

EXPLANATORY STATEMENT for
ASIC Corporations (Significant Financial Benchmarks) Instrument 2018/420

Prepared by the Australian Securities and Investments Commission

Corporations Act 2001

The Australian Securities and Investments Commission (**ASIC**) makes *ASIC Corporations (Significant Financial Benchmarks) Instrument 2018/420* (**the Instrument**) under subsection 908AC(2) of the *Corporations Act 2001* (**the Act**).

Subsection 908AC(2) of the Act provides that ASIC may, by legislative instrument, declare a financial benchmark to be a significant financial benchmark if ASIC is satisfied that:

- (a) the benchmark is systematically important to the Australian financial system; or
- (b) there is a material risk of financial contagion, or systemic instability, in Australia if the availability or integrity of the benchmark were disrupted; or
- (c) there would be a material impact on retail or wholesale investors in Australia if the availability or integrity of the benchmark were disrupted.

ASIC must not make a declaration unless the Minister has consented in writing to the making of the declaration. The Minister consented to the making of the declaration on 30 May 2018.

1. Background

Part 7.5B of the Act was introduced by the *Treasury Laws Amendment (2017 Measures No. 5) Act 2018* to implement a regime for the regulation of financial benchmarks. Certain provisions of Part 7.5B only apply to a financial benchmark that has been declared by ASIC to be a significant financial benchmark. In particular, the administrator of a significant financial benchmark is required to hold a benchmark administrator licence unless exempted by ASIC. In addition, compelled financial benchmark rules that may be made by ASIC under Part 7.5B are permitted to deal only with licensed significant financial benchmarks.

2. Purpose of the Instrument

The purpose of the Instrument is to declare five financial benchmarks as significant financial benchmarks which, in ASIC's opinion at the time of making the Instrument, meet each of the criteria in subsection 908AC(2) of the Act.

3. Operation of the Instrument

Name of legislative instrument

Section 1 provides that the Instrument is the *ASIC Corporations (Significant Financial Benchmarks) Instrument 2018/420*.

Commencement

Section 2 provides that the Instrument commences on the day after it is registered on the Federal Register of Legislation.

Authority

Section 3 provides that the Instrument is made under section 908AC of the Act.

Interpretation

Section 4 of the Instrument provides that financial benchmark has the meaning given by section 908AB of the Act.

Section 5 of the Instrument lists the five financial benchmarks that are declared as significant financial benchmarks.

4. The significant financial benchmarks declared in the Instrument

ASIC is satisfied that the financial benchmarks declared in the Instrument meet each of the criteria in subsection 908AC(2) of the Act to be declared as significant financial benchmarks for the following reasons:

The Australian Bank Bill Swap Rate

At the time of making this Instrument, the Australian Bank Bill Swap Rate (**BBSW**) is administered by ASX Benchmarks Pty Ltd.

BBSW is a set of key short-term interest rate benchmarks for the Australian dollar. The BBSW rates have been estimated to be referenced in contracts with a total notional value of around \$18 trillion, including derivatives, loans and securities. The payments on these products are typically directly linked to BBSW. The finance industry tends to use just one benchmark, such as BBSW, for each type of financial instrument, due to the requirements of industry standard documentation and efficiency. BBSW rates are also used in indices for investment fund benchmarking and asset allocation.

BBSW is the main reference rate used by issuers of securities in Australian dollars (apart from the Australian Government). Australian dollar floating-rate securities issued by financial institutions, state governments, corporates, and securitisation trusts reference BBSW to determine payments such as coupons. Around one-third of non-government bonds (approximately \$200 billion) denominated in Australian dollars reference BBSW; these bonds are held by a broad range of financial institutions and superannuation and investment funds. The Australian banks in particular issue floating-rate bonds referencing BBSW, since they are seeking to fund their floating-rate assets, such as business loans and mortgages, with floating-rate liabilities that have a similar interest rate profile. Almost all asset-backed securities issued by Australian securitisation trusts (around \$440 billion) use BBSW as a reference rate. Hybrid securities also generally have payments referencing BBSW and are

primarily issued by banks. Australian state and territory governments also have on issue around \$20 billion of securities that reference BBSW.

BBSW is widely used as a benchmark in syndicated loans and corporate loan contracts. Australian banks are estimated to have around \$300 billion of business loans directly linked to BBSW. In addition, the interest rates on other bank assets such as mortgages, other business loans and deposits are influenced by movements in BBSW.

BBSW is referenced in derivative products (where either the trade occurs in Australia or at least one Australian resident financial institution is a counterparty) with an estimated total notional value of around \$17 trillion, and are widely used by banks, superannuation and investment funds and corporations for hedging purposes. Cross-currency basis swaps that include an Australian dollar leg, such as AUD-USD and AUD-EUR cross currency swaps, reference BBSW. Australian banks and corporations rely on offshore markets for funding and need cross-currency basis swaps to hedge the resulting exchange rate risk. Foreign investors may use cross-currency swaps to hedge the exchange rate risk on their Australia dollar investments. Interest rate swaps referencing BBSW are also used by financial institutions and corporations to hedge their interest rate risk. These interest rate derivatives are primarily cleared through central counterparties (*CCPs*). In addition, bank bills futures are physically settled at expiry using bills that trade in the bank bill market underlying BBSW.

If BBSW were no longer available at short notice, this would generate widespread disruption in Australian dollar financial markets. A wide range of market participants, including banks, superannuation and investment funds, market operators and CCPs would be required to find an alternative benchmark or to cease trading the instruments that reference BBSW. Trading in financial products and derivatives that reference BBSW would be disrupted affecting the funding of Australian financial institutions, state governments and corporations. The Australian Government bond market would also be affected as interest rate swaps are extensively used to manage the interest rate risk on these securities.

Given the above, ASIC is satisfied that each of the criteria in subsection 908AC(2) is met in relation to the Australian Bank Bill Swap Rate because:

- its widespread and extensive use in the Australian dollar financial markets and loan markets make it systemically important to the Australian financial system; and
- if its availability or integrity were disrupted, there is a material risk of financial contagion or systemic instability in Australia because market participants would be unable to purchase financial products and derivatives that reference BBSW and would be unable to determine payouts due under loans, bonds and other contracts that derive their value by reference to BBSW; and
- if its availability or integrity were disrupted, the impact would be material on wholesale investors in Australia.

The S&P/ASX200 Index

At the time of making this Instrument, the S&P/ASX200 Index (*S&P/ASX200*) is administered by S&P Dow Jones Indices LLC.

The S&P/ASX200 is an equity index benchmark. It is designed to measure the performance of the 200 largest index-eligible stocks listed on the ASX by float-adjusted market capitalisation. The S&P/ASX200, as one of the most reported and publicised financial benchmarks in Australia, is arguably a barometer for confidence in the economy. The impact on investor confidence can be expected to be substantial if the integrity of the S&P/ASX200 was disrupted.

The S&P/ASX200 is an important benchmark for the funds under management (FUM) industry with 27% of the total funds under management invested in Australian equities referencing the S&P/ASX200 index as a performance benchmark. In particular, the S&P/ASX200 plays an important role in both the accumulation and decumulation phases of the retirement sector in Australia. In the accumulation stage, 32% of superannuation funds invested in Australian equities reference the S&P/ASX 200. The index is also the reference performance benchmark for around 42% of assets backing pension and annuities products. Around 42% of Exchange Traded Funds (ETF) moneys invested in Australian assets reference the S&P/ASX 200. If the integrity of the S&P/ASX200 benchmark was disrupted and the level of the benchmark distorted, the value of funds under management which reference the benchmark would be distorted. Given that managed funds held \$506 billion in Australian listed equities at end 2017, of which a significant proportion explicitly references the S&P/ASX200 as a benchmark, any such distortion would be of a significant scale.

The ASX SPI 200 futures and options contracts are derivatives products directly linked to movements in the level of the S&P/ASX200 index. The integrity of these products is therefore inherently reliant on the S&P/ASX200 index being a robust benchmark. The ASX SPI 200 futures and options enable exposure to the top 200 companies without an investor having to buy or sell shares in each of the 200 stocks that make up the index. Turnover in ASX SPI 200 futures has averaged \$8 billion per day in recent months but it tends to spike in the few days preceding a rollover – when soon-to-expire contracts are closed and new contracts opened with later expiry dates – and can reach around \$60 billion per day. The ASX SPI 200 futures and options are used by investors for both speculative trading and hedging of cash equity holdings and transactions. They offer high liquidity and transparency and as such are not immediately substitutable by over-the-counter (*OTC*) contracts. There are no other indices, apart from the S&P/ASX200, referenced in the listed futures market. If the S&P/ASX200 benchmark was to be distorted there would be a material impact on investors in the listed Australian equity futures market and the compromising of the market for exchange-traded equity derivative contracts could, in turn, disrupt the underlying cash equity markets (in which turnover averaged \$6.2 billion per day in FY2016-17).

As for OTC equity derivative contracts, while the proportion of these contracts directly linked to the S&P/ASX200 benchmark is low, the value of those that do explicitly reference the S&P/ASX200 amounted to a daily turnover of around \$500 million in early 2018.

Given the above, ASIC is satisfied that each of the criteria in subsection 908AC(2) is met in relation to the S&P/ASX200 Index because:

- its importance as a performance benchmark for funds under management and its use in the listed Australian equity futures market make it systemically important to the Australian financial system; and
- if its availability or integrity were disrupted, there is a material risk of financial contagion or systemic instability in Australia because of its importance in the listed Australian equity futures market and flow-through impacts on the underlying Australian cash equity markets; and
- if its availability or integrity were disrupted, the impact would be material on wholesale and retail investors in Australia.

The ASX Bond Futures Settlement Price

At the time of making this Instrument, the ASX Bond Futures Settlement Price is administered by ASX Clear (Futures) Pty Limited.

Bond futures contracts for 3-, 10- and 20-year Australian Government bonds are listed on the ASX. When these contracts expire, the ASX Bond Futures Settlement Price is used to calculate the value of these contracts. Given this, the credibility of the bonds futures contracts is inherently reliant on the bond futures settlement prices being robust benchmarks. Therefore, to the extent that the ASX bond futures are important to the functioning of the Australian financial system, the ASX Bond Futures Settlement Prices are also systemically important.

The ASX bond futures (and therefore the ASX Bond Futures Settlement Prices) are the key exchange-traded derivatives for the Australian fixed income market and are important to the functioning of the Australian financial system. The ASX bond futures market is highly liquid and is the primary venue for price discovery in the fixed income market, effectively forming the Australian dollar 'risk-free' yield curve. As a consequence, the pricing of Australian dollar bonds with fixed coupons issued by the Australian government, state governments, banks and corporations is heavily influenced by movements in the pricing of the bond futures. Pricing in the Australian dollar interest rate swap market for longer-term swaps is also heavily influenced by the pricing of the bond futures. If the ASX bond futures were to be disrupted due to a problem with the ASX Bond Futures Settlement Prices, this would affect the issuance and trading of government bonds, corporate bonds and interest rate swaps.

The 3- and 10-year ASX bond futures contracts are actively traded by a range of counterparties, and are ranked amongst the 10 most traded long-term interest rate futures contracts in the world. Daily turnover averages around 160,000 contracts for the 3-year contract, and 130,000 contracts for the 10-year contract. Given that each contract represents \$100,000 of Australian Government bonds, daily turnover is equivalent to \$29 billion. This is substantially larger than the turnover in the physical bond market.

Bond futures contracts in Australia are cash settled, with the calculation of the settlement price involving multiple ‘snapshots’ across a basket of bonds on the contract’s last trading day. That price is then used to calculate the amount paid by the seller of the contract to the party that purchased the contract.

Most bond futures contracts are rolled to the next contract as they approach expiry rather than being held to expiry (for instance, a market participant holding a contract expiring in March would close out this contract prior to its expiry and purchase a contract expiring in June in its place). Open interest in the 3-year and 10-year contract is mostly stable at around 1.1 million contracts for each tenor. This represents around \$220 billion across both contracts. There is some variation in open interest around the individual contract expiry date as participants roll their positions into the next contract. This compares with around \$500 billion of nominal Australian Government bonds outstanding. While the proportion of contracts that are held to expiry is small, a loss of confidence in the close-out pricing of bond contracts would jeopardise turnover through the life of the contract, hence the open interest in bond futures over the life of the contract is an appropriate indicator of the importance of the settlement price.

Given the above, ASIC is satisfied that each of the criteria in subsection 908AC(2) is met in relation to the ASX Bond Futures Settlement Price because:

- its importance in the Australian fixed income market in terms of pricing and exchange-traded derivatives makes it systemically important to the Australian financial system; and
- if its availability or integrity were disrupted, there is a material risk of financial contagion or systemic instability in Australia because market participants would be unable to settle ASX bond futures contracts; and
- if its availability or integrity were disrupted, the impact would be material on wholesale investors in Australia.

The Australian Interbank Overnight Cash Rate

At the time of making this Instrument, the Australian Interbank Overnight Cash Rate (*Cash Rate*) is administered by the Reserve Bank of Australia.

The Cash Rate is the Reserve Bank Board's operational target for monetary policy and is also a significant financial benchmark in the Australian financial markets. The Cash Rate is calculated as the weighted average of the interest rate at which overnight unsecured funds are transacted in the domestic interbank market.

The Cash Rate also influences other interest rates and forms the base on which the structure of interest rates in the economy is built. Movements in the Cash Rate are quickly passed through to other capital market interest rates such as money market rates and bond yields. The Cash Rate and other capital market interest rates then feed through to the structure of deposit and lending rates.

The Cash Rate is the overnight risk-free interest rate benchmark for the Australian dollar. It is used as the reference rate for the ASX's 30-day interbank cash rate futures contract (IBOC futures), Australian dollar overnight indexed swaps (OIS) and basis swaps between the cash rate and BBSW (BOBs). The Cash Rate is also used in indices for investment fund benchmarking and asset allocation.

OIS and IBOC Futures are used by market participants to hedge against movements in the Cash Rate, or to express views on likely changes in the Cash Rate. The open interest of IBOC futures totals just under 200,000 contracts. Given a contract size of \$3 million, the market value of those contracts is just under \$600 billion. The notional value of OIS contracts outstanding (where at least one Australian resident financial institution is a counterparty) is around \$7 trillion. Banks are the dominant participants in the OIS market, using OIS to hedge the interest rate risk between their variable rate assets (mortgages) and fixed rate liabilities (such as term deposits).

Given the above, ASIC is satisfied that each of the criteria in subsection 908AC(2) is met in relation to the Australian Interbank Overnight Cash Rate because:

- its importance as an interest rate benchmark and its influence on other interest rates make it systemically important to the Australian financial system; and
- if its availability or integrity were disrupted, there is a material risk of financial contagion or systemic instability in Australia because of its widespread use in derivative products; and
- if its availability or integrity were disrupted, the impact would be material on wholesale and retail investors in Australia.

The Australian Consumer Price Index

At the time of making this Instrument, the Consumer Price Index (*CPI*) is administered by the Australian Bureau of Statistics.

The CPI measures quarterly changes in the price of a range of goods and services accounting for a high proportion of expenditure by metropolitan households in Australia. The CPI is used as a benchmark in a range of financial products, including bonds and derivatives.

The inflation-linked bond market is used mainly by issuers whose revenue growth is limited to, or closely mirrors, inflation. Inflation-linked bonds are typically purchased by investors with long investment horizons such as defined-benefit superannuation funds or life insurance companies, with liabilities that increase in line with the CPI or wages.

Treasury Indexed Bonds (TIBS) are referenced against the CPI. The face value of Commonwealth TIBS outstanding is \$34.7 billion. State Governments are smaller issuers in this market, with a face value outstanding of \$6 billion. While the Commonwealth continues to be an active issuer in this market, the States typically only issue for specific projects where the revenue stream closely matches inflation. There are also several corporate issuers in this market.

Inflation swaps also reference the CPI, and the total notional value of inflation swaps (where at least one Australian resident financial institution is a counterparty) is around \$50 billion. Inflation swaps are used to convert a nominal interest rate exposure to a real rate, or vice versa. They are widely used in financing infrastructure projects, to bridge the gap between the longer and deeper nominal market and their inflation-linked revenue stream (futures prices of utilities or infrastructure projects are typically linked to inflation). If a corporation is unable to obtain long-term inflation-linked funding, they may instead issue nominal debt and then convert the obligation using an inflation swap to one linked to inflation (which more closely matches their expected future revenue growth).

Some managed investment schemes explicitly target the CPI as a performance benchmark and accordingly a disruption in the calculation of the CPI would affect those investments and likely lead to a material impact on retail investors.

Given the above, ASIC is satisfied that each of the criteria in subsection 908AC(2) is met in relation to the Australian Consumer Price Index because:

- its use in a wide range of financial products as the measure of inflation makes it systemically important to the Australian financial system; and
- if its availability or integrity were disrupted, there is a material risk of financial contagion or systemic instability in Australia because of the need to manage inflation exposures; and
- if its availability or integrity were disrupted, the impact would be material on wholesale investors in Australia.

5. Consultation

ASIC has not consulted separately on the Instrument. However, ASIC did consult on the five financial benchmarks declared in the Instrument in ASIC Consultation Paper 292 in July 2017. In addition, prior to the ASIC consultation, the five financial benchmarks were consulted on as potentially significant financial benchmarks by the Council of Financial Regulators (CFR) in Consultation Paper *Financial Benchmarks Regulatory Reform* in March 2016.

ASIC intends to engage in ongoing consultation with industry to ensure that the Instrument remains appropriate, and is updated as necessary.

6. Statement of Compatibility with Human Rights

Prepared in accordance with Part 3 of the Human Rights (Parliamentary Scrutiny) Act 2011.

ASIC Corporations (Significant Financial Benchmarks) Instrument 2018/420

The *ASIC Corporations (Significant Financial Benchmarks) Instrument 2018/420* (**the Legislative Instrument**) is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.

Overview of the Legislative Instrument

The Legislative Instrument, made by ASIC under subsection 908AC(2) of the *Corporations Act 2001* (**the Act**), declares five financial benchmarks as significant financial benchmarks which, in ASIC's opinion at the time of making the instrument, meet each of the criteria in subsection 908AC(2) of the Act.

Certain provisions of Part 7.5B of the Act only apply to a significant financial benchmark. In particular, the administrator of a significant financial benchmark is required to hold a benchmark administrator licence unless exempted by ASIC. In addition, compelled financial benchmark rules that may be made by ASIC under Part 7.5B are permitted to deal only with licensed significant financial benchmarks.

Human rights implications

The Legislative Instrument does not engage any of the applicable rights or freedoms.

Conclusion

The Legislative Instrument is compatible with human rights as it does not raise any human rights issues.