Country Report for Australia

November 2016

Executive Summary

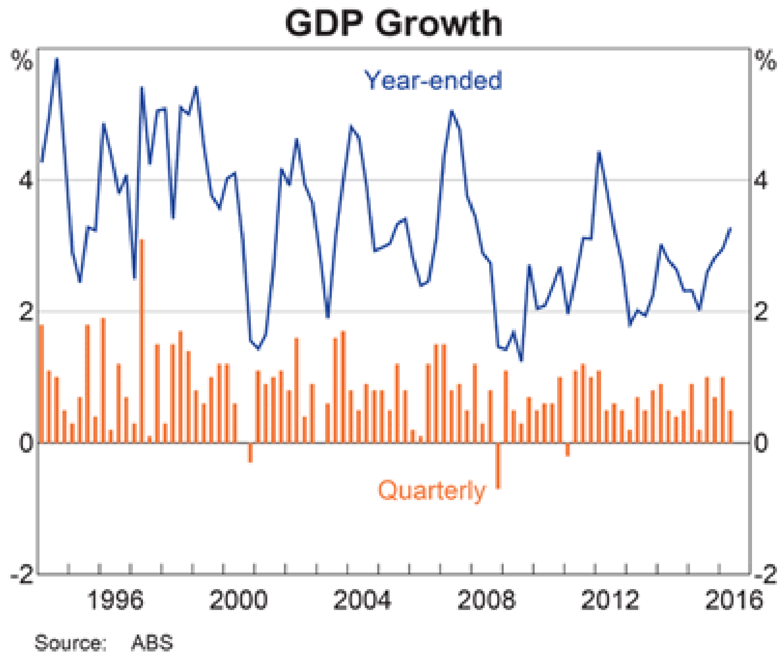
This report is divided into three sections covering economic developments and the outlook, the performance of financial markets and other factors affecting prospects for financial markets in Australia. The report covers developments over the 2015-16 financial year period, unless otherwise stated.

1. The Economy

1.1. Economic Growth

The Australian economy continues to perform strongly within an uncertain global environment, with gross domestic product (GDP) up 3.3% for the year to 30 June 2016, which is an increase from the annualised growth for the July 2015 quarter of 2.0% and representing the best annualised GDP growth figures since 2012. Importantly, another year of positive annual growth in 2016 meant that the Australian economy has grown continuously for 25 consecutive years. This growth comes at a time when the Australian economy transitions from heavy reliance on mining to increased focus on services exports, particularly for financial services.

Chart 1 – Australian GDP Growth



The Table below sets out statistics from the Reserve Bank of Australia in relation to the components of Australia's GDP growth for the year to March 2016.

Table 1 – Components of Australia's GDP Growth

Component	March 2016	December 2015	Year to March 2016
GDP	1.1	0.7	3.1
Consumption	0.7	0.8	3.0
Housing Investment	1.4	2.8	7.0
Mining Investment	-2.5	-9.6	-26.7
Non-Mining Investment	-3.7	1.0	-4.7
Public demand	0.6	1.4	3.5
Exports	4.4	0.4	6.6
Imports	-0.8	0.5	-2.0
Mining activity	4.8	-3.7	0.7
Non-mining activity	0.4	1.5	3.6

Low interest rates and the depreciation of the Australian dollar as a trend since 2013 has supported housing investment, consumption and export capability, necessary at a time when mining investment is falling considerably.

Australia's central bank, the Reserve Bank of Australia, has forecast growth to remain around 2.5% - 3.5% through to June 2017, and then to increase to 3.0% - 4.0% to December 2018. Such forecasts are predicated on a number of assumptions, including lower than average growth for Australia's major trading partners, particularly those in Asia, a relatively stable or potentially downward trending cash rate, relatively stable unemployment and our exchange rate trending around current levels, such as AUD1:USD0.77.

1.2. Political Developments

The key political development over the year was the Federal election held on 2nd July 2016. The election saw the coalition between the Liberal Party of Australia and the National Party of Australia returned, albeit with a significantly reduced majority and a bare majority of 76 seats in the 150 seat House of Representatives. The primary opposition party, the Labor Party, holds 69 seats while the remaining 5 seats are held by minor parties or independents.

This was the first election contested by the incumbent Prime Minister, Malcolm Turnbull and Treasurer, Scott Morrison, who took control from Tony Abbott and Joe Hockey respectively in mid-2015 through a ballot of the Liberal Party caucus. The election saw a 3.1% swing against the Government nationally in the House of Representatives

Of greater concern is the composition of Australia's upper house, the Senate, which is Australia's house of review. Due to an impasse on what the Government believed to be key legislation, the entire Senate was up for election as opposed to the conventional half-senate. As a result, the composition of the Senate is now that the Government controls only 30 of the 76 seats, Labor holding 26, the Greens (who have historically voted with Labor and would be expected to continue to do so) holding 9 seats and minor parties/independents holding 11 seats. Given that 39 votes will be required to secure passage of legislation, the Government will need to negotiate with 9 of the 11 "cross-bench" senators to allow for legislation to be passed where there is not bipartisan support, and this presents a major challenge for the Government.

The Government anchored its economic policy position to a reduction in the Australian company tax rate from 30% to 25% over a ten-year horizon. It would appear that the enabling legislation for such a reduction to occur is unlikely to pass both houses of Parliament without significant negotiation, and perhaps not at all.

1.3. The Industry

The financial and insurances services sector grew 5.3% in real terms between June 2015 and June 2016, outperforming real GDP growth of 3.3% over the same period. The financial and insurances services sector has the largest output share of the twelve industries making up the market sector of the Australian economy, with a 10.3% share of the total gross value add. Employment in the financial and insurance services sector rose by 40,900 to 434,300 over the year, making up 3.6% of total employment.

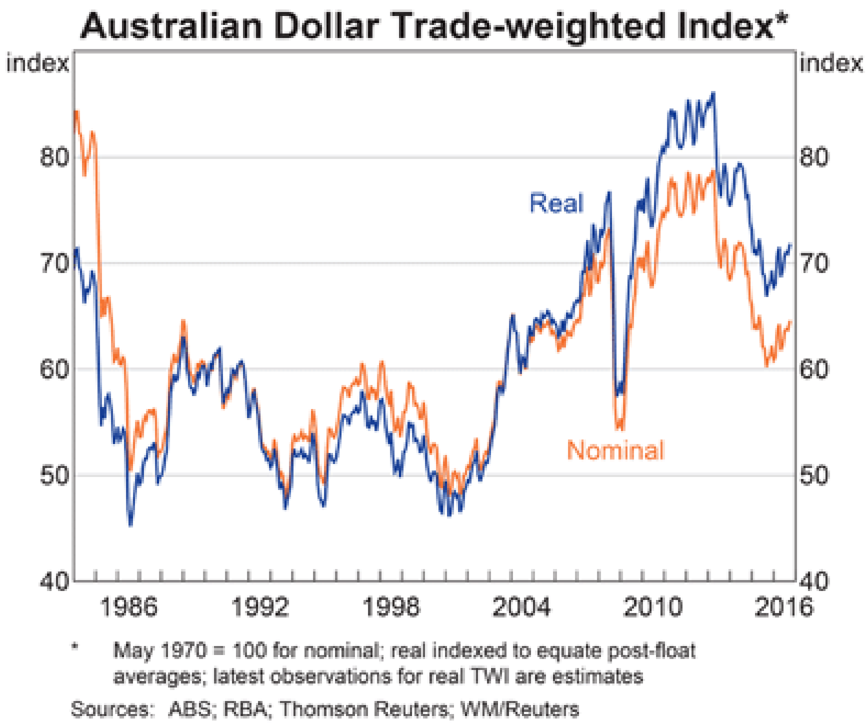
1.4. Exchange Rates

The Australian dollar exchange rate underperformed against most major currencies during the course of 2015-16, with the exception of the UK pound sterling, which fell sharply with the Brexit referendum result towards the end of the financial year.

Reductions in the Reserve Bank of Australia's official cash rate and a narrowing in the 10-year bond spread to the United States undermined the AUD's yield appeal. Commodity prices also weighed in the second half of 2015, although recovered in the first half of 2016, offering the AUD some support into financial year end.

Total foreign exchange turnover in the spot, forward and swap markets increased by 6% in the 2015-16 year compared to the previous year.

Chart 2 – AUD TWI

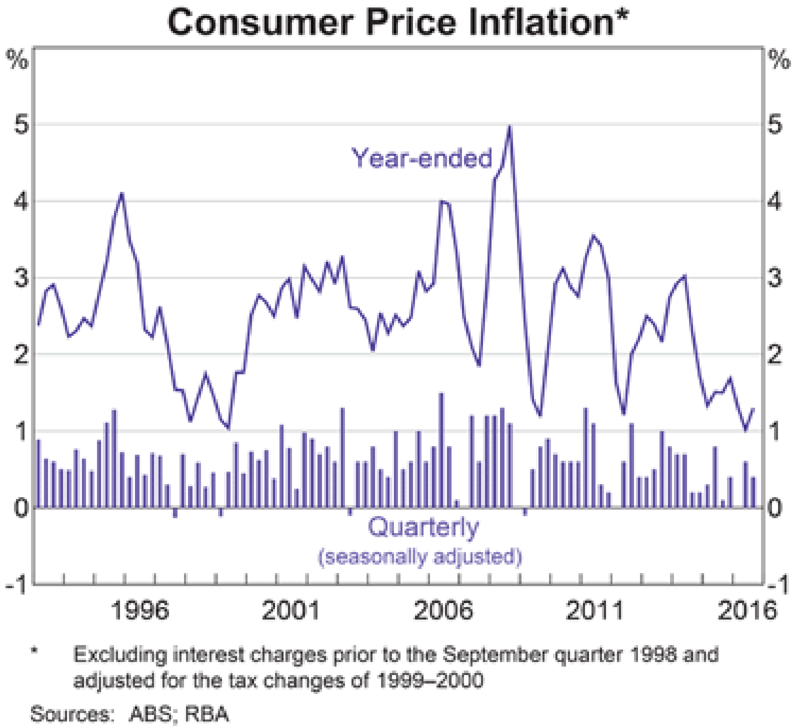


Source: Reserve Bank of Australia

1.5. Inflation

Annualised inflation, as measured by the Consumer Price Index (CPI) was 1.3% as at September 2016. This is below the Reserve Bank of Australia's target band of 2 – 3 per cent.

Chart 3 – CPI



A number of factors have resulted in low inflation, including spare capacity in the labour market driving down wage growth, together with enhanced competition in a number of markets. In addition, high investment in dwellings has caused rental inflation to plateau. As a result, inflation expectations have declined over the past year.

1.6. Government Finance, Balance of Payments and the Labour Market

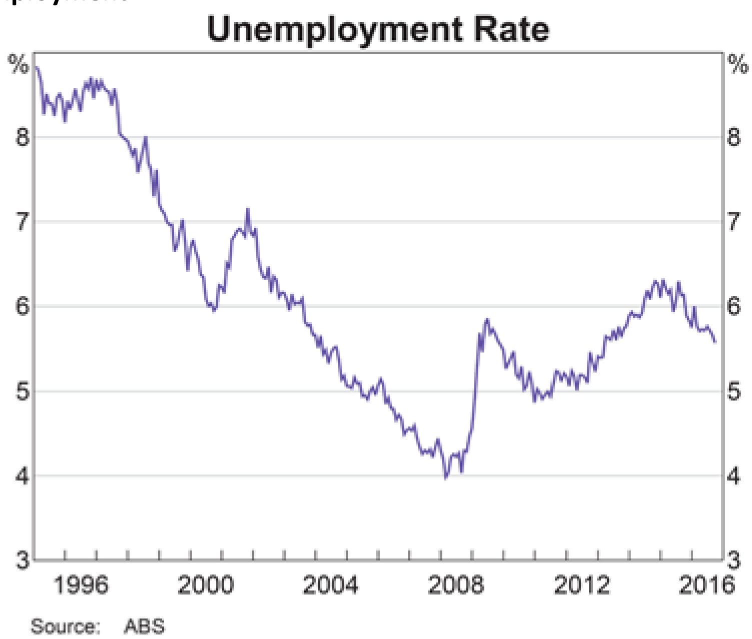
The Australian Government has projected a continuing budget deficit, currently at $39.9 billion or 2.3% per cent of GDP. This is expected to reduce from 2017/18, after a projected $37.1 billion deficit for the 2016/17 year, with a return to surplus not expected until the 2020/21 year. The fiscal position of the Australian Government is underscored by a net debt position of 16.9%, which has been increasing steadily since Australia has been running consistent deficits in the time since the Global Financial Crisis.

Export growth has remained strong in both the mining and non-mining parts of the economy, underpinned by the relatively weak Australian dollar. Given the reduction in mining investment, the continued upwards trajectory of mining exports would appear to be in jeopardy and the Australian Government is actively pursuing initiatives to promote the exports from other sectors of the economy, particularly services exports. China and Japan remain the largest export destinations, with South Korea featuring prominently as a large destination.

Chart 4 – Exports by Destination

The unemployment rate has remained at around 5.75%, which is around half a percentage point lower than at the end of the 2014/15 financial year. Employment growth has been slow, with forward indicators of future employment rates and trends being somewhat mixed. To the extent that there is a further reduction in the unemployment rate, this should eliminate some of the spare capacity in the labour market, thereby placing upwards pressure on wage growth.

Chart 5 – Unemployment



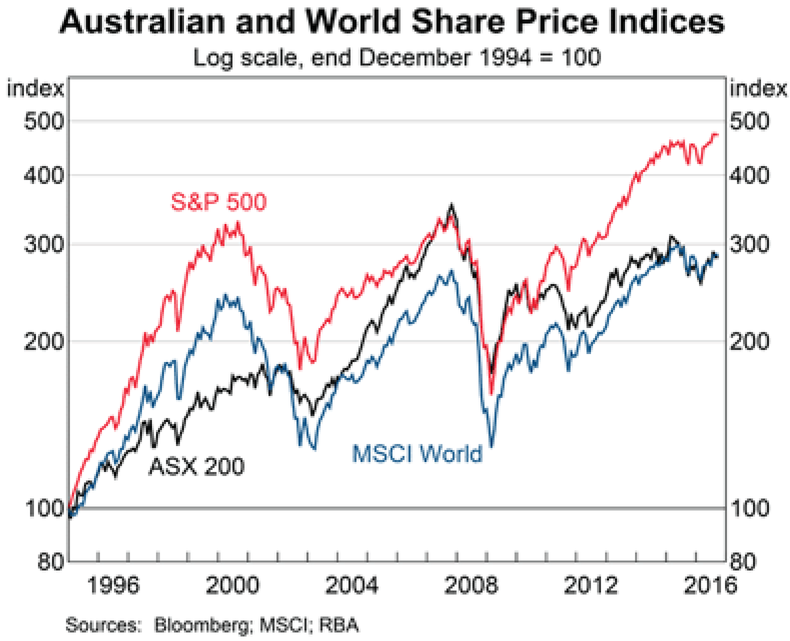
2. Outline of the Securities Markets

2.1. Price Trends of Equities

The 2015/16 financial year was a quiet one for Australian equities, with an increase of just 0.6% in the benchmark S&P/ASX 200 Accumulation Index. This is broken down by a 4.1% fall in the price index, which was offset by compounded dividends paid throughout the year.

Over the 2015-16 financial year, returns from Australian equities generally tracked those of world markets, as shown by the extent to which the performance of the benchmark ASX 200 mirrors the MSCI World Index, but the local bourse continues to underperform US equities on a total return, local currency basis.

Chart 6 – Australian Share Prices v US and Global

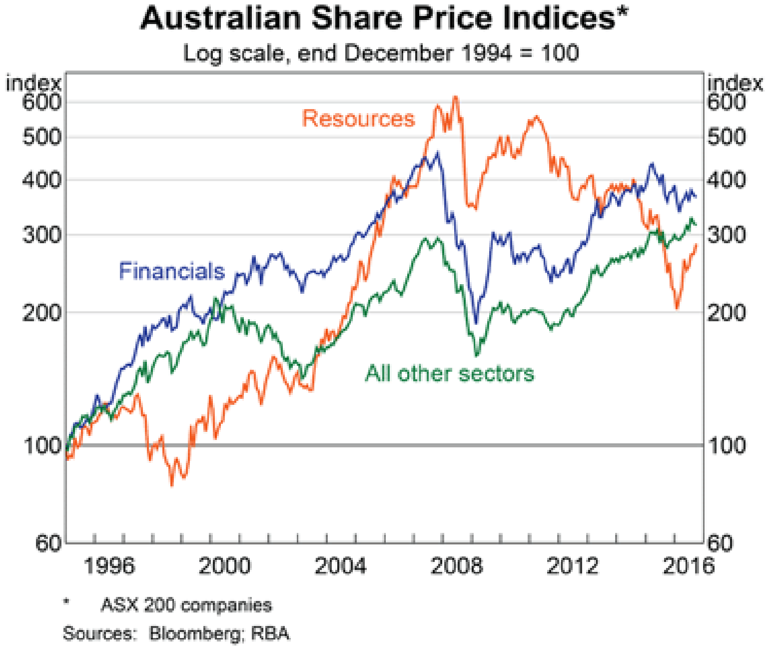


Global

Source: Reserve Bank of Australia

During the financial year, implied volatility peaked in August 2015 and February 2016, coinciding with the lows in the index. Generally speaking volatility was lower than in 2014-15.

Chart 7 – Australian Share Performance by Sector

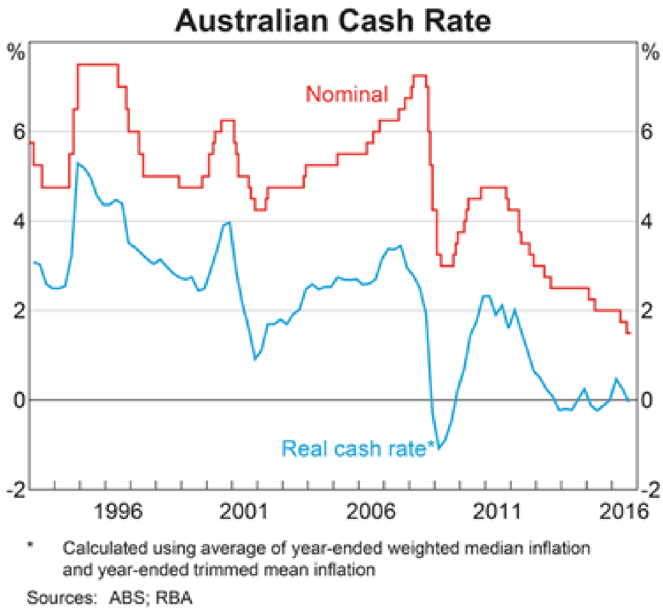


The reduction in mining investment referred to above was reflected by a comparative weakness in resources stocks over the course of the year, relative to financial stocks and also stocks from other sectors. The weakness in Australian resources stocks was also underpinned by low commodity prices, particularly in relation to iron ore.

2.2. Trends in Interest Rates

During the course of the 2016 calendar year, the Reserve Bank of Australia followed the trends of other central banks in cutting Australia's bash rate by 50bps from 2.00% to a record low 1.50%; a 25bp reduction in May 2016 followed by a further 25bps reduction in August 2016.

Chart 8 – Cash Rate



Source: Reserve Bank of Australia

Australian Government bond yields trended lower over the course of 2015-16, in line with a global decline in long-term interest rates, underscoring the fact that Australian interest rates are largely determined by global markets.

Issuance of Australian government securities remained strong, with the Australian government continuing to run underlying cash deficits in excess of 2% of GDP, such that net government debt rose to 17.3% of GDP. Issuance of Australian Treasury bonds capitalised on the current low-interest rate environment by being skewed to the long end of the curve, with a weighted average term to maturity of 6.6 years. A new 20 year bond futures contract was introduced on the ASX in September 2015, reflecting an extension in the duration of the physical bond market.

2.3. Activity Levels in the Markets for Stocks and Bonds

Trading activity on the principal secondary market for equities, the ASX, increased by 8.2% versus 2014/15 to just over $1.2 trillion while on the secondary market, Chi-X, turnover rose by 10.6% to $259.9 billion. Total market capitalisations were static over the course of the year. Trading in the derivatives market was mixed with growth in futures trading being offset by reductions in equity options, in relation to which trading was down 19%.

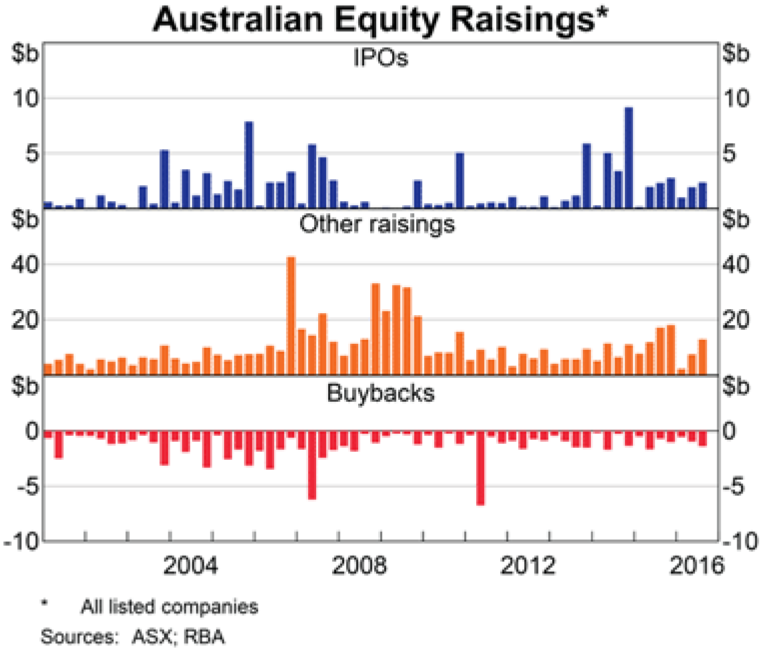
Trade volume continued to surge upwards. A daily average of 928,829 trades were effected on the Australian Securities Exchange (ASX) over the year, which was up 24% per cent from the previous year.

Government debt securities turnover rose by 28% over the course of the year, with a 31% increase in Commonwealth government securities offset by a 13% decrease in foreign government securities. Corporate fixed income securities exhibited a reduction in turnover of 11.1%.

2.4. Activity Levels in Equity and Debt Capital Markets

The value of initial public offerings in Australia during the 2015/16 year fell 39.4% to $23.6 billion, following an outstanding year in 2014/15. However, there was a 3% increase in the number of new entities listed in the financial year, up to 124. The largest initial public offerings came from the financial, consumer staple and information technology sectors. Secondary market raising rose more than 16.8% to $45.3 billion, driven largely by Additional Tier-1 requirements for Australia's banks.

Chart 9 – Australian Equity Raisings



Source: Reserve Bank of Australia

Link Administration Holdings Limited had the highest capitalisation of new IPOs with $2.3 billion, while the National Australia Bank's demerger of CYBC Plc created the largest new listing for the year with a market capitalisation of $2.8 billion.

3. Prospects for the Securities Industry

3.1. OTC Derivatives Market Reform

AFMA continues to drive OTC Derivatives Market Reform and the implementation of global reforms in Australia. AFMA engaged heavily with the Australian Government prior to the July election to ensure the passage of a Resilience and Capital Protection Bill, providing legislative certainty for the mandatory margining of non-cleared OTC derivatives in a manner consistent with global requirements, and also supports global harmony with respect to the close-out rights under certain market transactions.

The derivatives transaction reporting regime continued to create implementation challenges and needed reduction of compliance costs. AFMA persuaded the Government to allow for single-sided reporting for smaller derivatives, thereby eliminating duplication of the compliance burden, and also obtained large scale transitional relief on derivatives trade reporting.

3.2. BBSW Initiatives and Benchmark Rate Regulation

The past year has given rise to a significant number of developments in relation to Australia's interest rate benchmark, the Bank Bill Swap Rate (BBSW), both in terms of the development of the benchmark and also AFMA's involvement as the administrator of BBSW.

In July 2016, AFMA advised the conclusion of a process to refine the methodology under which BBSW is to be determined. Australia's regulators had requested that AFMA finalise amendments to the BBSW methodology. AFMA announced that, commencing as soon as practicable, BBSW would primarily be set based on a Volume Weighted Average Price (VWAP) of trades in eligible bank paper, conducted between 9:00am and 10:10am each morning. In addition, there would be a waterfall of other methodologies to the extent that the VWAP methodology could not be utilised to determine a BBSW rate across any tenor, being firstly the National Best Bid Offer (NBBO) methodology and then, failing that, an algorithmic calculation drawing on relevant pricing information. This methodology is in the course of being implemented, and is expected to be operational by mid-2017.

Secondly, also in July 2016, AFMA announced that it would step away from being the administrator of BBSW and was to undertake a competitive process to externalise its AFMAdata business. Such an externalisation would allow AFMA to focus on its core mission of policy advocacy and supporting development of Australia's financial markets. The AFMAdata externalisation process is progressing well and AFMA is hopeful of being in a position to announce a new administrator in coming weeks.
In October 2016, the Government announced that benchmark administration would become a regulated activity, with the regulatory regime applicable to benchmark administrators to commence by 1 January 2018.

3.3. Financial Market Infrastructure

3.3.1 T+2 settlement

AFMA initiated a project in early 2015 to reduce the settlement cycle of domestic fixed income products from T+3 to T+2. This move was supported for risk management and balance sheet reduction reasons, as well as aligning the Australian market with international standards. Shortening the cycle for fixed income also complemented the ASX's introduction of T+2 settlement for cash equities. In a co-ordinated effort, the fixed income and equities markets of Australia and New Zealand went live with T+2 settlement on 7 March 2016.

3.3.2 ASX24 Platform

The ASX24 (futures) trading platform is being replaced. Go-live is currently scheduled for the second half of February 2017, after originally being planned for April 2016.

3.3.3 ASX Significant Outage

ASX suffered a significant outage in its equities trading platform in August 2016. The platform failed over to the backup system but not all functionality successfully failed over, leading to multiple knock-on effects. ASX's vendors indicated that this type of failure had not been seen before and initially could not replicate the sequence of events. ASX is now resolving with its providers whether an upgrade or a more significant release (i.e. a package of multiple fixes) is required.

3.3.4 Distributed Ledger for CHESS

During the year, ASX both invested an equity stake in and announced a joint venture with Digital Asset Holdings to build replace its clearing and settlement platform, currently referred to as the CHESS platform, with distributed ledger (blockchain) technology. This work has progressed over the year and AFMA has attended demonstrations of the technology. It is not that the ledger is proposed to be a closed loop, as opposed to being publicly available and verifiable.

3.3.5 CHESS Replacement

The ASX has also undertaken a consultation in relation to the replacement of CHESS more broadly. The consultation is high-level and short on detail in terms of timing and costings. AFMA supports any developments that promote innovation and efficiency in the markets.

3.4. Implementation of Prudential Reforms

As the global Basel III reforms have solidified over the year, the implementation of the new capital and liquidity reforms in Australia by the Australian Prudential Regulation Authority (APRA) has continued to be refined, with the focus of local implementation of the Basel III requirements focussing on liquidity. In that light, AFMA has been engaging with APRA in relation to the Net Stable Funding Ratio and particularly foreign ADI liquidity. Again, AFMA has stressed the need for global compatibility.

3.5. Industry Funding of Regulators

AFMA has engaged with the Government's August 2015 consultation on the proposed industry funding for ASIC. AFMA highlighted the additional burden that industry funding would impose on the financial sector and the proposed model's incompatibility with the Government's objectives to lower the corporate tax burden and promote innovation in financial services.

The Government released a revised model for public consultation in November 2016 and AFMA continues to engage in dialogue with the Government in relation to refinements to the model.

3.6. Exchange Market Reform

The Government has recently re-committed to its policy position that the provision of clearing and settlement services in Australia is open to competition. To clarify the standards expected of entities engaging in such services, the Government released two policy statements in October 2016 clarifying the regulatory expectations for conducting equity clearing and settlement services and minimum conditions for holding clearing facility licences. These requirements are proposed to apply to the incumbent provider of services in Australia, the Australian Securities Exchange (ASX).

3.7. Regulation of Retail Financial Markets

AFMA has actively participated in the Government consultation process to develop a statutory professional standards framework for retail advisers, including detailed commentary on education matters.

In addition, in April 2016 the Government announced an accelerated law reform agenda flowing from the Financial System Inquiry, particularly in relation to enhancement of the retail corporate bond market, the proposed product design and distribution obligation for product manufacturers and a proposed ASIC product intervention power.

3.8. ASIC Reviews Market Cleanliness

In August 2016, ASIC released a report on the cleanliness of the Australian Equity Market. The report showed that from November 2005 to October 2015, there was an improvement in market integrity, based on a reduction in anomalous trading activity and price movement ahead of the release of sensitive information. That is, the report suggests that insider information and the loss of confidentiality ahead of material announcements has declined over the decade. The report also mentions that the Australian market ranks favourably in terms of cleanliness when compared to other developed equities markets.