Australian Government

Competitive and Sustainable BANKING SYSTEM

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Competitive and Sustainable Banking

The Gillard Government will take further action in three broad streams of reform to empower consumers to get a better deal in the banking system, to support our smaller lenders so they can put more competitive pressure on the big banks, and to secure the long-term safety and sustainability of the financial system so it can continue to provide reasonably priced credit to Australian households and small businesses.

STREAM ONE: EMPOWER CONSUMERS TO GET A BETTER DEAL

- **Ban exit fees on new home loans** – tough new laws to further strengthen existing mortgage exit fee reforms by banning exit fees outright on new home loans from 1 July 2011.
- **Boost consumer flexibility to transfer deposits and mortgages** – appoint former Reserve Bank of Australia (RBA) Governor Bernie Fraser to conduct a comprehensive feasibility study into technological options, the potential timeline and processes for implementing full account number portability.
  - Further enhance the capacity of Australian home borrowers to move their mortgages by accelerating the Treasury's development of potential frameworks to transfer Lenders Mortgage Insurance and introduce a central registry for mortgages.
- **Introduce mandatory key facts sheet for new home loan customers** – mandate that lenders provide potential borrowers with a simple one-page 'key facts sheet' showing how much they will pay every month and over the life of their loan, and where they can shop around so they can compare lenders side by side.
- **Empower Australian Competition and Consumer Commission (ACCC) to prosecute anti-competitive price signalling** – new laws to prevent banks from engaging in anti-competitive price signalling that is designed to keep interest rates higher than they would otherwise be.
- **Fast-track legislation to get a better deal for Australians with credit cards** – build on new national responsible lending reforms by cracking down on unfair treatment of credit card holders.
- **Launch community awareness and education campaign empowering consumers to *Bank on a Better Deal*** – national campaign to build understanding about the savings borrowers can make by walking down the road to get a better deal.
- **Taskforce with RBA to monitor and enhance ATM competition reforms** – Treasury to establish a taskforce with the RBA to take further action if required to enhance current reforms to boost competition and transparency on ATM fees.

STREAM TWO: SUPPORT SMALLER LENDERS TO COMPETE WITH BIG BANKS

- **Build a new pillar in the banking system by supporting the mutual sector** – the Australian Prudential Regulation Authority (APRA) will quickly approve over 20 mutuals to use the term 'bank' if they apply, and review guidelines which currently prevent other mutuals from applying.
  - Put mutuals and smaller banks at the centre of the *Bank on a Better Deal* campaign, including introducing a new official 'Government Protected Deposits' symbol, and continue helping mutuals to develop a structure to raise aggregated funding.
- **Confirm Financial Claims Scheme as a permanent feature of financial system** – to ensure continued depositor certainty and secure this critical source of funding for smaller lenders to help them make cheaper loans.
- **Introduce a third tranche of support for the residential mortgage-backed securities (RMBS) market** – invest a further $4 billion in high-quality, AAA-rated RMBS to continue supporting this vital funding market which our smaller lenders rely on heavily to put competitive pressure on the big banks, to build on the existing $16 billion investment.
- **Accelerate development of bullet RMBS market for smaller lenders** – accelerate design of most appropriate structure for smaller lender issuance of bullet RMBS, to strengthen and diversify their funding, as an alternative to traditional RMBS.

STREAM THREE: SECURE THE LONG-TERM SAFETY AND SUSTAINABILITY OF OUR FINANCIAL SYSTEM

- **Allow banks, credit unions and building societies to issue covered bonds** – diversify and strengthen funding for our financial system to secure its safety and sustainability in the decades to come, and harness our national superannuation savings to domestically fund more productive investment in our economy.
- **Develop a deep and liquid corporate bond market** – launch trading of Commonwealth Government Securities on a securities exchange, with Treasury to also finalise reforms to further reduce red tape associated with issuing corporate bonds to retail investors, to reduce our reliance on offshore wholesale funding by engaging our national savings.

Broad reforms to build on the strength of our financial system

The Gillard Government is introducing methodical reforms to give all Australians a fairer go in the banking system, and to build on the strength and stability our action secured during the global financial crisis and the measures we've already taken to promote competition.

The Government acted quickly and decisively during the global financial crisis by introducing the bank guarantees to secure Australia's financial system and support access to credit. Without this action, our banks would have lent less and interest rates for borrowers would have been higher. This would have led to lower economic growth and higher unemployment in Australia.

Governor Stevens of the RBA said actions like those taken by the Government maintained 'public confidence in the security of the banking system' and 'helped to stabilise what could have been a catastrophic loss of confidence in the global financial system'. The International Monetary Fund and the Organisation for Economic Co-operation and Development also recognised the stability of Australia's financial system, secured by the Government's decisive action.

However, Australia was not immune from the impacts of the global financial crisis – it did hit our smaller lenders particularly hard, creating big challenges for banking competition. The Government's bank guarantees secured the competitive foundations of our banking sector by ensuring the continued ability of our smaller lenders to make home loans and small business loans, but the global financial crisis made it much harder for them to access funding markets on economic terms to compete with the big banks.

These challenges can't be solved overnight – there is no silver bullet here – but the Gillard Government will keep working hard to support banking competition. The Government is strongly committed to making the banking system work for families, not against them.

Competition is the best way to keep prices in our economy lower over time. Smaller lenders can play a vital role in the banking sector – they can compete vigorously with the big banks by offering cheaper interest rates on loans. This puts pressure on the big banks to keep their interest rates to borrowers lower over time so that they don't lose customers.

The Government has already brought in a range of measures that have been critical in boosting competition in the banking sector, including:

» Our bank guarantees, which supported deposit funding for smaller lenders and enabled non-major banks to borrow some $65 billion in wholesale funding during a period when global funding markets were severely dislocated.

» Our $16 billion investment in high-quality, AAA-rated residential mortgage backed securities, which has been critical in supporting this important funding market which many smaller lenders rely heavily on to make home loans and small business loans.

» A national consumer credit law for the first time in 100 years – uniform consumer protection across all states and territories.

» Tough new laws to crack down on unfair mortgage exit fees – to ensure that customers can walk down the road and get a better deal without being gouged by an unfair penalty fee – with lenders restricted to acting on a 'cost recovery basis'.

» Strong reforms to get a better deal for all Australians with credit cards – so they don't get caught out paying more interest than they have to or incurring fees they shouldn't.

- Promoting a more level playing field for smaller foreign lenders by phasing down interest withholding tax to boost their capacity to access cheaper funding from overseas parents.
- Strengthening deposit funding for smaller lenders and retail corporate bond issuance through a 50 per cent tax discount being phased up to the first $1,000 of interest income.
- Mandated a new direct debit and credit listing service to make it easier for customers to switch from one institution to another.
- Established a consumer complaints hotline (1300 300 630) as a first contact point for consumer complaints about basic banking products.

These banking competition reforms compliment the Government's action to reflect legitimate community concern about excessive pay packets for bank CEOs by bringing in tough new laws to give shareholders a bigger say on executive salaries and make sure those salaries are linked to long-term performance.

The Government introduced legislation last year to crack down on excessive 'golden handshakes' to directors and executives, by ensuring termination benefits exceeding one year's average base salary are subject to shareholder approval, down from the previous threshold of seven times a CEO's annual remuneration.

In addition, the Financial Stability Board has already endorsed Australia's framework for ensuring financial sector pay packets don't reward risky behaviours which maximise short-term profits at the expense of long-term stability.

The Government is now finalising draft legislation, for introduction early next year, to implement the Productivity Commission's 'two-strike' rule which allows shareholders to spill a company's board if it fails to listen to their concerns on remuneration after being warned once.

The budget impacts of the measures in this announcement are expected to be modest, and will be accounted for in the 2011-12 Budget. The Government is fully committed to its strict fiscal strategy and returning the budget to surplus in 2012-13, well ahead of any major advanced economy.

Further information on the Government's three new streams of reform in the banking sector, together with information on opportunities to comment, are available at **www.treasury.gov.au/banking** or **banking@treasury.gov.au**.

STREAM ONE

Empower consumers to get a better deal

Ban exit fees for new home loans

The Gillard Government will ban exit fees outright for new home loans from 1 July 2011, and has carefully and methodically designed changes to the National Credit Code to build on our existing mortgage exit fee reforms.

If any bank seeks to simply re-badge their current mortgage exit fees as upfront entry fees – or recover exit fees through any other type of fee – the Australian Securities and Investments Commission (ASIC) has the power to pursue the bank if it appears that the fee is 'unconscionable' under the Government's new National Credit Code, which applies to both existing and new mortgages.

Several big banks have already responded directly to the Government's existing measures by removing their mortgage exit fees, and the Government will now legislate to ensure that these fees cannot be reintroduced, and that exit fees from other lenders are banned.

The Gillard Government has been concerned for some time that some banks are using mortgage exit fees to lock customers into their home loans. Exit fees (often called early termination fees) can be so high that they completely wipe out the savings from switching to a cheaper mortgage with another lender.

That's why on 1 July 2010, the Government introduced tough new reforms through the Australian Consumer Law to strengthen the hand of Australia's credit regulator, ASIC, to pursue banks over unfair mortgage exit fees.

These reforms ensure that ASIC has the power to take action against any bank if they charge an early exit fee which is considered unfair or unconscionable to a consumer.

ASIC has already released new rules which explain exactly how it will enforce the Government's existing ban on unfair or unconscionable exit fees, with the outright ban for exit fees on new loans coming in on 1 July 2011.

The banks are on notice that ASIC will take them to court if they try to profit from exit fees or use them to lock their customers in before the outright ban comes in next year.

These significant measures will boost competition in the home loan market over time, by giving customers greater freedom to walk down the road and get a better deal if their current bank isn't offering the most competitive interest rate.

The Government will introduce amendments to the National Credit Code to ban exit fees into the Parliament during the first sitting of 2011, following targeted consultation.

Boost consumer flexibility to transfer deposits and mortgages

The Gillard Government will take important steps to progress the transition to full bank deposit portability. Portability would allow Australian consumers to quickly and seamlessly switch their deposit account and mortgage to a competitor who is offering a better deal.

The Government will appoint former Reserve Bank of Australia Governor Bernie Fraser to conduct a comprehensive feasibility study to examine the technological options, the potential timeline and processes for implementing full account number portability.

Bank deposit portability would complement the Gillard Government's tough new ban on mortgage exit fees for new home loans and transaction account switching package, which empower consumers to keep the banks honest with the threat that they can always walk down the road and get a better deal.

Many bank customers hold their savings in a deposit account with the same bank as they have their home loan, so the inconvenience of moving their deposit account also acts as a significant barrier to moving their mortgage.

Deposit account number portability could ultimately provide consumers with a personalised, transferable account number to which all their direct credits and debits attach, and which moves with them when they switch. It could empower consumers to switch around and get the best deal on their savings.

Competition in the banking sector – like any part of the economy – requires that customers be able to move quickly, cheaply and easily between competitors. Banks currently exploit the financial and time costs that consumers incur when they switch to maintain a fee and interest rate structure that is higher than it otherwise would be.

The ability of consumers to walk down the road and get a better deal boosts competitive pressure on the big banks – any bank which doesn't offer a competitive deal and the highest level of customer service faces the risk of losing its customers.

The feasibility study by Mr Fraser will involve extensive consultation with the Reserve Bank of Australia, which has primary responsibility for the Australian payments system, and will examine the range of issues surrounding account number portability:

- Assessing the current technological limits and possibilities around portability.
- Preserving the regulatory integrity of bank payment systems for consumers, including privacy of information.
- The potential need for a Central Account Registry to oversee all banking details and account information, under appropriate supervision.
- The benefits, costs and risks of introducing account portability on various timelines.

Mr Fraser will consult with our financial regulators, the industry, technical experts and consumer groups and all other relevant stakeholders, and report to the Government on the findings of the study by 30 June 2011.

The Gillard Government will also take further steps to boost the capacity of Australian home borrowers to transfer mortgages by accelerating its development of potential frameworks to:

» Transfer Lenders Mortgage Insurance from lender to lender — to avoid consumers losing the value of the insurance when switching.

» Allow consumers to avoid lender fees, as well as mortgage discharge and re-establishment costs, through the introduction of a central repository to hold all mortgages so that refinancing a mortgage would not involve a borrower discharging and reinstating their mortgage.

These mortgage switching measures should further help to encourage consumers to switch home loans by lowering the associated costs and inconvenience.

The Government introduced a transaction account switching package in 2008 to make it easier for Australians to switch to a better deal. During the turbulence of the global financial crisis it is understandable that many savers would have had a preference for the stability of their existing institution.

However, the account switching package will continue to offer an easier way of switching transaction accounts while full account number portability is being developed. The Government expects that more consumers will utilise the account switching service as competition returns to the banking sector and the benefits of the package become more widely known.

Introduce mandatory key facts sheet for new home loan customers

The Gillard Government will make it compulsory for all mortgage lenders to provide potential borrowers with a simple, one-page key facts sheet which uses standard definitions to show consumers how much they will pay every month and over the life of their loan, and where they can shop around.

Consumers will be able to compare the cost and features of different home loans by putting one-page facts sheets from different lenders side by side, and comparing the savings they could make between mortgages. A potential home borrower could easily compare the relative cost of a mortgage from a credit union against a big bank.

The Treasury has already developed a pro-forma for the Government's new key facts sheet which has been released with this announcement, on which the Treasury will undertake targeted consultations with consumer groups and the industry, before releasing exposure draft legislation during the first sittings of Parliament in 2011.

It will be mandatory for lenders to clearly explain to potential home loan customers what every item in the one-page facts sheet means for them (e.g. 'over the life of your loan, you will repay $x for every $1 you have borrowed from us'). Providing this disclosure in advance of the consumer signing up for a home loan will give customers the opportunity to shop around and compare deals.

When considering a home loan offering, or comparing home loans, consumers are currently faced with a large amount of information that they often find difficult to understand.

This initiative will enhance consumer empowerment by improving transparency and standardising terminology between products, to assist consumers to better understand and compare information, and make more informed choices and appropriate product selections.

The Government will work with the industry to minimise any costs of compliance associated with this reform.

Empower ACCC to investigate and prosecute anti-competitive price signalling

The Government will bring in tough new laws to prevent banks from engaging in anti-competitive price signalling that is designed to keep interest rates or other fees higher than they would otherwise be, to build on our existing reforms to strengthen cartel laws.

The Government has been working with the ACCC since mid-2010 to carefully design amendments to the *Trade Practices Act 1974* (which from 1 January 2011 will be renamed the *Competition and Consumer Act 2010*). These reforms will capture anti-competitive behaviours in specific sectors like banking where there is strong evidence they exist, without creating unintended consequences for other sectors of our economy.

The Government will introduce amendments to the Trade Practices Act in the first sitting of the Parliament in 2011, following targeted consultations on exposure draft legislation.

The new laws will give the ACCC the power to take action against businesses in specified sectors like banking who signal their prices to their competitors in order to undermine competition. These tough new reforms will apply initially to banks, with the capacity for other sectors to be specified in future after further review and detailed consideration. Of course, all publicly listed companies will be able to fully comply with their continuous disclosure obligations.

Anti-competitive price signalling technically falls short of collusion because it does not involve a commitment to act in a certain way – but it can be just as harmful to competition as a price cartel. Laws prohibiting these 'facilitating' or 'concerted' practices already exist in the US, the UK and in Europe – and now the ACCC's new powers will close a gap in the Trade Practices Act, which is used by businesses like banks to avoid the full impact of genuine competition.

The Government's exposure draft legislation gives the ACCC the power to prosecute where it concludes that a bank has communicated its pricing intentions and other strategic information to a competitor for the purpose of substantially lessening competition.

Importantly, the proposed law will be clear that a court can make up its own mind as to what it thinks the real purpose was, based on the surrounding circumstances – so there is no need for a 'smoking gun'.

For example, the law designed as proposed would prohibit any bank executive from purposefully signalling to its competitors through the media or investment community that if other banks raise their mortgage rates it will follow them.

This sort of statement could sometimes be designed to say to other banks 'don't worry – if you raise your mortgage rates then I won't undercut you and take your customers'.

The Government has received independent legal advice that considers it would not be appropriate to ban the communication of pricing intentions that have the effect or likely effect of substantially lessening competition, as opposed to the purpose. Such a prohibition would create substantial uncertainty, because market participants could not know in advance how their competitors will react to their public statements, and therefore what the effect or likely effect would be.

Further, any private communications between two banks about their prices would be automatically prohibited under the proposed design, as these sorts of private tip-offs are invariably harmful for competition.

For example, the ACCC would be able to take action if one bank phones another bank privately to tell them about a planned mortgage interest rate rise.

Breaches will attract tough penalties of up to $10 million, 10 per cent of a business's annual turnover or three times the benefit of the conduct — whichever is higher.

Of course, in limited circumstances where price signalling may be legitimately providing overall net public benefits, the ACCC would be able to provide an exemption for the parties under the existing authorisation provisions.

Fast-track legislation to get a better deal for Australians with credit cards

The Gillard Government will build on its new national responsible lending reforms by fast-tracking our election commitment to crack down on unfair treatment of Australians with credit cards — to give consumers more control over the amount they borrow and stamp out lender practices which currently see them pay more interest than they should.

The Government has overhauled our consumer laws in the past two years. The commencement of the Australian Consumer Law marks the first time in 100 years that Australians have had a uniform consumer law across all states and territories which strengthens protections for them across every sector of our economy, including credit. The new National Credit Code introduced – for the first time — a national consumer credit law with tough new protections for consumers.

The Government will now fast-track reforms through the National Credit Code to increase fairness and consistency in the way fees and interest are charged on credit cards, to give consumers more say over how they use their credit cards and to help them better understand what they are signing up to.

The Treasury will now accelerate its industry and consumer consultations to allow the relevant legislative amendments to be introduced in the first sitting of Parliament in 2011.

Forming part of the Government's national credit regime, these tough new laws will save Australian cardholders money by forcing credit card lenders to allocate repayments to higher interest debts first:

- For example, the Johnson family may have a credit card balance of $5,000, consisting of a $2,500 'balance transfer' from a previous lender on which they are now paying interest at a special rate of 1.9% per annum, and another $2,500 which they have spent using a credit card from their new lender on which they are paying interest at 19.9% per annum.
- If the Johnson family were able to make a $2,000 payment towards their credit card balance, most lenders would seek to use this to pay off $2,000 of the debt which is only costing 1.9% per annum. The Government will legislate to ensure that the lender must instead use the $2,000 to pay down some of the debt on which interest is owed at the much higher rate of 19.9%, saving the Johnson family around $360 a year.

The Government's new credit card reforms will also:

- Prevent lenders from charging over-limit fees unless consumers specifically agree that their account can go over the limit.
- Ban unsolicited credit limit extension offers unless pre-agreed to by the consumer.
- Ensure all interest charges are applied consistently under an industry-agreed standard, including when interest starts to accrue and on what balances.
- Make sure lenders give consumers more say over nominating their own credit limit.
- Make it mandatory for credit card application forms to include a clear summary of key account features.
- Require lenders to inform consumers about the implications of only paying minimum repayment amounts on their statements.

The objective here is clear — a credit card market that is transparent, competes hard for every consumer dollar, and has built-in protections to help stop Australians falling into a credit card debt trap.

Launch *Bank on a Better Deal* — a national community awareness and education campaign

The Gillard Government will launch a community awareness and education campaign in early 2011 aimed at building understanding about the range of competitive deals on offer and empowering consumers to shop around.

We'll put our mutual credit unions and building societies, together with our regional and other smaller banks, right at the centre of this awareness campaign, to properly inform consumers about the safe and competitive alternatives they offer to the big banks. This will include the introduction of a new 'Government Protected Deposits' symbol, which will help consumers easily identify that their deposits are secure.

The Gillard Government is committed to building the capacity of every Australian to make better decisions about managing their money and to help enhance their financial wellbeing.

Improved financial literacy can increase economic participation and drive competition in the financial services sector, as part of the Government's broader agenda to foster competitive, efficient, well-informed and safe markets.

The Government will also launch a new, interactive consumer website with ASIC to help people boost their understanding of money matters through access to high-quality and independent online, personalised financial guidance that is free and readily accessible.

These reforms complement the Gillard Government's existing commitment to ensuring Australian students have the skills and knowledge they need to be informed consumers and make responsible financial decisions.

From 2011, the national school curriculum for Maths will contain a strong focus on the practical financial skills that students need, with additional training provided for teachers.

Establish taskforce with Reserve Bank to monitor and enhance ATM competition reforms

The Gillard Government will take further action, if required, to enhance the current implementation of reforms to boost competition and transparency on ATM fees, and will instruct the Treasury to establish a taskforce with the Reserve Bank to monitor the ATM industry.

The joint Treasury / Reserve Bank Taskforce will report to the Government in June 2011 on the need for further action, with an early report in February 2011 on appropriate action for dealing with issues specifically affecting Australian indigenous and other remote communities.

On 3 March 2009, the RBA and the ATM industry introduced a package of reforms designed to improve transparency, flexibility, efficiency and competition in the Australian ATM system. Key elements of the reforms included:

» Abolishing bilateral interchange fees paid by banks and other financial institutions to each other for the provision of ATM services. These interchange fees were rarely renegotiated, prices did not reflect costs, and over time interchange fees could have resulted in under provision of ATMs, particularly in high cost locations in rural, regional and remote areas.

» Allowing ATM owners to charge cardholders directly, significantly increasing the transparency of ATM fees (with charges disclosed to the cardholder prior to their transaction being finalised).

» Setting a cap on costs charged to new entrants wishing to connect to the ATM system.

These reforms have already strongly encouraged Australians to change their behaviour and switch to using ATMs which don't charge a fee, with ATM fees paid by cardholders being reduced by $120 million in the first year since the reforms were introduced.

Around two-thirds of ATM transactions now don't incur a fee, and nearly all cardholders have access to a network of at least 1,500 ATMs on which they do not pay a fee. In addition, the number of ATMs has increased by around 1,500, including in rural, regional and remote areas.

STREAM TWO

Support smaller lenders to compete with the big banks

Build a new pillar in the banking system by supporting the mutual sector

The Gillard Government will take action to help build a new pillar in our banking system from the combined competitive power of our mutual credit unions and building societies.

To help educate consumers about the safety and competitiveness of mutual lenders, the Government will emphasise the similarities between banks, credit unions and building societies.

At present there are more than 20 credit unions and building societies that meet APRA's authorisation guidelines on the minimum capital requirements for use of the term 'bank'. If these institutions apply to use the word 'bank', APRA has advised that it will approve them quickly.

APRA will also conduct a review of the current guidelines for approval to use the term 'bank', and will provide the results of this review to the Government in March 2011.

The Government will take further action by putting the safety and competitive power of credit unions and building societies at the centre of its *Bank on a Better Deal* awareness campaign.

This will include the introduction of a new official 'Government Protected Deposits' symbol which will help consumers easily identify that mutuals are as safe as banks and support this critical funding source for our credit unions and building societies:

» Mutual credit unions and building societies meet the same high standards of prudential regulation as banks, as they are supervised by APRA.

» All deposits held with a mutual are backed by the Government's Financial Claims Scheme — just like bank deposits.

The Treasury will also continue to actively facilitate the efforts of mutual credit unions and building societies to develop aggregated structures for mutuals to pool together and raise cheaper funding.

The Gillard Government believes strongly in the capacity of Australia's mutual credit unions and building societies to provide a safe and competitive alternative to the big banks.

Australians can have absolute confidence in the safety of their money wherever their deposit is held. Some 4.5 million Australians are members of a mutual, but many others may not be aware of the critical role they play in putting competitive pressure on the big banks.

Mutuals account for around 9 per cent of new home loans, and offer discounts of up to 1 full percentage point to the standard rates offered by the major banks.

In fact, independent analysis by InfoChoice showed that borrowers could save over $30,000 over the life of their loan if they choose a credit union or building society. Mutuals are also collectively the fifth largest holder of household deposits in Australia.

Most importantly, as mutual organisations, credit unions and building societies always put their members first. They are not-for-profit lenders — so they put their profits back into cheaper interest rates, lower fees, and better customer service.

Many credit unions and building societies are not, under current law, able to use the term 'bank', even though they are a safe and competitive alternative to banks.

The Government's reforms will help consumers to understand the critical role that mutual credit unions and building societies play in our financial system and our broader economy.

Confirm the Financial Claims Scheme as a permanent feature of our financial system

The Gillard Government will confirm the Financial Claims Scheme as a permanent feature of our financial system. Deposits covered under the Financial Claims Scheme are a critical source of funding for our regional banks, credit unions and building societies, making this an important measure to support the capacity of these smaller lenders to access funds for cheaper loans to compete with the big banks.

The Financial Claims Scheme was developed over the period leading up to the global financial crisis by the Council of Financial Regulators, whose members include the Governor of the Reserve Bank, the Secretary to the Treasury, and the Chairmen of both APRA and ASIC.

The decision to introduce the Financial Claims Scheme was taken well before the crisis, but was accelerated to secure confidence in the Australian financial system following the collapse of Lehman Brothers.

Australia's banks are well capitalised and have benefited from years of tough supervision by our world-class financial regulators. Our banks are soundly managed by international standards, having developed strong institutional cultures of responsible lending and risk management.

But Australia was not immune from the profound loss of confidence that occurred around the world during the depths of the global financial crisis, when depositors in Europe and the United States became concerned about the safety of their deposits.

To prevent a similar situation occurring in Australia, the Government quickly and decisively introduced the Financial Claims Scheme to provide certainty to Australian depositors through a free guarantee for their deposits of up to $1 million.

The Government has been working with the Council of Financial Regulators to review the current $1 million cap, up to which coverage is currently free, to determine an appropriate level at which the cap will be set from October 2011.

Introduce a third tranche of support for the RMBS market

The Gillard Government will invest a further $4 billion in high-quality, AAA-rated RMBS to continue to support this vital funding market which our smaller lenders rely on heavily to put competitive pressure on the big banks. This will include the continued additional objective of supporting lending to small business, and will not be available to support the major banks.

The Australian Office of Financial Management (AOFM) and the Treasury advise that this direct investment in RMBS is more appropriate to support the market than introducing a government guarantee of RMBS, because investors already understand that Australian RMBS are of very high credit quality. The Reserve Bank of Australia has also confirmed direct investment is more appropriate than a government guarantee.

The Government's $16 billion RMBS investment continues to put downward pressure on borrowing costs for households and small businesses. Our investment is helping the RMBS market again become a cheaper, more competitive source of funding for smaller lenders.

It is giving private investors the confidence to invest increasing amounts of their own money in this important market, and helping smaller lenders to continue lending at competitive interest rates and keep more market share than would otherwise be possible.

Small lender RESIMAC said this support for the RMBS market has 'been vital to permitting a continual flow of finance to the small business community', and that 'without such support, there would be literally thousands of Australian small business owners who would have been deprived access to finance' — like plumbers, pavers, dry cleaners and restaurants.

The AOFM estimates that close to 10 per cent of funds already invested from the Government's second $8 billion support tranche have been lent to Australian small businesses.

The AOFM has advised that it expects that the Government's second $8 billion tranche will be fully invested by early 2011 and that despite improvements in pricing, market conditions remain fragile for securitisation. The Treasury and AOFM advise that with additional support, the RMBS market would be expected to improve further from current levels and become an even more competitive funding source for smaller lenders.

The global financial crisis led to a profound dislocation in global capital markets, including the market for RMBS. In the two decades before the crisis, issuance of RMBS by our smaller lenders was one of the biggest drivers of competition in the Australian mortgage market, enabling particularly our regional banks, wholesale mortgage lenders and mutual credit unions and building societies to raise critical funding to lend out to families.

Since many small business owners borrow against their residential properties, the RMBS market was also vital to supporting lending to some 2.4 million small businesses across Australia.

Despite the securities issued by Australian lenders being backed by very safe loans, investors globally lost confidence in the RMBS market, largely due to a reduction in liquidity and a contagion effect from the very poor credit quality of sub-prime loans being used to back these securities in the United States.

This vital funding market effectively shut for many of our smaller lenders, meaning they couldn't borrow funds to lend to families for home loans and to small businesses.

In October 2008, the Government moved to support this critical funding market, directing the AOFM to invest $8 billion in high-quality, AAA-rated RMBS issued by smaller Australian lenders as part of the Government's

commitment to strong and effective competition in our mortgage market.

With the market still dislocated in November 2009, and after very strong results from the initial tranche, the Treasurer directed the AOFM to invest another $8 billion to continue the Government's temporary support for the RMBS market, this time with the additional objective of supporting small business lending.

Every dollar of this $16 billion investment will go to helping our regional banks, credit unions, building societies and wholesale lenders — not one dollar will go to the big banks.

The collapse of the RMBS market and its subdued recovery pose a significant challenge for funding of smaller mortgage lenders in Australia. Australian annual RMBS issuance has dropped from over $68.4 billion in 2006 to only $14.2 billion in 2009 and $15.6 billion in 2010 (to 31 August 2010). A significant part of the new RMBS issued has been dependent on AOFM support.

From November 2008 to early December 2010, of the $34.3 billion RMBS issued in Australia, $26.2 billion (76 per cent) were deals sponsored by AOFM and $12 billion (35 per cent) was actually purchased by the AOFM. The subdued RMBS market is a key factor preventing the smaller banks and non-bank lenders from competing against the big banks by offering cheaper home loans and small business loans.

The Government's support for the RMBS market has been absolutely vital in keeping some smaller lenders afloat, and allowing many smaller lenders to continue lending at cheaper rates to put more competitive pressure on the big banks.

The AOFM and the Treasury will continue to closely monitor conditions in the RMBS market to determine if the entire third $4 billion tranche of support for the market is required.

Accelerate development of bullet RMBS market for smaller lenders

The Government will task the Treasury to accelerate its work on designing the most appropriate structure for smaller lender issuance of bullet RMBS, as an alternative to traditional RMBS. The Treasury has been actively working with AOFM for some time to develop this market for smaller lenders to strengthen and diversify their funding.

The Government has already facilitated the first bullet RMBS issuance by a smaller lender to help it compete with the big banks. The AOFM recently announced its support for the issuance of a new RMBS transaction by Bendigo and Adelaide Bank, which includes a significant bullet tranche.

This transaction represented an important milestone in the development of the bullet RMBS market for Australia's smaller lenders, helping to provide them with cheaper funding so they can offer more competitive home loans and small business loans.

As the Treasury's work with AOFM has progressed, several other financial institutions have expressed interest in using this bullet structure to raise funds. A recent Commonwealth Bank issuance included a $210 million bullet tranche. The success of that deal further demonstrates the viability of the bullet RMBS concept, with more bullet issuances expected over the coming months.

Bullet issuances can be structured to be eligible for inclusion in certain bond market indices, such as the UBS Composite Bond Index. Many institutional investors, who invest on behalf of Australian superannuation funds, are required to replicate or invest in the securities contained in these indices. This additional structural demand and diversification of investors has the potential to make RMBS more reliable and cost effective.

The key feature of bullet RMBS is that they provide investors with regular interest payments over the life of the security, with full repayment of their principal in a single lump sum upon maturity. In contrast, traditional RMBS securities 'amortise', with the principal being repaid progressively over the life of the security together with interest payments.

However, while the big banks are able to easily absorb any timing mismatches which occur – for example, if they have to pay investors their principal back before the underlying loans are repaid – most smaller lenders are less able to absorb these costs. By supporting innovative structures like the Bendigo and Adelaide Bank transaction, which comprised around 50 per cent bullet securities, the Government is facilitating investment in this asset class.

The Treasury and AOFM will continue working with our financial regulators to develop the market for smaller lender bullet RMBS, including support where required from the Government's new $4 billion tranche of investment in the RMBS market.

STREAM THREE

Secure the long-term safety and sustainability of our financial system

Allow Australian banks, credit unions and building societies to issue covered bonds

The Government will amend the *Banking Act 1959* to allow Australian banks, credit unions and building societies to issue covered bonds, to secure the long-term safety and sustainability of our financial system so it can continue to provide reasonably priced credit to Australian households and small businesses.

A deep and liquid covered bond market will help to channel Australia's national superannuation savings through the financial system into productive investment in all sectors of our economy.

The Government has carefully and methodically been consulting since early 2010 with our financial regulators, as well as industry and market stakeholders, on alternative frameworks for the introduction of covered bonds in Australia, to strengthen and diversify our financial system's access to cheaper, more stable and longer duration funding in domestic and offshore wholesale capital markets.

The Government will release draft amendments to the Banking Act during the first sitting of Parliament in 2011, following targeted consultations together with our financial regulators, on details of a legislative framework which maximises the benefits for both sustainable access to funding and competition in the banking sector.

The future framework introduced by the Government for the issuance of covered bonds will ensure the security of Australian depositors' savings and protection of taxpayer funds.

Australian depositors will continue to have absolute certainty over their deposits under the Financial Claims Scheme, which is a permanent feature of Australia's banking landscape.

The Financial Claims Scheme also allows the Government to levy the banking industry to recover any taxpayer money used to pay depositor claims in the very unlikely event an institution fails and selling its assets does not recover taxpayer funds in full. This means Australian taxpayers will continue to be fully protected.

The Treasury will also consult on the appropriate level of cap to be placed on covered bond issuance for individual institutions, for example five percent of an issuer's total Australian assets. This will ensure a substantial buffer of assets to cover depositor claims, making it extremely unlikely that a levy under the Financial Claims Scheme would ever be needed.

The Government is aware that there has already recently been an example of the successful issuance of covered bonds in Australia by an overseas issuer, and that many overseas jurisdictions including in Europe, Canada, New Zealand and the United States already allow covered bond issuance.

Industry consultations to date have indicated that the ability to issue covered bonds will strengthen the capacity of all Australian major and regional banks, credit unions and building societies to continue providing reasonably priced credit to Australian households and small businesses in the decades to come.

Develop a deep and liquid corporate bond market

The Gillard Government will facilitate the trading of Commonwealth Government Securities (CGS) on a securities exchange in Australia, as part of its broad agenda to foster a deep and liquid corporate bond market, promote Australia as a leading financial services hub and boost our reputation as one of the most attractive investment destinations in the world.

The Treasury will also finalise reforms to further reduce the amount of red tape associated with issuing corporate bonds to retail investors, including further streamlining disclosure requirements and prospectus liability regulations.

A vibrant corporate bond market is critical to putting competitive pressure on bank lending rates to business, and to harnessing our national superannuation savings so we can domestically fund more productive investment in our economy, via both the banking system and the corporate sector, reducing our reliance on offshore wholesale funding markets.

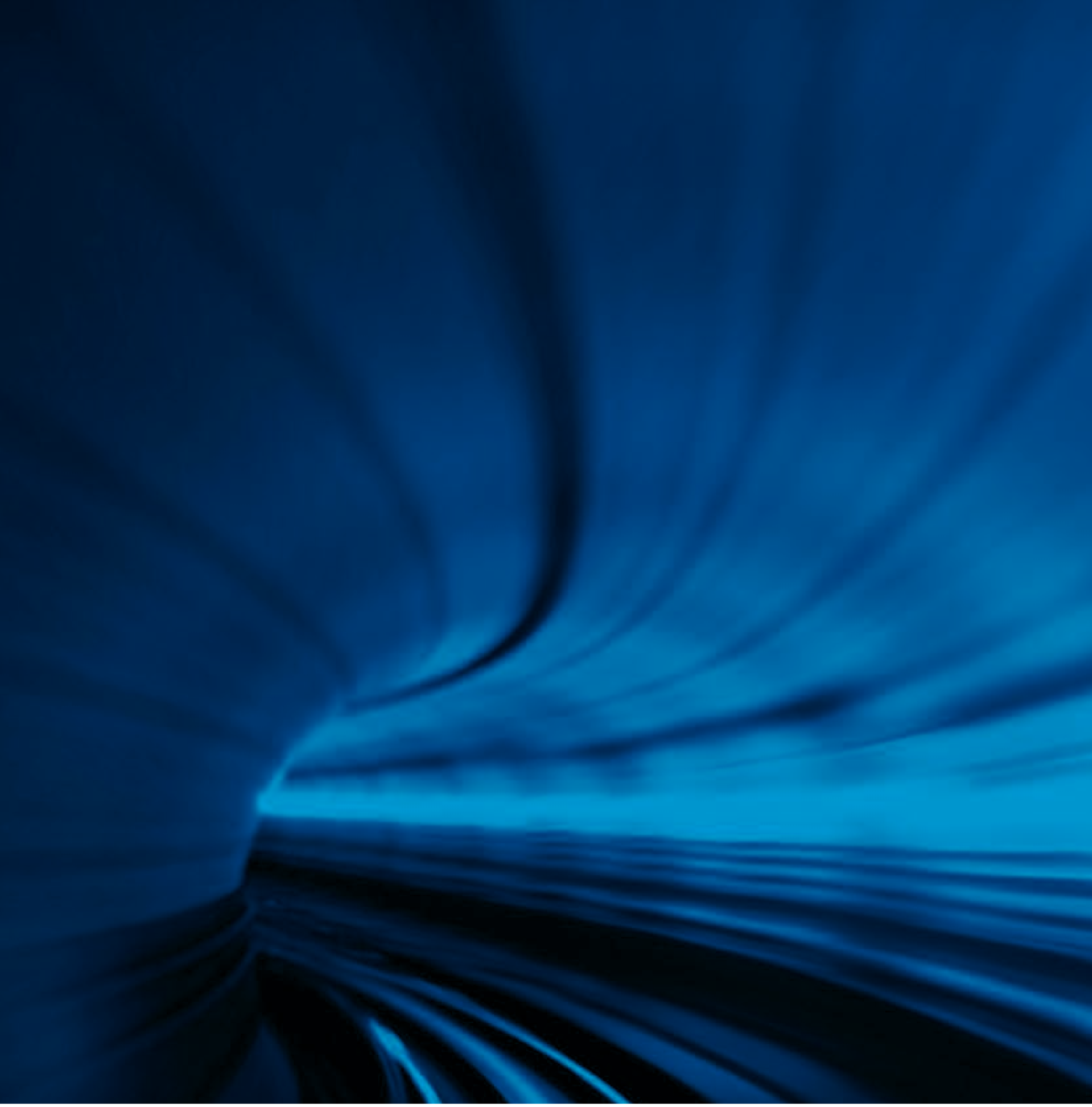
Allowing CGS to trade on a securities exchange will provide retail investors with a more visible pricing benchmark for investments they may wish to make in corporate bonds issued by Australian businesses, as well as help further encourage retail investors to consider diversifying their savings through investments in fixed-income products like government and corporate bonds.

Consistent with the Government's agenda to promote competition between financial markets operating in Australia, the Treasury will report to the Government on the cost and suitability of alternative market exchanges on which CGS could trade by 1 January 2011.

The Treasury will also finalise its work to build on the recommendations of the Australian Financial Centre Forum and report back by 1 January 2011 on the most appropriate design of reforms to better align disclosure for retail corporate bond issues with the process already allowed for share entitlement offers, which provides a very high level of protection for investors, as well as reduced transaction costs for issuers.

In the 2010-11 Budget, the Government announced initial measures to streamline disclosure for businesses borrowing from retail investors.

The Government also provided a new tax incentive to promote personal saving, by encouraging Australians to consider savings products like corporate bonds as a way to diversify their investments.

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