Member Reports

Australia

2010 Asia Securities Forum
September 28-29, 2010
Beijing, China
Country Report for Australia and Outline of the Securities Market

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 Economy

The Australian economy has performed well over the year, against a backdrop of recovering world output. The robust performance of the economy has been supported by fiscal stimulus, a strong labour market, a rebounding export market, and solid private consumption. The ongoing challenge for the economy is to maintain and improve upon the growth rates achieved over the year, by ensuring that projected growth in domestic demand will be sufficient to counteract the withdrawal of Government stimulus to the economy. Australia remains well placed to continue to benefit from its location in the world’s fastest growing economic region.

The Financial Markets

Australia’s financial markets have performed robustly in the most challenging environment for global markets over the past three years. Over the year, developments in domestic markets have reflected the broader recovery and substantial lessening of volatility in global markets. Money markets are liquid with the elevated pricing of risk experienced at the height of the financial crises falling substantially. Banks have been able to tap capital markets easily as the Government withdrew its guarantee scheme. Businesses have also tapped the equity market for funds substantially through the year.

Industry Prospects

The key development over the year has been the transfer of equity market supervision from the Australian Securities Exchange to the Australian Securities and Investments Commission. The new regulatory framework places Australia in a better position to meet the needs of a changing and increasingly complex landscape for market supervision, as well as the emergence of new trading platforms. The industry has also been monitoring the advancing work program of a number of international bodies focused on reform to the regulation of global financial markets, which will have a significant bearing on local market regulation.
1. The Economy

The Australian economy has performed relatively well over the past few years, which has been an intensely difficult and immoderate period of economic development internationally. The world economy appears to be on the track of recovery, albeit, an unevenly experienced recovery from the perspective of major advanced economies on the one hand, and emerging economies on the other. Australia is well placed to continue to benefit from its location in the world’s fastest growing economic region, through a booming export market for commodities and further strengthening of trade relationships within the region.

Table 1

<table>
<thead>
<tr>
<th>Fiscal year – 12 months to end-June</th>
<th>2006-07</th>
<th>2007-08</th>
<th>2008-09</th>
<th>2009-10</th>
<th>2010-11#</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic growth (GDP, %)</td>
<td>3.8</td>
<td>3.7</td>
<td>1.2</td>
<td>2.3</td>
<td>3.0</td>
</tr>
<tr>
<td>Private consumption growth (%)</td>
<td>4.2</td>
<td>4.0</td>
<td>0.9</td>
<td>2.8</td>
<td>3.0</td>
</tr>
<tr>
<td>Business investment growth (%)</td>
<td>7.3</td>
<td>15.3</td>
<td>4.8</td>
<td>(3.1)</td>
<td>7.5</td>
</tr>
<tr>
<td>Balance of payments</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current a/c deficit (% of GDP)</td>
<td>5.5</td>
<td>6.3</td>
<td>3.2</td>
<td>4.4</td>
<td>3.0</td>
</tr>
<tr>
<td>AUD/USD (year-end)</td>
<td>0.8487</td>
<td>0.9626</td>
<td>0.8114</td>
<td>0.8523</td>
<td>n/a</td>
</tr>
<tr>
<td>Inflation (yearly growth, %)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Consumer price index</td>
<td>2.1</td>
<td>4.5</td>
<td>1.5</td>
<td>3.1</td>
<td>2.8</td>
</tr>
<tr>
<td>- Underlying rate of CPI</td>
<td>2.6</td>
<td>4.2</td>
<td>2.5</td>
<td>2.8</td>
<td>n/a</td>
</tr>
<tr>
<td>Employment growth (yearly growth, %)</td>
<td>3.1</td>
<td>2.9</td>
<td>0.2</td>
<td>2.9</td>
<td>2.3</td>
</tr>
<tr>
<td>Unemployment rate (June quarter, %)</td>
<td>4.3</td>
<td>4.2</td>
<td>5.8</td>
<td>5.1</td>
<td>5.0</td>
</tr>
<tr>
<td>Wage price index (yearly growth, %)</td>
<td>4.0</td>
<td>4.2</td>
<td>3.8</td>
<td>3.0</td>
<td>3.8</td>
</tr>
</tbody>
</table>

Forecast (#) average year outcome for each item, from the Commonwealth (Federal) Government Economic Outlook.

1.1 Economic Growth

The economy grew by 2.3 percent in the 2009-10 financial year compared with a 1.2 percent growth in output the previous year. The improvement in economic activity is reflective of the further recovery in the global financial system from the dislocation experienced in late 2008 and early 2009. The significant fall in world output during this period demonstrates the strong linkages between financial markets and the real economy, and the implication that further improvements in global economic activity will be strongly dependent on the maintenance of stability in financial markets.

The robust performance of the Australian economy has benefited from a broader recovery of global economic growth, which is improving from the position of negative growth in 2009 more quickly than expected. The global economy has been driven by the strong performance of the Asian economic region, with robust growth rates experienced since mid-2009. The major advanced economies are also showing signs of recovery, albeit at a slower pace, as financial conditions improve and bank lending constraints ease. There was a period of heightened volatility in financial markets over the months of May and June earlier this year in response to concerns about fiscal stability in Europe. This period of risk aversion has since abated, with the establishment of new fiscal consolidation programs in Europe.
Whilst domestic GDP growth over the past two years represents the weakest economic outcomes since the recession in the early 1990s, the Australian economy has performed well through the duration of the global financial crisis relative to other advanced economies. The Australian GDP growth rate in 2009 is 4.5 percent above the advanced economy average. The relative strength of the Australian economy is attributable to the health of the domestic financial sector, with the major Australian banks continuing to report solid profits during the financial crisis. The economy has also been supported by robust economic growth in the economies of key trading partners, most notably China. Recent estimates suggest that Australia’s major trading partners have grown by about 6 percent over the year.

Despite the increased volatility in global financial markets in recent months, the outlook for the economy remains positive. The economy is forecast to grow by 3 percent in 2010-11 and a further 3.8 percent in 2011-12. This positive outlook is supported by a projected boost to the expected terms of trade due to the rising prices for Australia’s commodity exports. The global recovery is creating a strong demand for these commodities, and with the world economy projected to grow by 5.5 percent in 2010 and a further 4.7 percent the following year, the commodities export market is expected to continue its strong performance. The economy is expected to get close to full capacity utilisation with strong business investment forecast for the near future.

The recent and ongoing issues with sovereign debt levels and banking sector weakness in the European region presents downside risk to the global economic outlook. Uncertainties over the fiscal position of any of the major advanced economies could bring about renewed volatility in financial markets. As well, the uncertainty over US growth prospects contributes to the downside risk, although the latest IMF projections indicate a positive growth rate is expected for 2010. On the other side of the spectrum, downside risk is also
presented by concerns that the pace of growth in emerging economies cannot be sustained as there is an increasing build up of inflationary pressure. However, there are signs that this growth is moderating somewhat, with most economies moving to tighten monetary policy.

A number of factors counter these risks, and support the projection of a robust economic performance for Australia over the next two years. From the domestic perspective, the relatively strong fiscal position; stability of the banking sector; solid trading position within the region; and continued labour market strength will contribute to stronger economic growth in the near to medium term.

1.2 Political Developments

The key political development over the year was the federal government election held in August. The outcome of the election was a hung parliament, in which neither of the major parties won a sufficient number of seats in the lower house (the house of government) to form government. The August elections resulted in the first hung parliament in 70 years. At the time of writing, the incumbent Government, the Australian Labor Party, has only managed to form government with the support of a minor party and two independent Members of Parliament. The election of a minority Government presents a unique political environment for Australia, possibly introducing a level of policy complexity and uncertainty.

With the new Government having just been formed, the status of previously announced policy reform is still unclear. This includes policy reforms announced by the Government earlier this year as part of its strategy to develop Australia as a financial centre, incorporating taxation reform such as the removal of interest withholding tax on foreign borrowings by banks and the creation of an Asian region funds passport. Other key taxation reforms announced by the previous Government yet to be confirmed includes a new tax on resource sector profits, a reduction in the company tax rate, and the lowering of tax on savings.

Prior to the election, the Government enacted a number of key reforms affecting the securities industry, including the transfer of market supervision from the Australian Securities Exchange (ASX) to the Australian Securities and Investments Commission (ASIC). ASIC assumed responsibility for direct supervision of Australia’s equities and futures markets on 1 August.

1.3 Exchange Rates

The Australian dollar trended upwards over the year, with the AUD appreciating by 9 percent over the USD. Against other major currencies, the dollar was up 17 percent against the Sterling, up 19 percent against the Euro, up 8 percent against the Renminbi and down 1 percent against the Yen. From a trade-weighted perspective, the Australian dollar has appreciated by 6 percent over the past year, which is 19 percent higher than the post-float average, and a 35 percent rise from a trough in February 2009.

The robust performance of the export market and the rising terms of trade have supported the currency over the year. The appreciation of the Australian dollar is also attributable to the general strength of the economy and the widening of interest rate differentials globally.
Volatility in the currency rose to its highest levels since the financial crisis in May 2010, but has since abated. Even so, volatility remains high relative to its long-run average.

**1.4 Consumption and Investment**

Private household consumption grew by 2.8 percent in 2009-10, compared with 0.9 percent the previous year. The growth in private consumption over the year in part reflects the significant fiscal stimulus measures that were introduced to boost consumer confidence. These stimulus measures have contributed to the continued growth of household incomes over the past 2 years.

The fall in consumer confidence during the downturn was significant, but picked up quickly with the support of improvements in labour market conditions, as well as a recovery in household wealth with increases in equity and house prices over the year. Household net worth is estimated to be more than 20 percent higher than the trough recorded in early 2009. Consumption has continued to grow modestly over recent months, despite a withdrawal of significant fiscal stimulus and rising interest rates. The more modest consumption growth rates recorded over the past 2 years is indicative of a more cautious approach to finances taken by households relative to behaviour over the past decade, which is reflected in above decade average household savings rates.

Household consumption, which is well below pre-crisis levels, is expected to continue to recover over the near term, with measures of consumer confidence above long-run average levels. Household consumption will be supported by a strong labour market, continued improvements in consumer confidence and higher asset prices.

Business investment contracted by 3.1 percent in 2009-10, compared with a 4.8 percent growth in 2008-09 and 15 percent the previous year. Nevertheless, total business investment as a percentage of GDP, at 16 percent, is high by international standards. Relatively favourable economic conditions, strong profits and overall moderate gearing preceding the financial crisis meant that businesses were generally in a good position to meet the challenging environment over the past 2 years. There are signs that business investment is
starting to pick up, with survey measures of business confidence and conditions at above long-run averages since late 2009.

Business investment is projected to increase by 7.5 percent in 2010-11. Business investment will be led by investments in new machinery and equipment. In the mining sector, engineering construction has been projected to grow by 19 percent in 2010-11 and more than 20 percent the following year. In addition, the tighter credit supply conditions since the financial crisis appear to be moderating, and the resultant additional funding options open to businesses should support the positive business investment projection.

Overall, the greater spending caution displayed by households and the supportive environment for business investment suggests that domestic demand is likely to be driven by business investment, rather than private consumption, over the near to medium term.

1.5 Inflation

The Consumer Price Index (CPI) grew by 3.1 percent over 2009-10, compared with 1.5 percent in the preceding year. The underlying measure of inflation, which excludes volatile items, also recorded an increase to 2.8 percent from 2.5 percent the previous year. The underlying rate of inflation is within the Reserve Bank of Australia’s (RBA) inflationary target band of 2 – 3 percent.

The historically low level of inflation recorded in 2008-09 was due to a reversal of economic activity from full capacity utilisation pre financial crisis to a significant drop in investor and consumer confidence in line with the spike in financial market volatility. Underlying inflation, whilst significantly increasing through the year, is still well below the peak of 4.5 percent recorded in September 2008. Inflationary pressure was contained through the year, with very modest wage growth and a fall in production prices.

Headline and underlying inflation are expected to each be 2.8 percent through the year to June 2011 and 2012. The upside risk to this projection is upward inflationary pressure from expectations that the economy will near full capacity in 2010-11 and 2011-12.
1.6 Government Finance, Balance of Payments and the Labour Market

The Australian government ran a budget deficit in 2009-10, estimated to be around $55 billion or 4.2 percent of GDP, as it implemented a significant fiscal stimulus package to support the economy.

The Government has announced a budget strategy to reduce the deficit in 2010-11 to $40.4 billion or 2.8 percent of GDP and to return the budget to surplus in 2012-13. This projection places the Government budget ahead of any major advanced economies, whose collective deficit has been forecast by the IMF to be 6 percent of GDP in 2012. Net Commonwealth Government debt is expected to peak at 6 percent of GDP in 2011-12, which is modest by international standards.

Exports grew by 0.6 percent in 2009, contrary to expectations that exports would fall by more than 6 percent in line with the experience of global export markets. The export market picked up sharply in the first half of 2010, increasing by 6% - mostly due to growth in resource exports. Commodity exports have been supported by rising commodity prices over the year, with contract prices for iron ore and coal increasing by 140 and 75 percent respectively. Non-commodity exports have not performed as well, remaining below the pre-crisis peak. Exports of elaborately transformed manufactures fell by 21 percent in 2008-09 and a further 3.5 percent in 2009-10 in response to a collapse in global demand.

Over this period, the value of imports was slightly higher than exports, which contributed to a higher current account deficit of 4.4 percent of GDP in 2009-10. The current account deficit in expected to narrow in 2010-11, with expectations that the terms of trade will continue to be favourable.

The export market is expected to perform robustly over the near term, driven by non-rural commodity exports. Rural exports are also expected to contribute to overall volume growth, with farm production increasing over the year. The positive outlook for exports will also be supported by an expected recovery in the market for elaborately transformed manufactures, exports of which are forecast to increase by 4 percent in 2010-11.

Solid domestic demand and a strong currency are expected to increase imports significantly in 2010-11 and 2011-12. Import growth is expected to be broad-based, but led by capital equipment imports associated with resource sector construction.

There was a small decline in the terms of trade in 2009-10, estimated to be around 3 percent, reflecting the impact of the financial crisis on commodity prices. However, the terms of trade is forecast to increase by 17 percent in 2010-11 to around the highest levels on record, primarily due to rising contract prices for iron ore and coal. This is not expected to be sustained in 2011-12 as increased global supply should act to moderate pricing pressures. Even so, the terms of trade is expected to remain at high levels over coming years.

The labour market has performed strongly over the past 2 years. The global downturn did not appear to have a material or sustained impact, with unemployment peaking at 5.8 percent. The unemployment rate of 5.1 percent in the June quarter is lower than any of the major advanced economies. The supply of labour continues to grow, driven by good growth in the working-age population. The unemployment rate is expected to fall further in 2010-11 and down to 4.8 percent in late 2011-12. Business survey measures of hiring intentions are
above average levels, which suggest continued employment growth will be sustained by solid labour demand.

2. Outline of the Securities Markets

2.1 Price Trends of Equities

Equity market values have been trending upwards over the past year in line with global equity price movements. The ASX 200, the benchmark index for the Australian share market, is up by 44 percent since the trough at the height of the financial crisis. The index peaked in April, but has since recorded a slight deterioration mirroring global market reactions to concerns about the sustainability of sovereign debt levels. The ASX 200 is currently around 30 percent below the pre-crisis peak in 2007.

Graph 4

The financial and resource sectors have contributed significantly to equity value appreciation over the year. Bank share prices in Australia are less than 20 percent below mid-2007 levels, whereas banking sector share prices in the US, UK, Euro area and Japan are 50 percent or more below. Over the year, daily market volatility returned close to historical trends and substantially lower than levels experienced in 2008-09.

There was a marked improvement in reported business conditions and profitability for listed companies over 2009. Underlying profits for listed non-financial ASX 200 companies were around 20 percent higher in the second half of 2009, compared with the preceding first half of the year. Looking into the near future, resource companies’ earnings, in particular, are expected to recover strongly in 2010-11 with an expected increase of around 45 percent over 2009-10 profits. These strong profit projections contribute to a positive outlook for share prices in the near term.

2.2 Trends in Interest Rates
The Reserve Bank of Australia (RBA) has been tightening policy rates since October 2009. Since then the cash rate has been increased by 150 basis points to 4.5 percent. The tightening of monetary policy over the year has been in response to continued solid growth in consumption, strong labour market conditions and rising commodity prices putting upward pressure on inflation.

In recent months, the RBA has indicated the economy has demonstrated less spare capacity than earlier projected, which may lead to greater inflationary pressure. Financial markets have priced in a slight chance that the policy rate may be tightened further this year.

In the money market, yields have closely tracked changes in the cash rate. Bank bill spread to overnight indexed swaps (OIS), a measure of banking system credit risk, has continued to trend downwards since the sharp spike in late 2008 and early 2009. Spreads in the money market rose in May in response to increased global market volatility over that period, but has since narrowed.

In the bond market, yields for bonds issued by the federal Australian Government have risen since the sharp fall during the financial crisis as investors led a flight to quality. For example, 3-year Commonwealth Government Securities yields was up over 70 percent in April 2010 from a low point in February 2009. Government bond yields have been trending lower in recent months in response to concerns about global economic conditions. From a historical perspective, Australian Government bond yields have mirrored global markets by trending lower over the past 10 years. Global government bond yields at the short and long maturity spectrums are currently at historically low levels.

Graph 5

In the non-Government bond market, pricing was severely affected during the height of the financial crisis, despite all security classes performing well from a credit perspective. Spreads have fallen dramatically over the year, but remain noticeably higher than pricing levels pre-crisis.

2.3 Activity Levels in the Markets for Stocks and Bonds
In conjunction with the appreciation in equity values, share turnover of $1.3 trillion on the Australian Securities Exchange (ASX) was up 20 per cent in 2009-10 from the previous year. The boost in turnover resulted from an increase in the daily average number of trades as well as an increase to the average value traded by 24 and 21 percent respectively.

The turnover in exchange-traded share options recorded a steeper rise, taking overall exchange-traded equities to over $1.8 trillion. The rebound in share turnover reflects greater investor confidence over the year, as reflected in a slightly improved take-up of margin loans over the past few months. Nevertheless, current gearing levels are low by historical standards.

The secondary market for trading debt securities was also up by over 18 percent in 2009-10 from the previous year. This increase in turnover is mostly attributable to a higher level of trading activity in derivative markets, most noticeably in overnight indexed swaps (OIS) which recorded a turnover increase of over 190 percent as market participants anticipated cash rate increases and positioned themselves accordingly. Notable rises were also reported in both Government and non-Government debt securities, increasing by 17 and 37 percent respectively, reflecting higher levels of Government debt on issue and some return of investor confidence in private sector debt.

2.4 Activity Levels in Equity and Debt Capital Markets

The equity raising market has recorded another buoyant year of activity, with a total of $77 billion raised over 2009-10. This follows a record of $90 billion raised on the equity market the previous year. The large increase in equity capital raising over the past 2 years reflect strong issuance by banks, as well as corporates that have sought to deleverage their balance sheets. As a point of comparison, the average amount of equity capital raised in the preceding three years was just under $64 billion.

Secondary capital issuance, of over $65 billion, dominated equity raisings through the year. Equity raising activity via initial public offerings was also buoyant, with 93 new listings in 2009-10 compared with 45 the previous year. Around half of the newly listed companies were from the resources sector. The new listings brought about an increase in market capitalisation of $11.5 billion to a total of over $1.3 trillion as at the end of August 2010.

The value of bonds issued by the federal Government in 2009-10 amounts to over $52 billion, which brings the amount on issue to $127 billion as at June 2010. Total Government bonds on issue nearly doubled over 2009, as the Government introduced a fiscal stimulus program to boost the economy. Whilst the Government has announced a strategy to exit the current budget deficit and stimulus measures are being wound down, market expectation is that any material reduction in the budget deficit will take time to achieve and ongoing issuance within the near term is likely.

Debt raising in the capital markets for non-government participants was led by financial intermediaries. In line with the Government’s withdrawal of its wholesale funding guarantee scheme in March 2010, non-guaranteed bank securities increased 102 percent, while guaranteed bank securities fell 40 percent. The large increase in issuance is largely due to banks seeking to lengthen the maturity of their wholesale funding portfolios as they shift out of short-term debt. The significant spike of bank bond issuance is also explained by
an increased funding need as the domestic banks took on a greater share of funding household mortgages previously funded by a buoyant residential mortgaged-backed securities (RMBS) market. The banks have been able to access a diverse range of markets and currencies. A large proportion of bank bond issuance has been offshore.

Graph 6

![Graph 6](image)

The corporate bond market has also performed well over 2009-10, with issuance up 31 percent as investor confidence in the domestic economy returned. RMBS issuance was also up, by 72 percent, although a large portion of this issuance was bought by the Australian Office of Financial Management (AOFM) to stimulate market activity and to support competitive mortgage lending. Even so, demand for new issuance of these securities has been strengthening and the market continues to be supported by the relatively high quality of collateral underlying securities.

Table 2

Australian Non-government Bonds Outstanding

<table>
<thead>
<tr>
<th></th>
<th>Outstanding ($ billion)</th>
<th>Share (percent)</th>
<th>Average annual growth (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Jun 07</td>
<td>May 10</td>
<td>Jun 07</td>
</tr>
<tr>
<td>Financials</td>
<td>304</td>
<td>532</td>
<td>40</td>
</tr>
<tr>
<td>Asset-backed</td>
<td>222</td>
<td>117</td>
<td>29</td>
</tr>
<tr>
<td>Corporates</td>
<td>136</td>
<td>157</td>
<td>18</td>
</tr>
<tr>
<td>Kangaroo</td>
<td>105</td>
<td>124</td>
<td>13</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>765</strong></td>
<td><strong>929</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

Source: Reserve Bank of Australia

Throughout the past three years, Australian financial markets have been less affected than other markets. However, there has been a marked effect on the structure and pricing of the Australian bond market. An increase in paper issued by financial institutions has offset the decline in asset-backed issuance.

### 3. Prospects for the Securities Industry
A wide range of regulatory and taxation factors will help to shape the evolution of financial markets over coming years. The paragraphs below briefly identify some of the more significant developments in this regard.

### 3.1 Transfer of Market Supervision

On 1 August 2010, the Australian Securities and Investments Commission (ASIC) assumed responsibility for direct supervision of Australia’s equities and futures markets, with the transfer of supervisory powers from the Australian Securities Exchange (ASX). ASIC is now responsible for both supervision of real-time trading on all of Australia’s licensed markets and enforcement of the laws against market misconduct. The ASX retains responsibility for implementing and regulating market operating rules with respect to trading on its markets.

The securities industry has supported the transfer of supervision, which provides a regulatory framework to meet the needs of a changing and increasingly more complex landscape for market supervision, as well as the emergence of new trading platforms. The industry has undertaken a significant amount of work over the year to ensure that new legislative provisions implementing the transfer and market conduct rules are relevant to the markets being supervised.

### 3.2 Global Reform to OTC Derivative Markets

The International Organization of Securities Commissions (IOSCO) has continued to develop its program of work focused on the regulatory framework for over-the-counter (OTC) markets. Current developments in this area are focused on reducing operational and counterparty risk on OTC derivative markets, for example, by establishing central counterparties for the clearing of credit derivatives. In Australia, Government authorities have conducted a review which shows that domestic wholesale OTC markets have shown resilience and integrity during a period of great strain in global financial markets.

The regulatory environment for OTC markets continues to evolve, and developing Australian policy will be influenced by international develops in this area. In particular, the recent passage of the Dodd–Frank Wall Street Reform and Consumer Protection Act in the United States crystallises many major reforms including standardising OTC derivatives that are to be traded on exchanges and cleared through regulated central counterparties. In responding to regulatory changes in global markets, the challenge for Australia is the need to preserve its advantages as a relatively small but flexible, adaptive and well regulated financial market.

### 3.3 Global Developments on Prudential Regulation

A significant program of work is underway, driven by various international bodies including the G-20, Financial Stability Board and the Basel Committee on Banking Supervision (BCBS) to strengthen bank capital and liquidity requirements in light of lessons learnt from the financial crisis. The emerging Basel standards will clearly have an important bearing on the approach taken by the Australian Prudential Regulation Authority (APRA) to supervising banks operating in Australia.
Whilst Australian banks are well-capitalised and strong performers relative to their global peers; the proposed changes will present challenges. The most obvious and serious policy constraint facing banks in Australia is that there are insufficient high quality liquid assets to meet the banking system’s liquid assets requirement under the Basel proposals. We are concerned that the proposals would consequently have a significant adverse impact on the efficient operation of Australia’s financial markets.

The immediate challenge for the Basel Committee is to provide a global regulatory framework that enables national regulators to react to and manage the specific needs of their domestic banking system.

3.4 Retail Products and Investor Protection

The Government has been attuned to concerns about the impact of equity market devaluation on retail investors in leveraged financial products, such as margin lending. Although the instances of hardship created by the market downturn has been limited, the Government is working with industry to enhance disclosure around risks and the framework for regulating credit providers.

In Australia, the retail market is able to invest in a range of financial products with varying risk attributes. Within the context of the effects of recent market volatility, the Government more generally is reconsidering the need for the industry to be more proactive in assessing client suitability for a range of complex products. ASIC is also working with the industry to ensure that disclosure of risks for structured and other complex retail products are appropriate.

3.5 Taxation Reform

A wide ranging review of the tax system was carried out over the year, which resulted in a number of significant reform recommendations. The Government has stated that it will remove interest withholding tax on interest paid on offshore borrowings by financial institutions operating in Australia. This reform has been supported by the industry, which should assist in reducing the costs to financial institutions in sourcing funds from offshore markets.

The Government has also announced that investors will be able to obtain a 50 percent tax discount for the first $1,000 of interest they earn, including interest on deposits, bonds, debentures and annuity products. This proposal has also been supported by the industry, which had sought incentives to encourage Australians to save through deposits, which are disadvantaged relative to other investment opportunities.

The status of these reform measures will become more certain over coming months.

3.6 Australia as a Financial Services Hub

Over the past two years, the Government has progressed a program of initiatives to develop Australia as a financial services hub. A range of measures have already been implemented, including the reduction of interest withholding tax on distributions by Australian managed funds to non-residents.
A range of more substantial measures is currently being developed with industry, such as improving emerging market segments, including the retail corporate bond market and Islamic finance. Initiatives in these areas have the potential to provide new financing options for business and to facilitate portfolio diversification by investors. The Government has also indicated it will encourage the growth of offshore funds under management in Australia by creating an Investment Manager Regime which would provide tax certainty to non-resident investors, and developing an Asian Region Funds Passport regime to enable funds offered in one country to be offered in another passport country.

3.7 Selected Other Issues

The Australian Government’s work on establishing a broad-based emissions trading scheme in Australia has stalled as legislation to implement the trading scheme has been rejected by Parliament. The industry is supportive of the development of an emissions trading market, which would create new business opportunities. The new minority Government has not indicated its policy intentions with regards to an emissions trading scheme.

Achieving a more gender neutral balance in corporate Australia has received greater focus over the year, with the ASX changing its corporate governance rules to require listed entities to establish and disclose a policy concerning diversity, which includes measurable objectives for gender diversity. This initiative follows recent data showing a decline in the percentage of women on the boards of the top ASX 200 listed companies since 2006.

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