Senate Standing Committee on Economics

ANSWERS TO QUESTIONS ON NOTICE

Treasury Portfolio

Budget Estimates

29 May – 31 May 2012

Question: BET 58

Topic: Financial Market Operators and Participants

Hansard Page: Tuesday 29 May 2012, page 91

Senator CORMANN asked:

Senator CORMANN: I have just a couple of final questions. According to budget paper No. 2—again, page 277—ASIC will levy fees on financial market operators and participants, that is brokers, of $33 million over four years, and the parliament has passed legislation along those lines. How is the money to be expended?

Ms Gibson: This additional money will be used to improve both our capacity and our—it is $43 million, isn't it?

Senator CORMANN: It is $33 million over four years, as I understood it—unless it has gone up.

Mr Medcraft: It is to cover the recovery cost of enhanced markets.

Senator CORMANN: How is that being costed?

Ms Gibson: Approximately half of that is to renew our smart surveillance system, for which the contract expires on 30 June next year, and the balance is to upgrade that system and upgrade our capacity for surveillance. I believe there is consultation later this week on cost recovery, but we would envisage that as most of it relates to IT it would be borne by markets and the participants.

Senator CORMANN: But how does this cost—$33 million over four years—compare with the costs incurred by the ASX when it performed market supervision?

Ms Gibson: That would be comparing apples and oranges.

Senator CORMANN: Sure. Ultimately, though, you have to look at what the cost is to the marketplace and what the implications are in terms of the efficiency of capital markets. I understand what you are saying; it is not quite the same. But the people who are involved in the system are still the same.

Ms Gibson: We believe that overall the cost to the market has gone down, because the ASX has reduced its fees, TRIEX has come into the market and overall the costs of supervision that we would be charging are less than what were the previous cost charges of the ASX.

Senator CORMANN: You are suggesting that overall the costs to the market have reduced, including the cost recovery of around $33 million in additional fees?

Ms Gibson: We believe that the overall cost to participants has gone down because the ASX has reduced—

Senator CORMANN: That is not what participants seem to think, so you have probably got a bit of work to do in terms of communicating that.

Mr Medcraft: Can we provide what our understanding is of the value?

Ms Gibson: It was all detailed in the Treasury paper on cost recovery at the time of the introduction of supervision.

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Senator CORMANN: When this went through the parliament these things were not finalised, to be honest. I think we have had a bit of a conversation about this at estimates before. It is the first time that participants actually have to directly pay a fee as part of the cost recovery arrangements, because before it went through the—

Mr Medcraft: Would it help you if we provide you with the information in terms of the benefit and the relative costs?

Senator CORMANN: It would be exceptionally beneficial. In the interests of time and consistent with my agreements with my colleagues I will now pass over.

Mr Medcraft: We will take that on notice and provide that to you.

Senator CORMANN: Thank you.

Answer:

1. Funding and cost recovery

ASIC has three sources of market supervision funding that are subject to industry cost recovery. They are:

Funding Source	When approved
a) Transfer of market supervision	Mid-year Economic and Fiscal Outlook 2009-10
b) Implementing market competition and developing a framework to support competition in exchange market services	2011-12 Budget Measures
c) Enhanced market supervision (EMS)	2012-13 Budget Measures

Table 1 below shows the anticipated maximum cost recovery for the period 2012-13 to 2015-16 for a) &b) combined, and EMS identified separately:

Table 1:

Planned market supervision cost recovery	EMS Implementation years 2012-13	2013-14	2014-15	2015-16	Total 2012-13 to 2015-16
Current programmes [i.e. a) and b)]	18.868	16.621	16.212	12.723	64.424[1]
Maximum EMS from industry	0.000	5.487	7.952	13.703	27.143 [1 2]
FIDA EMS-related contribution	1.465	1.465	1.465	1.465	5.861[2]
Total of above	**20.334**	**23.573**	**25.629**	**27.891**	**97.427**

[1] **industry cost recvovery = $91.567m**

[2] **EMS $ = $33.003m**

Please note that:

1) the revenue figures for 1 July 2013+ are estimates only and have not been agreed with industry through a CRIS consultation process;
2) related EMS expenditure during the forward estimates is a maximum of $43.7 m. The Government is delaying cost recovery of difference between EMS revenue and expenditure (est. $10.7m) to 2016-17 to 2019-20;

3) the revenue figures will be lower if key procurements are achieved for less cost than the maximum amounts in the EMS measure;
4) the planned FIDA recovery must go through a robust approval process, including approval by the Minister; and
5) any underspend in the project will be returned to the Budget and industry will benefit through reduced cost recovery charges, while any overspend in the project will be borne by ASIC.

2. Benefits

Increased electronic trading that has changed the risk profile of our markets. If not adequately addressed, the risk of technology-related market manipulations, distortions and interruptions / failures will become unacceptably high. The EMS programme's aim is to ensure that investors continue to trade on Australia's markets with confidence, and Australia's international reputation for fair and orderly markets is maintained.

Unlike the Competition programme, the additional supervisory fees imposed on industry by the EMS measure do not relate to any new regulatory reform, so the estimated benefits to industry remain those we estimated at the time of introducing Competition for trading services. In the long-run, Competition is expected to lower the costs of transacting in Australian cash equity markets and Australia's overall competitiveness and ranking in global cash equity market trading is estimated to improve under Competition.

On the cost side, costs relative to projected industry turnover remain in line with comparable international jurisdictions.

Sections 2 a) and 2 b) below show the detailed results for estimating the two types of Competition benefits over FY2011 to FY2015; the estimated total benefit of these over those years is approximately $268m. A simple extrapolation of the benefits to include FY2016 increases this amount to approximately $311m. This is almost 200% greater than projected ASIC industry cost recovery (excluding FIDA) over the same time frame of approx $108[1]m (including EMS).

The estimation of the benefits of competition is by necessity imprecise. We propose a methodology for such an exercise and suggest some numbers for the benefits resulting from competition. These numbers should be taken as generic guidelines to inform further discussion and refining, not as forecasts.

In this exercise, it is assumed that the benefits of competition will arise from two main factors:

(i) a reduction in exchange fees in preparation for competition (this reduction was announced by ASX in July 2010).

Please note that we expect this figure to be understated as Chi-X has very recently included a Trade Reporting Facility to rival ASX; ASX has also very recently repriced some related services. At the time of writing it is too early to estimate likely future cost savings to industry arising from this, however we expect these will be significant.

[1] Comprises industry / non-FIDA cost recovery of approx $91.6m in respect of FY2013 to FY2016, plus earlier industry cost recovery in respect of FY2011 and FY2012 of approximately $16.4m

For the time being, this work extrapolates the price changes by ASX announced in June 2010 only. Should any further price reductions take place, or new tariff structures be introduced (for example, via maker taker pricing or other models) the actual benefits of competition could be higher than estimated below.

(ii) narrowing of bid ask spreads, as a result of increased turnover and depth of book at appropriate prices.

A third possibility is that stakeholders could also benefit from a decline in market impact costs. However, these potential cost savings have not been estimated, given that they are highly dependent on the quantum and the characteristics of the projected increase in liquidity (that is, how much the depth of the order book would grow, and how close to the midpoint of the spread would the prices be at which additional orders would be placed). In addition, bid ask spreads are a component of market impact costs. Because of this, the simulation of a reduction in spreads can be seen as a minimum value for the estimation of the benefits of reduced market impact costs.

Competition is also expected to promote innovation and advancements in trading technology in the market more generally. Similarly, the more substantial potential benefits of innovation have not been estimated in the analysis below.

Sections 2 a) and 2 b) below show the detailed results for estimating the benefits of (i) and (ii) above over FY2011 to FY2015.

2 a) Exchange fees

In June 2010, the ASX reduced its fees for headline trades (those in the central limit order book) from 0.28 bp to 0.15 bp (a reduction of 0.13 bp per side); for on order book crossings from 0.15 bp to 0.1 bp (a reduction of 0.05 bp per side); and for off order book crossings from 0.075 bp to 0.05 bp (a reduction of 0.025 bp per side).

These reductions take place per trade side (that is, on the buy side and on the sell side). As such, the total reductions per trade are doubled to 0.26 bp for headline trades, 0.1 bp for on order book crossings and 0.05 bp for off order book crossings. As a result, the total estimated benefit from FY2011 to FY2015 is $88.8 million for headline trades, $7.5 million for on order book trades and $4.6 million for off order book trades — assuming no growth in turnover. This equates to $100.9 million over the period from FY2011 to FY2015 (Table 2).

Table 2: Potential benefits from reductions in exchange fees, accruing over 5 years from FY2011 to FY2015, assumes zero growth in turnover from FY2011

		FY2011	FY2012	FY2013	FY2014	FY2015	Total
Headline	$'000 (FY2011 dollars)	20,247	18,922	17,685	16,528	15,446	88,828
	Bp (two-sided) (of FY2011 turnover)	0.147	0.138	0.129	0.12	0.112	
On-order book crossings	$'000 (FY2011 dollars)	1,703	1,592	1,488	1,390	1,299	7,472
	Bp (two-sided) (of FY2011 turnover)	0.012	0.012	0.011	0.01	0.009	
Off-order book crossings	$'000 (FY2011 dollars)	1,044	976	912	852	796	4,579
	Bp (two-sided) (of FY2011 turnover)	0.008	0.007	0.007	0.006	0.006	
Total	**$'000** (FY2011 dollars)	22,994	21,490	20,084	18,770	17,542	100,879
	Bp (two-sided) (of FY2011 turnover)	0.167	0.156	0.146	0.137	0.128	

Explanatory notes: uses a turnover of $1,373 billion for FY2011 (single sided); cost reductions of 0.26 bp for headline trades (that account for 56.7 per cent of turnover, excluding open auction, close auction and capped trades, according to the ASX 'Australia Cash Equity Markets, March 2010), 0.1 bp for on order book crossings (that account for 12.4 per cent of turnover) and 0.05 bp for off order book crossings (that account for 15.2 per cent of turnover); assumes a discount factor of 7 per cent per year, as prescribed by the Australian Government Best Practice Regulation Handbook of June 2010, paragraph E35.

Source: ASIC analysis.

2 b) Bid ask spreads

Analysis using 2010 data suggests that almost all of the highest market capitalisation stocks (top 50 stocks in the S&P/ASX 200) already trade at, or are very close to, the minimum tick size. Because of this, further reductions in spreads for these stocks are unlikely. The next grouping of stocks — ranking from 51 to 140 — tend to trade at spreads that are 3 bp wider than the top 50 stocks. The final grouping, from 141 to 200, trade at spreads that are on average 9.6 bp wider than the top 50 stocks.

These spread estimates are used in combination with the experiences in overseas markets to estimate the potential for reductions in bid-ask spreads in Australian stocks. It is assumed that the increased market efficiency brought about by competition should reduce the abovementioned spread differences by half. That is, the '51 to 140' stock grouping that trades at spreads 3 bp above that of large stocks would see a reduction of 1.5 bp in spreads. The '141 to 200' stock grouping that trades at spreads 9.6 bp above the largest stocks, would see a reduction in spreads of 4.8 bp. It is assumed that there will be no improvement for the top 50 stocks or for stocks outside the top 200.

These assumptions lead to a potential FY2011 to FY2015 cost saving of $166.8 million, assuming zero growth in turnover (Table 3).

Table 3: Potential benefits from reductions in bid ask spreads, accruing over 5 years from FY2011 to FY2015, assumes zero growth in turnover from FY2011

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		FY2011	FY2012	FY2013	FY2014	FY2015	Total
Stocks 51 to 140	$'000 (FY2011 dollars)	24,070	22,496	21,024	19,649	18,363	105,602
	Bp (two-sided) (of FY2011 turnover)	0.175	0.164	0.153	0.143	0.134	
Stocks 141 to 200	$'000 (FY2011 dollars)	13,951	13,038	12,185	11,388	10,643	61,204
	Bp (two-sided) (of FY2011 turnover)	0.102	0.095	0.089	0.083	0.077	
Total	**$'000** (FY2011 dollars)	38,021	35,534	33,209	31,036	29,006	166,806
	Bp (two-sided) (of FY2011 turnover)	0.280	0.260	0.240	0.230	0.210	

Explanatory notes: uses a turnover of $1,373 billion for FY2011 (single sided); cost reductions of 0.26 bp for headline trades (that account for 56.7 per cent of turnover, excluding open auction, close auction and capped trades, according to the ASX 'Australia Cash Equity Markets, March 2010), 0.1 bp for on order book crossings (that account for 12.4 per cent of turnover) and 0.05 bp for off order book crossings (that account for 15.2 per cent of turnover); assumes a discount factor of 7 per cent per year, as prescribed by the Australian Government Best Practice Regulation Handbook of June 2010, paragraph E35.

Source: ASIC analysis.