Country Report for Australia

November 2019

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 2018-19 June financial year period, unless otherwise stated.[1]

1. The Economy

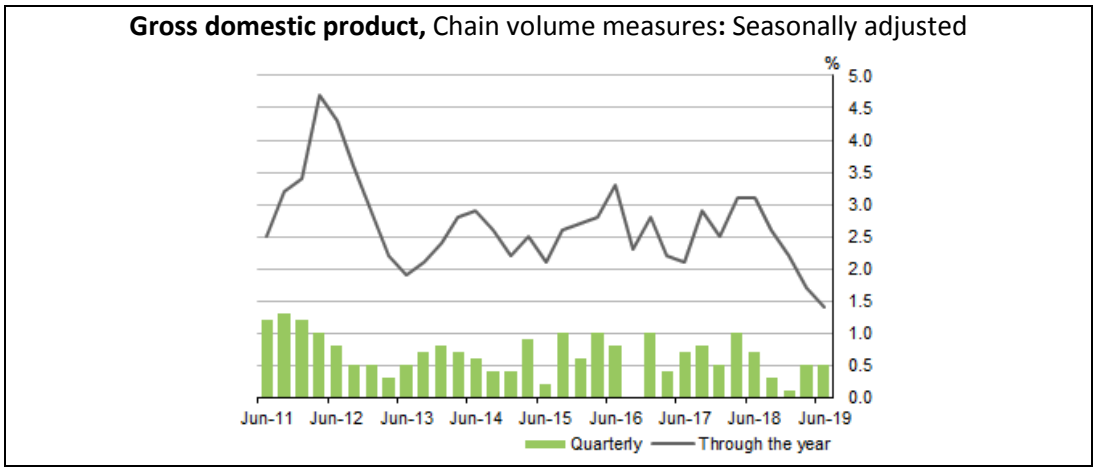
1.1. Economic Performance and Growth

The Australian economy completed a remarkable 28th consecutive year of economic growth in 2018-19, although the pace did moderate. The fundamentals of the economy remain solid and Australia maintained its AAA credit rating.

Real GDP grew by 1.4 per cent through the year to end-June 2019. Growth over the second half of the year was stronger than in the first half, suggesting that growth moderation in the economy may have reached a turning point at end-2018.

In year-average terms, real GDP grew by 1.9 per cent in 2018-19. Nominal GDP growth of 5.3 per cent in year-average terms for the 2018-19 year was slightly above the Commonwealth Government's budget forecast for the period.

Chart 1



Source: Australian Bureau of Statistics (ABS)

The economic outlook is supported by several policy-driven factors including lower interest rates, the recent tax cuts and a depreciation of the Australian dollar. In addition, significant infrastructure investment, improved investment in the resources sector and stabilisation of the housing market will all support economic growth.

[1] This Report does not incorporate information that became available after 1 October 2019.

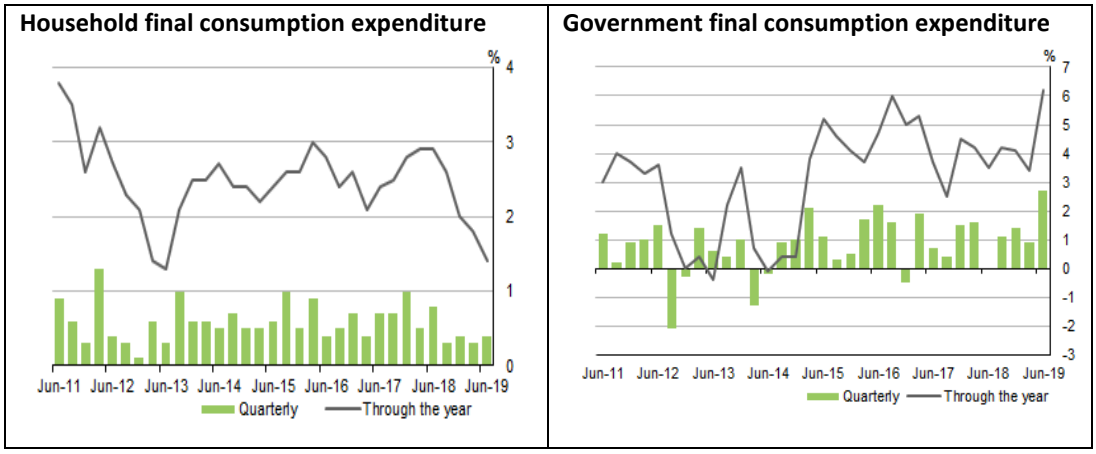
The major uncertainty to economic growth conditions was and continues to be the trade and technology disputes between the United States and China, which are considered to pose a significant risk to the global economy. Australia is an open economy and its economic prospects are impacted by the global economic conditions and outlook.

Consumption

Household consumption, which comprises just under 60 per cent of GDP, was subdued and recorded growth of 1.4 per cent over the course of the year. The growth was modest across most categories of consumption but discretionary items were most affected. There was no growth at all in per capita consumption, despite employment growing strongly.

The Reserve Bank of Australia (RBA) has suggested that an important part of the explanation for the softening of private consumption growth is that household disposable income has been only increasing slowly for an extended period, reflecting both subdued wage increases and strong growth in taxes paid.[2] Another factor in household expenditure decisions that RBA identified was the correction in the housing market and this weakness also affected the economy through its impact on residential construction activity. Drought conditions across significant parts of Australia, with consequences for farm output and incomes, has also contributed to weaker consumption growth.

Chart 2



Source: ABS

In contrast to household consumption, government final consumption expenditure remained strong through the year at 6.2 per cent. State and local government consumption expenditure was the main contributor to growth with increases in both employee expenses and non-employee expenses. National non-defence consumption expenditure also contributed to growth with continued spending on disability and aged care services.

Investment

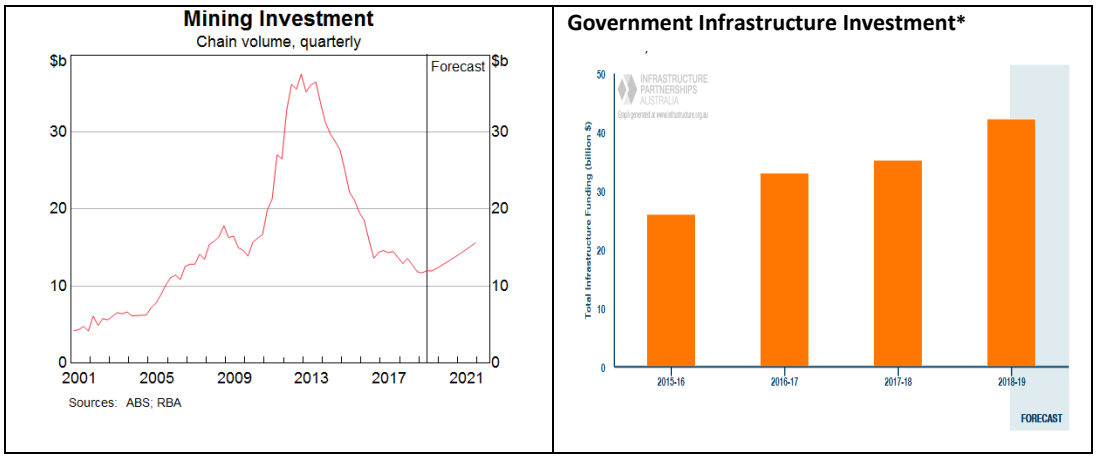
Investment has benefited from a pick-up in infrastructure investment in recent years. Notable aspects include development of new transport facilities in cities and private

[2] See https://rba.gov.au/speeches/2019/sp-gov-2019-09-24.html. Note - the commentary in this section draws on RBA published analysis and national accounts data issued in September 2019.

sector renewable projects and there is a good pipeline of planned infrastructure projects. The growth of non-mining investments eased in 2018-19 but from a solid base. Mining investment was affected by the wind-down of significant projects but it is expected to pick up over the next year or so.

Housing investment fell by just over 3 percent over the year as the residential property market was weak. There is a reduced pipeline of work on residential projects, though it is still at a high level and conditions in the housing markets stabilised recently.

Chart 3



** Infrastructure Partnerships Australia data for total general government sector infrastructure funding committed to in each budget year as well as forecasts of funding over forward estimates.*

Company profits were 12.5 per cent higher through the year, assisted by strong mining profits.

Labour Market

A point of economic interest has been the robustness of labour market data relative to GDP growth, with employment growth of 2.5 per cent being recorded during the year. There has been a large increase in labour supply with a material lift in the labour force participation by women and by older Australians. Thus, the unemployment rate was 5.25 per cent at end June 2019, which was similar to its level the year before.

Overall, living standards continue to increase with real net national disposable income per capita rising by 2.7 per cent through the year.

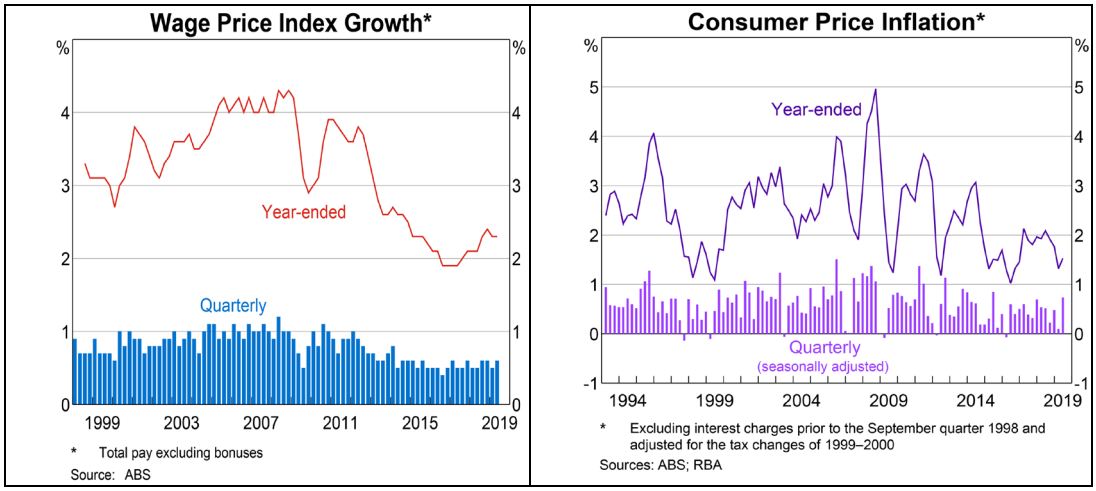
Inflation indicators

Over the year to June 2019, the Wage Price Index increased by just 2.3 per cent, with public sector wages rising at a slightly higher rate.

The relatively low wages growth contributed to low consumer price inflation, which was 1.6% in both headline and underlying terms over the twelve months to June 2019. There was a range of other factors at play such as the impact of the drought, the ongoing spare capacity in the economy and a lower exchange rate on the one hand and lower increases in utility costs and rents on the other.

This outcome extends the period over which inflation has been below the RBA's 2–3 per cent medium-term target range.

Chart 4



Balance of Payments and International Trade

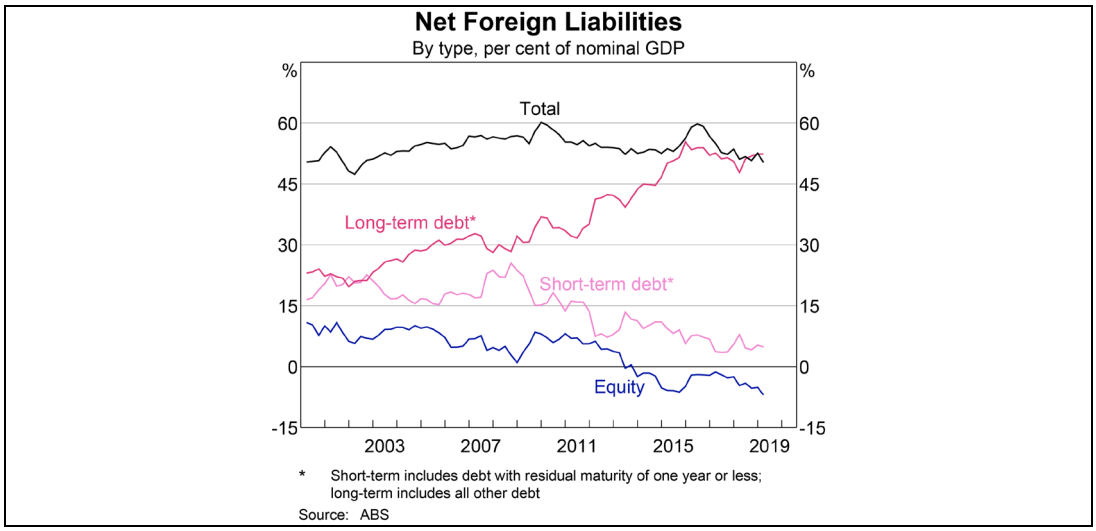
The Government has recently noted that Free Trade Agreements now cover over 70 per cent of Australia's two-way trading relationships.

Australia's service and manufactured exports have performed well in recent years, benefitting from the economic expansion of major trading partners and by a lower Australian dollar. A notable factor promoting service export growth has been increased tourism and education earnings, with the number of overseas students studying in Australia increasing markedly. Another noteworthy development is the strong growth in manufactured exports, including pharmaceutical goods and medical devices.

The growth in import volumes eased over the last year, largely because of more subdued growth including in investment which is relatively import intensive.

Against the above backdrop, a milestone development in the June quarter of 2019 was the recording of a current account surplus for the first time since 1975.

Chart 5



On the capital account, a notable development is that, since 2013, Australian equity investment abroad exceeds foreign equity investment in Australia – now by 7 per cent of GDP. This compares to an average net equity liability position of 10 per cent of GDP between 1990 and 2010.[3] Foreign investors remain a vital contributor to Australia's economic development. For example, the foreign ownership of the large mining companies is around 75 per cent.

Australia has also experienced significant growth in net debt liabilities, which currently are 52 per cent of GDP and there has been a large shift from short-term debt to long-term debt over the last decade.

1.2. Political Developments

In August 2018, Australia welcomed its 30th Prime Minister, Scott Morrison. A national election was held on 18 May 2019, with the ruling Liberal/National Party coalition led by Mr Morrison returned to government with a small majority.

The Government's tax policy agenda going into the election was modest and largely reflected in its Budget announcements, with the focus on personal tax relief over a ten-year horizon, particularly targeted towards low and middle-income earners. The Budget also incorporated a scheduled return to surplus in 2019-20 and includes significant funding increases for the financial regulators.

The financial services industry was a focal point for all political parties before and during the federal election. The industry traditionally receives significant political scrutiny and this was greatly accentuated consequent to a Royal Commission being held into misconduct by financial services providers, which focussed on retail financial services (discussed in more detail in Section 3 below). Both the Government and opposition Labor Party agreed to implement the Royal Commission's recommendations and the Government's immediate policy priority for financial services is to have the necessary legislation introduced by end-2020.

1.3. The Financial Services Industry

Australia's financial services sector is the largest contributor to the national economy, accounting for about 9 per cent of GDP. It has been a major driver of economic growth and employs 450,000 people (3.5 per cent of total employment) and its productivity growth has been well above that for the economy.

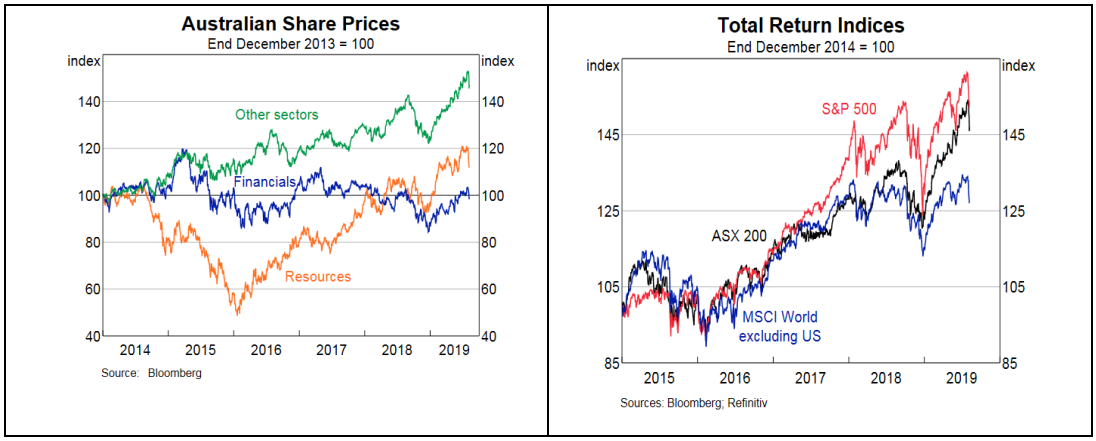
[3] For more detail see - https://www.rba.gov.au/speeches/2019/sp-dg-2019-08-27.html

2. Outline of the Securities Markets

2.1. Equities Markets

The ASX 200 index had a poor start over the first six months of 2018-19 but staged a significant recovery in 2019. By end-September 2019, it was over 20 per cent higher than its trough towards the end of 2018. This movement was broadly in line with overseas markets (see Chart 6). All the main sectors benefitted from the lift in share prices. The ASX 200 reached a record high at the end of July, before uncertainty related to the US–China dispute led to some price falls.

Chart 6



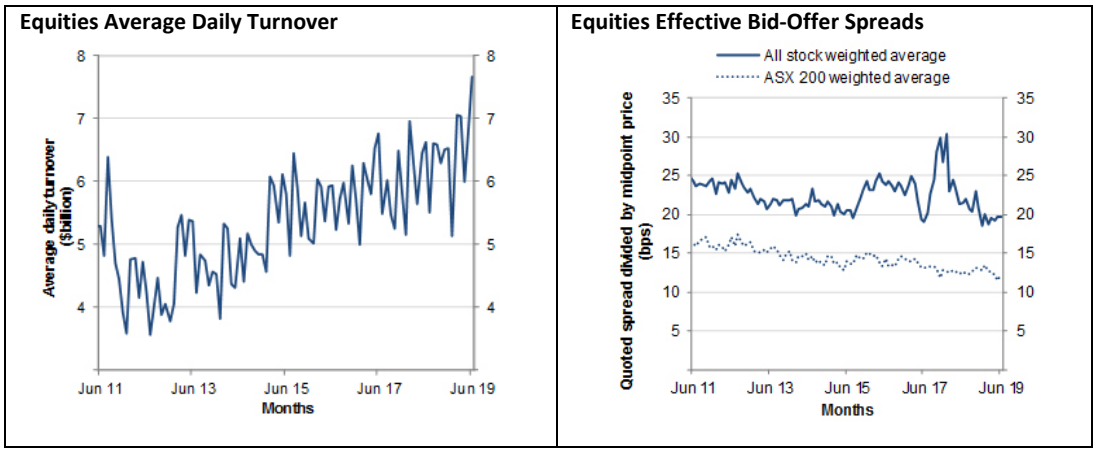
Charts sourced from RBA's website.

Total turnover on the share market recorded a robust increase in 2018-19 (see Chart 7), rising by over 10 per cent. The June 2019 quarter set a monthly record for market activity with $7.67 billion value traded per day – this compares to the previous record of $6.14 billion in June 2107. Trading in ASX equities futures increased by a healthy 16 per cent in 2018-19.

The quoted spread for the S&P/ASX 200 index decreased to 12 bps of the midpoint price over the June 2019 quarter, compared to 12.5 bps in the previous year.

In the June 2019 quarter, the ASX accounted for 82.5 per cent of the total dollar turnover in the share market and Chi-X accounted for the remaining 17.5 per cent.

Chart 7

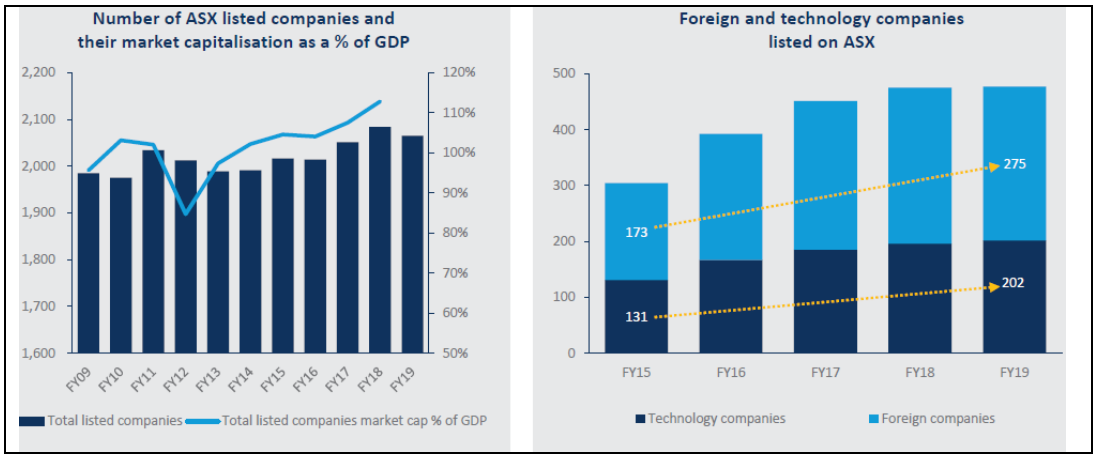


Charts sourced from ASIC's website.

Initial capital raised on ASX increased by 46 per cent in 2018-19 compared to the previous year. This was offset to some extent by reduced secondary capital raisings and total capital raised rose by 5% to $86 billion.

The number of listed companies in Australia has been generally increasing, with total capitalisation of ASX as a percentage of GDP growing steadily since 2012 (see Chart 8). The average listed company is becoming larger and the listed market remains very sizable and relevant. Over the last five years the listed technology sector has grown materially from 1.3% to 3.4% of the market by value. There were 202 tech companies at the end of FY19, with 13 of them capitalised at over a billion dollars.

Chart 8



Source – Australian Securities Exchange (ASX)

Australian Securities and Investments Commission (ASIC) Report 623, issued on 31 July 2019, provided solid evidence that the Australian equities market exhibits a high level of market cleanliness and fares well by international comparison. The findings recorded in the Report will help to maintain user confidence in the market and its participants. The outcome is consistent with the findings of ASIC's previous research and reflects the ongoing commitment of resources by market participants to a fair and efficient market and a thorough approach by ASIC to market surveillance and enforcement.

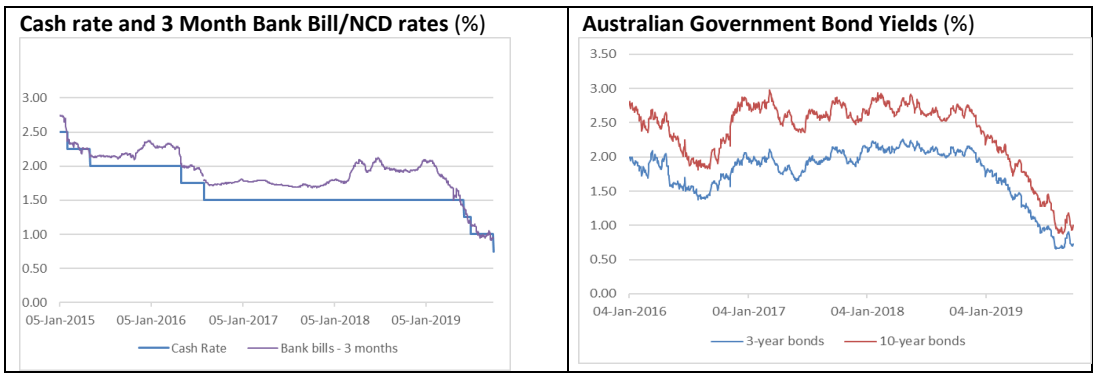
2.2. Interest Rate Markets

The Reserve Bank maintained the cash rate target at its August 2016 setting of 1.5 per cent before lowering the rate by 25 basis points in both June and July 2019. On 1 October, the RBA Board further lowered the cash rate by a further 25 basis points to 0.75 per cent.

Like other central banks, RBA is responding to global and domestic economic downside risks by lowering interest rates. While the economy has been through a soft patch recently, RBA expects a return to around trend growth over the next year. The October cut is to promote more assured progress towards both full employment and the inflation target.

Reflecting the economic conditions and subdued expectations, yields on 10-year Australian Government Securities (AGS) fell to 1.32 percent at end-June 2019, from 2.63 per cent a year earlier. The yield eased a further 30 basis points by end-September. Shorter dated government bonds exhibited a similar downward trend in yields.

Chart 9 – Cash Rate



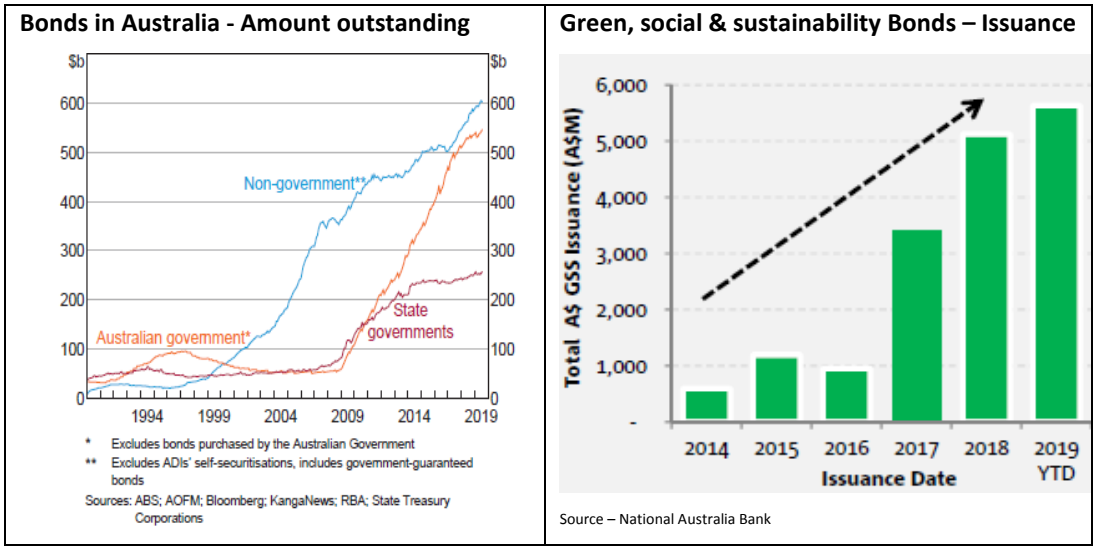
Source – Derived from data published on RBA's website that includes ASX and Yieldbroker rates.

Annual turnover of ASX bond futures contracts rose by 8 per cent in 2018-19 and turnover of short-term interest rate futures was higher at 11 per cent over this period.

In relation to OTC interest rate derivatives, the Bank for International Settlements (BIS) Triennial survey found that, in April 2019, turnover in Australia averaged US$97 billion per day, compared with US$56 billion per day in 2016. To provide context, global turnover in OTC interest rate derivatives rose even more sharply, by 240 per cent. Turnover in interest rate swaps in Australia increased by 63 per cent over the period and accounted for 86 per cent of all turnover in OTC interest rate derivatives. More than half of the average daily turnover of all interest rate swaps was due to turnover in overnight index swaps (OIS).

The pace of issuance by Australian governments declined as had been expected over 2018-19, reflecting the narrowing in the Commonwealth government budget deficit. Overall, there was a modest 2.2% increase in government bonds outstanding over the year to end June 2019. Issuance by non-government entities in the Australian market was relatively strong, primarily due to an increase in bank and asset backed outstandings of 12.5 per cent and 10.9 per cent respectively. Bank issuance eased back in the first half of 2019, whereas issuance of asset backed securities picked-up.

Chart 10



Throughout 2019, Australian credit and non-government bond markets have been influenced by geopolitical risks, including trade tensions, Brexit and concerns over Iran. Nevertheless, the Australian market has witnessed a solid flow of issuance in 2019.

Well in excess of a $100 billion of credit securities and Kangaroo bonds has been raised in the first 9-months of 2019 and with a heavy redemption schedule in the fourth quarter, total issuance for the year is expected to substantially higher. Issuance from financial institutions continues to dominate the Australian market accounting for approximately 60% of total supply. Diversity of foreign issuers has been a feature of the second half of the year with financial offerings from Europe, North America and Asia.

The increasingly dovish Australian interest rates outlook prompted investors to extend duration in their hunt for yield. Credit spreads have tightened throughout the year and, generally, the Australian market has outperformed equivalent offshore markets, so domestic and offshore issuers were able to achieve competitive pricing.

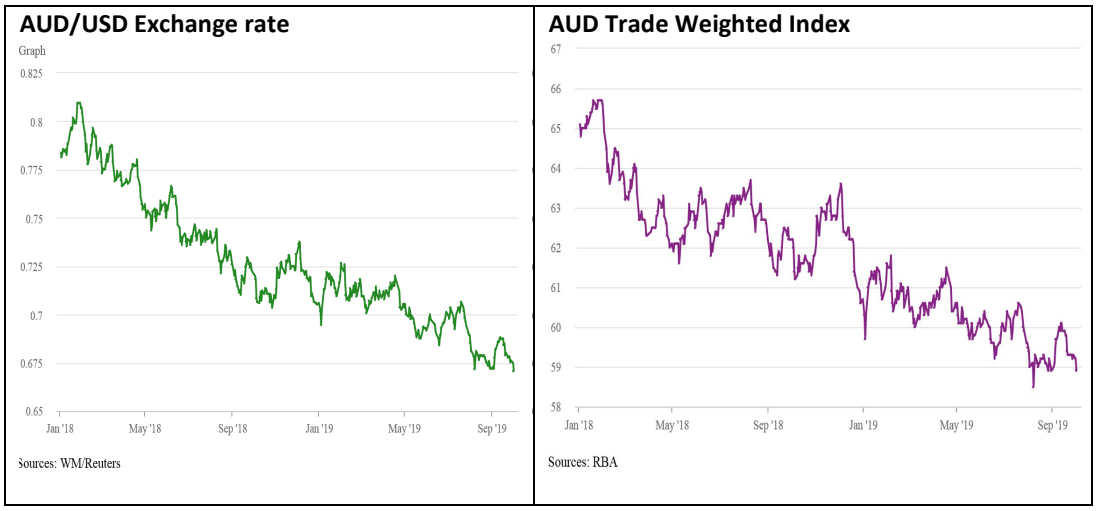
The Australian sustainable-finance market continues to grow rapidly, with the issuance of green, social and sustainability bonds in the AUD market for the 9-months to end-September 2019 now over $5.6 billion; exceeding last year's record issuance of $5.1bn.

RBA has observed that the announcement by Australian Prudential Regulation Authority (APRA) that it would require major banks to increase their total capital by 3 percentage points by January 2024 is likely to reduce the need for banks to issue senior unsecured debt for a time. It is considered likely that this additional capital will be sourced from issuance of Tier 2 hybrid instruments.

Other Markets

- **Foreign Exchange**

Chart 11



The BIS Triennial survey reported an increase in FX spot turnover in the Australian market of 24 per cent between 2016 and 2019, consistent with the global increase. Activity in the Australian outright forwards market increased by 57 per cent but turnover in foreign exchange swaps decreased by 19 per cent in the Australian market, in contrast to a 34 per cent increase in global swap turnover.

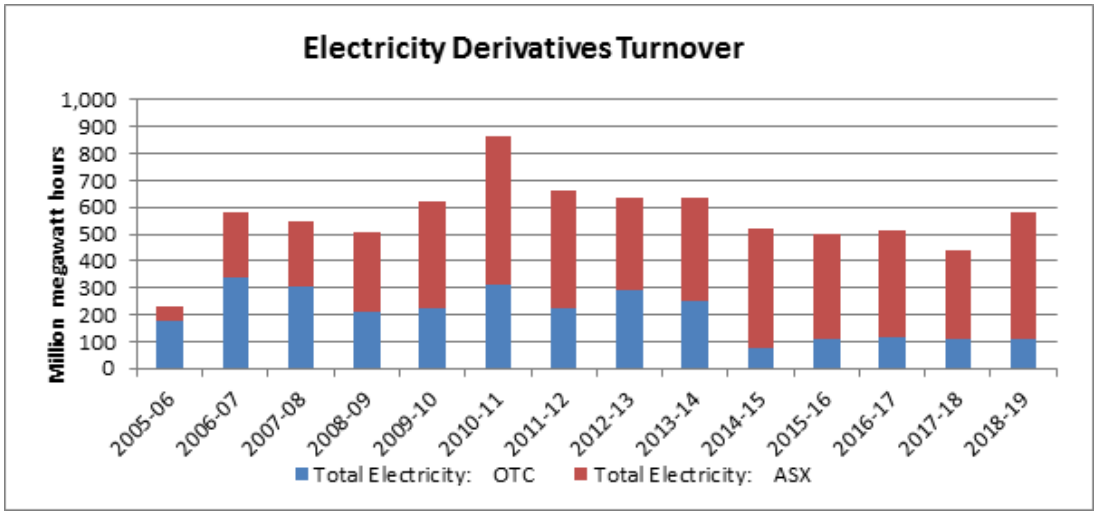
The AUD/USD currency pair remained the fifth most actively traded currency pair in global terms and the AUD share for all transactions was 7 per cent of global turnover.

In terms of exchange rate changes, the Australian dollar (AUD) depreciated to 70 cents at end-June 2019 from USD 74 cents a year earlier (see Chart 11). The AUD further depreciated to USD 67 cents by 1 October, when the cash rate cut was announced, which is its lowest level in some time. The trade weighted index also fell in value to a moderately lesser extent.

- **Electricity Derivatives Market**

AFMA compiles and publishes the 'AFMA Electricity Derivatives Turnover Report', which provides annual turnover data for the exchange and OTC electricity derivatives markets for 2018-2019 and earlier years.

Chart 12



Total electricity derivatives turnover (OTC and exchange) increased by 32 per cent in 2018-19 from the previous year, to 584 million megawatt hours.

The increase recorded was attributable entirely to the exchange market. The OTC market turnover declined by almost 1 per cent, though there were significant differences in the outcomes at state level across the national electricity market. More than half the OTC derivatives turnover was a period greater than 12 months.

3. Prospects for the Securities Industry

The financial services industry is in a rapidly evolving environment that is being shaped by regulatory reforms, the development and application of new technology and changing business practices. This section covers a selection of related items that may be of interest to Asia Securities Forum members.

3.1. Royal Commission into the Australian Financial Services Industry

The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services industry, announced by the Government in November 2017, was a dominant force in shaping industry regulation over the last year. The Commission focussed on retail financial services including banking, financial advice and insurance and released its report in February 2019. Both the Government and main opposition party agreed to implement its recommendations as a priority.

The Report sets out general rules to support widely understood norms of business conduct, including the following:

- The law must be applied and its application enforced;
- Industry codes should be approved under statute and breach of key promises made to customers in the codes should be a breach of the statute;
- Intermediaries should act only on behalf of, and in the interests of, the party who pays the intermediary;
- Culture and governance practices (including remuneration arrangements) both in the industry generally and in individual entities, must focus on non-financial risk, as well as financial risk.

The Commission found that the primary responsibility for misconduct in the financial services industry lies with the entities concerned and their boards and senior management. Consequently, it said close attention must be paid to culture, governance and remuneration practices. In this regard, the Commission recommended that:

- All financial services entities should review at least once a year the design and implementation of their remuneration systems for frontline staff,
- All financial services entities should, as often as possible, review their own culture and its governance, identify and deal with any problems identified and determine whether the changes made have been effective.

The Commission made recommendations concerning the financial regulators and their approach to regulation. Notably, it recommended that the 'twin peaks' model of financial regulation should be retained. Selected specific recommendations include:

- ASIC's approach to enforcement should commence with consideration of whether a court should determine the consequences of a contravention;
- APRA should have as one its aims for supervision of remuneration, the sound management by APRA-regulated institutions of not only financial risk but also misconduct, compliance and other non-financial risks;
- APRA should set limits on the use of financial metrics in connection with long-term variable remuneration;
- Establish a new oversight authority for APRA and ASIC, independent of government, to ensure they are carrying out their responsibilities.

One outcome of the Commission will be the adoption of senior manager accountability regulatory regimes for all financial entities, not just banks, and more formal constraints on remuneration arrangements for risk takers in prudentially regulated entities.

The Government has set out a road map to have legislation introduced to implement the Royal Commission's recommendations by end-2020. Both ASIC and APRA have received significant additional funding and new powers and their respective corporate plans prioritise implementation of recommendations of that impact them. Coupled with other changes, including a large in increase in penalties for misconduct, the net outcome is a significant tightening of regulation for all financial services activities.

3.2. Industry Professionalism Developments

3.2.1 FASEA Regime

The Government established the Financial Adviser Standards and Ethics Authority (FASEA) to raise the education, training and ethical standards of financial advisers. The standards require financial advisers to:

- complete a FASEA-approved exam;
- hold a *specified* bachelor's degree or equivalent qualifications;
- undertake continuing professional development;
- comply with a Code of Ethics; and
- be a member of an ASIC-approved code monitoring scheme.

The Government announced in August 2019 that it will legislate to provide additional time for existing advisers to meet new qualification and examination requirements set by FASEA. The previous timeframe presented practical challenges and this flexibility will increase the capacity of firms to maintain the provision of financial advice to investors during the transition period. FASEA training requirements are designed specifically to meet the needs of individuals who provide personal financial planning advice.

3.2.2 AFMA's professionalism program

AFMA's professionalism program for the financial markets is the outcome of a member consultation process and dialogue with the financial regulators conducted in 2017. Revisiting professionalism on a first principles basis, three key tasks emerged:

i. *Conduct standards* – More guidance on good market practice through conduct standards for firms, developed with member and regulator engagement and incorporating global practice;
ii. *Accreditation and training* – More comprehensive and better designed conduct components of accreditation of individuals and more flexible pathways to satisfy technical competencies;
iii. *Governance* – A Professionalism Committee to provide oversight to AFMA's activities in relation to conduct standards processes and accreditation/training.

Solid progress has been made on each of these fronts, with a predominant focus on the wholesale markets. AFMA's Professionalism Committee provides strategic guidance on conduct standard setting and accreditation activities, so they provide a practical and achievable way of meeting the expectations of market participants, regulators and the broader community.

AFMA's strategy in implementing the professionalism program draws on the capability of member firms and their employees. The strength of the program is its focus on delivering timely and well-targeted measures that substantively embed professionalism in the way business is done in financial markets. We have quickly moved forward from a discussion about high-minded professionalism principles to implementing practical supporting actions and achieving material outcomes.

For example, when it was agreed that the **conduct training** component of accreditation needs to be expanded, AFMA promoted and became involved in the setting of government Vocational Education Training (VET) competencies for business ethics in financial services. AFMA then built a course to teach these competencies, which it began to deliver in March 2019. The course satisfies the new VET sector competencies and gives the students functional tools to help them make the correct decision if faced with an ethical dilemma. AFMA's Board has determined all new and existing accredited individuals must demonstrate these competencies to retain their accreditation.

In relation to **conduct standards**, the Professionalism Committee approved an internal policy for the development of conduct standards. Amongst other things, it includes a provision to incorporate a discussion with the financial regulators if the Conduct Standard being considered is likely to have significant industry impact or is materially relevant to financial regulation. Applying the procedures set out in the policy for the development of conduct standards, AFMA developed and released the Swap Reference Price Transactions guidance.

Australian industry participants and regulators take account of international industry codes and standards for wholesale markets, where relevant. For example, AFMA has endorsed the FX Global Code (FXGC) and maintains the Australia register of FXGC Statements of Commitment. ASIC recently sought to examine banks adoption of specific principles in the FXGC in a targeted review of banks. Reflecting on this but taking account of similar developments overseas, there is greater interest in industry on the extent to which regulators may reference wholesale industry codes in their activities.

3.3. Interest Rate Benchmark Developments

The key Australian interest rate benchmarks are the Bank Bill Swap rate (BBSW)[4] and the RBA cash rate. Reforms have been undertaken to enhance the robustness of these benchmarks.

BBSW is a credit-based benchmark which measures the cost for highly rated ('prime') banks in Australia to issue short-term bank paper for each monthly tenor between one month and six months. Australia has an active Negotiable Certificates of Deposit (NCD) market, where the major banks issue NCDs as a regular source of funding, and a wide range of wholesale investors purchase them as a liquid cash management product. The market has successfully evolved such that price determination is principally by reference to transactions between investors and banks, with the interbank market now having a lower profile. In May 2018, the calculation process for BBSW switched from a best bid-offer methodology to reliance primarily on a Volume Weighted Average Price (VWAP) methodology.

[4] While referred to as the 'bank bill swap rate', the instruments traded on the underlying market have been predominantly NCDs for many years now.

There is close cooperation between the financial regulators, ASX as the administrator of BBSW and market participants to ensure that BBSW remains robust. Consistent with the desire for prudent risk management of benchmark risks, the need for which is highlighted by global IBOR developments, AFMA is collaborating with other Australian industry associations to strongly encourage market participants to document securities and loans referencing BBSW with the necessary fall-back provisions embedded in documentation as soon as it is practical to do so.

The risk-free benchmark for the Australian dollar is the cash rate, which is administered by the Reserve Bank and calculated as the weighted average interest rate on unsecured overnight loans between banks. The cash rate is the Reserve Bank's operational target for monetary policy. The cash rate is also known by the acronym AONIA (AUD Overnight Index Average) in financial markets.

AONIA is not a replacement for BBSW but complements international developments where fixed income markets are seeking to implement near risk free reference rates as alternatives to IBOR rates (interbank offered rates). The development of the market referencing AONIA as benchmark is nascent. The South Australian Government Financing Authority became the first Australian issuer to print a deal linked to AONIA, when it launched a new transaction for a 1-year AONIA Linked FRN in June 2019.

3.4. Equities Market Infrastructure and Technology

3.4.1 CHESS Replacement Project

The Clearing House Electronic Sub-register System (CHESS) is the ASX computer system used to record shareholdings and manage the settlement of share transactions. ASX is replacing CHESS with a new system based on Distributed Ledger Technology (DLT). The project is applying DLT as an enabling technology in a financial markets context, which is pioneering and is attracting global attention. The replacement system will include a permissioned, private DLT system. The DLT component consists of a shared, replicated ledger and a distributed database synchronising mechanism, where initially only ASX and clearing and settlement members would be authorised to participate and ASX is the only permissioned writer to the ledger.

This is a major undertaking that involves complex technical and business challenges. The project will use the Digital Asset Platform and Digital Asset Modelling Language, or DAML, which is a coding tool specifically designed for distributed ledgers. The targeted go-live for the new CHESS system is March-April 2021.

The system is expected to provide some market efficiencies through the elimination of messaging and manual processes to ensure the integrity of databases and industry standardisation across databases. ASX states that the DLT replacement of CHESS will deliver customers:

- real-time data and data that can be verified as true without messaging ASX;
- a secure environment for permissioned users; and
- the ability to cross-connect with other customers and automate work flows.

The development and application of DLT will also enable ASX to offer new services to equity market users such as data analytics and opportunities to leverage machine-based learning capabilities.

Stockbrokers and other market participants have a large amount of work to do to adapt systems and processes to the updated system currently being implemented. AFMA provides a forum for market participants to discuss the practical issues that present and to provide input that should assist ASX in delivering the project.

3.4.2 Technology and Regulation

The Australian financial system continues to be dynamic and innovative, with technology being applied to open the way for new products and services and presenting opportunities to improve the efficiency of the financial services industry. AFMA's members are leaders in this change process, as providers and users of new services.

The adoption introduces new operating and regulatory challenges. Cyber-security threats – such as data breaches, system disruptions and financial system attacks – and information security are a major concern for both businesses and regulators

Government regulators are active in responding to these concerns and this is a material aspect of the industry's development. For instance, ASIC's focus has been on addressing technology, security and operational failures by implementing new market integrity rules on technology and operational resilience for market operators and participants of listed securities and reviewing risk controls of market intermediaries.

There is significant ongoing engagement between industry and regulators on these matters and the Australian Council of Financial Regulators plays a coordinating role for regulators. One focus of cyber security work by the Council in the period ahead will be aligning financial sector efforts with broader initiatives, including those of the Australian Cyber Security Centre.

3.5 Retirement Income Review

On 27 September 2019, the Government announced a review into Australia's Retirement Income System. The review will cover the current state of the system and how it will perform in the future as Australians live longer and the population ages. Given the scale and continued growth of superannuation savings, the Review could have implications for the future development of financial markets in Australia.

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