan and equity contributions. Non-repayment of loans (or equity) can impact on the underlying cash balance and fiscal balance depending on the circumstances under which it occurs.

The Government guarantee on any debt that ABIP issues up to a maximum of $26 billion will create a contingent liability. If the guarantee is called upon, there will be an impact on the underlying cash balance. The guarantee fee will improve the underlying cash balance.

The overall financial impact of the arrangements will depend on a range of factors including: the value of loans approved; the extent of defaults; and the amount of dividends paid by the company to shareholders. The final impact will also depend on the fees and charges associated with the financing and guarantee arrangements, including (if the guarantee is required) the guarantee fee and interest costs on the Commonwealth borrowings.

3.7 Market effects of ABIP

3.7.1 Foreign bank participation in financing arrangements

Foreign banks will decide whether or not to withdraw financing from Australian markets, based on their own head office circumstances and strategic decision making regardless of the existence or otherwise of ABIP.

ABIP funding will only be available when an existing lender (such as a foreign bank) has the legal right to demand repayment of a loan.

In many circumstances, loans over commercial property assets have been syndicated to several lenders. Therefore, an exit by one or more of the syndicate members could threaten the entire loan regardless of whether other members of the syndicate are prepared to maintain their exposure.

In the event that an exiting syndicate member or members are foreign banks, there would be an increased need for domestic banks and other investors (including equity providers) to replace this funding shortfall.

If the domestic banks were to make up the shortfall they would have less funding available for other parts of the economy.

If replacement finance cannot be made available, assets may need to be sold to repay loans. This would place further downward pressure on commercial property prices, adversely affecting financial markets and the Australian economy.

ABIP will provide an incentive for borrowers to encourage foreign lenders to remain in syndicates, as it will price at a small premium above the market.

There will also be an incentive for the major Australian banks to discourage foreign banks from using ABIP as an ‘easy exit’ strategy from the Australian commercial property market, as their exposure would effectively be passed (in part) to the major banks via ABIP.

3.8 Other issues

3.8.1 Interaction with the *Trade Practices Act 1974*

It is difficult to definitively determine whether ABIP would contravene any provisions of the ***Trade Practices Act 1974***, including if the parties avail themselves of the joint venture defence under sections 76C and 76D[21].

To remove any uncertainty about the operations of ABIP, the Bill specifically authorises the activities undertaken by ABIP, its shareholders, directors, officers, agents and employees in furtherance of ABIP's objects to be exempt from the competition provisions of the ***Trade Practices Act 1974***.

3.8.2 Australian Financial Services Licence (AFSL)

Under the Corporations Act**,** an AFSL authorises a company or its representatives to provide financial services to clients. Without an AFSL, a company generally cannot carry on a financial services business.

Whilst the statutory concept of providing a financial service would not extend to the provision of credit per se, it is arguable that activities of ABIP that may be incidental to the provision of credit would constitute providing a financial service within the Corporations Act.

However, requiring ABIP to obtain an AFSL for its borrowing and lending activities would be disproportionate given the sophisticated nature of its possible client base and the limited scope and duration of its activities. ABIP is only intended to lend for two years, and its functions are limited by the proposed legislation providing for its incorporation.

3.8.3 Regulatory impact of ABIP

The Government's best practice regulation framework requires a preliminary assessment to be undertaken for all regulatory proposals. For proposals that will have no or low impacts on business and individuals or the economy (including no or low compliance costs), no additional regulatory analysis is required. For proposals that are likely to have a significant impact on business and individuals or the economy (whether in the form of compliance costs or other impacts), a more detailed analysis must be undertaken and documented in a Regulation Impact Statement (RIS). If the impacts include medium or significant business compliance costs, the RIS should include a full (quantitative) assessment of these costs.

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[21] Section 76C: Defence to proceedings relating to exclusionary provisions
Section 76D: Defence to proceedings relating to price fixing provisions

Treasury conducted a preliminary assessment of the ABIP proposal in accordance with this process. The regulatory impact of ABIP was assessed to be low. Applicants for financing from ABIP will not incur additional compliance costs over and above those they would have incurred had they applied for refinancing from another commercial lender. Additionally, the four major banks are participating in ABIP of their own volition.

Accordingly, the Office of Best Practice Regulation advised Treasury on 17 February 2009 that no further regulatory impact analysis (such as a full Regulation Impact Statement) was required for the ABIP proposal.

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APPENDIX 1 – SHAREHOLDERS' AGREEMENT – KEY FEATURES

The draft Shareholders' Agreement includes a number of key provisions as to how ABIP will be structured. These include:

Objectives (clause 2.1)

The objectives of ABIP are to:

(a) provide refinancing for loans relating to commercial property assets in Australia in situations where finance relating to the assets is not available from commercial providers other than the ABIP; and the assets would otherwise be financially viable; and

(b) to provide financing in other areas of commercial lending through financing arrangements of a kind unanimously agreed by the Shareholders.

Management (clause 2.2)

ABIP will have independent management, determined by and accountable to the Board. The Board may approve ABIP subcontracting to third parties.

Lending Criteria (clause 2.3)

The Board will assess potential loans in accordance with the lending criteria. Only applications authorised by the Act or the lending criteria may be approved. The lending criteria will provide that any major bank participating in a syndicate financed by ABIP will be required to maintain their previous level of exposure in percentage terms. Further, ABIP will only provide loans in respect of Australian commercial property assets.

Contributions (clause 2.4)

The shareholders agree to make contributions of experienced staff toABIP, where requested by the Board and as the shareholder considers reasonable. Any staff provided will act as employees of the company for the duration of the secondment, and will not divulge confidential information obtained during the secondment.

Structure of operations (clause 2.5)

The Board may determine the structure of the operations of ABIP, so long as activities do not extend beyond loans relating to commercial property assets.

Relationship of Shareholders (clause 2.6)

Shareholders are not liable for other shareholders' obligations. This agreement does not restrict commercial property lending activities external to ABIP.

Incorporation and Funding (clause 4.1-4.3)

The Shareholders agree to subscribe to shares in ABIP as follows

Commonwealth	2,000,000 at $1 per share
ANZ	500,000 at $1 per share
CBA	500,000 at $1 per share
NAB	500,000 at $1 per share
Westpac	500,000 at $1 per share

The shareholders also agree to provide loan financing to ABIP as outlined in the Facility Agreement.

Further Debt Funding (clause 4.4)

ABIP can only issue debt (beyond the initial $4bn of funding commitments of the Commonwealth and the four major banks) after unanimous agreement of shareholders.

All such additional ABIP-issued debt will have the benefit of the Government guarantee, for which ABIP will pay the Commonwealth a fee. The fee will be determined having regard to risk and liquidity factors associated with the debt and general market conditions at the time debt is issued. The maximum fee for unsubordinated debt will be 150 basis points per annum.

All ABIP-issued debt will rank in priority to the initial funding from the banks and the Commonwealth, except where this will lead to an increase in the regulatory capital that the banks are required to hold. In that case, a portion of the ABIP-issued debt will be subordinated.

Board control and composition (chapter 6)

The Board will consist of five directors, one appointed by each shareholder. Only a shareholder can remove their appointed director. Each shareholder will be responsible for fees paid to their appointee, and ABIP will not pay any directors fees. Shareholders may also appoint alternate directors.

The Commonwealth’s appointed director will be the Chair of the Board. If the appointee is not able to act in their capacity, the Commonwealth’s alternate or other nominated director will act as the chair.

Directors must act in good faith and in the best interests of the Company as a whole.

All decisions by the Board must be unanimous, except for enforcement decisions which require a majority of at least 4 directors. The Commonwealth must be a member of any enforcement majority.

The Board may delegate functions to subcommittees. The Commonwealth director must be a member of all subcommittees, and decisions of subcommittees must be unanimous.

The Board must establish an audit committee. Unless otherwise authorised by a unanimous resolution of the shareholders, the Board cannot delegate decisions referred to in the Lending Criteria or the Shareholders' Agreement, the decision to provide a loan, or enforcement decisions.

The Directors must meet every month unless otherwise agreed. Resolutions may be passed by a circulation to all directors, rather than at a meeting.

A director with a material personal interest in a matter must not be present at the discussion or vote on the matter, unless all other directors have knowledge of the interest and are satisfied that it does not disqualify that director. Material personal interests will not be seen to arise solely from the employment of a director by one of the shareholders, or from the director's appointing shareholder having any material interest in the matter.

Related Party proposal (chapter 7)

Any related party proposals must be at arms length, and approved by all directors. If all directors have a material personal interest in a related party transaction, then the proposal is subject to unanimous approval by shareholders. All shareholders must then disclose any material interests in the proposal.

Budget, Business Plan and Accounts (chapter 8)

ABIP will operate in accordance with a budget and business plan, approved by the Board.

ABIP's accounts must be audited each year.

Reporting Obligations (chapter 9)

ABIP must provide to each Shareholder monthly updates (a brief narrative description of the key operating highlights), half-year accounts and audited annual accounts.

ABIP must also provide notice of any litigation against ABIP, breach of contracts to which ABIP is a party, and any information with may be relevant to decisions by the Board or shareholders.

Distributions to Shareholders (chapter 10)

All profits (after reasonable reserves for working capital and provisioning) are to be distributed to shareholders in half-yearly dividends, unless there is a Board resolution to the contrary. All remaining profits are to be distributed at the sunset date.

Provisioning (10.c.iv)

Until $500 million has been borrowed from the Company, a cash-flow provision of 50 basis points will be applied. Once more than $500 million has been borrowed from the Company, a dynamic provisioning policy will be adopted which is consistent with approaches adopted by APRA and major ratings agencies.

Shares and other interests (chapter 11)

Shareholders may not transfer any rights under the Shareholders' Agreement, shares in ABIP, or loans to ABIP other than to a wholly owned subsidiary, without the approval of all shareholders. These rights, shares and loans to ABIP cannot be used as security by the shareholders in their dealings with third parties without the approval of all shareholders.

Confidential Information (chapter 12)

No shareholders or directors may disclose confidential information, except under certain circumstances (such as when required by law). Under no circumstances may information about specific applicants, borrowers or loans be disclosed.

Term of the Agreement (chapter 14)

The Shareholders' Agreement will remain in effect until the Company is wound up. This will occur as soon as practicable after the sunset date.

APPENDIX 2 – ABIP LENDING CRITERIA

The objectives of ABIP are to provide refinancing for loans relating to commercial property assets in Australia in situations where finance relating to those assets is not available from commercial providers (other than ABIP), and the assets would otherwise be financially viable.

ABIP may also provide financing arrangements in other areas of commercial lending if circumstances necessitate and provided those arrangements are agreed unanimously by the members of ABIP.

This appendix outlines details regarding the proposed scope of ABIP's lending activities to the commercial property sector. In addition to meeting the criteria below, borrowers will need to demonstrate that they meet ABIP's prudent lending criteria with respect to financial soundness (such as the Loan to Value Ratio and the Interest Cover Ratio). These criteria are commercial-in-confidence, but are broadly consistent with those of the four major domestic banks. The lending criteria are still in draft form and remain subject to final approval.

Transactions

ABIP will not refinance loans from the four major domestic banks.

ABIP's primary focus will be to:

- participate in the refinancing of commercial property assets where commercial providers (other than the four major domestic banks) in the transactions will not renew their participation in the financing arrangements; and

- refinance maturing Commercial Mortgage Backed Securities (CMBS), and refinancing Medium Term Notes (MTN) or equivalent debt securities.

Property classes within scope

The ABIP Board may approve ABIP funding for:

- completed investment commercial property (for example, without limitation completed and predominantly leased income producing retail shopping centres, commercial office buildings and industrial property);

- specialised property assets (for example, freehold hotels leased to competent/creditworthy operators, retirement assets and accommodation hotels); and

- partly completed development assets with secured pre-commitments on a turnkey basis.

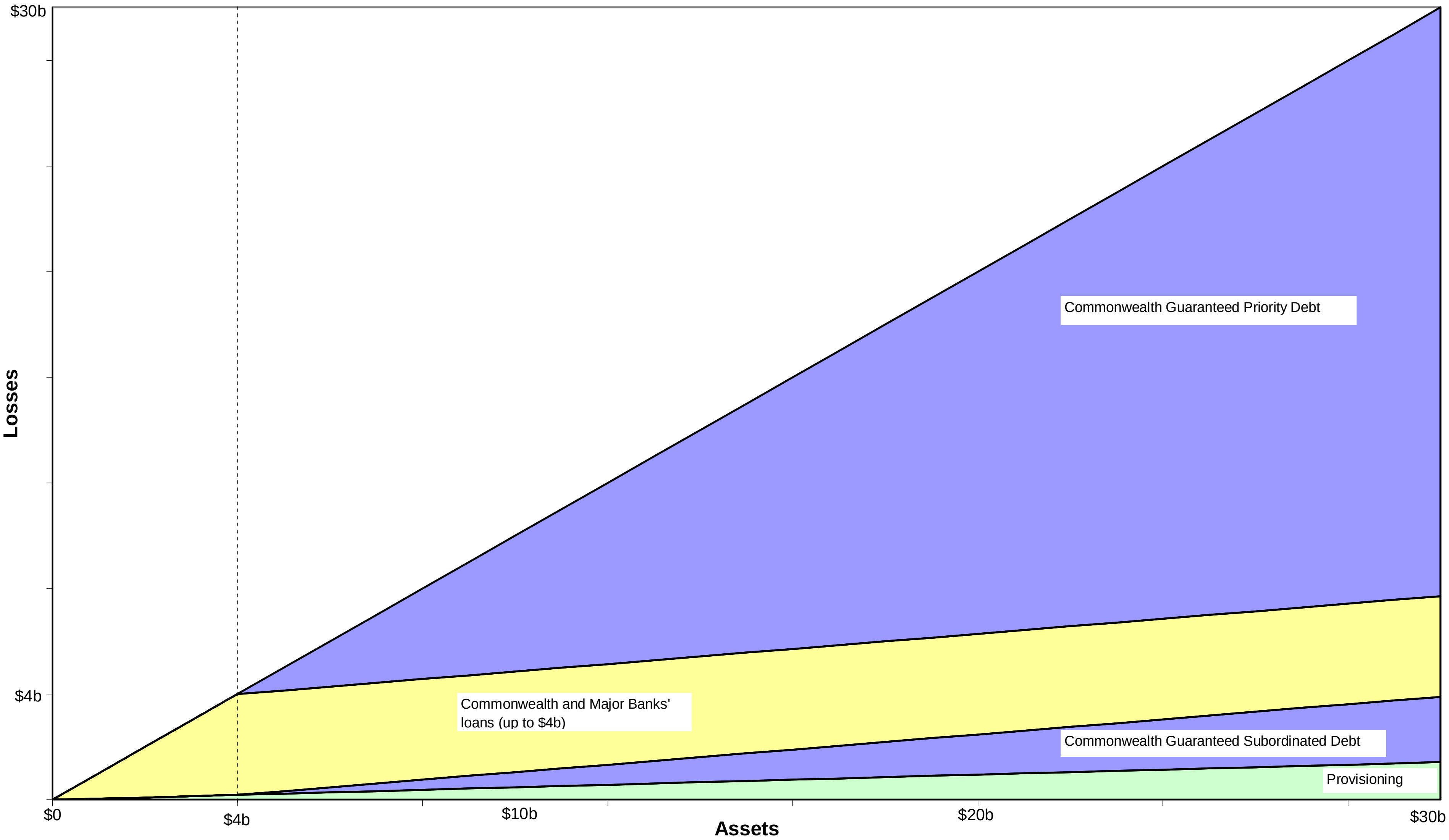
Properties outside of scope

The following types of property are outside the scope of ABIP's investment mandate:

- property located outside Australia;
- land banks;
- speculative development assets;
- rural property;
- residential housing (including multi-unit developments);
- environmentally contaminated assets;
- exposures carrying material levels of construction, completion and/ or market (income letting) risk;
- portfolios underpinned by retirement village deferred management fees;
- lending to passive investors in special purpose assets;
- fund of funds; and
- property equity securities.

Where a property has mixed residential and commercial use, and the ABIP Board is satisfied that the commercial use is a substantial component of the property's value, the ABIP Board may authorise ABIP to provide funding in respect of the commercial component of the property.

APPENDIX 3 – ABIP LOSS SHARING ARRANGEMENTS



Illustrative purposes only – not to scale

APPENDIX 4 – ABIP FLOW OF FUNDS