

Country Report for Australia

November 2018

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 2017-18 June financial year period, unless otherwise stated.¹

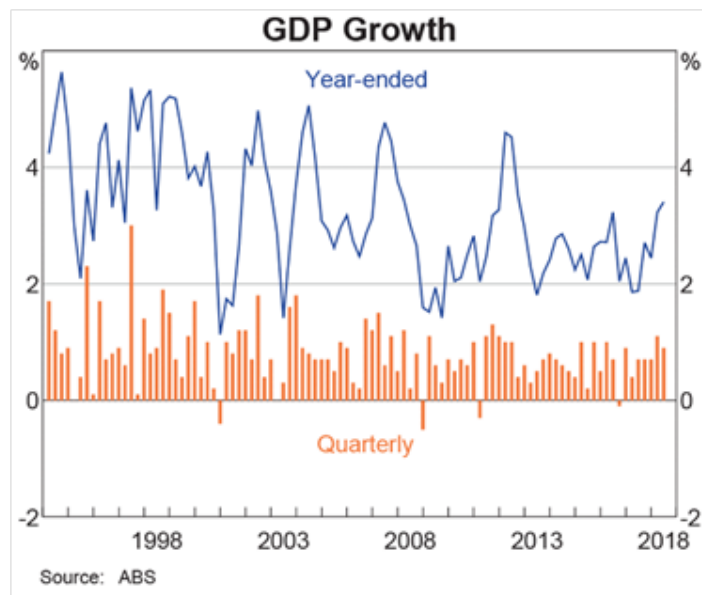
1. The Economy

1.1. Economic Performance and Growth

The Australian economy grew 3.4% over the 2017-18 financial year, including 2.0% growth in the latter two quarters of the financial year. Positive growth for the financial year means that the Australian economy has now gone 27 years without a recession (defined as two consecutive quarters of negative growth), and remains one of the longest economic expansions on record anywhere in the world. GDP per capita rose 0.5% over the year with population growth running at 1.6% in the year to March 2018, the same as recorded in 2017. Australia's population exceeded 25,000,000 for the first time in August 2018.

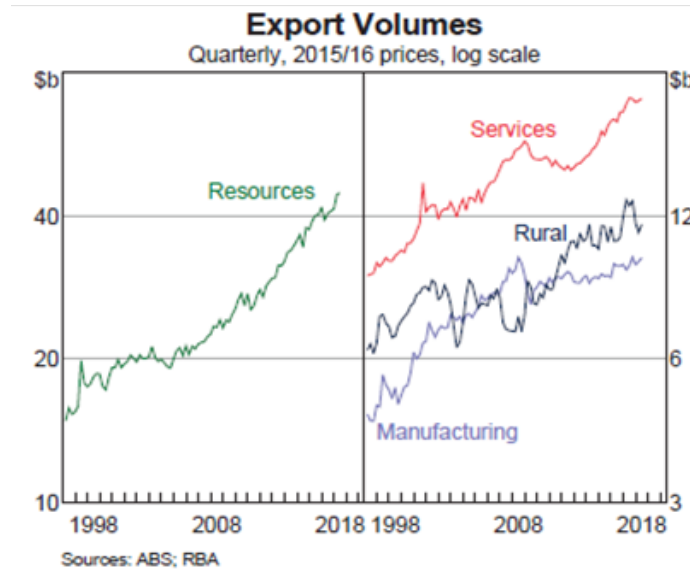
The Reserve Bank of Australia predicts that GDP growth in 2019 will be between 3.0% and 3.25%.

Chart 1 – Australian GDP Growth



¹ This Report does not incorporate information that became available after September 2018.

Chart 2 – Australian Export Volumes



In summarising its predicted economic outcomes for the 2018-19 financial year and beyond, the Reserve Bank of Australia noted:

- Australia’s terms of trade have held up well given strong demand for Australian steel, particularly from China. This demand is expected to decrease moderately over the medium term;
- Australia is currently experiencing a significant drought in certain areas, which has led to mixed results and outlook for the agricultural sector;
- Resources exports remain a strong contributor to the Australian economy, and will do so in the medium term until the effects of a reduction in mining investment come through;
- Business conditions remain positive with strong investment in the non-mining sector. Private and public infrastructure investment is strong, as is investment in machinery and equipment.

1.2. Political Developments

In August 2018, Australia welcomed its 30th Prime Minister, Scott Morrison, who replaced the incumbent Malcolm Turnbull. This was not due to a national election but rather a change of leader of the ruling party, the Liberal Party of Australia, which governs in coalition.



The change of Prime Minister is the latest chapter in an unprecedented period in Australian politics; from 2010 Australia has changed Prime Minister on five occasions, but only once as a result of an election – the other four occasions due to a change in the leader of the ruling party.

Australia will have a further election on or before May 2019. Currently, the Liberal-National coalition government holds a slim majority of 76 out of 150 seats in the House of Representatives. The main opposition party, the Labor Party, holds 69 seats while the remaining 5 seats are held by minor parties or independents. The Government does not hold a majority of seats in the Senate, which is in a position to reject or amend legislation. The Government controls only 30 of the 76 upper house seats.

During the course of the 2017/18 year, the Government tried, and failed to pass legislation reducing Australia’s corporate tax rate from 30% to 25% for all companies over a ten-year horizon. The legislation was passed only in relation to companies with a turnover of less than AUD 50 million. As a result, Australia is expected to have a two-tier tax system in the future.

1.3. The Financial Services Industry

Employment in the sector increased from 433,500 in May 2017 to 456,600 in August 2018. The sector remains the largest industry in the market sector of the Australian economy, providing 9.5% of GDP and has outperformed in terms of multi-factor productivity growth over the last 25 years.

1.4. Exchange Rates and Foreign Exchange Volumes

Over recent years the Australian dollar has benefited from high interest rates relative to those in other advanced economies, however the gradual unwinding of very accommodative monetary policy settings by some central banks and which is unlikely to be followed by the RBA in the near term suggests that the local currency could come under pressure from the reallocation strategies of global investors.

Chart 3 – AUD Trade-Weighted Index

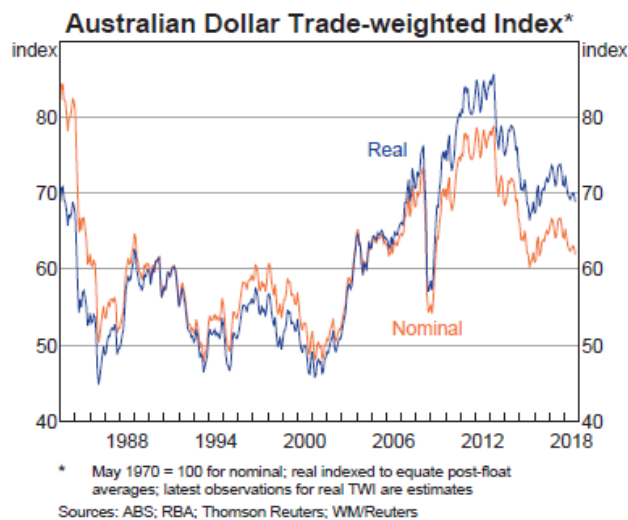
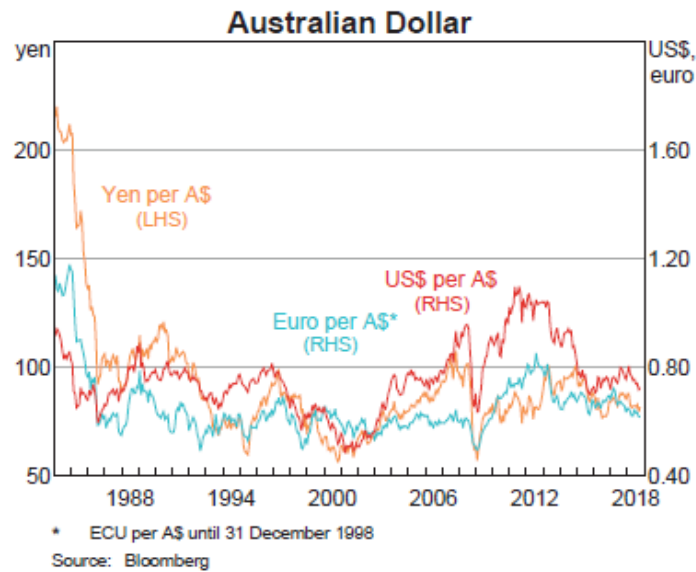


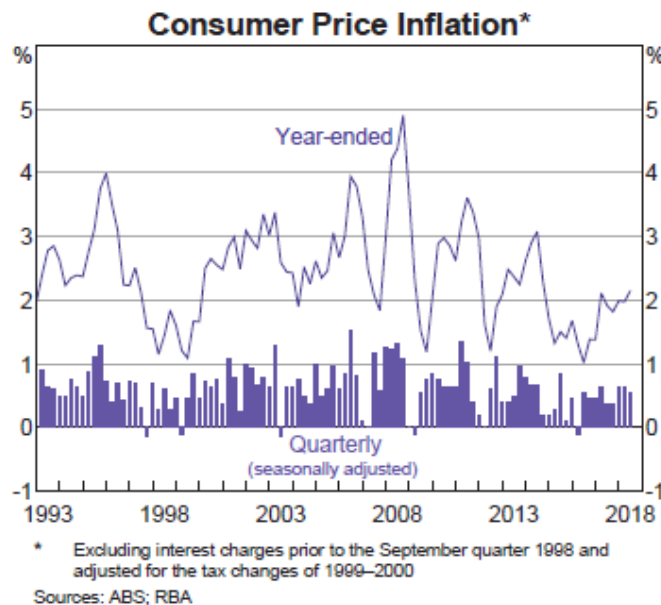
Chart 4 – Australian Dollar



1.5. Inflation

Inflation accelerated modestly from a rate of 1.9% for the year-ended June 2017 to 2.1% for the year-ended June 2018, and now has entered RBA’s 2-3% medium-term target range. This low and stable inflation outcome primarily reflects spare capacity in the economy and the associated low wages growth. Market economists and unions expect inflation to be around 2¼ per cent over the next year.

Chart 6 – Consumer Price Inflation



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

The Federal Government’s 2018-19 budget estimates a deficit of \$14.5 billion or 0.8% of GDP, an improvement on the deficit of 1.0% of GDP estimated for 2017-18. The projected return to surplus has been brought forward to the 2019-2020 year with a

paper-thin surplus of \$2.2 billion estimated. Increased surpluses are projected for the 2020-21 (\$11.0 billion) and 2021-22 (\$16.6 billion) years.

In respect of the 2018-19 year and beyond, the main assumptions that underpin the budgetary positions are:

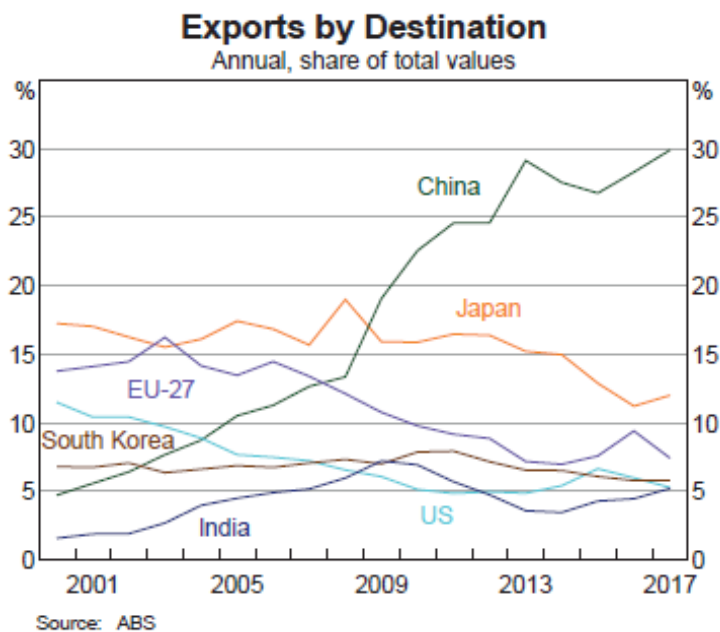
- Real GDP growth of 3.0% (constant over the projected period);
- Unemployment of 5.25% (largely constant over the projected period);
- CPI inflation increasing to 2.25% for 2018-19 and then to 2.50% from 2019-20;
- Wages increasing by 2.75% in 2018-19, 3.25% in 2019-20 and 3.50% from 2020-21 onwards.

The Government also announced a limit on the tax:GDP ratio of 23.9%.

Australia's current account deficit in seasonally adjusted terms increased \$1,794 million to \$13,472 million in the June quarter 2018 driven mainly by increased net primary income deficit, according to latest figures from the Australian Bureau of Statistics (ABS).

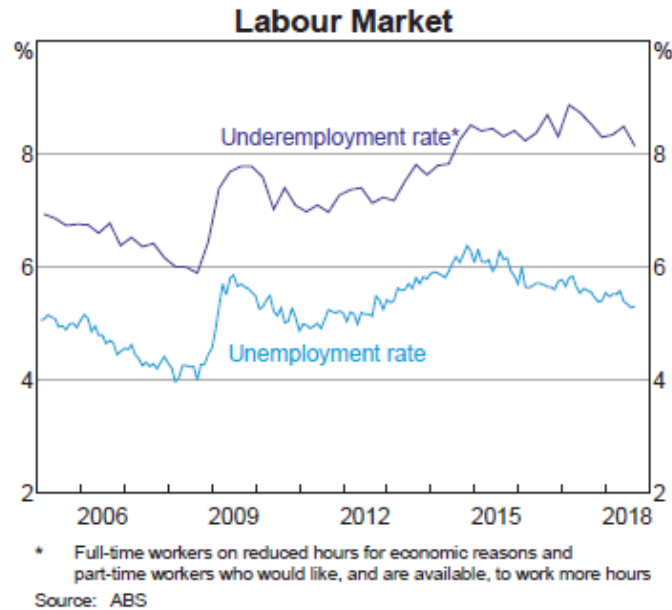
The balance on goods and services surplus in the June quarter 2018 was \$2,812 million, a fall of \$532 million on the March quarter 2018 surplus of \$3,344 million. Exports of goods and services rose \$2,679 million (3 per cent) and imports of goods and services rose \$3,211 million (3 per cent). The net primary income deficit widened by \$1,102 million to \$15,934 million in the June quarter 2018.

Chart 7 – Exports by Destination



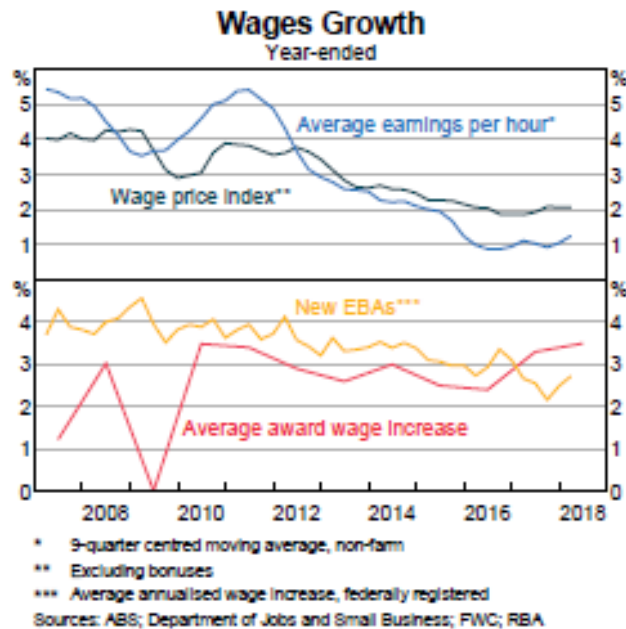
The unemployment rate ending the 2017-18 year was 5.4 per cent, a slight decline from 2016-17 (5.7%) and roughly a ½ percentage point above conventional estimates of full employment in Australia, indicating that there is still spare capacity in the labour market. Employment has grown by 2.5% over the last year, which is higher than the 1.5% growth in working-age population.

Chart 8 – Unemployment Rate



Wages growth continues to be low and stable across most industries and states, reflecting the spare capacity in the labour market and the process of adjustment to the end of the mining boom. Low wages growth has weighed on inflation since wages are the largest component of business costs. Mirroring this, low inflation and expectations that inflation will remain low in the near term continues to weigh on wages growth.

Chart 9– Wages Growth



2. Outline of the Securities Markets

2.1. Equities Markets

The S&P/ASX 200 price index rose 8.3% through the 2017-18 year, finishing at 6,194 points as at 30 June 2018. The market is still trading well below its all-time high of 6,828 points from November 2007.

Chart 10 – Share Price Accumulation Indices Australia v US and Global

Source: Reserve Bank of Australia

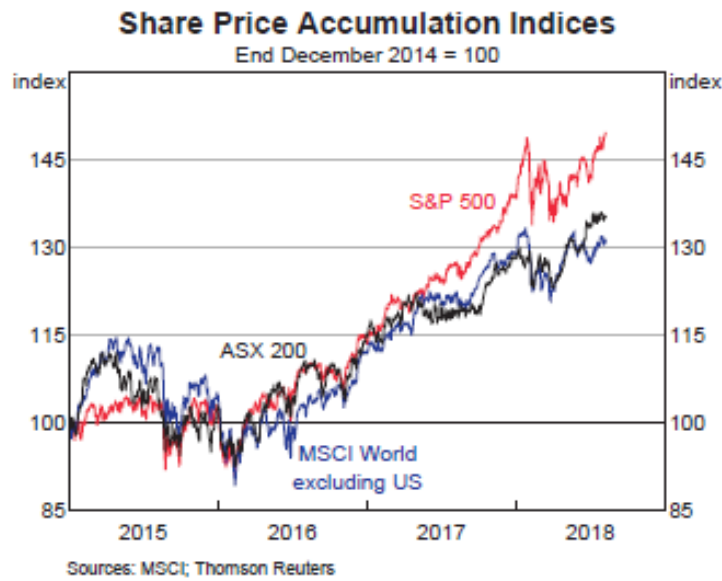
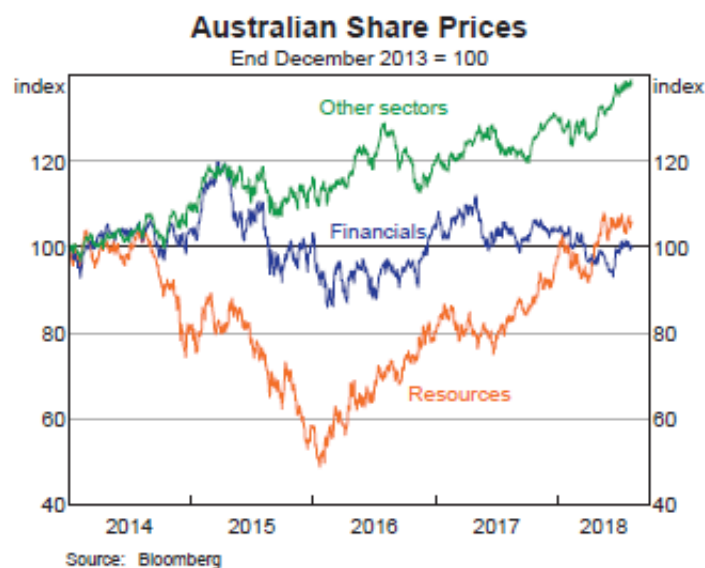


Chart 11 – Australian Share Prices

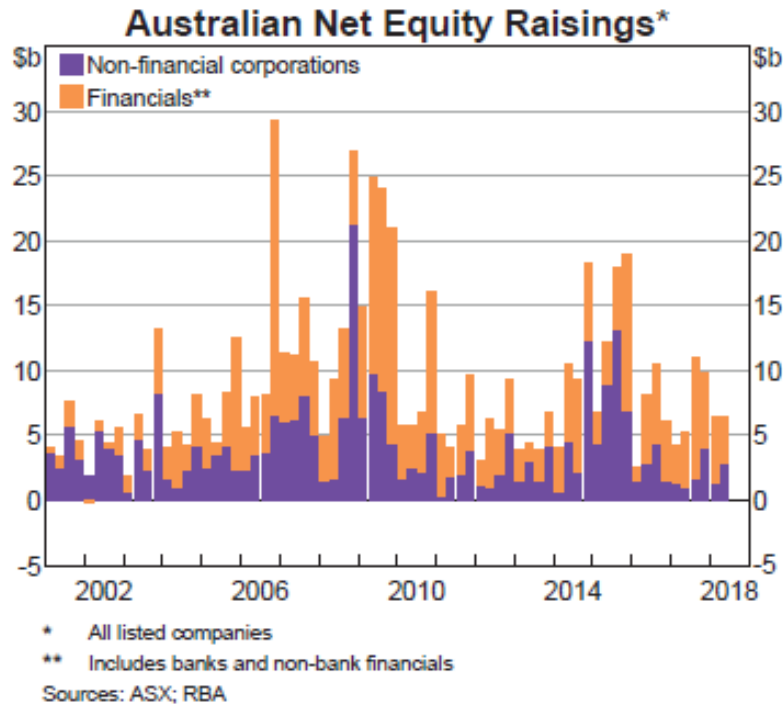


Australian share prices have largely followed global developments in recent months to be around three per cent higher since the end of 2017. Market volatility has remained low. Resources sector share prices are 9 per cent higher since the end of 2017,

consistent with an overall increase in commodity prices. Analysts' earnings expectations for the sector have continued to increase. Banks' share prices are lower than they were at the end of 2017 with bank returns under significant pressure due to unprecedented regulatory scrutiny and compliance costs.

Expectations are that overall earnings will continue to rise, consistent with survey measures of business conditions, which remain elevated. Price-to-earnings ratios for the resources and financials sectors are close to long-run averages, while ratios for other sectors are somewhat above average.

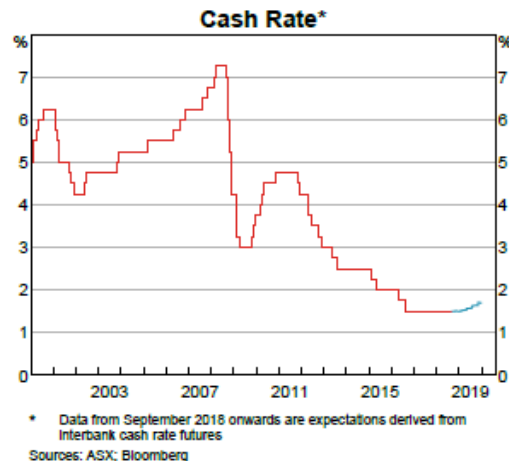
Chart 12 – Australian Net Equity Raisings



2.2. Trends in Interest Rates

The Reserve Bank has maintained the cash rate target at 1.5 per cent since August 2016. Financial market prices imply that the cash rate is expected to remain unchanged this year and increase to 1.75 per cent around the end of next year.

Chart 13 – Cash Rate



Issuance from the Australian Government and state borrowing authorities has continued to be well received by the markets. The pace of issuance by the Australian Government is expected to decline over 2018/19, reflecting the narrowing in the forecast budget deficit. The stock of bonds issued by the state borrowing authorities is expected to be little changed over 2018/19.

2.3 Australian Government Bonds

Yields on 10-year Australian Government Securities (AGS) have moved lower to around 2.65 per cent, to be little changed since the start of the year. The yield on 10-year AGS is around 30 basis points below the yield of 10-year US Treasury securities.

Chart 15 – Government Bond Yields

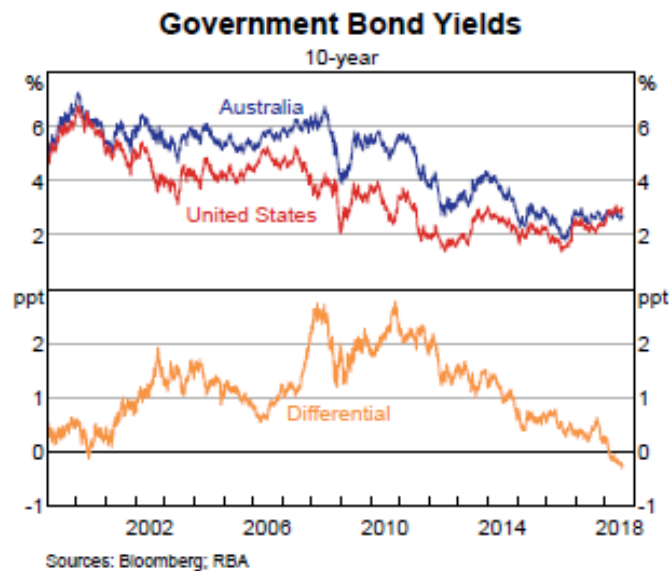
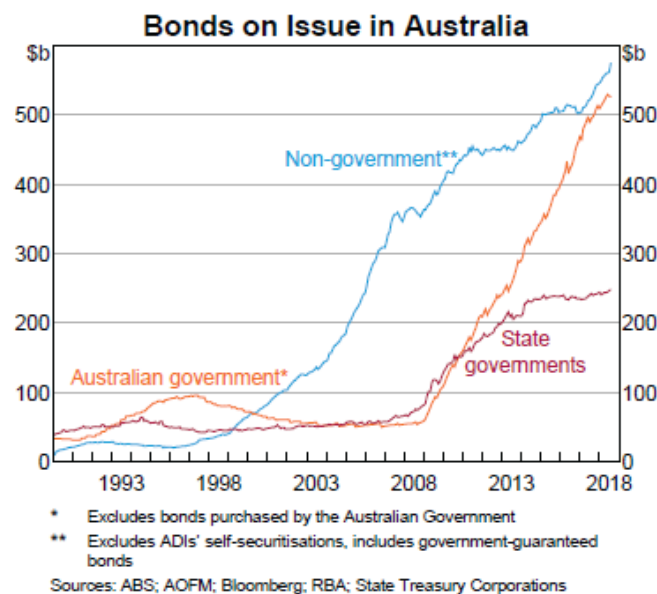


Chart 16 – Bond Issuance



3. Prospects for the Securities Industry

3.1. Royal Commission into the Australian Financial Services Industry

In December 2017, the Government announced a Royal Commission into Misconduct in the Banking, Superannuation and Financial Services industry. The Government announcement for the Royal Commission was consequent to significant political pressure and a number of high-profile cases of misconduct in the Australian financial services sector. A Royal Commission is a highly formal enquiry and the Commissioner has significant powers, at least equal to those of a judge.

The Terms of Reference for the Royal Commission were broad. However, the Commissioner chose to focus on:

- Consumer lending practices;
- Financial advice;
- Loans to small and medium enterprises (SMEs);
- Services to regional communities;
- Superannuation; and
- Insurance.

Given the focus on retail issues, none of these matters particularly affect wholesale banking (i.e. the AFMA membership), although there is the potential that some of the recommendations that the Commissioner will make may impact the manner in which participants in wholesale banking and financial markets undertake their operations. In addition, it is noteworthy that retail broking has not been a particular focus of the Royal Commission.

The Commissioner handed down his interim report on 28 September 2018 and the final report is due on 1 February 2019.

3.2. Equities Market Infrastructure and Technology

The ASX is in the process of finalising its plans for the replacement of the system that underpins post-trade processes of Australia's cash equity market, known as CHES (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 CHES replacement based on a private 'permissioned' distributed ledger technology (DLT) system with the ASX owning and operating all of the computers associated with the system. The ASX made a positive determination as to the suitability of DLT technology system in December 2017 and has noted the potential to apply this technology more broadly in the Australian market, such as in relation to fixed income products.



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.

Consequent to the most recent consultation by the ASX, it has been announced that the earliest time at which the new system will be operational is Q4 2020, and more likely the first half of 2021. This is to allow for additional testing from both an industry and ASX perspective. AFMA is heavily engaged on behalf of its members on the issues arising from the implementation of the new system, including the potential cost to participants.

3.3. 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 and 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. This initiative compliments the statutory regime that applies to licensed financial advisers and considers potential recommendations that may arise from the Royal Commission (referred to above) and the appropriateness of such potential recommendations to participants in wholesale banking and financial markets.

The key components of AFMA's professionalism program were settled after an extensive consultation process with members during the year and include:

- The establishment of a Professionalism Committee to centralise senior oversight of AFMA's professionalism activities in relation to conduct standards processes and accreditation/training.
- Issuance of 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.

In relation to the third element of the AFMA Professionalism program, AFMA has worked with the Australian government to establish government-approved competencies for business ethics in financial services. AFMA has worked extensively to develop a course to train participants in financial markets in ethical and conduct matters to adhere to the competencies, so as to allow those that undertake the course to demonstrate that they have been trained and assessed against a Government-endorsed objective standard. The pilot for this course will occur in October/November 2018 and will be rolled out in Q1 2019.

3.4. Financial Institution Culture Regulation

The Australian financial regulators have heightened their focus on the operating culture of financial institutions. As noted in the 2017 AFMA Country Report, the Government has introduced the 'Banking Executive Accountability Regime' (BEAR) which 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. The BEAR regime commenced for major Australian banks on 1 July 2018 and AFMA is working with APRA regarding implementation for other (including foreign) banks in 2019. As a result of the BEAR regime, banks have started to amend their remuneration practices and to increase transparency around revenue generation.

The Reserve Bank of Australia has highlighted the examples of poor culture in the Australian financial system that have been revealed through the Royal Commission and noted the adverse implications for individual institutions financial performance and capital position and for the financial system as a whole.

3.5. Professional Standards for Financial Advice

During the year, the Government's statutory professionalism framework for retail financial advisers was implemented. In order for a professional to be authorised to provide personal advice to retail customers, an individual will need to:

- Hold a Bachelor's degree in a related discipline;
- Pass an exam;
- Meet continuing professional development requirements;
- Complete a year of on the job training (for new entrants);
- Comply with a code of ethics and be a member of a professional association that enforces such a code.

AFMA does not propose to be a professional association, given it does not have individual members, nor does it focus on retail financial advice. However, the regime for financial advice may be indicative of other regimes that may apply to other banking and financial markets roles, particularly consequent to the Royal Commission referred to above.

3.6. 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 program of work to support the professionalism of business in Australia's financial markets.

AFMA was one of the first industry bodies to host a register of Statements of Commitment to the FX Global Code, which is available (and publicly searchable) on the AFMA website.



3.7. Industry Funding of Regulators

The Government has continued to implement new laws that change the way Australia's securities regulator, 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.

AFMA has expressed some concern with the equity of the cost-recovery implementation model, particularly in circumstances where ASIC recovers the cost of its enforcement action from participants, in addition to receiving pecuniary compensation from the particular entities against whom enforcement action was commenced.

3.8. Interest Rate Benchmark Developments

AFMA has been engaging actively with its members, the Reserve Bank of Australia and ISDA with respect to the potential discontinuation of benchmark rates and the confirmation of fallback benchmark rates. This is particularly in light of the announcement by the FCA of the lack of support for LIBOR from 2021. While it is expected that the primary interest-rate benchmark in Australia, the Bank Bill Swap Rate (**BBSW**) will continue, many Australian institutions hold LIBOR exposures and agreement of an appropriate fall-back rate will enhance the robustness of financial contracts, including derivatives and fixed income products.

As previously advised, effective 1 January 2017, ASX became the administrator of BBSW, which had previously been produced by AFMA. BBSW has historically been drawn from live executable market prices since 2013. However, in the middle of 2018, BBSW was transitioned to a volume-weighted average price (**VWAP**) methodology which will cause BBSW to be calculated with respect to actual transactions where there is sufficient liquidity to allow this to occur.

3.9. Product Design and Distribution Obligations

The Australian Government is consulting on legislation to implement product design and distribution obligations, and to give Australia's securities regulator, ASIC, an intervention power. Broadly, these powers require issuers of financial products to consider the likely target market for the products that they are creating, and to ensure that the design and distribution of those products aligns with the interests of the target market. The design and distribution obligations apply to products for which a disclosure document would ordinarily be required, as well as some other classes of products including basic banking products.

Under the new power, ASIC will be able to intervene to ban the marketing of a product, or to compel changes to the manner in which products are being marketed/distributed, where there is potential or actual significant detriment to customers. It is expected that this power will be used rarely, if ever.

AFMA has been consulting heavily with the Government regarding the scope of both the design/distribution obligation and the intervention power, particularly to the extent that shares and other listed instruments are exempt from the regime, especially given that such instruments are traded on the secondary market.