ASIC ANNUAL FORUM 2014

ADDRESS BY ASX MANAGING DIRECTOR AND CEO – ELMER FUNKE KUPPER

24 March 2014

Check against delivery

A real exchange for Australia in a global market

Thank you for giving me the opportunity to share my thoughts with you.

Today, I will talk about ASX's upcoming submission to the Financial System Inquiry. We believe that the Inquiry comes at an important time. I would like to explain why this is and what we see as the main issues.

Australia punches above its weight in financial markets

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Australia punches above its weight

	Australia's financial markets
Investable assets	• 3rd largest pool in the world at $1.7tr
Capital formation	• $400bn raised during the GFC, 4th in the world
Equities	• More than 2,000 listed entities, market capitalisation $1.5tr • 8th in free-float market capitalisation
Derivatives	• Largest interest rate futures market in Asia, top 5 globally • Large OTC interest rate market, top 5 globally
Foreign exchange	• Australian dollar is 5th most traded currency in the world

Australia has highly successful financial markets. Today, our economy is the 12th largest in the world, and yet in financial markets we punch above our weight. A good example is our interest rate derivatives market, which is the largest in Asia and among the top five in the world.

The success of Australia's financial markets has been driven by a growing economy, the size of the superannuation sector and the quality of our regulators. Our markets were tested during the Global Financial Crisis (GFC) and came through with flying colours.

I am optimistic about the future of Australia and its financial markets. Most of the ingredients that make us successful domestically, and that can make us more relevant in Asia, are already in place. All we need to do is make the right policy choices. And this is where the

Financial System Inquiry comes in. It is an opportunity to debate some of the vital market structure issues and necessary policy decisions to ensure we prosper over the next decade.

A need to refocus on global regulations and competitiveness

The main challenge we face today is that key market regulations are no longer local. Instead, they are global.

Until recently, Australia's regulatory focus has been largely on the domestic equity market. In the domestic equity market, we can make the regulatory decisions locally with input from local participants.

ASIC has done a very good job regulating a more fragmented market place. Australia is now considered the benchmark of how to regulate competitive equity markets effectively and efficiently.

More recently, focus has shifted from the local regulations that affect our domestic equity market to the global regulations that impact on our derivatives markets.

Derivatives markets are critical to our economy. Compared to the equity market, they are larger, rank higher in the world, and carry materially more risk.

This is particularly true for the interest rate markets. Today, Australia's interest rate derivatives markets are the largest in Asia and the 4th largest in the world. They play a vital role in the funding of the banking system and of corporations; they define the benchmark yield curve against which risk is priced; and they are crucial for the management of the country's current account deficit.

They also carry significant risk. For example, derivatives account for over 30% of ASX's revenues but require more than 70% of the default risk capital held by ASX's clearing operations.

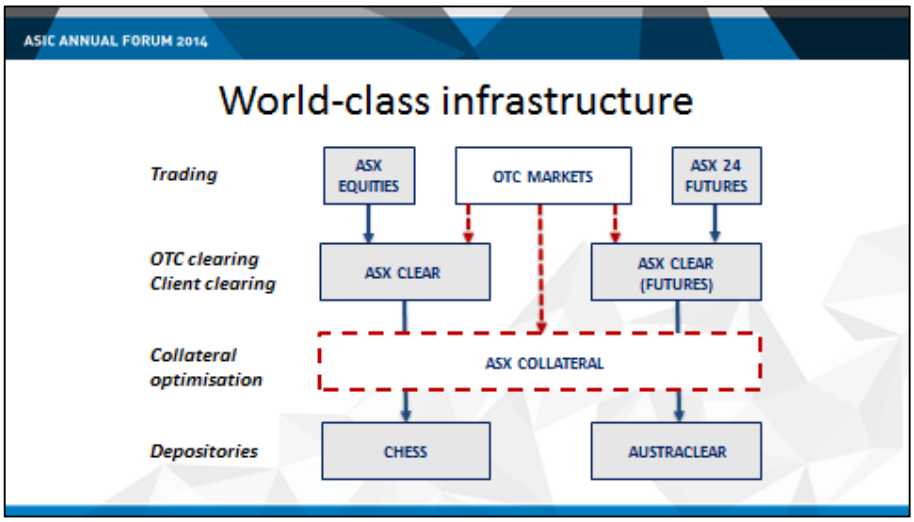
Following the GFC, regulators agreed to change the way the risks in the derivatives market are managed, particularly in the over-the-counter (OTC) markets where parties (banks, for example) trade bilaterally with each other.

Regulators have taken two important steps: first, they decided that the default risk that exists in the OTC markets should be managed through a centralised clearing infrastructure. While banks can continue to trade with each other, once the trade is done the risk has to be transferred to a clearing house. A clearing house becomes the central counterparty to both sides of the transaction, which reduces the market impact of a default of one of the banks in the bilateral transaction.

Second, regulators have tightened the standards and capital requirements for those same clearing houses.

Australia signed up to the global framework and, as consequence, ASX is impacted by the new global regulations. The good news is that we can comply and make the necessary investments. That's what ASX is doing.

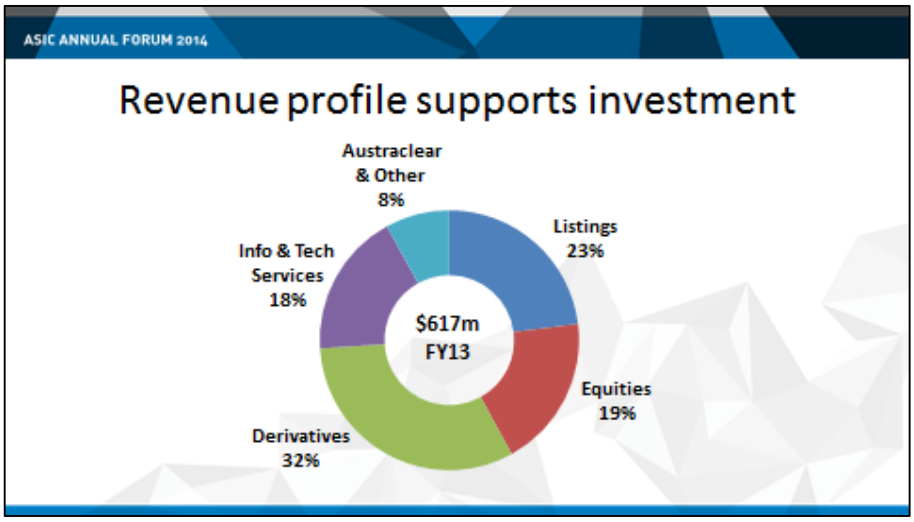
Last year, ASX raised $553 million in new equity, most of which went to our clearing operations. ASX's derivatives clearing house now meets the higher global capital standards and has an AA- credit rating from S&P.



In addition, ASX is investing in the infrastructure that is required to deliver the clearing solutions for the Australian dollar market. By the end of this financial year, Australia will have a clearing solution for OTC derivatives; a client clearing solution that gives important new protections to end investors; and a collateral management service that provides efficiencies to the banks that operate in our markets. Each service deploys the best available technology and risk management solutions.

The importance of scale and financial strength

ASX's ability to invest in this national infrastructure comes from our scale and financial strength. There are two sources for our scale. The first is our business model.



As a fully integrated exchange group, ASX has a broad range of businesses and diversity in our revenues. This compensates, to some degree, for the absolute scale our market lacks compared to the US and Europe.

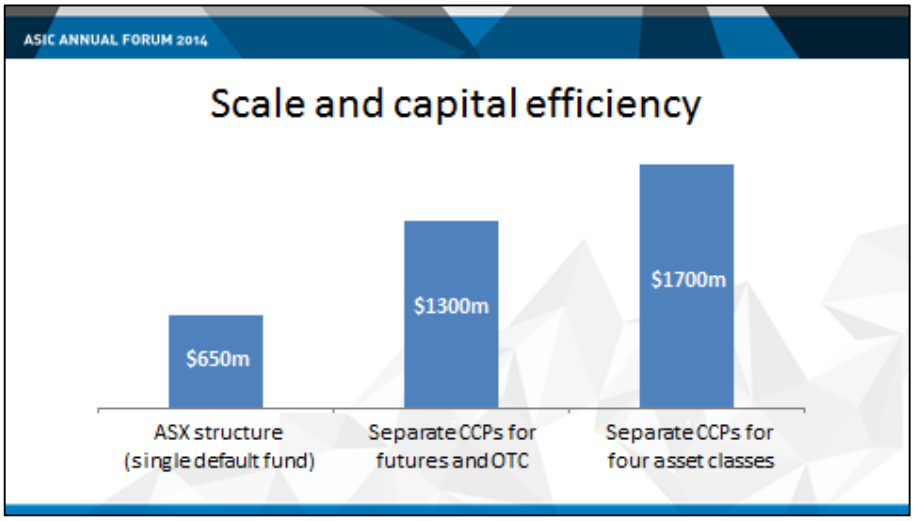
Importantly, it is the difference that makes the difference – we derive scale from our business model and this makes us competitive. Therefore, we should be careful when we copy models from the US or Europe.

ASX's business model is similar to the models we find in markets in our region, such as Singapore, Hong Kong and Japan. If, as a nation, we are to align ourselves more with Asia over time, then our business model makes sense.

To illustrate the importance of the total business, let's look at ASX's $553 million capital raising. Most of the capital we raised went into our clearing houses. It did not generate any new earnings, so our return on equity went down.

And the capital we added supports less than 40% of our revenues. We were able to raise the capital to support 40% of our revenues because we have the other 60%. Yes - ASX is a profitable business and it needs to be to make investments in critical infrastructure.

The second source of our scale comes from our derivatives markets and the derivatives clearing house. Scale matters here, not just to lower costs, but also to create an efficient risk management solution; one that optimises the use of capital and collateral.



ASX has one clearing house for all of its main derivatives products. This creates significant capital efficiency. If we had to create separate capital structures for each derivative market – say, interest rates futures, interest rate swaps and electricity – the amount of required capital would more than double. It would not be economic and we would not be able to invest.

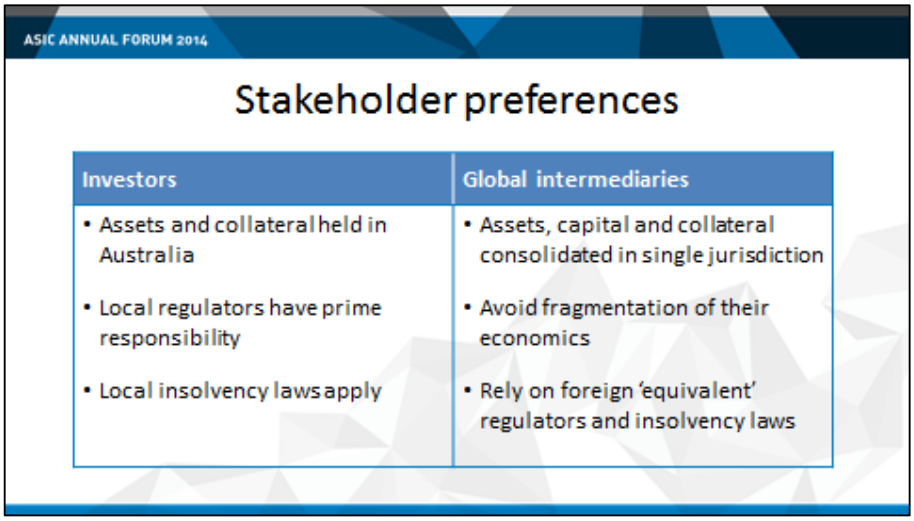
Today, our derivatives markets have scale collectively. This enables us to offer Australian investors access to a world-class market infrastructure.

Having access to a world-class infrastructure also matters for our regional ambitions. It is a pre-condition to be a financial centre. All major financial centres have a central infrastructure, as do all of the major markets in Asia. A central infrastructure attracts capital, investment, skills and people. I'd like to think that this is what we want for Australia's long-term future.

The bottom line is that we cannot afford to make individual regulatory decisions that deal only with discrete aspects of our markets in isolation. We should focus less on the regulatory settings *within* Australia and much more on the competitiveness *of* Australia. We should look up and out, and make decisions about risk much more strategically.

Resolving the 'tension' that has been built into global regulations

The new global regulations have created 'tension' between the interests of investors and the interests of global intermediaries, many of whom are ASX's direct customers.



On the one side, we have investors who would prefer their risk and their collateral to be managed locally under Australian law. If I were a large local fund manager it would not be open for discussion. I would demand it.

We know how this can bite from our experience with MF Global. MF Global was an international intermediary that was particularly important in the Australian grains market. When MF Global collapsed it turned out that much of its clients' collateral was actually held in Europe. Not many end-users had appreciated that when they signed contracts. It took end-customers a year to get their money back and it is a credit to the Australian administrators that they got it back at all.

On the other side, we have the international banks that play a very important role in our financial markets. They have an incentive to optimise their economics globally, which means that they may want to concentrate all their risk in one central location outside Australia. They see fragmentation of their economics as suboptimal. This is not criticism of the banks; it is recognition of their economic reality, just as fragmentation of ASX's derivatives clearing house could have undesirable impacts on our end-users.

This tension means Australia cannot leave matters to chance or wait to discover how the story ends in five or ten years' time. By then it will be too late. We need to write the ending ourselves, to ensure Australian decision-makers remain in control and the interests of Australian investors are protected. This is the issue ASX's submission to the Inquiry will address.

Setting location requirements for all major markets upfront

So, what do we need to do to ensure we stay in control of systemic risk and make the most of the opportunities in our region?

Not much as it turns out. But what we need to do really matters and we haven't done it yet.

What is needed is a clear statement from the Government and the regulators about where they want the infrastructure that manages the risk of Australia's financial markets to be located.

Do they want systemically important markets to be managed in Australia, or can this be outsourced to another jurisdiction, probably Europe? Once clear decisions about location requirements are made for all main markets, regulations and business investment decisions follow naturally.

In ASX's submission to the Inquiry, we will argue that location decisions need to be made upfront for all main financial markets, including equities and derivatives. This is the only way that all operators – not just ASX - can know if sufficient scale is available in Australia to make the necessary ongoing investments.

ASX is not looking for government assistance or protection. We ask for clarity. We believe there should be a level playing field and a regulatory framework that enables business to invest in Australia's systemically important infrastructure.

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Key market location requirements

High level category	Clearing requirements
Domestic equities	Australia
Domestically traded derivatives (A$ rates , equity index, electricity)	Australia
Internationally traded OTC derivatives (A$ interest rate swaps)	Australia for systemically important 'persons'
Commodities (soft and hard commodities)	No mandate

ASX is making specific location recommendations for each major market, driven above all else by a need to control systemic risk. In most cases, our recommendations confirm current practice.

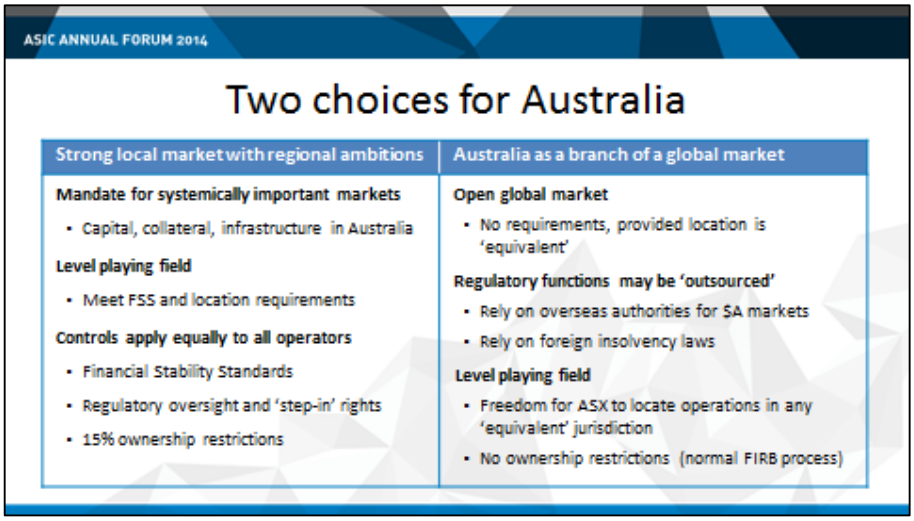
In the OTC market, however, ASX recommends a tightening of controls to ensure that the systemic risk that attaches to Australian dollar derivatives continues to be managed firmly. Our recommendation for Australian dollar OTC derivatives will create the same outcome as can be observed for other significant currencies, including the US dollar, Pound, Euro and Yen. And since the Australian dollar is the world's 5th most traded currency, this outcome will matter to our country long-term.

Our recommendations create a level playing field. Any operator is welcome to compete in the Australian market if it puts capital, collateral and core infrastructure on the ground.

We believe that when a decision is taken it should be locked-in for at least five years. This will provide the certainty necessary for business to commit to invest.

The choices for Australia's financial markets

ASX believes that Australia must have a strong local risk infrastructure. We recognise that others may have a different view. Therefore, we should look at the two available choices.



The first option is consistent with ASX's recommended location requirements. It creates a strong local market with an attractive position in the Asian region. All the requirements apply equally to all competitors.

The alternative for Australia's policy makers is to create a global level playing field. Under this choice, ASX would be relieved of its domestic infrastructure obligations and current ownership restrictions. In practice, this would mean that ASX could move its infrastructure offshore or engage in exchange consolidation. The only requirement would be that the jurisdiction to which the risk is moved be considered 'regulatory equivalent'. That includes North America, Europe and Asia.

If Australia's policy makers choose this path then the removal of all restrictions has to be delivered upfront and with certainty.

Under this scenario, regulators would effectively be outsourcing systemic risk to another jurisdiction and relying on that jurisdiction to support Australian investors in times of crisis.

ASX is not advocating this alternative. Nevertheless, we believe it is important to clearly articulate the choices so we can have an informed debate about the trade-offs - between financial stability and the role of Australia in the region on the one hand, and the value of global efficiencies on the other.

Australia is in the fortunate position that it can make a positive choice about its long-term future. We believe we know enough to make the right choice now.

Thank you for listening.

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