MEMBER NEWS

August 2016

ASIC finds equity market exhibits a high level of cleanliness

News

AFMA welcomes the release of Report 487, a review of the cleanliness of the Australian equity market. Report 487 provides valuable context, finding that the Australian equities market exhibits a high level of market cleanliness and fares well by international comparison. The outcome recorded in the Report 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.

Management of conflicts of interest and handling confidential information is an integral part of a licensee's compliance obligations, and is critical to ensure that corporate advisory interests of the licensee do not influence client facing activities such as research and advice.

Report 486 (see next item) describes some areas where market participants need to consider if their practices can be improved. These are important issues which should be addressed by industry where needed to improve standards across the board. This approach will ensure that the industry can further build on the statistically significant improvement in market cleanliness reported by ASIC.

AFMA members take their obligations very seriously and continually review their arrangements to ensure they meet regulator and client expectations. As part of our ongoing engagement, AFMA will be discussing the findings of the report with members and ASIC.

See the ASIC Viewpoint in this Newsletter for further information on the two Reports.

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An eleventh hour reprieve on margining rules

News

APRA announced on 22 August a delay in the commencement of the margining and risk mitigation requirements for non-centrally cleared derivatives following representations by members led by AFMA. This announcement was coordinated with the Monetary Authority of Singapore (MAS) and the Hong Kong Monetary Authority (HKMA) after close consultations between the three regulators. The initial margin requirements were being phased in from 1 September, but have now been deferred to an unspecified date.

This delay is welcomed by AFMA given the breakdown in global coordination around the timetable which has a made an already complex implementation exercise even more challenging. The original timetable had been set in place at a globally coordinated level in March 2015 through the Working Group on Margining Requirements (WGMR) of the BCBS-IOSCO process. Coordination broke down on 9 June when the European Union announced that its rules would not be finalised in time for a September launch. European authorities are aiming to deliver final standards by the end of 2016, pushing the start date in Europe to sometime in the middle of 2017. This announcement caused considerable consternation in the industry around the world. The United States and Japan remained firmly committed to the original timing. This led to concerns about further market fragmentation and disruption of cross-border trading and an uneven playing field for firms subject to the US timetable ahead of others.

In Australia, March 2017 was the more important date because that is when the new variation margin rules were to take effect and impact a much broader group of local covered entities. Given the long lead times for document preparation and negotiation with counterparties, which will take much more than six months, it is important that final rules are available so that legal drafting could go ahead and local protocols developed. APRA has been consulting on margining and risk mitigation for non-centrally cleared derivatives rules which will be contained in CPS 226. However, in the last week of August the final margining rules have not yet been settled. This lack of rules made commencement of the original implementation timetable starting from September very worrisome and impossible to meet in practice. The only sensible course of action in the circumstances was a deferral by the regulators. An important aspect of APRA's announcement was their statement that the final version of CPS 226 will be released in the near future. AFMA looks forward to this being done as soon as possible so that preparation work may begin. At a technical level, the delay will occur because APRA will not set a commencement date for the CPS 226 rules when they are made.

It is good to see that key regulators in the Asia-Pacific are consulting and coordinating their actions. While the global OTC derivatives market is fragmenting under the pressure of imperfectly harmonised regulation, it is ever more critical that the Asia-Pacific authorities work together to maintain and foster market activity in the region by coordinating their regulation and actions.

The importance of these margining rules should not be underestimated. They are not mere technical rules of interest to operations and documentation teams. They are the last major cog of the OTC derivatives reforms which started in 2009. They are deliberately intended to affect the economics of providing non-cleared/non-standardised OTC derivatives and can be confidently predicted to change the market in a structural way. A likely and officially intended outcome is that uncleared bilateral derivative transactions will decline further and most will be centrally cleared. Collateral management is also needing to adapt to this much more demanding environment. AFMA will continue to work closely with members as we move from the policy and rule development phase to practical implementation phase with a focus on the operational, collateral management and documentation issues.

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ASIC reports on research and conflicts handling

News

ASIC has released Report 486 in relation to handling confidential information and conflicts in sell side research and corporate advisory. The Report describes ASIC's review of events around Newcrest and the privatisation of NSW electricity infrastructure, four transactions including a large IPO, a small IPO, a placement and a block trade, and a thematic review of large and mid-size firms to assess controls for handling material non-public information and managing conflicts.

A group of AFMA members engaged in ECM, research and equities trading met recently to discuss the findings of the review. AFMA will be meeting with ASIC at the end of August to pass on the preliminary thoughts of members. In the interim, a number of members have indicated they intend to look at their practices and procedures in light of the Report, but will await the public consultation process and issue of regulatory guidance before implementation of any significant changes. ASIC has indicated consultation will occur before the end of this year.

Any members firms who are not already engaged in the dialogue about the Report and would like to be included can contact Head, Policy, Tracey Lyons.

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ATO consults on General Purpose Financial Statement requirement

Have Your Say

The ATO has released a [Consultation Paper] on the recently enacted requirement that any "significant global entity" (i.e. one with an Australian tax presence and associate-inclusive turnover in excess of $1 billion) that currently does not lodge general purpose financial statements with ASIC lodge such statements with the Commissioner of Taxation. This measure was included to allow for cross-bench support for, and ultimately passage of, the Bill containing the Multinational Anti-Avoidance Law.

The ambit of the proposed measure is unclear, and given it arose as a late amendment to a Bill, there is no guidance in an Explanatory Memorandum to assist in clarifying its scope. Particular issues that arise in a global context include whether the statements are to be prepared in respect of the global operations and, if so, whether global transactions will need to be translated into AIFRS so as to adhere to Australian accounting standards. Our view in a branch context is that the lodgement of the publicly available accounts of the ultimate parent/head office should be sufficient where such accounts includes the Australian operations. This would minimise compliance burdens.

Submissions to the Consultation Paper close on 30 September and AFMA will be making a submission. Please contact Director, Policy, Rob Colquhoun if you would like further information or to provide comments for inclusion in the submission.

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AFMA Viewpoint: Monthly CPI would increase offshore participation in indexed bond market

Viewpoint

AFMA made a submission to the Productivity Commission's inquiry into Data Availability and Use. Among other recommendations, the submission argued for the consumer price index (CPI) to be published at a monthly rather than the current quarterly frequency. As the submission notes, this would increase offshore participation in Australia's inflation-indexed bond market.

The Consumer Price Index is an important benchmark index for the Australian economy and a significant input and benchmark for monetary policy. Timely information is crucial to the conduct of a forward-looking and pre-emptive approach to monetary policy. Yet the single most important input into the monetary decision-making process is also one of the least timely by international standards. Australia, along with New Zealand, is one of the few countries to release its inflation data at a quarterly rather than a monthly frequency. Even New Zealand publishes a monthly food price index, a useful series for forecasting the quarterly CPI inflation rate.

The RBA's submission to the ABS's 16th CPI Review noted that:

> More timely data would help provide an earlier indication of the trend in inflation, which is particularly important around turning points. It could also be helpful in distinguishing between signal and noise. In recent years there have been a couple of instances of quarterly readings for inflation that subsequently proved not to be representative of the general trend. The greater frequency of monthly data is likely to allow earlier identification of situations where an observation is unrepresentative.[1]

There is also strong support for a monthly CPI among financial market participants.[2]

The lack of timeliness in compiling and issuing inflation data potentially gives monetary policy a backward-looking bias. This is suggested by the fact that changes in the official cash rate occur most frequently at the monthly RBA Board meeting immediately following the quarterly CPI release. For example, during the 2002-08 tightening episode, 67 per cent of interest rate changes followed this pattern, including every one of the six increases in the cash rate from May 2006 to February 2008.[3] This suggests the Reserve Bank may sometimes delay policy action by one or two months while it waits for the latest inflation data. This is also potentially confusing to the public and their inflation expectations, implying that the Bank is passively responding to past inflation outcomes rather than actively targeting the future path of inflation.

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[1] Reserve Bank of Australia. Economic Group, "Submission to the 16th Series Review of the Consumer Price Index" (Reserve Bank of Australia, March 2010), 1–2, http://www.rba.gov.au/publications/submissions/prices/16th-series-review-of-cpi/pdf/16th-series-review-of-cpi.pdf.

[2] Paul Bloxham, "Monthly Measure of Inflation Needed," *The Australian*, October 4, 2010, http://www.theaustralian.com.au/business/monthly-measure-of-inflation-needed/story-e6frg8zx-1225933517558.

[3] Stephen Kirchner, "Benefits Grow in Monthly CPI Data," *Canberra Times*, March 1, 2010, http://www.institutional-economics.com/images/uploads/ctoped1mar10.pdf.

A monthly CPI release would ensure that each Reserve Bank Board meeting had the benefit of an update on the inflation rate, which also serves as the baseline for the RBA's inflation forecast. The RBA would no longer have a bias to changing interest rates in the wake of the quarterly CPI release. The RBA and financial markets could more quickly identify potential turning points in the inflation rate and the economy.

It is considered desirable for central banks to smooth changes in interest rates over time, to minimise the risk of policy errors. This argues for a gradualist approach to policy. More timely policy action could facilitate this gradual approach by reducing the need for future changes in interest rates.

A monthly CPI would also facilitate offshore participation in Australia's inflation indexed bond market and could be expected to increase offshore holdings of Treasury indexed bonds (TIBs). Globally, most inflation-linked bonds are priced based on the Canadian Treasury model for the indexation of cash flows on a monthly basis introduced in 1991. Australian inflation indexed bonds do not fit neatly into global bond portfolios based on a quarterly CPI and would benefit from harmonisation with the global standard.

While the Reserve Bank and financial markets would welcome a monthly CPI, the Australian Bureau of Statistics has traditionally resisted the idea, claiming that the increased cost of a monthly data collection would outweigh the benefits to users. This is a very narrow reading of benefits. If a higher frequency CPI leads to more timely monetary policy action, the economy-wide benefits could be very large. Most other developed countries have decided that a monthly CPI is worth the cost. The ABS has previously estimated that a monthly CPI would cost $25 million a year compared to the $10m it spends compiling the existing quarterly release or a net additional cost of $15 million a year.[4]

It is worth noting that the Melbourne Institute has produced a monthly inflation gauge with a low tracking error to the official CPI and at low cost, making innovative use of data sources. It is also worth noting overseas efforts to create real-time measures of inflation, such as the Billion Prices Project at MIT, also making innovative use of low cost data collection technologies.[5] There are a number of commercial enterprises focused on providing real-time measures of economic activity and prices.[6] In China, the leading internet search engine, Baidu, is developing indices of employment and consumer spending based on search and other user-generated data.[7]

[4] Australian Bureau of Statistics, "Outcome of the 16th Series Australian Consumer Price Index Review" (Canberra: Australian Bureau of Statistics, December 6, 2010), Appendix 5.

[5] http://bpp.mit.edu

[6] For example, https://www.now-casting.com

[7] David Ramli, "Baidu Creates Own Indexes to Paint Picture of China's Economy," *Bloomberg.com*, accessed June 22, 2016, http://www.bloomberg.com/news/articles/2016-06-22/baidu-creates-own-indexes-to-paint-picture-of-china-s-economy.

Savings could potentially be made by reducing the frequency of other ABS releases, such as the monthly labour force data. The labour force data are very noisy at a monthly frequency and subject to a number of problems in relation to the survey sample and the use of population benchmarks. A former head of the ABS has said that the current iteration of the monthly labour force survey methodology produces data that 'aren't worth the paper they are printed on.'[8] Monthly readings on the labour market can be left to private sector surveys, like the ANZ job advertisements series. Most ABS users welcomed the discontinuation of the similarly volatile and revision-prone monthly current account data in 1997 in favour of a quarterly release. The combination of a volatile monthly labour force release and a quarterly CPI release distorts public debate about economic policy, by giving labour market outcomes greater media prominence than inflation outcomes.

The Productivity Commission will issue a draft report in November 2016, with the final report scheduled for March 2017.

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[8] Jacob Greber, "Former ABS Boss Says Jobs Data 'Not Worth Paper They're Written On'," *Financial Review*, October 14, 2015, http://www.afr.com/news/economy/former-abs-head-says-employment-data-not-worth-paper-theyre-written-on-20151014-gk8syh; Bill McLennan, "Full Letter: Why the ABS Is Broken," *Financial Review*, October 15, 2015, http://www.afr.com/news/politics/national/full-letter-why-the-abs-is-broken-20151015-gka3j2.