Executive Summary

This report is divided into three sections covering economic developments and the outlook, the performance of financial markets and other factors affecting prospects for financial markets in Australia. The report covers developments over the 2016-17 June financial year period, unless otherwise stated.¹

1. The Economy

1.1. Economic Growth

The Australian economy grew 1.8% in real terms over the 2016-17 financial year, somewhat below its long-run trend growth rate. The Australian economy has grown for 104 quarters without a recession (defined as two consecutive quarters of negative growth), one of the longest economic expansions on record anywhere in the world. GDP per capita rose only 0.2% over the year, however, with population growth running at 1.6% in the year to March 2017.

Chart 1 – Australian GDP Growth

The Australian economy has benefited from strong growth in export volumes, coupled with a recovery in the terms of trade, as well as growth in public demand driven by infrastructure spending. The Reserve Bank of Australia, in its August Statement on Monetary Policy, forecasts an acceleration in GDP growth closer to its long-run trend rate in 2018.

¹ This Report does not incorporate information that became available after mid-October 2017.
RBA Output Growth Forecasts: Year-Ended Basis (%)

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<td>Real GDP Growth</td>
<td>1.8</td>
<td>2-3</td>
<td>2.5-3.5</td>
<td>2.75-3.75</td>
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1.2. Political Developments

The Liberal-National Coalition government has a slim majority in the House of Representatives and does not hold a majority of seats in the Senate, which is in a position to reject or amend legislation. Consequently, it has been challenge for the Government to progress its full legislative agenda.

In the 2016–17 Budget, the Government announced that it intended to progressively reduce the corporate tax rate from 30 per cent to 25 per cent and the associated legislation received Royal Assent on 19 May 2017. The full tax cut will not be extended to all corporate entities until 2026-27.

1.3. The Financial Services Industry

The financial and insurance services sector outperformed the economy as a whole and most other sectors, with growth of 4.5% over the year. Employment in the sector fell from 435,800 people in May 2016 to 433,500 in May 2017. The sector remains the largest industry in the market sector of the Australian economy and has outperformed in terms of multi-factor productivity growth over the last 25 years.

1.4. Exchange Rates

The Australian dollar exchange rate largely tracked US dollar developments through the year while volatility in global foreign exchange markets was at historically low levels.

Chart 2 – AUD TWI

*May 1990 = 100 for nominal; real indexed to equate post-fiscal averages; latest observations for real TWI are estimates
Sources: ABS, RBA, Thomson Reuters, WM/Reuters
Source: Reserve Bank of Australia
The Australian dollar was generally supported by higher commodity prices and the terms of trade, which rose 14.9% over the year on a national accounts basis. Interest rate differentials offered less support, with the Australia-US 10 year bond spread on a narrowing trend for much of the year, although the spread widened again into financial year-end, supporting a late rally in the currency that has persisted into the 2017-18 financial year. Also supporting the currency is a narrowing in the current account deficit to its lowest share of GDP since 1979. This has reduced Australia’s external funding requirement and the associated capital inflows.

Foreign exchange turnover for 2016-17 fell by nearly 9% over 2016-17 to $A37 trillion and remains below its pre-GFC peak of $A47 trillion in 2006-07. Weakness was seen across AUD and non-AUD turnover and spot, swap and forward markets. Only non-AUD swap and forward markets saw an increase in turnover. With AUD maintaining a narrow range against major currency pairs over the year, hedging demand was reduced and this was reflected in market turnover.

1.5. Inflation

Inflation accelerated modestly from a rate of 1.0% for the year-ended June 2016 to 1.9% for the year-ended June 2017. Inflation has been below the RBA’s 2-3% medium-term target range since the end of 2014. The forecasts contained in RBA’s August 2017 Statement on Monetary Policy do not have inflation returning comfortably to the mid-point of the target range until mid-2019.

Australia has shared in the global trend to lower inflation, despite improving labour markets and reduced spare capacity in the economy.

RBA Inflation Forecasts: Year-Ended Basis (%)

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<tr>
<td>CPI Inflation</td>
<td>1.9</td>
<td>1.5-2.5</td>
<td>1.75-2.75</td>
<td>1.75-2.75</td>
<td>2-3</td>
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1.6. Government Finance, Balance of Payments and the Labour Market

The Federal Government’s 2017-18 Budget estimated a 2016-17 Budget deficit of $A37.6 billion or 2.1% of GDP, the ninth consecutive year of budget deficits. The continued run of underlying cash deficits has seen net debt increase from 18.5% to 18.6% of GDP in 2016-17, with a peak of 19.8% of GDP projected for 2018-19.

The current account deficit narrowed to its lowest share of GDP since December 1979 at 0.8% of GDP in December 2016, reflecting strong growth in export volumes and an improved terms of trade, although the deficit has widened since to 2.1% of GDP for the year-ended June on the Australian Bureau of Statistics measure. China continues to dominate Australia’s trade in goods and services, while the US and UK dominate direct investment and portfolio flows.

Chart 4 – Exports by Destination

The labour market shows solid employment growth, but with the unemployment rate ending the 2016-17 year almost steady at 5.7%. Average earnings growth on a national accounts basis has been at multi-decade lows, consistent with the global trend to subdued wages growth despite firming labour markets. The combination of low inflation and low productivity has weighed on wages growth.

Chart 5 – Unemployment Rate
2. Outline of the Securities Markets

2.1. Price Trends of Equities

The S&P/ASX 200 price index rose 9.3% through the 2016-17 year, underperforming US and global share price indices, while the corresponding total return index (including reinvested dividends) was up 14.1%. With a year-end index value of 5,721, the market was still left trading well below its all-time highs.

The Australian equity market shared in the global trend to lower volatility, with the S&P/ASX 200 VIX measure of volatility averaging lower levels than in 2015-16. Average domestic market capitalisation rose 9.8% to $1,747 billion. The primary market saw a 24.8% decline in cash equity raisings, although the number of companies with quoted securities rose 1.8% to 2,051. The daily average of value traded on ASX and Chi-X rose 13.8% to $6.8 billion while the daily average number of trades rose 22.3% to 1.6 million. A record 1.7 million trades were matched on 9 November 2016 as Donald Trump was elected President of the United States. Average trade size continued to fall, to stand at $4,134.

ASIC reported in August 2016 that the Australian equities market exhibits a high level of market cleanliness and fares well by international comparison. ASIC’s ‘Review of Australian equity market cleanliness’ found that insider information and the loss of confidentiality ahead of material announcements has declined over the last decade.

Australia continues to have one of the world’s highest rates of share ownership. One of the key findings from the ASX sponsored ‘Australian Investor Study 2017’ is that 37% of adult Australians (6.9 million people) hold investments available through a financial exchange – up slightly on the 36% from the last survey in 2014.
2.2. Trends in Interest Rates

The Reserve Bank of Australia lowered its official cash rate by 25 basis points at its August 2016 Board meeting to a new record low of 1.5% as inflation remained below the 2-3% medium-term target range, helping set the tone for the short-end of the Australian yield curve to start the year.

Chart 8 – Cash Rate

Australian government bond yields trended higher into the end of calendar 2016 and peaked in mid-March 2017, reflecting trends in global debt markets, before declining...
into the end of the financial year. The 10-year bond yield began the year at 1.96% rose to peak just under 3.00% before ending the year at 2.6%. The yield curve followed a similar pattern, steepening into March 2017 before flattening again to end the year at 78 basis points on the 10-year/2-year spread.

Research by the Australian Office of Financial Management suggests that the secular decline in Australian government bond yields has primarily been driven by a falling term premium, a trend also seen in overseas bond markets. The term premium is estimated to have been negative over 2016-17, implying investors do not see additional risk in investing in long-term versus short-dated Australian government debt securities.

2.3. Activity Levels in the Markets for Stocks and Bonds

Trading activity on the principal secondary market for equities, the ASX, increased by 3.5% versus 2015/16 to just under $1.25 trillion while on the secondary market, Chi-X, turnover rose by 13.6% to $295.2 billion. Overall secondary market turnover rose 5.3% to $1.542 trillion. With an average domestic market capitalisation of $1.747 trillion, the overall market liquidity ratio was 88%.

According to the AOFM, turnover in Australian Treasury Bonds for 2016-17 was $1,079,057 million. Turnover in Treasury Indexed Bonds was $42,082 million. Governments and corporates maintained strong issuance profiles for government and non-government debt securities.

Chart 9 – Bond Issuance
3. Prospects for the Securities Industry

3.1. Equities Market Infrastructure

The ASX is planning for the replacement of the system that underpins post-trade processes of Australia’s cash equity market, known as CHESS (the Clearing House Electronic Subregister System), which is over 20 years old. The replacement program is an important element of ensuring that ASX’s core clearing and settlement infrastructure for cash equities meets international best practice, and that its performance, resilience, security and functionality continue to meet the needs of its users.

ASX announced in January 2016 that it had selected a vendor, Digital Asset Holdings (DAH), to develop a potential CHESS replacement based on a private ‘permissioned’ distributed ledger technology (DLT) system. Working with DAH, ASX has developed a working prototype of the DLT system. ASX has engaged in a market-wide consultation process to ensure it understands what users want from a replacement system, and that it meets the highest security, resilience and performance standards. ASX is on track to make an assessment on the suitability of DLT technology towards the end of 2017.

3.2 Financial Institution Culture Regulation

The Australian financial regulators have heightened their focus on the operating culture of financial institutions. The Government is strengthening the powers of the Australian Prudential Regulation Authority (APRA) through the introduction of the ‘Banking Executive Accountability Regime’ (BEAR) announced in this year’s Federal Budget. The regime strengthens APRA’s abilities to impose civil penalties and dismiss bank executives for poor conduct, and requires a significant share of executives’ incentive remuneration to not vest for at least four years. Under the regime, accountable executives must be appointed in relation to an authorised deposit taking institution’s (ADI) banking business, as well as non-banking business.

Another stream of work in this area is a proposal to strengthen ASIC’s power to ban individuals from providing financial services. Currently, ASIC can prevent a person from providing financial services (for example, where the individual has breached a financial services law) but cannot prevent them from managing a financial firm. Nor can ASIC remove individuals involved in managing a firm that may have a culture of non-compliance. The Government is consulting on proposals to ensure that ASIC can take appropriate action to ban senior managers from managing financial services businesses.

3.3. Professional Standards for Financial Advice

The Government has established the Financial Advisers Standards and Ethics Authority (FASEA) to implement the statutory professionalism framework for retail financial advisers that will commence from 1 January 2019. Board members and a CEO were appointed during the year. FASEA has announced that its first task will be to develop a framework for accrediting providers of approved degrees for new industry entrants.

3.4 Industry Professionalism Initiative

The financial markets industry in Australia has a long standing program through AFMA to support professionalism in financial markets and to promote a positive industry culture. Australia’s financial markets are fundamentally sound have performed well in serving their economic purpose of facilitating efficient capital allocation. Nonetheless,
having regard to the evolving nature of the industry and a general desire to address any emerging weaknesses, AFMA has been leading an industry initiative to strengthen the collective industry processes to further the objective of professionalism. The statutory framework referred to in 3.3 only applies to retail financial advice and not more broadly to financial markets.

The initiative takes account of the official sector’s statements on industry culture, both in Australia and in key overseas jurisdictions, and broader stakeholder expectations of fair and efficient financial markets. The key components were settled after an extensive consultation process with members during the year and include:

- A Professionalism Committee to centralise senior oversight of AFMA’s professionalism activities in relation to conduct standards processes and accreditation/training.
- Conduct standards that provide more extensive guidance on what constitutes good market practice. The standards will appropriately reflect international best practice, where this has been set out as an accepted standard.
- AFMA accreditation of individuals in our industry that incorporates more extensive and better designed conduct training, including guidance on market practice given in AFMA’s conduct standards. In addition, the pathways to satisfy technical competencies will be opened up.

Implementation of the professionalism program is now being progressed.

3.5. FX Global Code of Conduct

The FX Global Code of Conduct, launched in May 2017 has been well received in the Australian market. The FX Code’s guidance applies to the everyday conduct of business in the FX market and will support the integrity and effectiveness of the market. The Deputy Governor of the Reserve Bank of Australia was one of the main architects of the Code. The FX Code aligns well with AFMA’s a program of work to support the professionalism of business in Australia’s financial markets.

3.6. Industry Funding of Regulators

The Government has introduced new laws that change the way ASIC is funded by requiring industry participants to fund ASIC’s operations. The rationale for an industry funding model is to provide greater stability and certainty in ASIC’s funding, and to ensure that it is adequately resourced to carry out its regulatory mandate.

Regulated entities have been categorised into 48 subsectors across all corporate entities subject to the Corporations Act, auditors, insolvency practitioners, credit licensees, Australian financial service licensees, market operators and participants, and other regulated entities and individuals. ASIC’s regulatory costs will be allocated among these subsectors through either a flat levy or a graduated levy, or a combination of the two. In 2017–18, about 64% of ASIC’s total budgeted resources of $388 million will be recovered through levies on industry.

3.7. Interest Rate Benchmark Developments

Australia is well placed with the framework for interest rate benchmark reform that the the Financial Stability Board has provided. Australia has established a risk free rate (the
cash rate) and is improving the conditions that support an effective bank bill swap rate (BBSW) benchmark, which is the principal interest rate benchmark.

The Government has introduced legislation to implement a new regulatory framework for benchmarks that is consistent with the IOSCO Principles for financial benchmarks and is similar to new overseas regimes in important respects.

Effective 1 January 2017, ASX became the administrator of BBSW, which had previously been produced by AFMA. This followed a very competitive request for proposal process that began in July 2016, after AFMA had announced its intention to divest the business. BBSW has been drawn from live executable market prices since 2013. ASX is continuing work already underway to further strengthen the BBSW methodology by calculating it from a wider set of market transactions using a volume weighted average price method.

3.8. Bank Regulation

In July, the Australian Prudential Regulation Authority (APRA) announced the additional capital required for Australian authorised deposit-taking institutions (ADIs) to be considered ‘unquestionably strong’. The major banks will need to target a Common Equity Tier 1 capital ratio of around 10.5 per cent by January 2020 (based on the current capital framework), while the effective increase in capital requirements for smaller ADIs will be around 50 basis points. APRA also announced that it intends to set new capital standards, expected to become effective from 2021, that will include minimum requirements consistent with these benchmarks.

Much of the work aimed at building resilient financial institutions through the Basel III capital and liquidity reforms, has been undertaken but not all aspects are complete. In August, APRA released a discussion paper on the standardised approach for measuring counterparty credit risk.

APRA has also released the final version of its prudential standard on the margining requirements for non-centrally cleared derivatives. This is a significant business issue for industry participants.

APRA made several important adjustments to the rules based on submissions made by AFMA including the exclusion of physically settled FX from both the initial margin and variation margin requirements and a clear statement on acceptability of substituted compliance. Under the standard, compliance with the margining requirements of foreign authorities listed in the standard – such as those in the European Union, Japan or United States – will satisfy APRA’s margining requirements in some cases (‘substituted compliance’).

3.9. Technology

In May, the Government announced several new measures to facilitate development of the fintech sector, such as reducing barriers for new entrants into the banking sector and proposed legislation to provide an enhanced ‘regulatory sandbox’.

Meanwhile, the financial regulators are working on a comprehensive stocktake of the cyber risk landscape in the financial sector, drawing on supervisory information and industry liaison, as well as information from cyber-focused bodies and programs.