



MARKET NOTICE

Market Notice: 2016_5

Date: 19 July 2016

Subject: Evolution of the BBSW Methodology

The Council of Financial Regulators, in its February Discussion Paper *Evolution of the BBSW Methodology*, asked AFMA to finalise a set of amendments to the BBSW methodology by end-June 2016. AFMA has concluded this process and has settled the changes to the future methodology.

AFMA agrees with the Council's assessment of the issues confronting BBSW, as set out in its Discussion Paper. AFMA also agrees that the Council's principal recommended methodology change, to place primary reliance on a volume weighted average price calculation, should put BBSW on a sounder footing going forward.

The principal feature of the BBSW methodology change is the establishment of a sequentially staged calculation waterfall:

- Stage 1. Volume Weighted Average Price (VWAP)** of primary issuance and secondary trading of Eligible Securities within a trading window defined as 9:00am – 10:10am;
- Stage 2. National Best Bid and Offer (NBBO)** – the current methodology, which uses live executable bids and offers to calculate BBSW, will operate only if Stage 1 fails to form BBSW;
- Stage 3. Algorithmic calculation** – this would draw on relevant market pricing information that is available only in the circumstance where both Stage 1 and Stage 2 fail to form BBSW.

The existing definitions of *Prime Bank* and *Eligible Securities* will both be retained. This will preserve the core property of BBSW as a measure of Prime Bank funding costs in the wholesale market for NCDs/bank bills.

The waterfall arrangement will support production of the benchmark both under normal market conditions and in a stressed environment. The intention is that BBSW will generally calculate under Stage 1, with occasional use of Stage 2 on lighter trading days. Given the level of trading in the market for Eligible Securities and the ongoing operation of the NBBO as the primary fall-back, it is expected that Stage 3 would be rarely used in practice and then would not be used for not more than two consecutive days.

The introduction of Stage 3 will improve the capacity of the benchmark to withstand short periods of exceptional market stress, irrespective of the source. Stage 3 algorithms will operate in the following order:

First, the absolute day-to-day movement in either the average of the bordering formed tenors or the closest formed tenor under Stage 1 (when operational), or if none is thus formed then those formed under Stage 2, will be applied to either extrapolate or interpolate any unformed tenor;
Second, if there are no formed tenors under Stages 1 or 2, the absolute day-to-day movement in the 90 Day Bank Bill Futures will be applied subject to conditions – details to be finalised with ASX;
Finally, the prior day's rate will be used if the other algorithms cannot be calculated.

Transitional steps to facilitate a VWAP methodology will begin in the third quarter of 2016 and the go-live date for Stage 1 will be determined during the test phase for the new operating infrastructure. Stage 2 is currently operational and Stage 3 will be put in place by end-August 2016.

The 2-month BBSW tenor will continue to be published, along with the 1, 3 and 6 month tenors. However, market feedback is that the 4 and 5 month BBSW tenors have limited application in practice and they will be phased out at the time Stage 1 goes live.

The Council of Financial Regulators has consulted the market on the potential for a regulator to compel submissions to a significant financial benchmark. If this course were to be adopted by government, it would serve as a final backstop for the calculation of BBSW.

The changes to the BBSW methodology outlined here take account of feedback from AFMA member firms and committees, market participants and subscribers to the benchmark. The changes have been approved in accordance with AFMA's governance process for financial benchmarks.

AFMA has a work program underway to set out the detailed rules and procedures required to implement the new methodology within the shortest possible timeframe, while containing the associated operational and compliance risk in the manner required for a significant benchmark.

AFMA has previously advised the market that it intends to step away from benchmark administration and to transfer administrator responsibilities to an appropriately qualified entity (see **Market Notice 2016_3**). While AFMA is responsible for the design of the new methodology and is working on the detailed rules and procedures, the new administrator will be expected to take responsibility for implementation.

AFMA will inform the market of further significant developments in relation to the formulation of the detailed procedures and rules. These updates will be made available via the AFMA website.

About AFMA

The Australian Financial Markets Association (AFMA) is the leading industry association promoting efficiency, integrity and professionalism in Australia's financial markets and provides leadership in advancing the interests of all market participants. These markets are an integral feature of the economy and perform the vital function of facilitating the efficient use of capital and management of risk. Market participants perform a range of important roles within these markets, including financial intermediation and market making. AFMA represents over 120 members, including Australian and international banks, leading brokers, securities companies, state government treasury corporations, fund managers, traders in electricity and other specialised markets and industry service providers.