

Australia as a Financial Centre

Building on our Strengths

Report by the Australian Financial
Centre Forum

November 2009

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Australian Financial Centre Forum
An Australian Government Initiative

17 November 2009

The Hon Chris Bowen MP
Minister for Financial Services,
Superannuation and Corporate Law
P O Box 6022
Parliament House
CANBERRA ACT 2600

Dear Minister

It gives us great pleasure to present the Report of the Australian Financial Centre Forum.

The Australian financial sector has emerged from the global financial crisis strong, well regulated and highly regarded around the world. For the most part, it is competitive, efficient and innovative in meeting the needs of Australian households and businesses.

Somewhat surprisingly, given this solid domestic base and the enormous opportunities in offshore markets, its engagement in cross-border activities within the Asia-Pacific region and beyond is much less developed. This is reflected in low levels of imports and exports of financial services.

Our Report focuses on a number of areas where sensible policy changes will, in the Panel's judgment, lead to a more competitive, efficient and internationally engaged financial sector, a sector where offshore participants want and need to do business.

The potential benefits to Australian households, businesses and the workforce are numerous: lower borrowing costs, lower fees on financial products, wider choice of financial products and improved job opportunities. Greater financial integration is also important to Australia's broader strategic interests in the region.

Realisation of these opportunities and benefits will require more than a discrete set of policy changes. It will also require a bold and imaginative response on the part of the financial sector, as well as ongoing policy reviews and changes in future years as financial markets continue to evolve and as other financial centres compete with us to attract business. Our Report includes recommendations designed to encourage and facilitate this ongoing process of reform.

This Report is very timely. The reputation of Australia's financial sector has arguably never been higher. The Asia-Pacific region remains the fastest growing region in the world. Important policy changes have recently been made in Australia and more are in prospect. The opportunities need to be grasped by government and by industry, to the benefit of all Australians.

In setting up the Forum, you emphasised that successful expansion into global markets requires an ongoing dialogue and partnership between government and the financial sector. This Report is the outcome of such a dialogue. It has benefited from wide ranging discussions with industry - including importantly through our Reference Group of industry bodies; with regulators; and with government advisers. We are confident that, if acted on by both government and industry, it will go a long way towards advancing the Government's stated objective of positioning Australia as a leading financial services centre.

The Panel would like to acknowledge the excellent work of the Secretariat, consisting of Geoff Weir (Director), John Larum, Fyfe Strachan and Narelle Hards, and the strong support from the Treasury. We also thank Kevin Davis, Research Director Melbourne Centre for Financial Studies, and Alan Stokes, Editorial Consultant for their valuable assistance in compiling this Report.

Yours sincerely



Paul Binsted



Alf Capito



Patricia Cross



Jeremy Duffield



Craig Dunn



John Story



Mark Johnson
Chairman



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EXECUTIVE SUMMARY

- The financial sector is at the core of the economic system, providing a range of services to households, businesses and governments. Economic research demonstrates a well-established causal link from financial sector development to economic growth. Having an open, efficient, well regulated and competitive financial sector is thus in the interests of all Australians.
- Countries with high quality financial sectors like Australia should be reaping the full benefits by exporting their financial services skills and experience to other countries.
- Australia is situated close to the fastest growing region in the world, where the need for ongoing development and liberalisation of financial markets in many countries is opening up enormous opportunities. Australia has arguably the most efficient and competitive ‘full service’ financial sector in the Asia-Pacific region. Our financial sector ranks highly in international surveys on many of the key requirements for a successful financial centre. These include a highly skilled workforce and a first class regulatory framework that has served us well through the global financial crisis. Yet our exports and imports of financial services are low by international standards. Our funds management sector, one of the largest and most sophisticated in the world, manages only a small volume of funds sourced from offshore.
- There are many reasons for this ‘inward focus’ of our financial sector. Central amongst them are some policy settings which inhibit a greater volume of cross-border financial transactions occurring through Australia – a distinguishing feature of successful financial centres.
- This Report sets out a small number of policy recommendations which, if implemented, can substantially boost our trade in financial services and further improve the competitiveness and efficiency of our financial sector. This will reduce costs and widen choices for consumers and businesses and increase skilled job opportunities in the financial sector and in a wide range of supporting industries and services. Greater financial integration with the region is also consistent with our broader national interests.
- The recommendations in the Report and their potential benefits are summarised in the table below. The key ones are as follows:
 - the Investment Manager Regime, funds management vehicles and Asian passport package of proposals, which will help Australian fund managers to attract overseas investors into funds run out of Australia. The Investment Manager Regime will also make it a lot easier for both local and international companies to use Australia as a regional base from which to manage offshore assets;
 - the recommendations on withholding tax on offshore borrowings and on Islamic finance, which will improve Australia’s access to offshore pools of savings at competitive rates, so as to provide more diversified and cheaper funding for Australia’s investment needs;
 - the Offshore Banking Unit recommendations, which will increase the volume of offshore financial transactions that are channelled through Australia;
 - the recommendations for an ‘online gateway’, on State taxation and regulation of the insurance sector, on increased competition on exchange traded markets, on corporate debt issuance and

- on the Asian passport, which will reduce the cost and increase the range of financial products available to consumers and business in Australia; and
- the regulatory review recommendations, which will help maintain and enhance Australia’s first class regulatory framework, increase the confidence of offshore investors to invest in or transact through Australia’s financial centre, and protect the interests of domestic consumers of financial products.
- Australia needs to more actively and effectively promote the strengths of its financial sector and the advantages to overseas investors of recent and prospective policy changes. The Report contains recommendations designed to do this.
 - This Report builds on a process of reform that has been underway for some time. Some of the earlier policy changes have had limited impact, for a number of reasons:
 - policies with good intent have not always been implemented or administered as effectively as they might have been;
 - policy changes have often not been regularly updated and amended over time to ensure that they remain as relevant and effective as intended in a world of rapid financial innovation and change; and
 - policy changes in Australia are taking place against a background of rapid policy change in other countries and financial centres in the region.
 - The Forum sees a central role for an ongoing body focused on ensuring that policy measures directed at achieving the Government’s objective of establishing Australia as a leading financial centre are effectively implemented; on monitoring policy developments in overseas financial centres; and on providing advice on future policy changes that may be required.

Summary of Recommendations

| Policy Initiatives | Recommendation reference | Benefits |
|---|--------------------------|---|
| Increasing the size of the market | | |
| • Investment manager regime | 3.1 | Increased business in Australia and more opportunities offshore |
| • Offshore banking units | 3.2 | |
| • Funds management vehicles | 3.3 | |
| • Regional funds passport: managing offshore funds | 4.3 | |
| Improving access to capital | | |
| • Remove withholding tax on offshore borrowing and remove LIBOR cap | 3.4, 3.5 | More diversified funding sources and lower borrowing costs for consumers and business |
| • Remove impediments to Islamic finance | 3.6, 4.8 | |
| Enhancing competition and efficiency | | |
| • Remove state insurance taxes and rationalise regulations | 3.7, 4.7 | Lower costs and wider choice for consumers and business |
| • Increase competition in exchange-traded markets | 4.5 | |
| • Simplify retail debt issuance | 4.6 | |
| • Regulatory online gateway | 4.4 | |
| • Regional funds passport: domestic competition | 4.3 | |
| Maintaining best practice regulation | | |
| • Avoid unnecessary regulation | 4.1 | Maintenance of an efficient and effective regulatory system that protects consumers |
| • Regulatory reviews | 4.2 | |
| Deepening regional engagement | | |
| • Government declaration of intent | 6.1 | Promotion of Australia as a financial centre |
| • Financial missions | 6.2 | |
| Strengthening government — business partnership | | |
| • Financial Centre Task Force | 3.8, 6.3 | Support for effective and ongoing policy reform |

1. INTRODUCTION: OPPORTUNITIES AND CONSTRAINTS

BACKGROUND

On 26 September 2008, the then Assistant Treasurer and Minister for Competition Policy and Consumer Affairs, the Hon Chris Bowen MP, announced the establishment of the Australian Financial Centre Forum, designed to position Australia as a leading financial services centre. The Minister stated that the focus of the initiative was on ensuring that Australia's policy settings allowed the financial sector to take full advantage of business opportunities in the region. He also emphasised that successful expansion into global markets required an ongoing dialogue and partnership between government and the financial sector.¹

The Minister announced the appointment of Mr Mark Johnson, retired Deputy Chairman of Macquarie Bank, to lead the work of the Forum, along with the establishment of a small group of senior financial sector executives to form a Panel of Experts. The Panel consisted of Mr Paul Binsted; Mr Alf Capito; Mrs Patricia Cross; Mr Jeremy Duffield; Mr Craig Dunn; and Mr John Story.

The Forum was further supported by the establishment of a Reference Group of representative industry bodies.²

WHY IS IT WORTH DEVELOPING AUSTRALIA AS A LEADING FINANCIAL CENTRE?

Australia's financial sector is an important contributor to national output, employment, economic growth and development. The sector accounts directly for around 7.5 per cent of GDP, and employs directly around 390,000 people, or 3.6 per cent of total employment.³ Indirectly, it employs a substantially larger number of people, by way of outsourced legal, accounting, technology, administration, processing and other services.

However, the financial sector's contribution to economic growth and output is much more important than these measures suggest. The financial sector is at the core of the economic system, providing a range of services which are necessary for other domestic and trade related industries to function efficiently and enabling consumers to effectively manage their consumption-savings requirements over time. While economic growth tends to induce accompanying financial sector growth, empirical research demonstrates a well-established causal link from financial sector development to economic growth.⁴

In short, from a purely domestic focus, having a financial sector that meets the financing and investment needs for consumers, businesses and governments as efficiently and competitively as possible increases the nation's capacity to grow.

1 The Hon C Bowen MP (Assistant Treasurer and Minister for Competition Policy and Consumer Affairs), *Appointment of the Chair and Panel of Experts to Lead the Government's Initiative to Position Australia as a Leading Financial Services Centre in the Asia-Pacific Region*, media release, 26 September 2008.

2 See Appendix 1 for Reference Group membership.

3 Based on four quarters to August 2009. Source: Australian Bureau of Statistics (ABS), *Labour Force; Australia*, cat. no. 6202, ABS, Canberra, 2009.

4 See for example, R Levine 'Finance and Growth: Theory and Evidence' in *Handbook of Economic Growth*, ed P Aghion and S Durlauf, Elsevier Science, The Netherlands, 2005.

Efficiency and competitiveness are more likely to be evident in an economy that is open to international competition and world's best practice. Countries that have highly efficient and competitive financial sectors are also likely to be exporting those services. Australia has a comparative advantage in many parts of its financial sector compared with most other countries in the region. If we are to take full advantage of our skills and experience in financial services, then it is essential to ensure that there are no major policy impediments to either offshore activity or inward investment.

Countries with less developed financial systems can enhance their economic growth by importing financial services from another country with a more developed financial sector. In the context of this Report, the export of Australia's financial services skills and experience to other countries can benefit both those countries and Australia: in Australia's case, directly through the export of financial services and also indirectly, via the increased trade opportunities resulting from stronger growth in the region and beyond.

THE OPPORTUNITY

Australia is situated close to the fastest growing region in the world (see Box 1.1 below). In many countries in the region, growth in income and wealth, along with demographic factors, will increasingly require development of a wider range of financial services, including capital markets to help finance development, retirement income schemes, and asset management and insurance products to provide for wealth management and its protection. This is likely to require, over time, a further opening up of their financial markets to innovation and competition from new entrants.

Box 1.1: Growth factors in the region

Economic growth in the Asia-Pacific region has continued to outperform other regions, including through the period of the global financial crisis.

- Over the 10 years to 2008, real GDP growth averaged 6.6 per cent, compared with 3.4 per cent for the rest of the world.⁵
- For 2009, the International Monetary Fund (IMF) is forecasting GDP growth of 6.2 per cent for developing Asia⁶; minus 2.4 per cent for newly industrialised Asian economies⁷ and minus 1.1 per cent for world output. For 2010, the IMF is forecasting GDP growth of 7.3 per cent for developing Asia; 3.6 per cent for newly industrialised Asian economies; and 3.1 per cent for world output.⁸
- Asia-Pacific high net worth individuals held about 23 per cent of global high net worth individual wealth in 2008, up from around 18 per cent in 2000.⁹

5 Total Economy Database, The Conference Board, June 2009, viewed 17 September 2009, <http://www.conference-board.org/economics>.

6 Defined as: China, India, Indonesia, Malaysia, Philippines, Thailand and Vietnam.

7 Defined as: Hong Kong, Korea, Singapore and Taiwan.

8 IMF, *World Economic Outlook October 2009: Sustaining the Recovery*, IMF, Washington DC, 2009 at p 2.

9 Merrill Lynch and CapGemini, *World Wealth Report*, Merrill Lynch, Pierce, Fenner & Smith Incorporated and Capgemini, 2009, p 3; Merrill Lynch and CapGemini Ernst & Young, *World Wealth Report*, Merrill Lynch and CapGemini Ernst & Young, 2001, p 4.

Box 1.1: Growth factors in the region (continued)

Such outperformance is expected to continue, driven by relatively strong productivity and population growth in the region. Asia's share of world output is projected to grow from 30 per cent currently to 40 per cent by 2050.¹⁰

While private sector savings ratios are typically high in the region, the range of financial assets in which to invest is, in many cases, limited. With continuing increases in incomes and wealth, demand for more sophisticated financial services is likely to increase rapidly.

Australia has arguably the most sophisticated and advanced financial sector in the region. However, while Australia is a very open trading economy overall, our exports and imports of financial services as a percentage of GDP are, by international standards, low. The opportunities for leveraging off our financial services skills and expertise, in the region and beyond, are potentially enormous, and have been fully recognised by the Government. This has been reflected in the establishment of the Forum and also in a series of policy decisions taken since it came into office.¹¹

The policy changes recommended in this Report are designed to build on these developments. The recommendations are geared towards a wide range of opportunities for greater international engagement: Australian based fund managers managing more offshore sourced funds; foreign competitors setting up business in Australia or marketing their financial products in Australia; Australian banks doing more transactional business in the region; financial institutions having easier and cheaper access to offshore pools of savings to finance investment; or the Australian based treasury operations of a financial services company managing its offshore assets out of Australia.

If implemented and then acted on by industry, the recommendations in this Report will:

- improve Australia's growth prospects and standard of living;
- reduce the costs of financial products to Australian consumers and businesses by encouraging competition and efficiency and by improving access to offshore pools of savings at competitive rates;
- improve the range and choice of products available to consumers;
- increase exports of financial services products;
- increase skilled job opportunities within the financial sector;
- attract talented and experienced Australian expatriates working in offshore financial centres back to Australia; and

10 Treasury projections based on data from the United Nations (UN), IMF and the Organisation for Economic Cooperation and Development (OECD).

11 These policy measures include: reducing the withholding tax on distributions to non-residents by Australian managed investment trusts; modernising the attribution rules; repealing the foreign investment fund rules and instigating reform of the controlled foreign company rules; allowing deemed capital account treatment for gains and losses made on disposal of investment assets by managed investment trusts; reforming the foreign investment screening framework to make it less onerous for foreign investors; and reforming market supervision arrangements to provide that the Australian Securities and Investments Commission (ASIC) will supervise trading activities which take place on a licensed financial market, in order to facilitate the introduction of competition.

- through greater financial integration, enhance Australia's broader national interests within the Asia-Pacific region.

Importantly, the recommendations need to be seen as a package: many of them are very closely interrelated. Some of them are ambitious and long-term in nature. The potential benefits will inevitably take time to realise, and ultimately will depend on the willingness of Australian based companies to respond to the enormous opportunities unfolding in many overseas markets. The Government has made clear its commitment in the form of recent and prospective policy changes; it is up to the private sector to seize the emerging opportunities.

Given Australia's geographic location, its trade links, and the very strong growth in the Asia-Pacific region, many of these opportunities are likely to be focused in the region. While this is reflected in the Report, the Forum has also been conscious of the need not to neglect ongoing links and opportunities in Europe, the US and elsewhere.

WHAT ARE THE DESIRABLE CHARACTERISTICS OF A 'LEADING FINANCIAL CENTRE'?

The focus of this Report is on policy proposals designed to help develop Australia as a leading financial centre. Amongst the many questions raised as a consequence of the international financial crisis is what kind of financial sector is desirable. Questions have been raised at the more philosophical level, including by Lord Turner¹², as to whether some aspects of financial services were really of any net benefit to society at all. More broadly, as the very rapid growth in the size of the financial sector in a number of countries increased the adverse impact on the global economy from the financial crisis, issues have inevitably arisen as to the appropriate role of government policy in encouraging such growth. This questioning encompasses matters such as the correct balance between the size and stability of the financial sector; between competition and stability; innovation and regulation; domestic and international focus; and between focusing on comparative advantages as against developing all aspects of financial services.

These were all very pertinent issues for the Forum in considering what constitutes a leading financial centre, and more specifically what kind of financial centre Australia should aspire to. Some offshore financial centres have been largely built on providing major tax and other concessions to international financial services companies to entice them to establish their regional headquarters in that country. A number of parties have suggested that approach to the Forum as the best model for Australia.

In the Forum's view, such an approach is neither desirable nor sustainable. As the financial crisis has demonstrated, the most important characteristic of a leading financial centre is that it is stable and well regulated, and that at its core is the provision of a wide range of financing and investment products for domestic consumers, businesses and governments as efficiently and competitively as possible. The assessment of this Report is that, for the most part, Australia already has such a base.

Beyond that, a key characteristic of a leading financial centre is a high degree of 'internationalisation': that is, financial transactions involving offshore parties that are transacted through the centre. This characteristic is likely to follow naturally from the first one: financial sectors that are open, efficient, competitive and stable are likely to attract offshore business, so long as there are no policy or other constraints that prevent this. It is thus crucial that domestic policies do not inhibit companies that have the capacity, skills and comparative advantage from expanding into offshore markets and transacting with offshore counterparties; and also that domestic policies do not inhibit offshore

12 UK Financial Services Authority (FSA), *The Turner Review: a regulatory response to the global banking crisis*, FSA, London, 2009.

international financial services companies from competing domestically or from using that financial centre as a regional base.

Financial capital is highly mobile, and there is no shortage of countries with the ambition to develop a financial centre. There is a growing body of surveys and academic studies on what encourages financial services companies to set up in one location rather than another.¹³ Many factors typically feature in such studies, including quality of life; corporate governance; culture and language; and operational costs, to name a few. However, one feature which most frequently comes at or near the top of the list in terms of importance is human capital. Indeed, in a world of increasingly mobile financial capital, and where such factors as the rule of law, adequate technology and reasonable market liquidity are becoming more common, the importance of human capital is, if anything, increasing.¹⁴

Vision and principles

In distilling these observations as to what constitutes a sustainable leading financial centre and what kind of centre Australia should aspire to, the Forum has, in consultation with industry, developed a vision statement of:

A financial sector which is open, competitive and underpinned by strong, stable and sound institutions. It exhibits the lowest possible barriers to entry consistent with the maintenance of financial stability and integrity, so as to encourage new entrants and foster price competition and innovation. It is a sector with a reputation for transparency, integrity and efficiency. It is a sector where the critical mass of skills, experience and reputation encourages both domestic and international participants to do business. It thus exhibits a high volume of cross-border transactions in a wide variety of financial products, services and currencies.

Closely associated with this vision, and in part reflecting the literature on the key characteristics of a leading financial centre, the Forum has also developed a more detailed set of principles designed to guide policy towards achievement of the vision. These policy principles are set out more fully in Appendix 3. In summary form, they are as follows:

- (a) *Development and maintenance of a competitive, efficient and consistent taxation and tax administration system ...*
- (b) *Maintenance of a best practice, principles based regulatory framework ...*
- (c) *Maintaining world class education, training and immigration programs which ensure the continuous availability of a highly skilled and innovative workforce ...*
- (d) *Removal of barriers to the competitiveness, efficiency and liquidity of domestic financial markets ...*

13 See for example *Sustaining New York's and the US' Global Financial Services Leadership*, prepared by McKinsey & Company for Mayor Michael R Bloomberg and Senator Charles E. Schumer, 2007 ('the Bloomberg-Schumer report'); Governor's Advisory Panel on Financial Services, *New York's future in financial services: the final report of the Governor's Advisory Panel on Financial Services*, New York State Department of Economic Development, New York, 1989; Z/Yen Group Ltd, *The Global Financial Centres Index 6*, City of London Corporation, London, 2009.

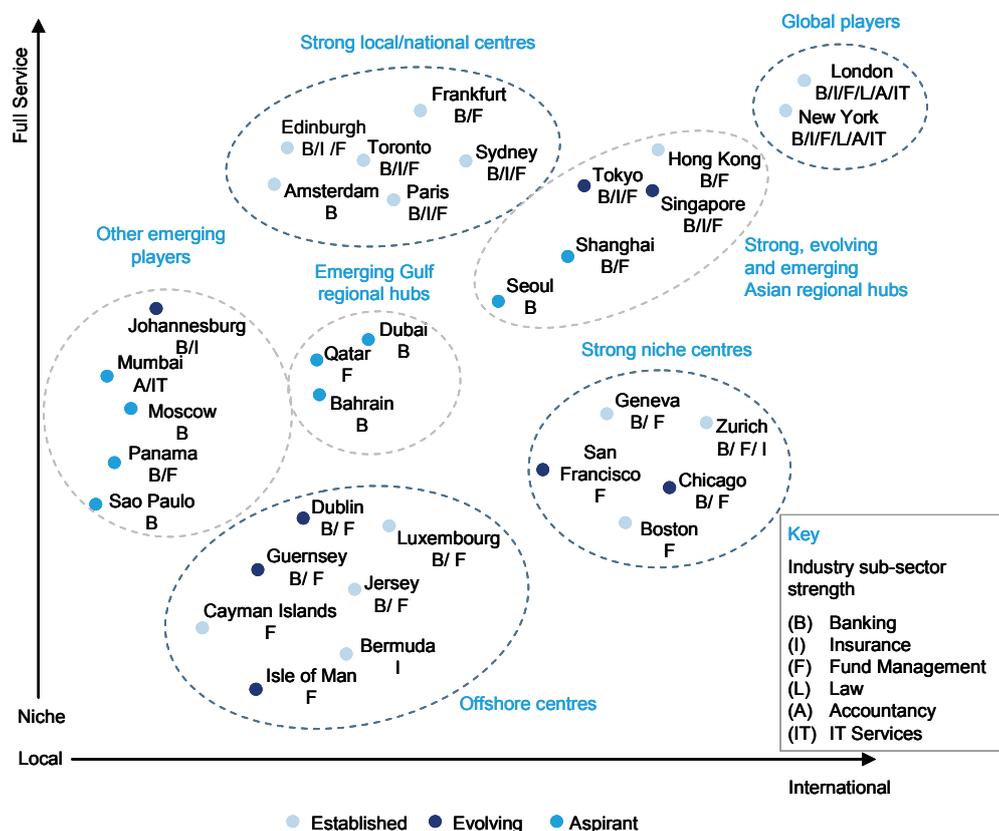
14 For example, the Bloomberg-Schumer report noted the following: 'As market effectiveness, liquidity and safety become more prevalent in the world's financial markets, the competitive arena for financial services is shifting toward a new set of factors – like availability of skilled people and a balanced and effective legal and regulatory environment', op cit, pp 11-12.

This vision statement and set of principles have guided the Forum’s analysis of the many proposals it has considered.

HOW DOES AUSTRALIA’S FINANCIAL SECTOR COMPARE WITH LEADING FINANCIAL CENTRES OVERSEAS?

As outlined above, two key features of leading, sustainable financial centres in the Forum’s view are a well developed, efficient, competitive and well regulated domestic financial centre; and a high degree of cross-border activity transacted through the centre. A recent report on the UK financial services sector categorised established and emerging financial centres in terms of whether they were global or local in transactional scope and also the range of services provided, which is reproduced in Chart 1.1.¹⁵ While the chart refers to individual cities, a more useful and accurate reference would be to Australia rather than Sydney, given the importance of the financial sector in Melbourne as well as Sydney.

Chart 1.1: Categorisation of financial centres



Source: Oliver Wyman, Citi, published in *UK International Financial Services — The Future, A Report From UK Based Financial Service Leaders to the Government*, May 2009.

The chart suggests that Australia as a financial centre is well developed in terms of the range of services offered, but fairly inwardly focused. This subjective assessment is confirmed by the following and other observations set out in this Report:

15 HM Treasury, *UK International Financial Services - The Future, A Report From UK Based Financial Services Leaders to the Government*, HM Treasury, London, May 2009, p 33.

- our exports and imports of financial services relative to the size of our financial sector are low by international standards; and
- despite having one of the largest and most sophisticated funds management sectors in the world, the volume of funds under management in Australia that is sourced offshore is very low.

These broad characteristics of our financial sector – arguably the most advanced financial centre in the region but with only limited cross-border activity – to an important extent reflect policy related factors which are discussed at length in this Report. They also partly reflect some more underlying factors. Within the region, our substantially higher corporate and personal tax rates compared with a number of countries, along with our geographic location – close to but not in Asia – place inherent limitations on our scope to compete with Singapore or Hong Kong as a location for the regional headquarters of large international financial companies. Limited access to some financial markets in the region has constrained opportunities for offshore expansion by Australian financial companies. Our banking sector has been heavily focused on domestic lending, and has not had large amounts of excess capital for offshore ventures.

However, Australia also has many innate advantages. Our geographic proximity to Asia and similar time zone compared with financial centres in Europe or the US put us in a potentially advantageous position in terms of interaction with Asian markets and customers. Our growing trade integration with the region provides increasing trade financing and other opportunities for our financial sector. Australia has developed innovative investment vehicles and funding arrangements in areas such as real estate and infrastructure financing, leading to expertise in these areas which in some cases we are already exporting to the region and beyond.

Our well educated and mobile workforce, along with our political stability, the proven success of our macroeconomic policy framework, our sound legal and regulatory framework and our quality of life, have encouraged some multinational financial services companies to set up businesses in Australia. Our superannuation system has resulted in Australia having one of the largest and most sophisticated funds management sectors globally, with world class asset consultancy businesses, a well developed financial advisory sector, leading edge technology platforms and strong legal and accounting services.

The financial crisis has emphasised some of Australia's advantages. The high credit rating and strong capitalisation of our major banks, in an environment where counterparty risk has become a heightened concern to financial market participants, has already resulted in an increase in business for them in the region. The reputation of our regulatory system has been significantly enhanced around the world. Australia has recently been ranked by the World Economic Forum as second amongst the world's financial centres.¹⁶

In most areas of Australia's financial sector – insurance, banking and funds management – there are examples of Australian companies successfully growing their offshore businesses. There are also some examples of large international financial services companies using Australia as a regional base. These examples are, nonetheless, surprisingly few given our advantages. There are many reasons for this, including conscious and sensible business decisions to focus on domestic growth opportunities; market access restrictions in overseas countries; and lack of overseas brand recognition. However, a recurring theme in the Forum's discussions and in submissions received was that, in many cases, they reflected domestic, policy related constraints to cross-border activity, or to the establishment of regional headquarters in Australia. These policy constraints are the central focus of this Report.

16 N Roubini and J Bilodeau, *The Financial Development Report 2009*, World Economic Forum, US, 2009.

THE WAY FORWARD

This Report aims to build on a reform process that has been under way for some time, and also to ensure that this process continues. Its objectives are not new. There have been several government initiatives in recent decades, often with bipartisan support, aimed at building on our comparative advantages and helping to develop Australia as a regional financial centre. By way of example, in 1992 the then Prime Minister, the Hon Paul Keating MP, announced changes to the offshore banking unit regime (which was introduced in 1986) designed to 'integrate Australia more closely with the Asia-Pacific growth economies by becoming an expanding financial centre of the region'.¹⁷ Again, in 1997, as part of an 'Investing for Growth' strategy, the then Treasurer, the Hon Peter Costello MP, announced a number of measures focused on 'making Australia a more attractive regional financial centre'.¹⁸

Some of these earlier measures have had only limited effect. There are a number of reasons for this, but key amongst them are the following:

- policies have not always been implemented or administered as effectively as they might have been;
- policies have often not been updated and amended over time to ensure that they remain as relevant and effective as intended in a world of rapid financial innovation and change; and
- policy changes in Australia are taking place against a background of rapid policy change in other countries and financial centres in the region.

Against this background, the Report recommends, in addition to a set of policy changes designed to improve efficiency and competitiveness and remove obstacles to greater international engagement, the establishment of a Financial Centre Task Force. The proposed body would be charged with providing advice and industry feedback on the effective implementation of recent and prospective financial sector policy changes, as well as on possible further policy changes that may be necessary if the Government is to achieve its objectives for the sector.

STRUCTURE OF THE REPORT

The remainder of the Report is structured as follows. Chapter 2 provides an overview of the size, growth, structure, competitiveness and efficiency of Australia's financial sector, along with some international comparisons. It also examines in more detail the extent of 'internationalisation' of the sector. The overall assessment confirms the categorisation presented above: Australia has a financial services sector that is highly sophisticated, generally efficient and competitive, but limited in its degree of 'internationalisation'. The chapter identifies some areas of domestic weakness where policy measures may lead to improvements. It also flags some of the key policy related constraints to greater internationalisation.

Chapters 3, 4 and 5 focus on areas where tax, regulation and human capital policies could be sensibly changed to improve the domestic efficiency and competitiveness of the financial system and our ability to capitalise on our comparative advantages by way of greater international engagement.

Chapter 6 examines the way forward. It pulls together the key recommendations in the Report, and the opportunities they provide, in order to emphasise their interrelated nature. It proposes an

17 The Hon P Keating MP (Prime Minister) 'One Nation' Statement, Canberra, 26 February 1992, p 77.

18 The Hon P Costello MP (Treasurer), 'Australia – A Regional Financial Centre' in *Investing for Growth*, Department of Industry, Science and Tourism, 1997, Canberra, p 1.

enhanced role for the Government and for industry in raising the profile of Australia's financial sector in the region. It also sets out detailed recommendations for a task force focused on providing ongoing industry feedback and policy advice on issues relevant to achieving the Government's objectives for the financial sector. These 'follow through' recommendations are, in the Forum's view, critical to the ultimate achievement of the Government's objectives.

Chapter 7 summarises the key recommendations of the Report.

2. AUSTRALIA'S FINANCIAL SECTOR: STRENGTHS AND WEAKNESSES

This Chapter provides an overview of the financial sector and an assessment of its strengths and weaknesses. A key focus is efficiency, competitiveness and the degree of internationalisation. In summary, the Forum finds that most parts of the financial sector are efficient, competitive and generally rank well internationally where such comparisons are available, but that the degree of internationalisation is typically limited. The Chapter highlights those areas where either domestic efficiency and competitiveness or the degree of internationalisation could be improved by sensible policy changes.

2.1 THE AUSTRALIAN FINANCIAL SECTOR: A MACRO PERSPECTIVE

Users of financial services

The financial sector consists of institutions, markets and individuals providing a variety of financial products and services to households, business and government. There is also considerable intra-industry activity reflecting specialisation within each sector. The range and variety of products and services provided by the financial sector is one measure of its sophistication or stage of development.

The economic functions that the finance sector performs can be described in a number of ways. One classification is provided in Chart 2.1, which illustrates the sector's main activities and beneficiaries.

Chart 2.1: Major activities of the Australian financial services industry

| | Funds management and financial planning | Investment banking | Commercial banking | Insurance |
|--|---|---|--|-----------------------------|
| Main activities | Funds management Asset management Asset consulting Retirement savings, pensions and annuities Portfolio and platform administration Custodian services Financial advice | Equity issuance/ structuring Debt issuance/ securitisation Non-exchange traded securities Market making/ trading (equity, debt, currency) Corporate advice Risk management | Credit — corporate and personal Transactions — corporate and personal Corporate money market Personal savings | General Life |
| Benefits to consumers/ households | Saving, investing and financial planning advice | Wealth accumulation | Cash management, transactions and borrowing | Wealth and other protection |
| Benefits to business/ government | Providers of capital | Access to funds, balance sheet management, liquidity, and corporate strategic advice | Transactions, cash/liquidity management and financing | Asset protection |
| Support services | Legal, accounting, actuarial, transaction processing, custody, information technology | | | |

Consumers exhibit a life cycle evolution of their financial requirements. When young and often still largely dependent on parental support, basic savings and payments services as provided by banks and other institutions are typically required. Later in life, when preferred consumption levels exceed current income and/or purchases of costly durable items such as motor vehicles and housing occur, credit card, mortgage and other loan products will be required. Insurance products are also likely to be utilised.

In deciding which financial products are most suitable, financial advice may also be sought. Those individuals developing their own business enterprises will also require specialised services including financial, legal and accounting advice as well as business loans and transactional facilities. Over time, as income increases and saving for retirement assumes importance, individuals will invest in a variety of financial assets including direct shares, managed funds and superannuation funds. In the retirement phase, some will draw down funds that remain actively under management while others may purchase pension style products from financial institutions.

An effective and efficient financial system delivers a variety of services to consumers over their life cycle. The more efficient and competitive the financial system, the lower the cost at which these products and services can be provided; the more sophisticated it is, the wider the range of products, services and choices available.

However, while technological and financial innovation is producing greater choice and a wider range of products to meet individual needs, it can also result in more complexity for consumers. Consumers may at times invest in financial products without understanding either the risks (for example, with debt-financed investments) or the product features, such as pricing. Australia's compulsory, largely defined contribution superannuation scheme, which places investment risk onto households, further underlines the critical importance of consumer understanding of risk, a point brought home starkly by the recent financial crisis and sharp fall in financial asset prices.

A critical element for the effective functioning of a financial system that serves the national interest is thus consumer financial literacy: in particular, understanding of risk and of financial products. This area is receiving considerable focus from both the Government and the regulatory authorities, and is the subject of a range of recent policy reform measures and current enquiries. This issue is returned to in Chapter 4.

The financial sector also provides crucial services for business. While it is common to focus on activities such as lending, payments services, cash management, capital raising, insurance, provision of advice etc, the underlying economic functions performed are in some ways more fundamental: lenders and other financial stakeholders in firms play important monitoring and governance roles aimed at ensuring the efficient operation of those firms. Financial markets generate prices for financial assets that provide valuable signals for economic agents making resource allocation and investment decisions.

Many of the financial services provided are closely interrelated with the efficient functioning of business activities. Trade finance is one such example, where banks, insurance companies and others facilitate the transfer, sale and payment for goods and services between geographical locations, where knowledge about counterparty reliability can be limited and different national legal systems may be involved in the transaction.

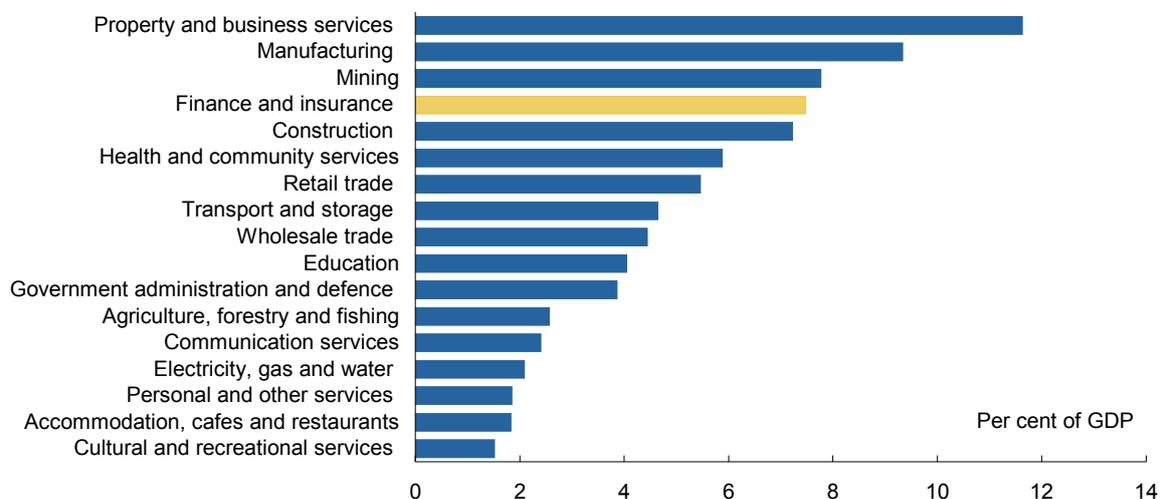
While the financing of physical trade played an important role historically in the growth and location of financial institutions (and the networks of interrelationships that were established), modern technology and globalisation is affecting the location and development patterns of financial centres in different ways. Close customer proximity is still important in some cases where personal relationships are critical, such as financial advice or advice on mergers and acquisitions (M&A), but typically not in other cases, such as foreign exchange trading.

A well developed domestic financial market increases the potential for participation in offshore activity in those markets where geographic location is less important. Consequently, an understanding of the current structure, strengths and weaknesses of Australia's financial system is a necessary first step in identifying opportunities for, and impediments to, greater international engagement.

Contribution to the economy

The financial sector is an important contributor to national output, employment, economic growth and development. As Chart 2.2 shows, the Australian finance and insurance sector accounts directly for around 7.5 per cent of GDP in the Australian economy. This is comparable to the contribution of the mining sector. The finance and insurance sector has one of the highest sectoral growth rates, which has seen its share of gross value added increase from around 6.6 per cent a decade ago.

Chart 2.2: Industry gross value added — Australia

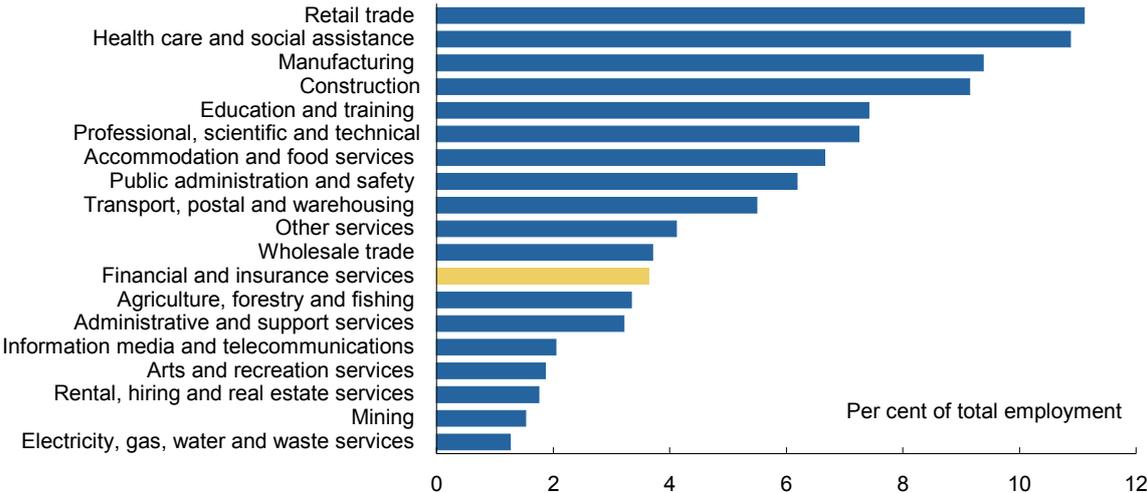


Source: ABS cat. no. 5206.0, June 2009. Data is for the four quarters to June 2009.

The financial sector's share of total employment has hovered in the 3.5-4.0 per cent range for over a decade (see Chart 2.3). However, this does not include employment in the full range of related business services areas associated with finance sector activities. Anecdotal evidence suggests that these support services represent a very important part of the overall contribution of financial services to employment.

The financial sector's contribution to economic growth and output is more significant than these direct measures suggest. As noted in Chapter 1, the finance sector facilitates growth in the rest of the economy, and academic literature shows a clear causal link from financial sector development to economic growth. It is thus in Australia's national interest to ensure that its financial sector is as open, competitive and efficient as possible.

Chart 2.3: Industry employment — Australia

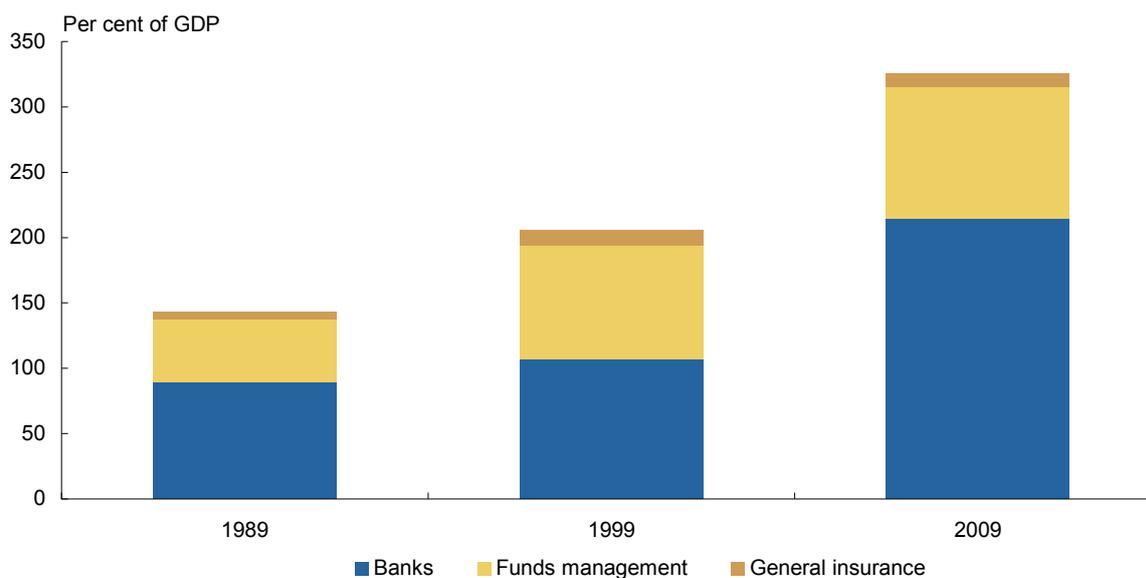


Source: ABS cat. no. 6202.0, August 2009. Data is for the four quarters to August 2009.

Employment in the financial services sector is concentrated in finance (predominantly banking) which accounts for around 210,000 jobs, while insurance and superannuation account for a combined 80,000 jobs. Services to finance – which include stockbroking; investment management and advisory services; credit card administration services; (non-bank) money changing services; share registry operations; and stock exchange operations – account for a further 100,000 jobs. As was noted above, these data do not include a range of broader financial services support areas.

The major components of Australia’s financial sector are commercial and investment banking, insurance, and funds management. Chart 2.4 shows the relative size of these sub-sectors in terms of the ratio of total assets to GDP, along with their very rapid growth over the past 20 years. The growth in bank assets reflects a combination of factors, including the rapid increase in private sector borrowings in recent decades and growing specialisation within the financial sector, resulting in increased transactions between companies within the sector itself. The growth in funds management assets reflects amongst other things the growth of superannuation funds under management and the returns on those funds.

Chart 2.4: Financial sector assets/GDP — Australia



Bank assets are for authorised deposit-taking institutions (ADIs), which include Australian banks, foreign subsidiary banks and foreign branch banks. As at March 2009, the assets of those three groups were \$2,741 billion, \$103 billion and \$397 billion, respectively. (Source: Australian Prudential Regulation Authority (APRA), Quarterly Bank Performance, March 2009, Issued 22 September 2009.) These banks can conduct both 'commercial banking' (mainly deposit-taking, borrowing and lending) and 'investment banking' (equities, debt, mergers and acquisitions and corporate advisory). The Australian banks are primarily engaged in 'commercial banking', while the foreign banks are mainly engaged in 'investment banking'. Funds management assets include superannuation, life offices and other managed funds. Source: Reserve Bank of Australia (RBA) *Bulletin Statistical Tables*, Tables B01, B02 and B18. Data as at June 2009.

The size of Australia's financial sector relative to the overall economy is very similar to that of many other developed economies, such as the US, UK, Japan and Canada, but significantly less than a number of overseas financial centres, most notably Luxembourg, Hong Kong and Singapore.¹

Within this overall picture, however, there is considerable variation across different parts of the financial sector in terms of Australia's ranking by size. While the IMF currently ranks the Australian economy fourteenth globally based on GDP², our onshore funds management market is, on one widely used measure, the fourth largest in the world and the largest in the Asia-Pacific region.³ Australia's equity market is the second largest in Asia (after Japan) and ranks seventh in the world⁴, and Australia is the eleventh largest issuer of international debt securities.⁵ The Australian dollar was the world's sixth most traded currency in 2007.⁶

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- 1 The figures for financial services value added as a percentage of GDP for a range of countries for which comparable data are available are: Luxembourg 52.9 per cent; Hong Kong 19.5 per cent; Singapore 12.6 per cent; UK 7.6 per cent; Japan, Australia and the US 7.5 per cent; New Zealand 7 per cent; Canada 6.5 per cent; and France 4.6 per cent. Sourced from the websites of national statistical agencies in each country.
 - 2 IMF, World Economic Outlook Database — April 2009, gross domestic product, current prices (US dollars).
 - 3 See Investment Company Institute (ICI), *Worldwide Mutual Fund Assets and Flows*, ICI, Washington DC, first quarter 2009, accessed 1 October 2009, www.ici.org; supplementary analysis by Australian Trade Commission (Austrade), *Benchmark Report 2009*, Austrade, Canberra, 2009, p 16. Note that the ICI data is based on a definition of 'mutual fund' which refers to a publicly offered, open-ended fund regulated by the investment law of each country (including money market funds).
 - 4 Adjusted for free-float market capitalisation. See Standard & Poor's, *World by Numbers*, September 2009.
 - 5 By amount outstanding, as at June 2009. Bank for International Settlements (BIS), *Quarterly Review*, Table 11, September 2009.
 - 6 BIS, *Triennial Central Bank Survey: foreign exchange and derivatives market activity in 2007*, BIS, Basel, December 2007.

Financing the current account deficit

One of the important features of the Australian economy is the persistence of current account deficits, which reflect an excess of domestic investment over domestic savings and an associated need for foreign capital to supplement domestic savings. Australia's reliance on foreign capital has been largely true since Federation and – for good reasons set out in Box 2.1 – is likely to remain the case for many decades to come.

Box 2.1: Australia's savings/investment balance and reliance on imported capital

Australia's reliance on offshore capital to finance the excess of domestic investment over domestic saving is a reflection of a number of factors. At times in Australia's history, it has largely reflected sizable public sector deficits: that is, an excess of public sector expenditure over public sector savings. However, there are also a number of structural features of our economy that underpin our typical *private sector* excess of investment over savings.

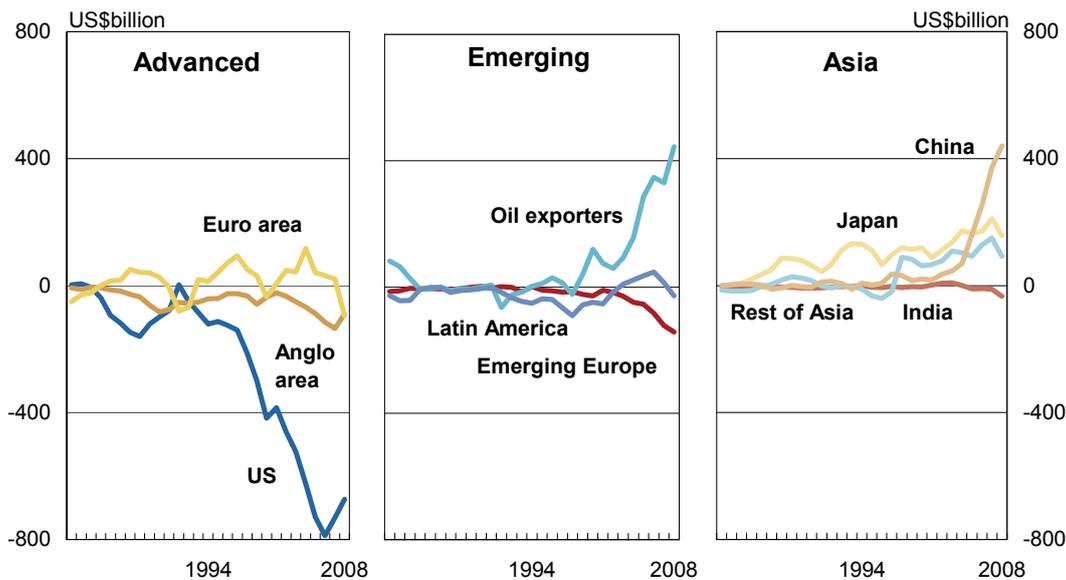
Australia's private sector savings to GDP ratio is not low by Organisation for Economic Cooperation and Development (OECD) standards. By contrast, our private sector investment to GDP ratio is high. This is not surprising given that Australia has a much higher than average proportion of capital intensive industries, in particular mining and energy, and also a small number of people spread over a very large land mass, which adds to both public and private infrastructure requirements. At the household level, preferences for, by international standards, large and typically detached dwellings does mean that, as a nation, we spend proportionally more on housing than many other OECD countries, although the difference between Australia and major OECD economies is not that large. Some would argue that dwellings are an unproductive use of capital, but this is an individual preference which seems unlikely to change any time soon.

The financial sector plays an integral role in facilitating the capital inflows required to finance the current account deficit, as well as providing financial services for importing and exporting. At June 2009, the banking sector accounted for \$0.5 trillion or 27 per cent of the \$1.8 trillion stock of Australian offshore liabilities.⁷

In contrast to Australia's ongoing need for imported capital, Asia and the Middle East have for some time been major suppliers of global capital. In the Asian region, savings ratios have generally exceeded investment ratios for a number of decades: in the case of Japan, since the 1980s; for most other economies in East Asia, since the Asian financial crisis in the late 1990s; and for China since the mid 2000s. Oil exporters (defined as the Middle East region plus Russia) became large suppliers of global savings in the 2000s, reflecting the sharp rise in the world price of oil. Chart 2.5 summarises these global savings/investment balances.⁸

7 RBA, *Bulletin Statistical Tables*, 'Banks, Liabilities', Table B3 and 'Australia's Gross Foreign Assets and Liabilities', Table H4.

8 For a detailed analysis of these global savings and investment balances, see J Cassidy and D Orsmond, 'Patterns and trends in global savings and investment ratios', *Reserve Bank Bulletin*, September 2009, pp 1-7.

Chart 2.5: Current account balance — selected countries and regions

Source: CEIC Data Ltd, IMF, RBA, September 2009.

While the worst of the global financial crisis is now over, strains and uncertainties clearly remain. The crisis demonstrated that Australia cannot simply assume that it will always be able to readily finance its current account deficit in offshore capital markets. Chapters 3 and 4 of the Report contain a number of recommendations designed to improve our access to a wide range of offshore sources of capital at competitive rates.

2.2 INTERNATIONALISATION OF AUSTRALIA'S FINANCIAL SECTOR

One of the defining features of a financial centre is that it is engaged in a significant volume of cross-border financial activity, thereby providing additional opportunities for exports, growth and employment. In terms of the Forum's vision statement for the Australian financial sector:

It is a sector where the critical mass of skills, experience and reputation encourages both domestic and overseas participants to do business. It thus exhibits a high volume of cross-border transactions in a wide variety of financial products, services and currencies.

Many Australian financial institutions are engaged in direct investment in offshore markets. Such investment can generate direct benefits to Australia in terms of the return earned on the investment. While in no way wishing to downplay the importance of direct investment, the main focus of this section is on internationalisation in the form of cross-border financial transactions which take place through the Australian financial sector.

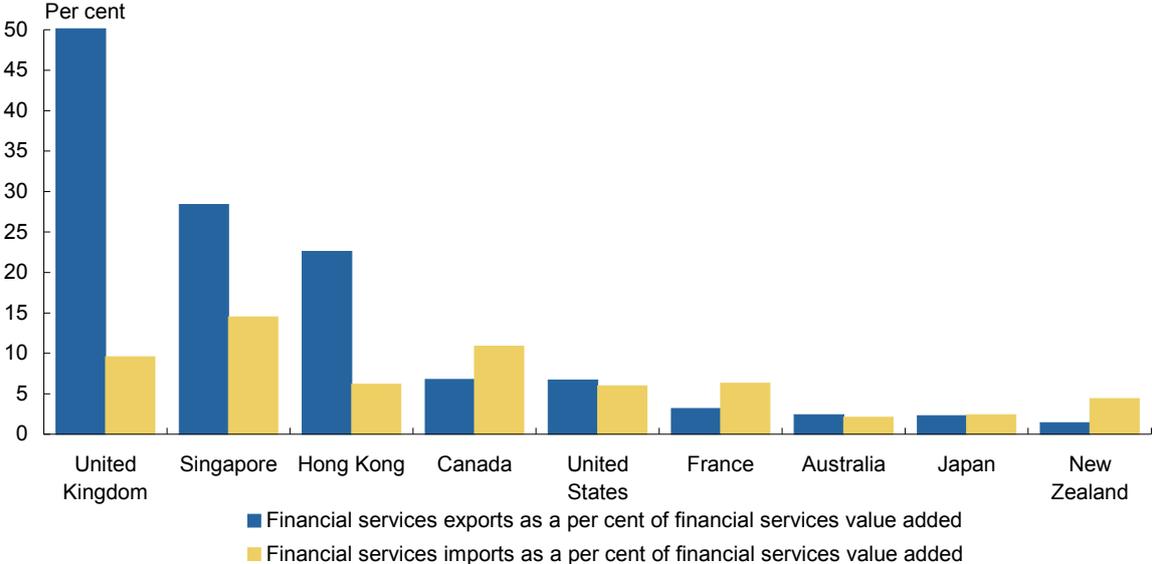
In the Forum's view, such cross-border transactions are not so much an end in themselves as the likely and desirable consequence of a financial sector that is open, competitive, efficient, and where there are no major policy constraints to 'trading' in financial services with other countries. Such trading may include an Australian based fund manager managing offshore sourced funds; an Australian bank providing trade finance for an offshore client; or the treasury operations of a large multinational financial services company using Australia as its regional headquarters for managing its offshore assets and activities.

Chart 1.1 in Chapter 1 provided a qualitative, schematic representation of Australia as a 'full service' financial centre, but with only a limited degree of internationalisation. While such a qualitative assessment and judgment accords with that of the Forum, the data available to examine in detail the

degree of internationalisation of Australia’s financial sector compared with other countries are, unfortunately, incomplete and of inconsistent quality. Set out below are some broad observations.

As was noted earlier, Australia’s financial sector ranks very close to many other advanced economies, such as the US, UK, Japan and Canada, in terms of its contribution to GDP. However, as Chart 2.6 shows, it ranks much lower in terms of financial services exports as a share of financial services value added. It ranks lowest in the group of countries shown in Chart 2.6 in terms of imports of financial services as a share of value added.⁹

Chart 2.6: Internationalisation of financial services sectors



Source: UN and OECD data.

These data support the qualitative assessment in Chapter 1 that Australia’s financial services sector is well developed, covering a wide range of services, but not very highly internationalised.

Within Australia’s services sector more broadly, exports of commercial services have grown extremely rapidly, driven by education, travel related services and ‘other business’ such as legal and accounting services, and now constitute a major source of export revenue.¹⁰ This shows the potential scope for significant increases in Australia’s exports of those tradable services in which we have a comparative advantage, and where barriers to entry or other constraints do not inhibit such trade.

9 Financial services exports and imports cover financial intermediary services conducted between residents and non residents. This includes intermediary service fees from letters of credit, bankers’ acceptances, lines of credit, financial leasing and foreign exchange transactions; commissions and fees relating to transactions in securities – brokerage, placements of issues, underwritings, redemptions, and arrangements of swaps, options and other hedging instruments; services related to asset management, financial market operations and regulatory services; and security custody services. Insurance services are included as part of ‘Financial services’ in Chart 2.6. Insurance services cover insurance for freight (related to exports and imports); ‘direct’ insurance (including life, other casualty or accident, health, general liability, fire, marine and aviation); and reinsurance. Also included are agent commissions relating to insurance transactions. Source: IMF, *Balance of Payments Manual*, 5th edition, 1993, pp 66-67.

10 Austrade, *Benchmark Report 2008*, Austrade, 2008, p 11.

2.3 INTERNATIONAL EVALUATIONS OF AUSTRALIA'S FINANCIAL SECTOR

A range of international surveys rank countries generally, or their financial sectors more specifically, in terms of their attractiveness as a place to do business. The criteria used vary significantly, and some are not all that transparent.

At the broadest level, Australia is highly regarded internationally as a place to do business. The Economist Intelligence Unit ranks Australia seventh in the world in terms of the quality and attractiveness of its business environment.¹¹ Australia has been ranked fourth in the world and highest in the region for its corporate governance.¹²

Dun & Bradstreet's 2009 *Global Risk Indicator* places Australia amongst the top four out of 131 countries. The index provides risk ratings based on an assessment of economic, commercial, external and political risk. The highest possible rating, which the survey assigns to Australia, Canada, Norway and Switzerland, is allocated to countries that display the lowest degree of uncertainty against these measures.¹³

The 2009 Index of Economic Freedom, sponsored by the Heritage Foundation and the *Wall Street Journal*, ranks Australia third out of 183 countries, commenting as part of that overall assessment that: 'Australia's well-developed and highly competitive financial sector provides a wide range of products and services through advanced banking, insurance, and equity industries.'¹⁴

Australia ranks fifteenth out of 133 countries in the World Economic Forum's *Global Competitiveness Report 2009-2010*, a study which includes many financial services specific criteria.¹⁵ In the area often seen as most critical to the success of a financial centre, namely human capital and education (see Box 2.2), Australia was seen as having a competitive advantage for the quality of its education system. On criteria relating to financial market sophistication, Australia generally ranked highly and was seen as having a competitive advantage in six out of the nine categories.

More broadly, on the Milken Institute's *Opacity Index 2009*, Australia ranks third best in the world. The index is arrived at by measuring five components of negative social capital – corruption; legal system inadequacies; deficiencies in economic enforcement policies; accounting standards and corporate governance; and regulation.¹⁶

Australia ranks seventh out of 57 countries on the IMD World Competitiveness Scoreboard.¹⁷

Looking more specifically at financial centres, the World Economic Forum's *Financial Development Report 2009* ranks Australia second amongst the world's financial centres, behind the UK but ahead of the US, Singapore and Hong Kong. Australia ranked first in terms of financial access and ranked highly in both banking (fifth) and non-banking (third).¹⁸

The most recent Global Financial Centres Index, produced biannually by the Z/Yen Group and published by the City of London, ranks Sydney in eleventh place out of 75 cities.

11 The Economist, 'Land of Vanishing Opportunity', *The Economist* (online), 11 February 2009.

12 Governance Metrics International, *Global Corporate Governance Ratings*, September 2009.

13 Dun and Bradstreet (Australia) Pty Ltd, *Australia a Safe Haven for Business Investment*, media release, 21 August 2009.

14 The Heritage Foundation, *2009 Index of Economic Freedom*, the Heritage Foundation and the *Wall Street Journal*, 2009, accessed 1 October 2009, www.heritage.org.

15 World Economic Forum, Switzerland, 2009.

16 J Kurzman and G Yago, *Opacity Index 2009: measuring global risks*, Milken Institute, US, 2009.

17 IMD, *World Competitiveness Yearbook 2009*, IMD, Switzerland, 2009 viewed 30 October 2009 www.imd.ch/wcy.

18 World Economic Forum, US, 2009.

The Global Financial Centres Index also ranks what respondents see as the most important determinants of financial centre attractiveness (see Box 2.2). As was noted in Chapter 1, human capital issues typically rank very highly in studies of the determinants of a financial centre, as does the regulatory environment. This is reflected in this index, and also in the Bloomberg-Schumer report on New York as a financial centre, which categorised the availability of professional workers as one of four highly important factors.¹⁹ In both surveys, the regulatory environment ranked highly, while the corporate tax regime ranked around the middle in terms of importance.

In the Global Financial Centres Index, Sydney performs particularly well for its people (quality and availability of staff) and its business environment: it is ranked among the top 10 centres internationally for both.

Box 2.2: Global Financial Centres Index — what makes a financial centre attractive?

- 1 Availability of skilled personnel
- 2 Regulatory environment
- 3 Access to international financial markets
- 4 Availability of business infrastructure
- 5 Access to customers
- 6 A fair and just business environment
- 7 Government responsiveness
- 8 Corporate tax regime
- 9 Operational costs
- 10 Access to suppliers of professional services
- 11 Quality of life
- 12 Culture and language
- 13 Quality/availability of commercial property
- 14 Personal tax regime

Source: Z/Yen Group, *Global Financial Centres Index 6*, City of London Corporation, London, 2009.

2.4 FINANCIAL SECTOR ACTIVITIES

This section provides an overview of the key sub-sectors of the financial sector.²⁰ Where data permit, international comparisons of the degree of internationalisation and of relevant indicators such as size, efficiency and competitiveness are also presented. Strengths and weaknesses that are the subject of policy recommendations in later chapters of the Report are highlighted.

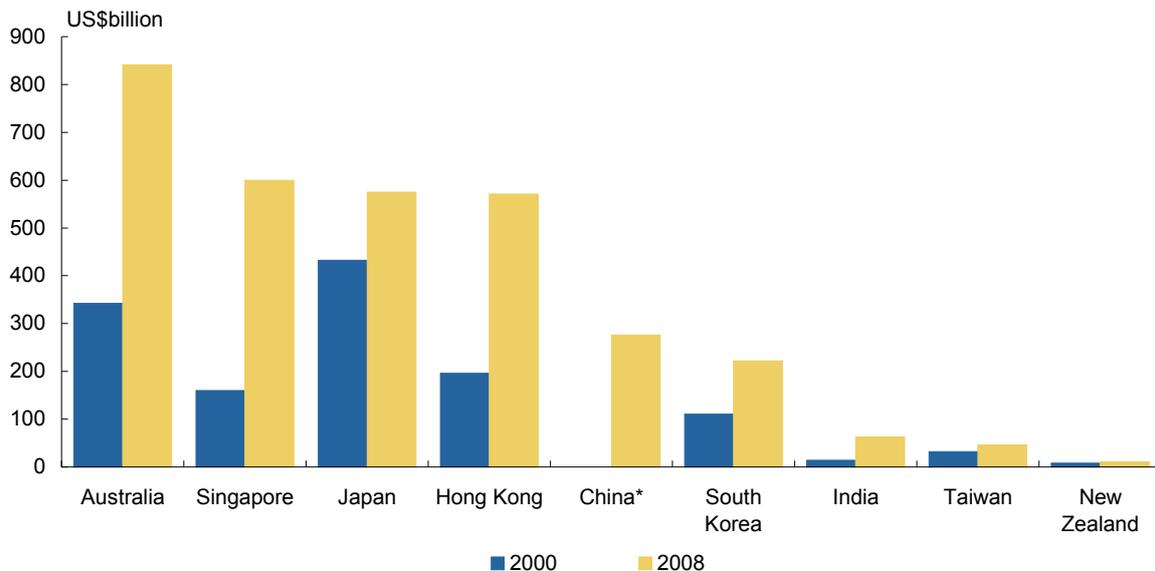
19 *Sustaining New York's and the US' Global Financial Services Leadership*, prepared by McKinsey & Company for Mayor Michael R. Bloomberg and Senator Charles E. Schumer, 2007.

20 This analysis covers both institutions and activities. The key institutional groups are the commercial banks (principally the largest four Australian banks) and the international and domestic 'investment banks'. The principal activities of the commercial banks are deposit-taking and lending. The principal activities of the investment banks are equity markets (primary fund raising, secondary trading and derivatives), debt markets (primary fund raising, secondary trading and derivatives) and investment banking (including mergers and acquisitions and strategic investment advice). In practice, there is considerable overlap between these institutions and their activities: most investment banks are also deposit-taking institutions; and all of the four major commercial banks are also engaged in investment banking activities.

Funds management: overview

The Australian funds management industry has A\$1.2 trillion under management.²¹ Reflecting the impact of the global financial crisis, this is down from a peak of around A\$1.4 trillion in late 2007. Over the past 10 years, Australia's managed funds have doubled in size. While international rankings can depend on the particular definition of 'managed funds' that is used, on at least one widely used definition²², Australia has the largest pool of funds under management in the region and the fourth largest in the world (Chart 2.7).

Chart 2.7: Net assets of investment funds — Asia-Pacific



* 2000 data for China not available.

Source: Austrade, Australia's Financial Markets 2009, updated from ICI, Worldwide Mutual Fund Assets and Flows, Q4 2008 (www.ici.org). Hong Kong data sourced from: Securities and Futures Commission, 'Market and Industry Statistics', Net Asset Value of Authorised Unit Trusts and Mutual Funds by Type. Singapore data sourced from: Monetary Authority of Singapore, '2008 Singapore Asset Management Industry Survey'. Note: ICI definition of 'mutual fund' refers to a publicly offered, open-ended fund regulated by the investment law of each specific country (including money market funds).

The comparatively large amount of funds under management in Australia reflects the compulsory superannuation system. Superannuation funds under management grew from \$184 billion in December 1996 to \$891 billion in June 2009.²³ Based on the broader definition of superannuation assets (including superannuation assets managed by life insurance companies), total assets increased from \$285 billion to \$1.08 trillion in the same period.²⁴

Reflecting the large pool of investment funds in Australia, there are a significant number of international funds management companies with a presence here. While some long established local funds management companies tend to dominate the market in terms of assets under management, half of the 20 largest managers are overseas companies.²⁵

The funds management business typically exhibits strong economies of scale. This factor, along with both political and competitive pressures on fees, results in many funds management companies putting a high premium on actively growing funds under management. However, growth strategies

21 ABS, *Managed Funds Australia*, cat. no. 5655.0, ABS, Canberra, June 2009.

22 See definition in footnote 3 earlier.

23 RBA, *Bulletin Statistical Tables*, Table B18, June 2009.

24 APRA, *Statistics – Quarterly Superannuation Performance*, June 2009 (issued 24 September 2009), p 7 and *Statistics – Superannuation Trends*, September 2004 (issued 11 January 2005).

25 Rainmaker Information Pty Ltd, *Australia's funds management global footprint: a stocktake of overseas sourced funds under management*, Rainmaker Information Pty Limited, 2008, p 3.

vary considerably, for reasons considered below. For the funds management sector as a whole, somewhere between 3.5 per cent and 11 per cent of total funds under management are sourced from offshore.²⁶ To a significant extent, this low *percentage* of total funds under management sourced offshore reflects the dominance of domestically sourced superannuation funds. However, the *absolute amount* (\$42 billion) of funds under management sourced offshore is also surprisingly low, given the experience and sophistication of our funds management sector. There are many reasons for this, which are discussed further below.

The Forum has been able to source comparative data on the degree of internationalisation for only a few offshore financial centres. The percentage of funds under management sourced offshore in the UK, Hong Kong and Singapore are 31 per cent, 64 per cent and 80 per cent respectively.²⁷

How does Australia rank as a place to do funds management business? In a recent survey of the attractiveness of target investment management markets (that is, from the perspective of a new entrant focusing on the attractiveness of the domestic market), Australia was ranked second behind the US in a comparison of 20 countries.²⁸ This reflected Australia's high rankings for growth potential; use of professional managers; distribution based on independent advice; and selection of fund managers based more on capability rather than brand. From a new entrant's perspective, Australia's ranking was reduced because of 'fierce competition' on fees. From the perspective of the domestic investor, such pressure on fees is, of course, a positive factor.

A recent survey concluded that the larger Australian superannuation funds were broadly competitive globally on administration and investment fees.²⁹ While some of the headline figures suggested that Australian fees were on the high side, the report argued that Australia's position was more favourable after allowing for differences in asset allocations, active versus passive management and in the costs of defined contribution versus defined benefit schemes.

The report also identified the importance of scale economies, suggesting that parts of the industry will be under pressure to merge or otherwise rationalise.

Another perspective on the performance of the industry is to examine global comparisons of pension fund returns. In an OECD study of real investment returns, Australia recorded the highest returns, with the second lowest volatility, compared with other countries in North America, Western Europe and in Asia-Pacific.³⁰

Funds management: assessment

A June 2008 survey³¹ of the global footprint of Australia's funds management sector found that:

26 The lower figure is from the ABS, *Managed Funds Australia*, cat. no. 5655.0. The higher figure is from Rainmaker, *ibid*.

27 Investment Management Association, 'Asset Management in the UK 2008', Investment Management Association, UK, 2008, viewed 30 September 2009, www.investmentuk.org; Hong Kong Securities and Futures Commission, 'Fund Management Activities Survey 2008', Securities and Futures Commission, Hong Kong, 2009, viewed 30 September 2009 www.sfc.hk; Monetary Authority of Singapore, '2008 Singapore Asset Management Industry Survey', Monetary Authority of Singapore, Singapore, 2008, viewed 30 September 2009, <http://www.mas.gov.sg>.

28 Cerulli Associates, *Quantitative Update: Global Markets 2009*.

29 Investment and Financial Services Association (IFSA), *2009 International Superannuation and Pension Fund Fees*, 20 August 2009.

30 There are many caveats to these comparisons, including the upward bias to returns from the relatively high proportion of equities in Australian pension funds, compared with many other countries. That said, risk adjusted returns for Australian investments were still quite favourable. Source: OECD, *International Pension Fund Performance*, August 2008.

31 Rainmaker, *op cit*.

- Some 11 per cent of funds under management was sourced offshore. (Due to methodological differences, this is considerably higher than the 3.5 per cent Australian Bureau of Statistics (ABS) figure, and probably at the very top end of the range).
- Funds sourced from offshore have increased significantly in recent years and constitute a growing proportion of total funds under management. Taking the mid-points of ABS and Rainmaker data, the proportion sourced offshore increased from 7.1 per cent in March 2005 to 7.8 per cent in December 2007.
- The top four Australian based managers of offshore sourced funds are Australian companies. Australian companies also constitute half of the top 20 managers of offshore sourced funds.
- There has been a significant shift away from domestic assets to international assets. This has been true both for equities and, even more so, fixed interest assets: since 1997, international equities have increased from 15 to 19 per cent of total funds under management, and international bonds from 3 to 5 per cent.
- Alternative assets (infrastructure, hedge funds and private equity) are a major and growing asset class in Australia, increasing as a share of total funds under management over the same period from 5 to 11 per cent.³²
- 87 per cent of Australia's offshore sourced funds are invested in offshore assets, with the bulk of those funds directed to international equities or alternative assets.
- Of the funds sourced from overseas, 35 per cent was sourced from Asia. Of this, 13 per cent was from Japan and 11 per cent from China.

In summary, the Australian funds management sector is increasingly managing international as well as Australian assets; is a significant manager of alternative assets; is managing a small but growing share of funds sourced from offshore, the vast bulk of which are then invested in offshore assets; and Australian companies are the dominant local managers of offshore sourced funds.

Rapid economic growth and ongoing market development in the Asia-Pacific region offer potentially enormous opportunities for growth in offshore sourced funds under management from Australia. An examination of the source of these offshore managed funds by type of client helps to illustrate how small a manager of overseas sourced funds Australia is, and how enormous the opportunities are. Rainmaker estimates that Australia's share of global pension, mutual and sovereign funds is around 0.2 per cent, an exceptionally low number given the size of our funds management sector.

The Rainmaker report suggests this global pool of pension, mutual and sovereign funds is expected to increase from US\$52 trillion in 2007 to around US\$150 trillion over the next decade. A separate 2009 report by McKinsey suggests that, within these global pools of funds, potential opportunities for external fund managers are particularly large in the Asia-Pacific region.³³

32 This is in part a reflection of the fact that Australian fund managers have a strong global reputation in 'alternative' asset classes. For example, in the case of infrastructure assets, Australian managers featured in five of the top 15 places globally by size, with the top ranking held by Macquarie Group. (Watson Wyatt, *Global Alternatives Survey*, July 2009. Macquarie Group was also ranked the largest overall alternative asset manager on a global basis. In this survey 'alternative' assets include real estate, infrastructure, private equity and fund of hedge funds.) It is also worth noting with respect to alternative asset classes that Australia has the largest hedge fund centre in the Asia-Pacific region, with over two thirds of those assets invested in markets outside Australia. (Asiahedge, cited in Austrade, *Benchmark Report 2009*, op cit, p 22.)

33 McKinsey and Company kindly gave the Forum access to a confidential 2009 Asset Management Survey, from which this observation is taken.

The Rainmaker survey concludes: '... even a marginal increase in Australia's market penetration from its current 0.2 per cent level could lead to considerable increases in overseas sourced funds under management for Australian investment managers'.³⁴

Given the size of Australia's funds under management, the expertise in particular sectors, the very strong economies of scale and the pressure on fees, the extent to which the industry is still predominantly domestically focused is striking. The Forum had numerous discussions with a wide range of funds management companies on the reasons for this.

A number of Australian funds management companies see it as extremely difficult to convince potential offshore investors that an Australian based company with limited offshore brand recognition has the expertise to manage offshore investments from Australia. Indeed, some Australian funds management companies were largely of the view that the business risk in channelling large amounts of capital into building business in the region was simply too great. Others saw major opportunities: as noted earlier, the top four Australian based managers of offshore sourced funds are Australian companies.

For Australian branches of large and well recognised international funds management companies, brand recognition can make selling into Asia potentially much easier in principle, although even here strategies differ. Some global funds management companies divide the world up rigidly and then service each market through their local operations; a few, to varying degrees, use Australia as a regional base.

In the discussions with funds management companies, the Forum was struck by the frequency and strength of concerns regarding uncertainties on the tax treatment of funds managed out of Australia but sourced from offshore. These concerns extended across the whole range of funds management companies. They were cited by large international funds management companies as a key reason why they would not use Australia as a regional funds management base; they were cited by Australian funds management companies as a business risk which argued against raising funds offshore; and they were cited by companies that are sourcing funds from offshore as one reason for structuring their operations such that most of the funds management and execution activities were done offshore.

Australian based fund managers wanting to offer their products in the Asian region also face a number of market access constraints, including regulations that can place significant restrictions on the sale of funds management products to retail customers.

Most Australian based funds management companies managing offshore sourced funds did so by way of utilising 'off the shelf' vehicles typically domiciled in Luxembourg, Dublin or the Cayman Islands. An important reason for this was that such vehicles were much more widely used and recognised in the region than Australia's managed investment trust vehicle.³⁵ In a majority of cases, these offshore vehicles were managed by offshore investment advisers. This represents lost opportunities for Australia in terms of jobs and tax revenue.

Chapters 3 and 4 elaborate further on these policy related constraints, and provide recommendations designed to address them.

In the Forum's view, the funds management sector represents the leading example of a sector where Australia has a comparative advantage that could be better exploited, and where some sensible policy initiatives could significantly improve the scope for greater internationalisation of the sector.

³⁴ Rainmaker, op cit, p 9.

³⁵ See Chapter 3 for a more detailed discussion of managed investment trusts and other funds management vehicles.

Financial planning: overview

The Australian financial planning sector assists investors in the accumulation of wealth via indirect and direct investment in financial markets. Financial planners provide advice across a range of financial activities, including superannuation, tax and social security. As part of that advice, financial planners may also provide product recommendations.

The Financial Planning Association of Australia, whose membership includes 93 of the top 100 financial planner licensees, estimates that its membership has about \$650 billion under advice.³⁶ These funds can be invested in a variety of ways, such as the direct purchase of shares, via managed funds or through platforms that offer a range of investment opportunities and services.

There are a number of financial planning business models, from those that are tied to the large financial services groups (including the major banks) through to independent planners. Remuneration arrangements for these businesses include asset based fees, fee for service (time basis), commission based fees on products (up-front fees and ongoing fees), and rebates from fund managers.

Another important feature of Australia's financial planning industry is the use of sophisticated infrastructure, such as 'wrap accounts' and similar platforms.³⁷

Financial planning: assessment

The Australian financial planning industry's professionalism has been recognised by the UK Financial Services Authority (FSA) as a potential model for the UK. The FSA noted: 'In recent years, financial advice practitioners in countries such as South Africa and Australia have managed to improve their professional standing and the UK should be able to learn from these experiences.'³⁸ The FSA considered that the main way to achieve higher standards of competence and behaviour, and better labelling of services, would be to enhance the role of professional bodies. The FSA report provided a case study of a strong professional body, using Australia's Financial Planning Association as an example.³⁹

Australia is also recognised for the advanced nature of its financial planning technology, such as wrap accounts. In a report to the European Commission, BME Consulting noted that in the US and Australia, wrap accounts were widely used, in contrast to Europe. The report noted that wraps were an 'attractive, albeit costly, way for consumers to manage a range of assets efficiently' and for smaller investors to access professional portfolio managers.⁴⁰

Australia's scope for offering financial planning advice in overseas markets is potentially enhanced through its close involvement in the globally accredited Certified Financial Planner (CFP) qualification.⁴¹ In June 2009, 72 per cent of Financial Planning Association practitioners were CFP

36 The Financial Planning Association estimates that there are between 16,000 and 18,000 financial planning practitioners in Australia. In addition, there are some companies that provide specialised intermediary services, such as stockbrokers and mortgage brokers, but these groups do not provide comprehensive financial advice.

37 Wrap platforms are web based portfolio administration services that allow intermediaries, and sometimes their clients, to view and administer investment portfolios. Wrap accounts usually allow investors a choice of direct and indirect investments, including with selected funds managers.

38 FSA, *A Review of Retail Distribution*, Discussion Paper, June 2007, p 36.

39 *ibid*, sections 3.18 and 62.

40 BME Consulting, *The EU Market for Consumer Long-term Retail Savings Vehicles*, Final Report, 15 November 2007, viewed 22 October 2009, http://ec.europa.eu/internal_market/finances/docs/cross-sector/study_en.pdf.

41 The CFP qualification requires satisfactory completion of coursework; a minimum level of experience; and abiding by the Financial Planning Association's *Code of Professional Practice*.

qualified. These qualifications help improve prospects for extending the provision of financial advice into overseas markets.

Despite the quite different financial planning models in many overseas countries, a number of Australian financial planning organisations are either servicing offshore clients from Australia or have established businesses in the region, including via acquisitions of established businesses. These latter groups use their Australian intellectual property (for example, provision of independent advice, including through financial plans) and, to a more limited extent, their Australian technology, depending on the development stage of the relevant market.

Given Australia's recognised capabilities (including for professionalism and technology), Australian financial planning groups certainly have the potential to continue to make inroads into offshore markets. Realisation of those opportunities is dependant on, amongst other things, the reputation and integrity of Australia's financial advisory sector being maintained and, where necessary, improved. The collapse in recent years of a number of financial product and service providers has to some extent damaged the reputation of the financial planning sector, at least within Australia if not more widely. On 25 February 2009, the Parliamentary Joint Committee on Corporations and Financial Services resolved to inquire into the issues associated with the recent collapse of financial product and services providers and report by 23 November 2009.

One of the central issues which the Parliamentary Joint Committee is addressing is the basis on which financial planners are remunerated. The industry itself has started to address the issue. The Forum is encouraged by industry initiatives regarding the phasing out of commission based remuneration for financial planners.⁴² The Forum also notes the clear priority which the Minister for Financial Services, Superannuation and Corporate Law, the Hon. Chris Bowen MP, has attached to addressing 'conflicts of interest and perceived conflicts of interest from payment models in the sector'.⁴³ This priority is desirable to ensure that consumers are given independent advice that is appropriate to their needs and circumstances. It is also consistent with ensuring that the reputation of Australia's financial sector, in particular funds management and financial planning, is maintained overseas, a prerequisite for greater international engagement.

Banking: overview

Commercial banking

Commercial banks provide transactional banking, cash and liquidity management and financing for consumers and institutions. In Australia the four major commercial banks dominate the market. A significant number of foreign banks are also authorised deposit-taking institutions (ADIs). Their share of the market is nonetheless small, at around 11 per cent of total deposits.⁴⁴

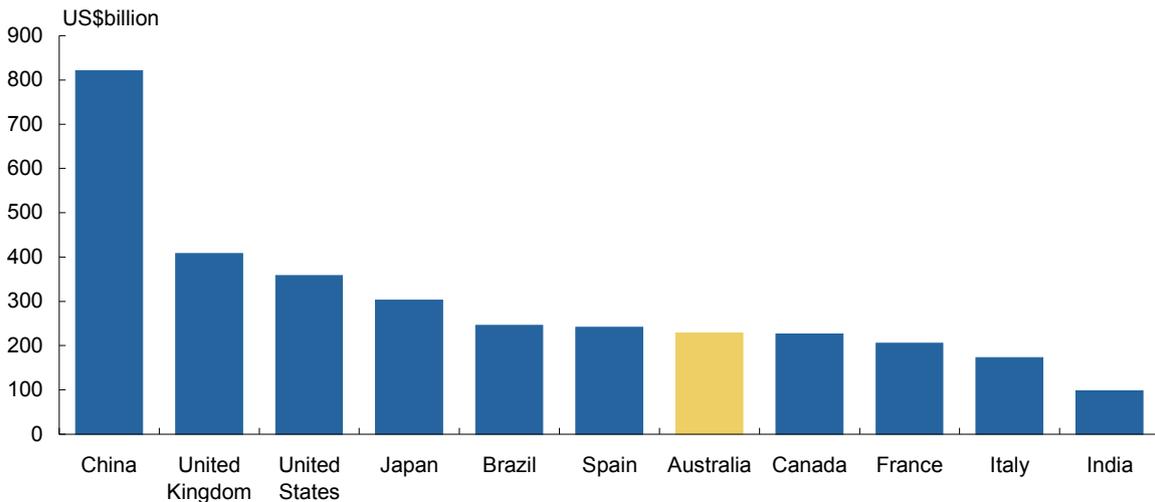
The market capitalisation of Australian commercial banks placed them seventh globally in September 2009 (Chart 2.8).

42 These proposals were outlined in the Financial Planning Association's Financial Planner Remuneration Consultation Paper, April 2009. The Financial Planning Association defines commissions as a payment made by the product provider to the financial planner, through their licensee, for recommending the product. Under the Financial Planning Association's proposal, asset based fees and service based fees, as well as time based fees, would be permitted. This proposal is also consistent with *IFSA's Draft Super Charter: A new Commitment to Super Members*, 17 June 2009.

43 The Hon C Bowen MP (Minister for Financial Services, Superannuation and Corporate Law), Address to the Investment and Financial Services Association's 2009 Conference, Gold Coast, 5 August 2009.

44 APRA, *Quarterly Bank Performance*, March 2009 (published 22 September 2009).

Chart 2.8: Market capitalisation of banks



Source: Bloomberg, September 2009. Australian banks covered are: Commonwealth Bank of Australia, Westpac, National Australia Bank, ANZ, Bank of Queensland, Bendigo Bank, Adelaide Bank.

The Australian financial sector has performed well through the global financial crisis. The crisis impacted heavily on the market capitalisation of international banking stocks. The major Australian banks, by contrast, withstood the financial crisis well, as reflected in market capitalisation and credit ratings. Chart 2.9 shows changes in market capitalisation of the four major Australian banks, and a number of major international banks, through the global financial crisis.

Chart 2.9: Change in market capitalisation of banks — Australia and international



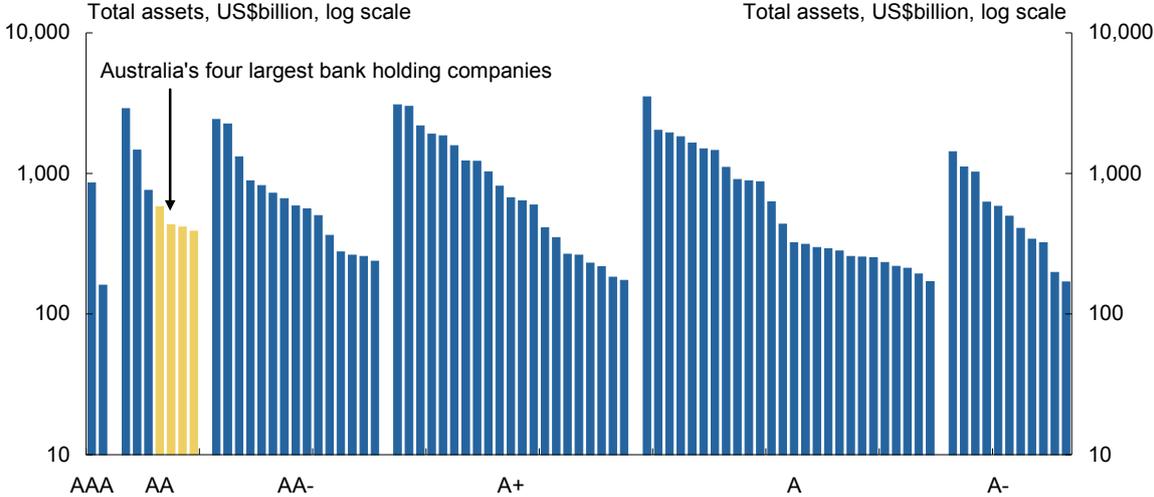
Source: Bloomberg. Comparisons are based on the market capitalisation of the international banks, from the market high (for the total capitalisation of all banks shown) of 5 October 2007 to the market low of 9 March 2009. Australian banks are based on Australian dollar capitalisation; international banks on US dollar market capitalisation. Note that the comparisons will be affected by acquisitions and divestments of businesses over that period.

The strength and liquidity of Australia’s financial sector was assisted by timely Government interventions to support the financial system and to keep pace with international developments during the global financial crisis. Critical among these were enhanced depositor protection arrangements and a temporary guarantee of banks’ wholesale debt funding. These measures helped ensure the Australian financial sector’s stability and liquidity at the height of the market turbulence. According to the IMF country report on Australia of August 2009:

The Australian banking sector entered the financial turmoil in a sound position and has been resilient to the global crisis. Banks’ capital ratios are well above the regulatory requirements. The major banks’ AA credit ratings have remained unchanged since the crisis unfolded, and they were able to raise private equity capital in the midst of the global crisis. Impaired assets are still low by international standards, although they have increased in the past year.⁴⁵

Of the largest 100 banking groups in the world, only nine are rated AA or above, four of which are the major Australian commercial banks (Chart 2.10).

Chart: 2.10: Largest banks by credit rating — global



Source: Bloomberg and *The Banker*, October 2009.

The four major Australian commercial banks are pursuing individual growth strategies. Some are actively looking to expand offshore activities and some are more focused on domestic growth. Using 2007 data, roughly 21 per cent of bank profits for the four major banks was generated offshore, of which 13 per cent was from New Zealand operations, with smaller contributions from the UK and Europe.⁴⁶ Asia and the Pacific represented a very small proportion of the four major banks’ profits. Reflecting the very different growth strategies being pursued by the four major banks, the proportion of offshore profits ranged from 12 per cent to 31 per cent.⁴⁷

On the issue of competitiveness and fees, compared with other developed economies Australia rates reasonably well but is not in the most competitive group. In a slightly dated (2006) but comprehensive report commissioned by the British Bankers Association, Oxera conducted a detailed survey comparing the price and cost of the main banking products used by UK consumers with those in

45 IMF, *Australia: Selected Issues*, country report 09/249, IMF, Washington DC, 2009, p 17.
 46 Australian Bankers’ Association (ABA) data provided to the Forum, September 2009. Data relate to 2007.
 47 *ibid*.

10 other countries, including Australia.⁴⁸ The main findings with respect to Australia were (a high ranking means very competitive):

- a low to middle ranking for the cost of cheque accounts and personal loans;
- a middle ranking for interest rates⁴⁹ paid on savings accounts and for transparency of charging; and
- a very high ranking for credit card costs.

A more recent Reserve Bank of Australia (RBA) article noted that the ratio of bank fee income to assets had continued to decline for most categories of consumer and business fees.⁵⁰ However, the survey did not include any international comparisons.

Investment banking

The main activities of investment banks are raising capital (through underwriting and distribution, debt and equity securities), providing liquidity by trading in securities, and providing strategic advice and support to companies on a range of issues such as M&A.

Investment banking functions are performed by specialist investment banks (both Australian and foreign) and, in some areas, by the Australian commercial banks. Most major international investment banks have a presence in Australia. In addition, there is one major Australian investment bank which is heavily engaged in both domestic and offshore activity: in 2007, the proportion of its profits generated offshore was 40 per cent.⁵¹

The significant presence of international investment banks in Australia reflects the need for close client contact, especially for equity and debt raising, as well as M&A. A local presence is less critical for securities trading, foreign exchange and futures.

The Australian commercial banks are major participants in the debt markets, with around a 50 per cent market share of capital raisings.⁵² For equity raisings, the global investment banks dominate, with around a 90 per cent market share.⁵³

In terms of the value of M&A, Australia ranked first in the Asia-Pacific region in the first three quarters of 2009, with a global market share of 7.3 per cent. While worldwide M&A fell 38 per cent from the same period in 2008, Australian M&A volumes rose 42 per cent. However, Australia's ranking and performance were heavily affected by a single very large transaction.⁵⁴

48 Oxera, *The Price of Banking: an International Comparison*, report prepared for the British Bankers Association, Oxera, November 2006. The countries in the survey were UK, Australia, Canada, France, Finland, Germany, Ireland, Italy, Netherlands, Sweden and the US.

49 Interest rates paid are adjusted to make them comparable across countries.

50 R McLachlan and M Wright, 'Banking Fees in Australia' in *Reserve Bank Bulletin*, May 2009, pp 11-15.

51 ABA data provided to the Forum, September 2009. Data relate to 2007.

52 Thomson Reuters, *Debt Capital Markets Review – Third Quarter 2009*, viewed 14 October 2009, <http://online.thomsonreuters.com>.

53 Thomson Reuters, *Equity Capital Markets Review – Third Quarter 2009*, viewed 14 October 2009, <http://online.thomsonreuters.com>.

54 Thomson Reuters, *Mergers and Acquisitions: Financial Advisors. Third Quarter 2009*, viewed 20 October 2009, <http://online.thomsonreuters.com>. The measure is based on announced M&A. Excluding the BHP Billiton/Rio Tinto deal, Australia ranked third in the region, with a global market share of 3.3 per cent. Also excluding this deal, the change in Australian M&A business over the period was more in line with the global decline.

Banking: assessment

The financial crisis, including necessary measures taken by the Government during the height of the financial crisis to ensure the stability of the banking sector, has had a major impact on competition within the banking and non-bank lending sector. This has been particularly true in mortgage lending, where the drying up of the securitisation market has seen a number of mortgage brokers cease operations or be acquired by one of the major banks. Foreign bank branches and subsidiaries of financial institutions also came under considerable pressure as their traditional sources of funding dried up. Reflecting these developments, and with the takeovers of St George and Bankwest, the major four banks increased their share of the mortgage market from 57 per cent in August 2007 to 74 per cent in August 2009. Over the same period, the share of foreign banks fell from 8 per cent to 5 per cent and non-bank lenders' share fell from 15 per cent to 11 per cent.⁵⁵

While the financial crisis required policy measures to be taken that entailed a trade-off between financial system stability and competition, in the Forum's view it is critical that the sources of competition to the major Australian banks re-emerge strongly over time. Chapter 3 includes recommendations along these lines. For the same reason, and as noted earlier, the Forum also welcomes the measures taken by the Government to support the securitisation market.

Overall, Australia's banking system has been resilient in the face of the global financial crisis and opportunities have opened up for the banks to do more global business, in both commercial and investment banking spheres. Given the central role that the banks play in channelling offshore funds to domestic activity, it is critical that the banks can access a diverse range of offshore funding. Policy proposals designed to improve access by banks and other financial institutions to offshore funding at competitive rates are discussed in Chapter 3.

Chapter 3 also contains proposals for reforms to Offshore Banking Units (OBUs) which would enhance the capacity of Australian banks and other financial services companies to engage in a wide range of cross-border financial transactions from Australia.

Capital markets

Capital markets include publicly traded equity and debt markets, trading and market-making functions (encompassing debt, equity, currency and hybrid securities) as well as non-exchange traded ('over the counter' or OTC) securities. Appendix 4 provides some background on how exchange traded and OTC markets operate in Australia.

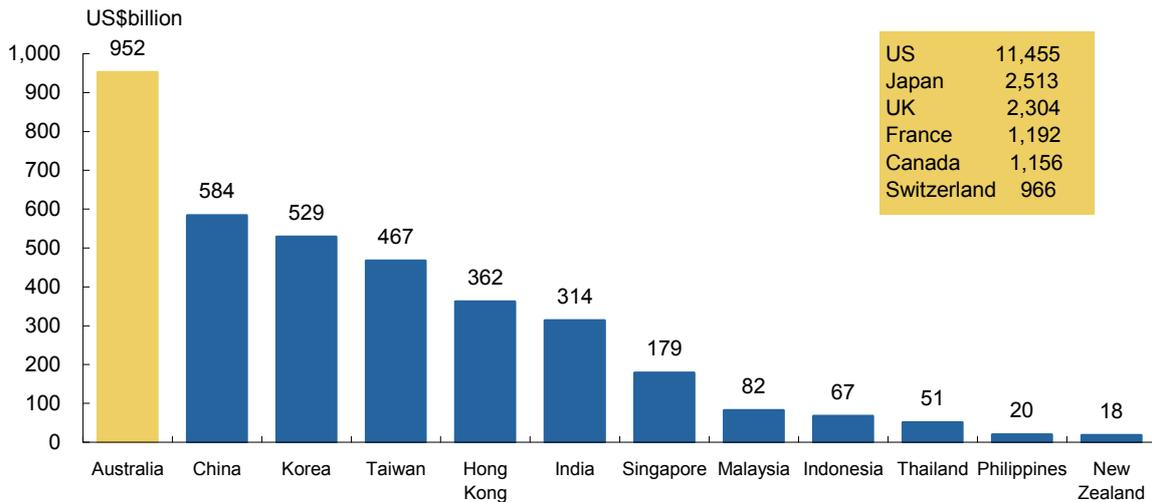
Capital market activities are primarily conducted by commercial banks and investment banks. These institutions also provide advice and financial support for various corporate transactions, such as M&A.

Equity capital markets: overview

The Australian equity market is the seventh largest globally and the second largest in Asia after Japan, based on free float market capitalisation (Chart 2.11).

⁵⁵ CoreData-brandmanagement, media release, 1 October 2009, based on APRA, RBA and ABS data and CoreData-brandmanagement analysis.

Chart 2.11: Equity markets — Asia-Pacific region (ex-Japan)

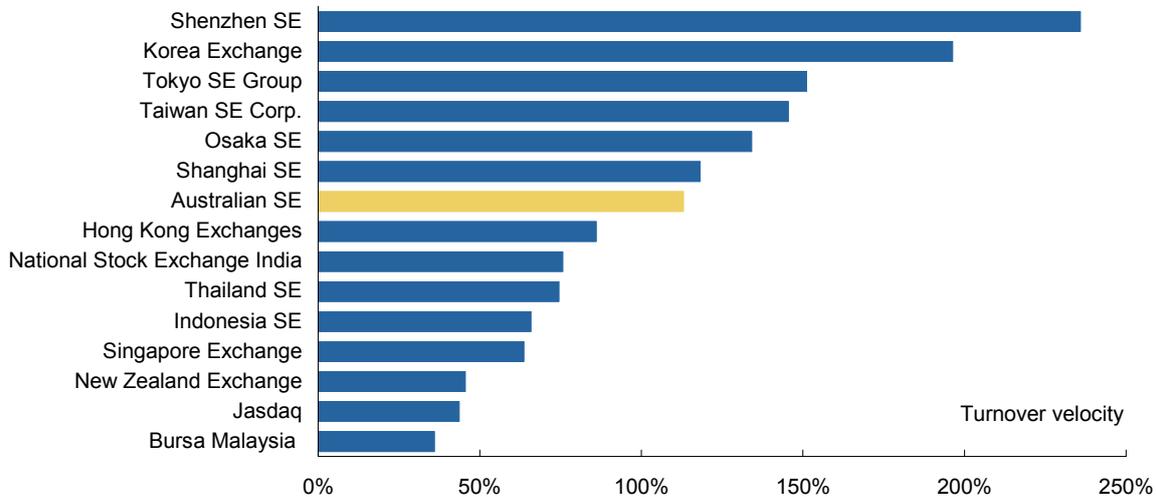


Source: Standard and Poor's, *World by Numbers*, September 2009, Austrade analysis. Adjusted for free float market capitalisation

The financial sector dominates the Australian equity market capitalisation, accounting for around 36 per cent of the S&P/ASX 200 index. Within the financial sector, Australia's four largest banks account for around half of the sub-index.⁵⁶

The ASX ranks seventh in the Asia-Pacific region for turnover or liquidity (Chart 2.12).

Chart 2.12: Liquidity of equity markets — Asia-Pacific region (turnover velocity)



Source: World Federation of Exchanges, *Annual Statistics*, Equity markets, 'Turnover velocity of domestic shares', 2008.

Through the global financial crisis, Australia remained an attractive market to raise capital.⁵⁷ Indeed, Australian equity issuance increased significantly, both in absolute terms and as a share of global issuance, during the course of 2008 and into 2009 (Chart 2.13). In the nine months to September 2009, Australian equity issuance was the third largest in the world after the US and UK.⁵⁸

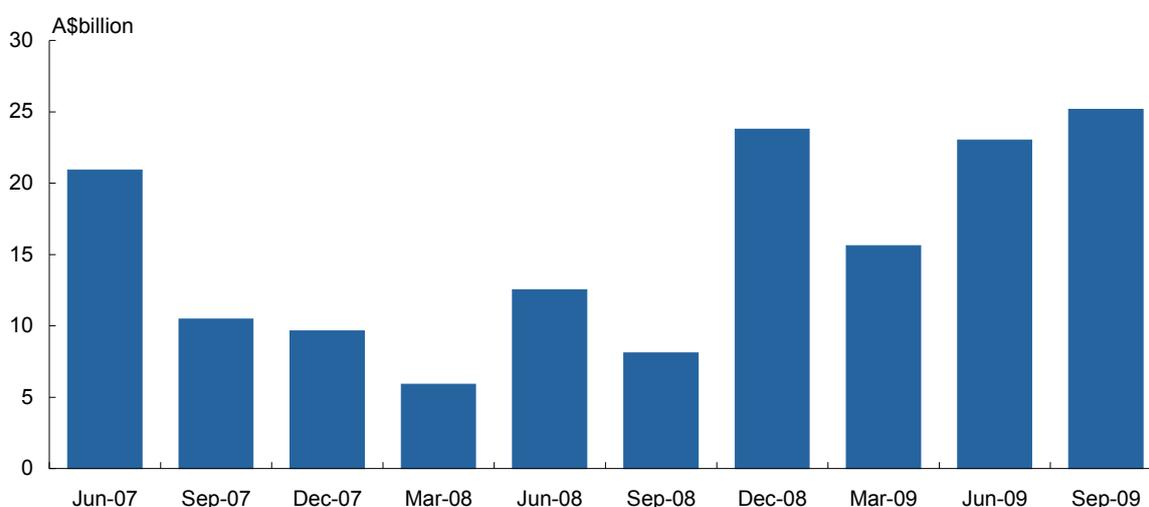
56 Australian Securities Exchange (ASX), *Financial sector profile*, August 2009.

57 Between March 2008 and September 2009, 38 of the top ASX 50 listed companies raised equity in Australia. Source: Data provided by UBS Australia to the Forum, September 2009.

58 Thomson Reuters, *Equity Capital Markets Review – Third Quarter 2009*, op cit. Data includes equity and equity-related issuance.

During the financial crisis, financial companies were the most active issuers in the market, raising capital to strengthen balance sheets and, in some cases, to purchase assets.

Chart 2.13: Equity issuance — Australia



Source: Thomson Reuters, October 2009.

The ability to raise capital through the financial crisis, at least for the larger and more creditworthy companies, was arguably an important factor in limiting the economic downturn in Australia.

The size of our funds management sector, alongside the strong ‘equity culture’ underpinning it, has provided a major underlying source of demand for equities in Australia and has been a key factor supporting market liquidity, in the process lowering the cost of equity capital for companies.

There are mixed data on the extent of internationalisation of Australia’s equity market. In June 2009 overseas domiciled companies accounted for just under 9 per cent of the ASX’s market capitalisation⁵⁹ and around 4 per cent of turnover, which is low compared to European and North American exchanges.⁶⁰ By contrast, non-resident ownership of Australian listed equities is substantially higher at 42 per cent in June 2009.⁶¹

Some international comparisons are available for equity trading costs. These assessments vary depending on the methodology used. GSCS Information Services provides regular updates on global equity trading transaction costs, which suggest that Australia’s ranking has improved significantly in recent years and Australia now ranks well internationally. Separate ranking by Elkins McSherry suggest that Australia ranks less well internationally, but still highly within the Asia-Pacific region.⁶²

Equity capital markets: assessment

Australia’s equity market is deep and liquid, and has been resilient in the face of the global financial crisis. However, the extent of internationalisation is, in at least some respects, limited.

59 Around 30 per cent of the overseas domiciled figure relates to NewsCorp, with an additional significant proportion from New Zealand companies. Information provided by the ASX to the Forum, September 2009.

60 World Federation of Exchanges, *Annual Statistics*, Equity markets, ‘Total value of share trading’, 2008.

61 ABS, *Australian National Accounts: Financial Accounts*, cat. no. 5232.0, June 2009, Table 40.

62 GSCS Information Services data, published regularly in *The Trade Magazine* (analysis based on data published in issue 11, 2007; issue 15, 2008; and issue 19, 2009); Elkins McSherry data, published regularly in the November edition of *Institutional Investor*, (analysis based on data published in vol 41, issue 11, 2007 and vol 42, issue 10, 2008).

An unusual feature of the market is the ASX's role as market operator, central counterparty and market supervisor (see Appendix 4 for background). In the Forum's assessment, this has been a significant barrier to new competition and innovation. The Forum received a good deal of feedback from industry concerning the lack of equity trading platform development (see Appendix 4) and innovation.

In order to facilitate the entry of new market operators, the Government recently announced that the Australian Securities and Investments Commission (ASIC) would take over the market supervision function from late 2010.⁶³

The issue of competition in the equity market is discussed further in Chapter 4.

Debt capital markets: overview

The Australian debt market is significant in the region but relatively small on a global basis (Chart 2.14).⁶⁴ This is in contrast to the Australian equity market's more significant global position.

- The *domestic* debt market is the thirteenth largest globally and fourth largest in the Asia-Pacific region (after Japan, China and Korea).⁶⁵
- The *international* debt market is the eleventh largest globally and the largest in the Asia-Pacific region. Australia accounts for around 1.8 per cent of international debt securities outstanding.⁶⁶

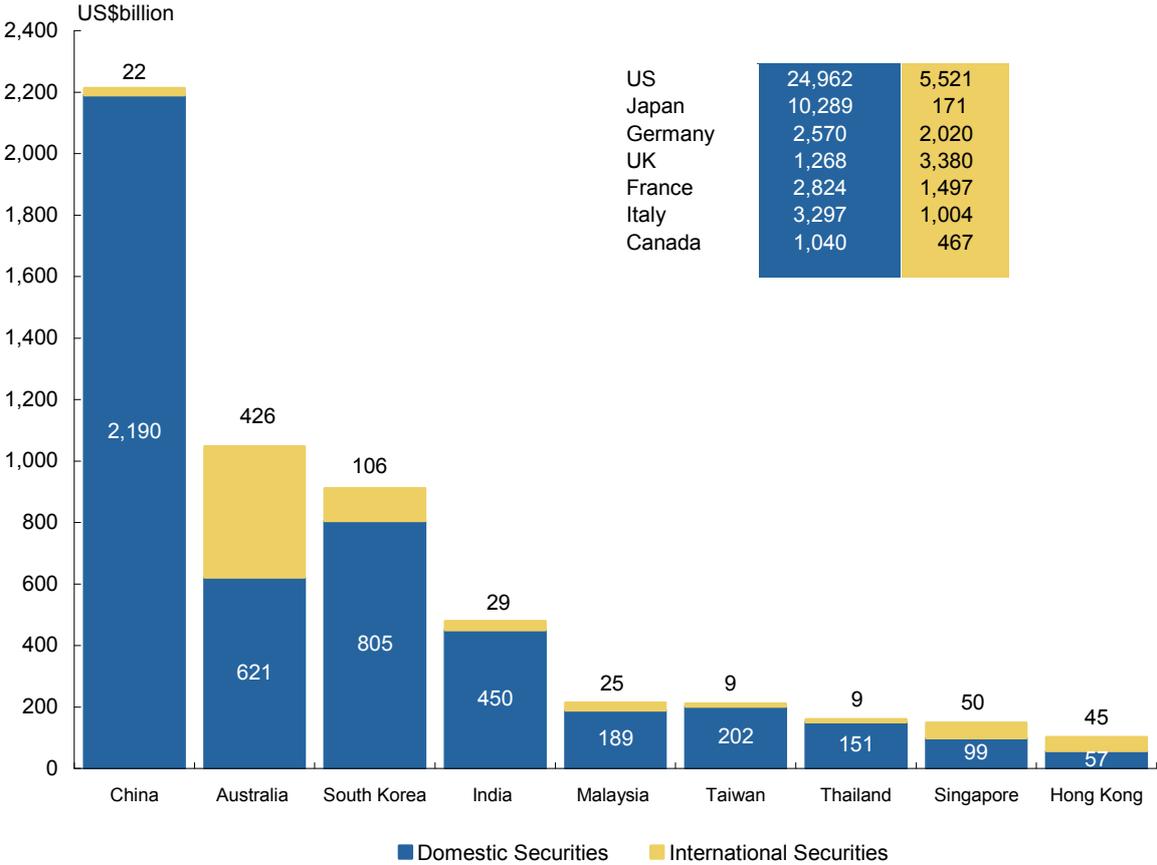
63 The Hon Chris Bowen MP (Minister for Financial Services, Superannuation and Corporate Law), *Reforms to the supervision of Australia's financial markets*, media release, Canberra, 24 August 2009.

64 The securitised debt market is covered in a later section of this Report. Securitisation is a process that allows the re-allocation of risk by aggregating debt instruments in a pool, then issuing new securities that are backed by the pool, to create asset backed securities.

65 By amount outstanding, as at March 2009. BIS, *Quarterly Review*, Statistical Annex, Table 16A, September 2009.

66 By amount outstanding, as at June 2009. BIS, *Quarterly Review*, Statistical Annex, Table 11, September 2009.

Chart 2.14: Debt securities outstanding — Asia-Pacific (ex Japan)



Source: BIS, *Quarterly Review*, September 2009, Tables 11 and 16A (data as at March 2009); Austrade analysis. Domestic debt securities cover long-term bonds and notes, treasury bills, commercial paper and other short-term notes issued in the domestic market. International debt securities cover long-term bonds, notes and short-term money market instruments issued in international markets.

Financial corporations dominate Australian debt issuance, with limited government and non-financial issuance. The relatively low proportion of government borrowing reflects Commonwealth Government budget surpluses prior to the global financial crisis.

Australia has been a preferred location within the Asia-Pacific region for bond issuance by high credit quality, non-resident issuers, generally referred to as ‘kangaroo bonds’ when they are denominated in Australian dollars. Such issuance is the major component of international issuance in Australia, and indeed is now a significant part of the overall bond market, with A\$145 billion in bonds issued since December 1999.⁶⁷ As at August 2009, kangaroo bonds accounted for 27 per cent of outstanding non-government bonds issued in Australia.⁶⁸ Much of the kangaroo bond issuance is by financial institutions, agencies and supranationals.

While there are a number of reasons why Australia has attracted issuance by offshore high credit quality issuers, one important factor is the existence of liquid derivatives markets which enable hedging and risk management, in particular currency and interest rate swap markets. The fact that Australia has these desirable features should, in principle, also support the development of a deeper domestic corporate bond market.

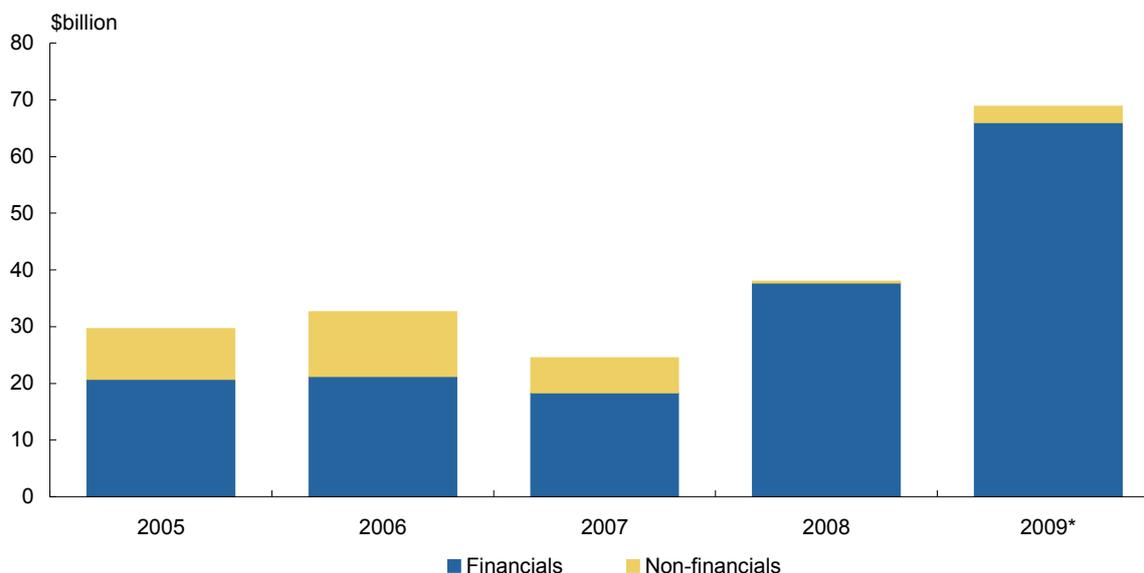
⁶⁷ RBA data provided to the Forum. Data is for the period from January 2000 to October 2009, inclusive.

⁶⁸ RBA, *Bulletin Statistical Tables*, Debt Securities Outstanding, Table D4.

In contrast to our equity capital market, Australia's domestic corporate bond market is not very deep or liquid. It is also dominated by bank issuance and tends to be concentrated at shorter ends of the maturity spectrum: the average maturity of Australian corporate debt on issue is just 2.5 years.⁶⁹

These features of our corporate bond market were evident prior to the global financial crisis, but were exacerbated by that crisis. Chart 2.15 shows the extremely low levels of corporate issuance for the non-financial sector in 2008 and the first three quarters of 2009.

Chart 2.15: Corporate issuance — Australia



Source: RBA data provided to the Forum. *2009 data is up to 15 October 2009.

Debt capital markets: assessment

While there is widespread agreement that the corporate bond market is underdeveloped, there did not appear to be a uniform view in the Forum's discussions as to whether this represented a serious constraint to the development of Australia as a leading financial centre. One view is that corporate financing needs are already well provided for by the domestic banking sector at competitive rates, that the lack of a deeper corporate bond market is simply a reflection of this, and that in any case the higher rated corporates can readily access the US market.

The perspective of the Forum is somewhat different. If Australia is to develop into a leading financial centre that provides liquid and efficient financial services across a broad range of products and asset classes, then a more diversified and liquid bond market should be part of that vision. As the Australian financial sector becomes more internationalised, and as the need for non-bank corporate debt financing within the region increases, Australia could potentially play a role in future years in facilitating that issuance and in managing Asia-Pacific corporate debt portfolios.⁷⁰ There are also potential flow-on effects for the listing of derivative products on Australian exchanges. While such ambitions are long-term ones, there seems little doubt that the enormous growth potential in the Asia-Pacific region and the implications of this for the development of higher quality corporate bond issuance could provide opportunities for Australia.

⁶⁹ UBS Australia.

⁷⁰ It is worth noting that, following the 1997-98 Asian crisis, a number of Asia-Pacific governments attached priority to developing their local and regional bond markets as alternatives to traditional bank financing. See J Batten, W Hogan, P Szilagyi, 'Kangaroo Bond Issuance in Australia', *JASSA: the FINSA Journal of Applied Finance*, Special Issue, 2008, p 27.

Domestically, there are also strong arguments in favour of a deeper and more liquid corporate bond market. One of the lessons of the financial crisis for companies has been the desirability of maintaining a diversity of potential funding sources. The traditional reliance of the larger and more creditworthy Australian companies on local bank borrowing, and the associated 'crowding out' effect, has arguably been an important factor behind the growth of syndicated loans for small and medium sized companies, involving foreign as well as large domestic banks. Recent funding pressures on some foreign banks in Australia, reflecting the global freezing up of wholesale credit markets, impacted on the capacity of many smaller and medium sized companies to raise capital in Australia, and reinforced the need for more diversified funding sources.

The pressure on foreign banks, along with the drying up of securitised markets, has seen a very strong re-intermediation process under way in most economies. In Australia, the combination of this process of re-intermediation and the Government's guarantees on bank deposits and borrowings has boosted the banks' market share of lending activity and sharply reduced competition from other sources. In the Forum's view, this process, while perhaps largely unavoidable during the global financial crisis, is undesirable in the medium and longer term. Growth of the domestic corporate bond market and the recovery of the non-bank securitisation market are desirable in the interests of competition and efficiency.

An additional consideration is Australia's ongoing need for substantial infrastructure development. Financing of these large scale, long-term infrastructure projects will come partly from a variety of private sector sources. Given the need for banks to diversify their loan portfolios, to avoid excessive maturity mismatch between assets and deposits and to not have excessive exposure to one borrower or project, an important source of funding should be more widely held long-term corporate bonds. This is yet another reason why a deeper, more liquid and longer maturity corporate bond market is seen by the Forum as being in the national interest.

While a more liquid corporate bond market is desirable for all the above reasons, there are no obvious policy constraints preventing this development. Rather, many of the reasons why the market is not particularly liquid or diverse are more structural in nature.

Firstly, and perhaps most importantly, the large Australian banks have provided a significant proportion of the non-financial corporate sector's borrowing needs. That said, the maturity of bank loans is often significantly shorter than many companies would like, which can result in refinancing risk. Competition between banks for lending to the corporate sector, with the potential additional benefit of cross-selling a wider range of financial services, has kept spreads on bank lending to the corporate sector typically lower than spreads on directly issued corporate paper.

As a consequence, many corporate treasurers in large Australian companies have, historically, not actively sought to develop domestic wholesale or retail demand for their debt. Many smaller and less well known companies would like to be able to issue domestically but perceive a lack of demand for longer dated paper by Australian fund managers for all but the largest companies, or else demand but only on very expensive terms. The need for liquidity by fund managers to deal with redemptions and switching between funds often cuts across companies' needs for issuing longer dated paper.

For very large and well known local companies, wholesale issuance including at longer maturities is a good deal easier, but some corporate treasurers informed the Forum that local fund managers were often uncompetitive in their pricing. Treasurers for both large and small companies shared the view that, at the retail level, prospectus requirements were onerous. This is discussed more in Chapter 4.

Secondly, to the extent that companies require longer maturity or additional debt financing beyond bank loans, Australian companies can access the much more liquid US or European corporate markets. However, such access is neither cheap nor easy, especially for smaller and lower credit rated Australian companies, and the regulatory requirements on public issuance are quite onerous for all

companies. Furthermore, swapping such issuance back into Australian dollars is far from costless, in part because it draws heavily on corporate credit lines with banks.

Thirdly, low asset allocation to fixed income in Australia within the funds management sector has limited the demand for Australian corporate paper. Fund managers' needs for liquidity can, as noted earlier, dampen demand for longer dated paper, at least from smaller and less well known companies.

Fourthly, where Australian fund managers are looking for fixed income assets, the lack of a liquid and diversified corporate bond market in Australia has probably resulted in at least some of the larger managers going offshore for their corporate credit exposure.

While there are no obvious policy constraints to the long-term development of the wholesale corporate bond market, there are opportunities for some regulatory changes that may encourage development of a deeper retail corporate bond market. Chapter 4 discusses these opportunities and related policy measures that may be required.

Securitised debt market: overview

One part of the Australian debt market that has been severely impacted as a result of the financial crisis is the securitised debt market. This market has provided a very important source of competition with respect to mortgage interest rates in Australia. Box 2.3 provides some background information on this segment of the debt market.

Box 2.3: The securitised debt market

Securitisation allows the re-allocation of risk by aggregating debt instruments into a pool, then issuing new securities that are backed by the pool to create asset backed securities.

Prior to the global financial crisis, the share of housing loans financed through securitisation rose from minimal levels prior to the 1990s to a high of around 25 per cent by mid-2007.⁷¹ The vast majority of issuance was taken up by global investors.

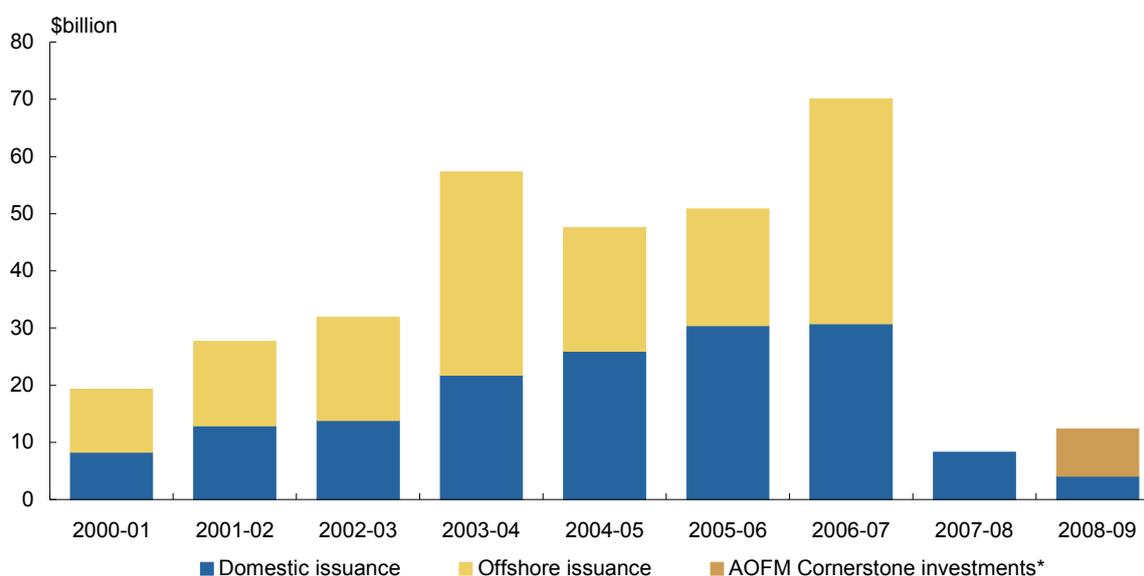
Securitisation was used by the banks, particularly regional banks and smaller deposit-taking institutions, as a means to raise funds and diversify their liabilities. On the asset side, investors both in Australia and globally were able to invest in highly rated (typically 'AAA') mortgage backed securities with attractive returns, compared with other AAA rated assets, such as OECD government bonds.

⁷¹ ABS and RBA data, cited in S Black, Reserve Bank of Australia, 'Recent Developments in Securitisation', *Jassa: the FINSIA Journal of Applied Finance*, Special Issue, 2008, pp 7-14. The Australian Securitisation Forum also provided information and data.

Box 2.3: The securitised debt market (continued)

Unlike in the US, the vast bulk of residential mortgage backed securities (RMBS) in Australia is 'prime', most of which is covered by lenders' mortgage insurance that provides investors with protection against most losses. There is no 'sub-prime' market analogous to the one that existed in other countries.⁷² There are a number of other features of the Australian market that have meant it has withstood some of the worst excesses of the leveraged credit environment witnessed offshore. For example, unlike in the US, Australian mortgage loans are full recourse: repossession does not spell the end of the mortgagor's obligation to repay (unless the sale of their home discharges that obligation). The Australian consumer credit framework also requires the lender to assess the borrower's capacity to repay.

The global credit crisis and some aspects of Governmental responses to it, in particular the introduction of Government guarantees on bank lending, impacted severely on the securitised debt market both in Australia and overseas. As Chart 2.16 shows, issuance of RMBS in Australia since the second half of 2007 has been minimal.

Chart 2.16: RMBS issuance — Australia

*AOFM Cornerstone investments refers to investments where the Australian Office of Financial Management (AOFM) has been a substantial supporter of the issue.

Source: RBA data provided to the Forum, August 2009.

Securitised debt market: assessment

In the Forum's view, the recovery of the securitised debt market is very important for competition in the mortgage market. There have been recent signs that this segment of the market may be turning the corner in Australia. The Australian Office of Financial Management's (AOFM) RMBS purchase program has played a critical role. In the Forum's view, this process of recovery is very welcome and

⁷² Sub-prime is usually defined in terms of the riskiest categories of loans. Risk could reflect such factors as loan size; the borrower's credit rating; the borrower's debt as a proportion of assets, income or collateral; or documentation standards.

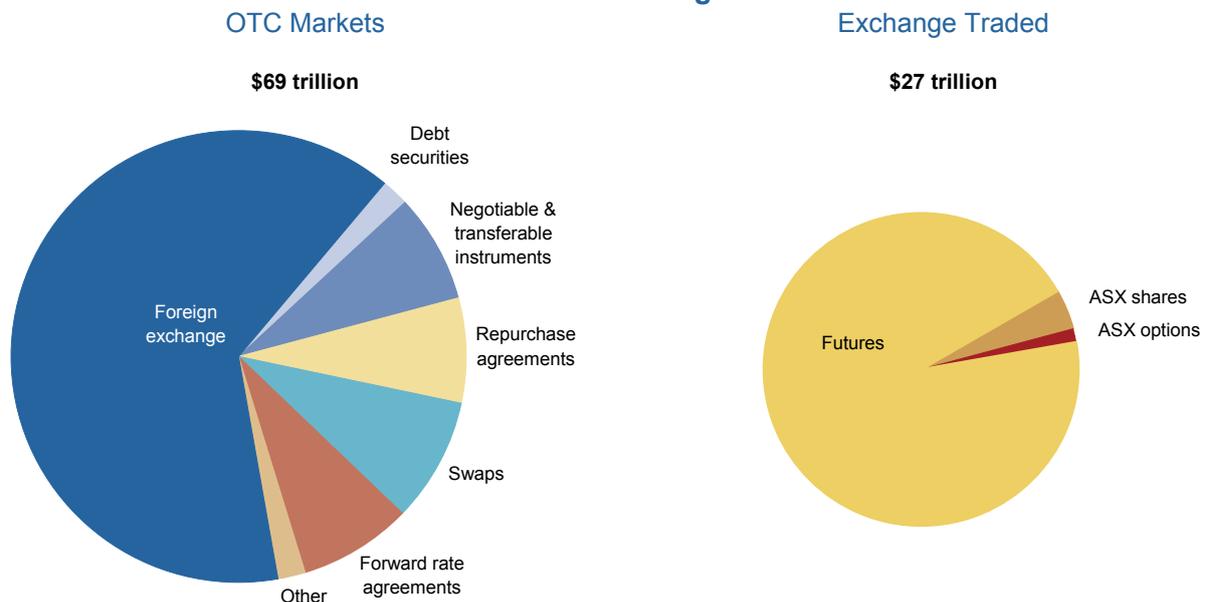
should continue to be encouraged by the Government.⁷³ Such a recovery will provide alternative sources of mortgage finance. In order to restore investor confidence, there have also been self-regulation proposals by the industry.⁷⁴ The Forum welcomes these self-regulation proposals, which may need to be supported by additional measures implemented by the regulators.

Non-exchange traded securities: overview

OTC trading is the trading of financial instruments such as stocks, bonds, commodities or derivatives directly between two parties. This contrasts with public exchanges (such as the ASX), for listed securities and futures. Appendix 4 provides further background on the OTC market.

OTC trading represents more than 70 per cent of the value of turnover in Australia's financial markets.⁷⁵

Chart 2.17: Turnover of OTC and exchange traded markets — Australia



Source: AFMA, 2009 Australian Financial Markets Report. Data is for 2008-09.

In Australia, the main OTC market is foreign exchange, representing 64 per cent of turnover in 2008-09. For foreign exchange turnover, two-thirds of transactions was with offshore financial institutions. Non-Australian dollar foreign exchange turnover represented more than half of activity.⁷⁶

73 The Government, through the AOFM, has undertaken a program of purchasing new RMBS issues. The Government announced an extension of this program on 11 October 2009, in order to support competition in the Australian mortgage market.

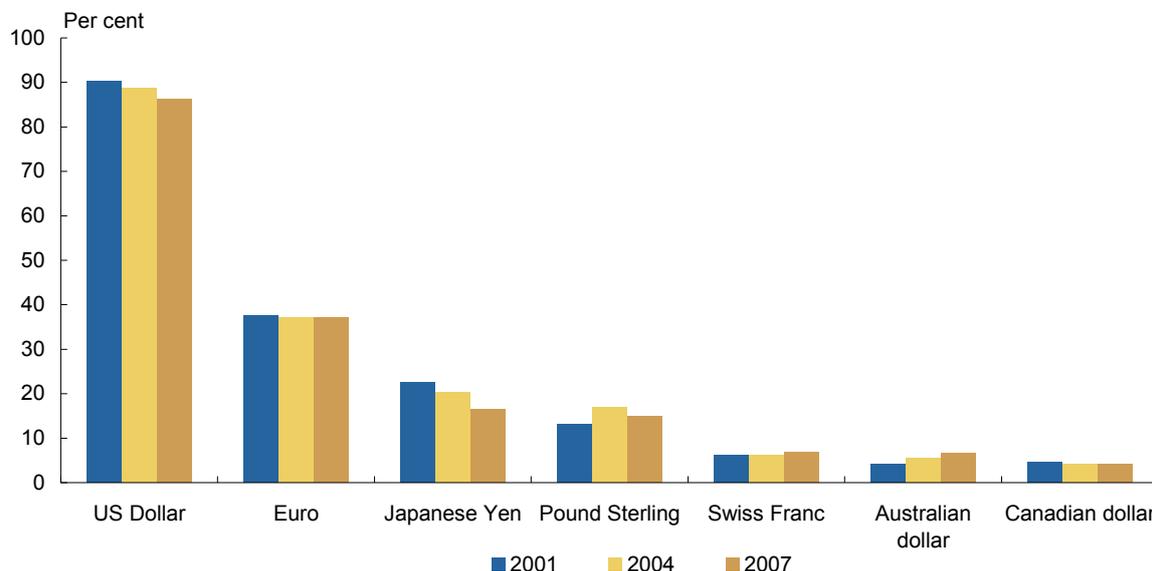
74 The self-regulation initiatives were set out in the Global Joint Initiative Report, *Restoring Confidence in the Securitization Markets*, 3 December 2008, prepared by the various representatives from the global securitisation industry, including the Australian Securitisation Forum. The initiatives included: industry-wide market standards of due diligence disclosure and quality assurance for RMBS; stronger and standardised originator representations and warranties as well as repurchase procedures for RMBS; and development of industry-wide standard norms for RMBS servicing duties and evaluating servicer performance.

75 Australian Financial Markets Association (AFMA), *2009 Australian Financial Markets Report*, AFMA, ASX and Austrade, Sydney, 2009, p 2.

76 *ibid*, pp 2, 49-50.

In 2007 (most recent data), the Australian dollar was the sixth most traded currency in the world (Chart 2.18). This reflects, amongst other things, the dollar's role as a proxy for commodity prices and global economic growth.

Chart 2.18: Currency turnover
Share of daily global turnover*



Source: BIS, *Triennial Central Bank Survey*.

* Because two currencies are involved in each transaction, the sum of the percentage shares of individual currencies totals 200 per cent instead of 100 per cent.

Non-exchange traded securities: assessment

As a result of the global financial crisis, the Financial Stability Board has recognised the systemic importance of central counterparty clearing facilities⁷⁷ and the desirability of greater reliance by financial markets on them.⁷⁸ In both Europe and the US, important regulatory changes are in the process of being finalised, which will mean that many OTC derivative instruments will, in future, need to be cleared through central clearing mechanisms.

Going forward, many OTC derivative instruments traded in Australia are also likely to be cleared through either offshore central clearing mechanisms or local central clearing mechanisms. It is vital that Australia has open and 'equal treatment' access to such overseas clearing systems. The industry is working closely and effectively with the regulators on this matter.

Chapter 4 returns to Australia's central clearing mechanisms and specifically the need to ensure they operate as efficiently and transparently as possible.

⁷⁷ Under central counterparty clearing arrangements, which apply to most exchange traded markets around the world and some OTC markets, the central counterparty becomes the legal counterparty to all purchases and sales of the relevant financial instruments. Instead of there being one contract between the buyer and the seller, there are separate contracts between the buyer and the central counterparty, and the seller and the central counterparty.

⁷⁸ See, for example, Financial Stability Board, *Improving Financial Regulation: report of the Financial Stability Board to the G20 leaders*, Financial Stability Board, September 2009.

Insurance: overview

The Australian insurance industry includes general insurance (such as home and contents and motor vehicle), life insurance and reinsurance. Around 90 per cent of life insurance business relates to superannuation.⁷⁹

On a global basis, the Australian insurance sector has a market share of around 1.7 per cent, the twelfth largest. Chart 2.19 shows the size of the Australian insurance market in a global context. Other widely used measures of the domestic significance of the insurance industry, such as penetration and density⁸⁰, show Australia generally below the OECD average.⁸¹ This could reflect a number of factors, including possibly 'underinsurance' because of high indirect taxes (discussed in Chapter 3).

Chart 2.19: Global insurance markets 2008

| | World ranking | Country | Premium volume (US\$ billion) | Share of world market (%) |
|------------------------|---------------|-------------|-------------------------------|---------------------------|
| North America | 1 | US | 1,241 | 29.1 |
| | 9 | Canada | 105 | 2.5 |
| Europe | 3 | UK | 450 | 10.5 |
| | 4 | France | 273 | 6.4 |
| | 5 | Germany | 243 | 5.7 |
| | 7 | Italy | 141 | 3.3 |
| | 8 | Netherlands | 113 | 2.6 |
| | 11 | Spain | 87 | 2.0 |
| | 15 | Belgium | 49 | 1.2 |
| | 16 | Switzerland | 49 | 1.1 |
| | 18 | Ireland | 45 | 1.1 |
| Asia-Pacific | 2 | Japan | 473 | 11.1 |
| | 6 | China | 141 | 3.3 |
| | 10 | South Korea | 97 | 2.3 |
| | 12 | Australia | 71 | 1.7 |
| | 13 | Taiwan | 64 | 1.5 |
| | 14 | India | 56 | 1.3 |
| | 24 | Hong Kong | 24 | 0.6 |
| | 31 | Singapore | 17 | 0.4 |
| | 34 | Malaysia | 9 | 0.2 |
| | 35 | Thailand | 9 | 0.2 |
| | 39 | Indonesia | 7 | 0.2 |
| | 41 | New Zealand | 7 | 0.2 |
| Other countries | | | 500 | 11.6 |
| World | | | 4,270 | 100.0 |

Source: Austrade 2009 Benchmark Report, using Swiss Re, Sigma No 3/2009; World Insurance in 2008.

A little over 60 per cent of the Australian insurance market is made up of *general insurance*, similar to the OECD average. The general insurance industry is dominated by three major domestic players that

79 APRA, *Life Insurance Trends: March 2008*, APRA, Sydney, issued July 2008, p 5.

80 Penetration is defined as the value of insurance premiums as a percentage of nominal GDP. Density is defined as the value of premiums per capita.

81 OECD, *Insurance Statistics Yearbook, 1998-2007*, OECD, Paris, 2009. Comparisons relate to 2007.

hold around 60 per cent of the overall market with foreign companies having a 26 per cent market share.⁸²

There are 32 registered *life insurance* companies operating in Australia.⁸³ However, the industry is highly concentrated, with the top three life insurers holding almost three quarters of the market. Foreign companies have 27 per cent of the domestic life insurance market.

For reinsurance, 18 companies operate in Australia. Most are foreign owned and operate general and life insurance businesses.

General insurance, life insurance and reinsurance companies remain well capitalised.⁸⁴

Australian insurance companies looking to expand offshore can do so by writing business from Australia for offshore clients or by establishing offshore branches or subsidiaries. In practice, offshore regulatory licensing requirements (including for capital) and market barriers (particularly for distribution) may make it difficult for Australian insurance companies to write offshore business from Australia. For this reason, Australian insurance companies looking to grow offshore usually do so by establishing or acquiring offshore businesses.

As is the case in both banking and funds management, the growth strategies of Australian general insurance companies vary substantially, between those focused primarily on domestic growth and those heavily focused on developing their offshore business. Looking at the three dominant domestic general insurers, the proportion of premium revenue from offshore operations in 2008 ranged from 10 per cent to 80 per cent.⁸⁵

The Forum was unable to obtain a figure on offshore activity for the overall general insurance sector, and international data are limited. However, the partial data available suggest a reasonably high degree of overseas activity by Australia's general insurance industry compared with a number of other developed countries.⁸⁶

Insurance: assessment

While Australia's insurance companies are generally profitable and well capitalised, and a number of the leading general insurance companies have significant offshore subsidiaries, domestic business has been affected by high indirect taxes and, to a lesser extent, by non-harmonised state regulation. The resultant higher costs can lead to underinsurance and complicate the operation of a national business. These complications can also act as a barrier to entry and competition.

A stronger and less complex domestic business also provides a firmer base for international expansion. Proposals to reduce insurance taxes and to reduce the regulatory burden on insurance companies are discussed in Chapters 3 and 4, respectively.

While there are some examples of global insurance companies using Australia as a regional headquarters, there is certainly scope for Australia to play a greater regional role in this sector.

82 As at 31 December 2008. Based on gross premium revenue. Source: APRA, *Half Yearly General Insurance Bulletin, December 2008*, APRA, Sydney, issued 6 August 2009.

83 As at 30 June 2009. Source: APRA, *Quarterly Life Insurance Performance Statistics, June 2009*, APRA, Sydney, issued 29 September 2009.

84 As at 30 June 2009, life insurers offering non-investment linked policies held 1.4 times minimum capital requirements, and those offering investment-linked policies held 1.8 times minimum capital requirements. Source: APRA, *ibid.*

85 Source: company annual reports 2008.

86 OECD, *Insurance Statistics Yearbook*, *op cit.*

Chapter 3 includes recommendations designed to facilitate the use of Australia as a base for regional decision making on investment management issues, including for the insurance sector.

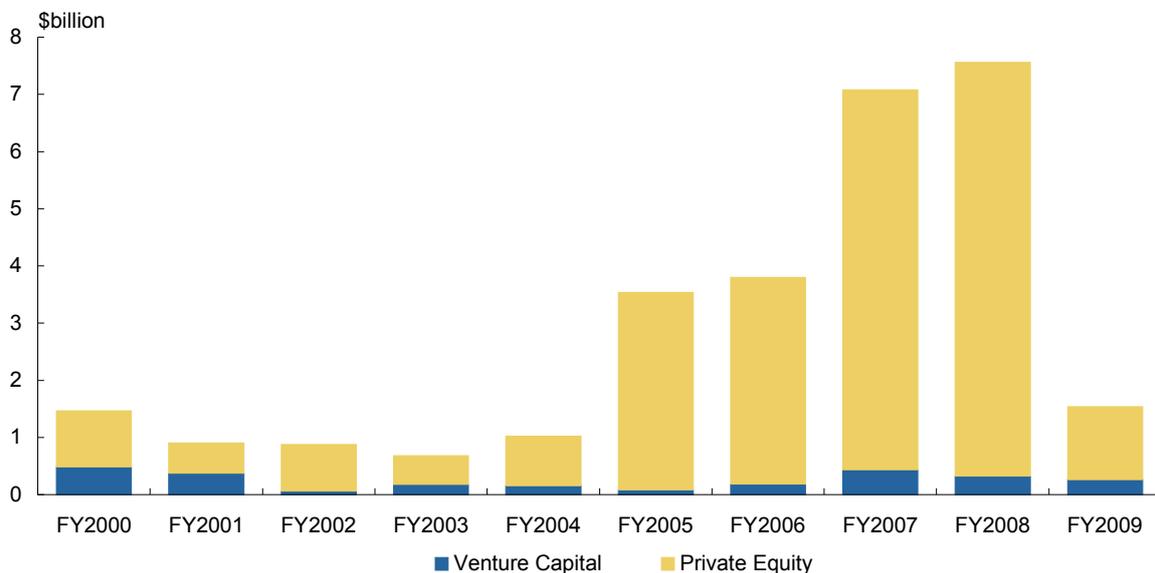
Private equity and venture capital: overview

Private equity consists of equity ownership in operating companies that are not publicly traded on a stock exchange. Private equity investments can take place through the injection of capital into a company or through acquisition. Capital for private equity is raised primarily from institutional investors.

Venture capital refers to capital designated for early stage business development.

The Australian private equity and venture capital industry (hereafter 'PE') consists of nearly 200 investment firms managing \$25 billion.⁸⁷ Reflecting the impact of the global financial crisis, the amount of funds raised by Australian PE funds dropped sharply in 2008-09 to \$1.5 billion, from \$7.6 billion the previous year (Chart 2.20).⁸⁸

Chart 2.20: Private equity capital raisings — Australia



Source: Australian Private Equity and Venture Capital Association (AVCAL) unpublished data, provided in October 2009. Data is for fiscal year (FY).

Australian private equity ranked fourth in the region and seventeenth globally in terms of new investments during 2008.⁸⁹

PE investors are generally sophisticated individual investors or organisations such as pension (superannuation) funds. Investment in private equity by Australian superannuation funds accounted for 55 per cent of total investment in private equity as at June 2008. Non-residents accounted for a

⁸⁷ As at June 2009. Source: Australian Private Equity and Venture Capital Association (AVCAL) data provided to the Forum.

⁸⁸ This figure refers to funds raised in the relevant year. These funds are usually drawn down over a three to five year period.

⁸⁹ Austrade, using 2008 data from Thomson Reuters Financial. The largest private equity investments in the region were in India, China and South Korea.

further 11 per cent. While superannuation funds dominate total PE investments, these investments represent only 1 per cent of total superannuation funds under management.⁹⁰

The growth potential of Australia's PE industry is emphasised by the fact that PE buy-outs accounted for only 3 per cent of all M&A deals in Australia in 2008, compared with 7 per cent in the US and 12 per cent in the UK.⁹¹ Buy-out activity is also small relative to total listed equity market capitalisation: the total value of funds raised by private equity firms in the 10 years to June 2009 was just 2 per cent of equity market capitalisation.⁹²

While local investor commitments to PE have risen more than threefold since 2000, the proportion of foreign PE commitments has halved from 22 per cent to 11 per cent.⁹³ By contrast, 30 per cent of the funds invested in European PE come from North America alone.⁹⁴

Private equity and venture capital: assessment

The Australian Private Equity and Venture Capital Association (AVCAL) has argued that one of the reasons for the limited offshore investment in the private equity sector in Australia is the absence of an appropriate investment vehicle for venture capital. While a venture capital limited partnership (VCLP) vehicle was introduced in 2002, its use has been quite limited, mainly because of legislative restrictions.

Recommendations relating to the venture capital investment vehicle are contained in Chapter 3.

New market opportunities: overview

One of the key features of financial markets is the rapid pace of innovation and emerging new opportunities. Financial centres that are quick to recognise and accommodate such new opportunities can often establish a 'first mover' competitive advantage. Examples of this that have worked to Australia's advantage are real estate investment trusts and private sector infrastructure financing vehicles.

Australia has also been active in environmental markets. In the electricity market, a variety of state electricity generation derivative instruments are traded, such as swaps and options. These derivatives are traded by the generators, retailers and intermediaries. Trading is done via the Sydney Futures Exchange and the OTC market. Turnover in the largest market (NSW) has been adversely affected by uncertainty around the potential sale of the NSW Government's electricity assets.

Another environmental market is for Renewable Energy Certificates (RECs). The REC market has developed since 2001 following Commonwealth legislation designed to increase renewable electricity generation, with a renewable energy target of 20 per cent by 2020. Renewable energy suppliers (for example, from hydro or wind power) can create their own RECs. Those suppliers then sell the RECs to other parties, such as electricity retailers, who are required under the legislation to meet renewable energy targets. These parties can use these RECs to demonstrate their compliance with the renewable

90 ABS, *Venture capital and later stage private equity, Australia*, cat. no. 5678.0, ABS, issued June 2009; and RBA, *Bulletin Statistical Tables, Managed Funds*, Table B18.

91 AVCAL, using data from Zephyr by Bureau van Dijk.

92 AVCAL, data provided to the Forum on 12 October 2009.

93 ABS, *Venture capital and later stage private equity*, op cit.

94 J Escharri, Secretary-General, European Private Equity and Venture Capital Association, letter to United States Securities and Exchange Commission, 9 September 2009, available at: www.evca.eu/uploadedfiles/EVCA-SEC-Response-09-09-09.pdf.

energy target. Sales are negotiated between the parties, with RECs transferred via a market based online system.

New market opportunities: assessment

The Australian Government is committed to commencing the Carbon Pollution Reduction Scheme (CPRS) on 1 July 2011. The proposed CPRS would cover 75 per cent of Australia's greenhouse gas emissions, making its coverage among the widest in the world.

Subject to the passage of CPRS legislation, and given Australia's experience in a number of environmental markets, the broader carbon trading market could provide significant opportunities for Australia to develop as a regional carbon trading centre. These opportunities include trading and broking services; financing (for example, for emissions reduction and energy efficiency projects); carbon hedging (spot, forward and derivative contracts); carbon and clean technology funds management; and carbon accounting.

Emissions trading schemes (ETS) are either in existence or being developed in many countries. The European Union has operated an ETS market (in response to Kyoto obligations) since 2005. The US released legislation in June 2009 for an ETS. Japan and South Korea are also developing their own ETSs.⁹⁵ The European Union ETS dominates current market transactions (spot, futures and options).

The main barriers the industry faces in developing as a regional carbon trading centre are the current lack of legislative certainty in relation to the CPRS; competition from other regional centres (including through incentives); and – according to industry feedback – very slow processes for approving new market licences, including for new international operators.

The Forum also considered the opportunities for Australia in **commodity markets**. Commodity markets include energy, metals and grains. Two of the largest global markets are the London Metals Exchange and the CME (formerly the Chicago Board of Trade). These well-established global markets are deep and liquid, offering physical, futures and options contracts. Ninety five percent of London Metals Exchange business comes from offshore.⁹⁶

Despite Australia being a major commodities exporter, it does not appear to have a comparative advantage in conducting financial transactions in the commodities markets. The Forum could not identify any specific policy barriers to the development of these markets in Australia: it would appear to largely reflect the fact that the London and Chicago markets are well-established and very deep and liquid, making them attractive for global transactions.

Given the opportunities to develop carbon markets and potentially other new markets in Australia, and the importance in such new product areas of 'first mover' advantage, the Forum emphasises that regulatory processes for assessing new market licences need to be timely. This issue is addressed further in Chapter 4.

⁹⁵ New Zealand commenced an ETS in early 2009, until a change in Government put the scheme on hold. Recent amendments to New Zealand's emissions trading legislation, as well as close collaboration with Australia, are likely to see New Zealand's scheme recommence, with wider sectoral coverage.

⁹⁶ See London Metals Exchange website at <http://www.lme.co.uk/who.asp>.

3. TAXATION

This Chapter examines the impact of the tax system on the two most important characteristics of a financial centre, namely competitiveness, efficiency and innovation; and engagement in a high volume and wide variety of cross-border activities.

The tax system impacts on all of these characteristics. It is one of the central determinants of the competitiveness of the financial sector; of its capacity to attract and retain talented people; and of the willingness of domestic and offshore participants to engage in cross-border transactions through that financial centre.

Amongst the wide range of taxation issues raised by industry in submissions to the Forum and in private discussions, there were inevitably some submissions and comments suggesting that the Forum will never achieve its objectives unless personal tax rates, corporate tax rates and other forms of taxes such as payroll tax are dramatically lowered. Perhaps surprisingly, however, the extent of such feedback was very limited.

Clearly, the level of both personal and business tax rates is very important in terms of the competitiveness of Australia's financial sector. However, it is equally important to all other sectors of the economy. The Government has established a wide ranging review of Australia's tax system, Australia's Future Tax System (AFTS) review, which will be reporting by the end of 2009.¹ That review will be considering, amongst other things, the level of taxation and the appropriate balance between taxation of capital, labour and natural resources. It will also be looking at the impact of the tax system on debt versus equity financing.

In contrast to the very broad focus of the AFTS review, the focus of the Forum is only on the financial sector. For this and other reasons referred to in Chapter 1, this Report has avoided issues relating to the overall level of taxes or the balance between the taxation of labour, capital and natural resources, or other broad tax issues affecting the whole economy.

One exception to this approach relates to Australia's dividend imputation system. This feature of our tax system is also being examined by the AFTS review. Submissions the Forum has received and discussions with market participants have been supportive of the continuation of the dividend imputation system, which is designed to avoid double taxation of dividends paid to Australian shareholders by an Australian resident company. Some of the benefits of Australia's dividend imputation system are set out in Box 3.1. Reflecting these benefits, the Forum strongly supports retaining the dividend imputation system.

Proposals were put to the Forum for modification of the dividend imputation system. They are also discussed in Box 3.1.

1 See <http://www.taxreview.treasury.gov.au>.

Box 3.1: Dividend imputation — benefits and proposals

Amongst the perceived benefits of Australia's imputation system are:

- a lower cost of capital for companies, particularly those that do not have access to the international capital market;
- increased neutrality in respect of debt versus equity financing, and as a consequence lower levels of corporate gearing than would be the case in the absence of imputation, which has arguably contributed to the strength of the Australian corporate sector through the recent financial crisis;
- enhanced integrity in the company tax system, with reduced incentives to avoid Australian tax and incentives to shift profits to Australia for companies paying franked dividends; and
- an incentive for Australian multinationals to invest in Australia.

Under Australia's imputation system, imputation credits are provided only for Australian company tax and are primarily of benefit to resident shareholders who can use them to offset their personal Australian tax liability. Non-resident shareholders do not benefit from imputation credits other than to avoid any dividend withholding tax that may be payable. As imputation credits must generally be uniformly allocated to all shareholders – resident and non-resident – the imputation credits paid to non-resident shareholders are essentially wasted.

Two proposals have been put to the Forum for modification of Australia's imputation system:

- (a) that Australian resident multinationals be allowed to direct or stream unfranked foreign source income to non-resident shareholders and Australian-sourced (franked) income to resident shareholders; and
- (b) that wholly owned Australian subsidiaries of foreign multinationals be allowed to stream franked dividends to Australian shareholders in the foreign parent, conditional on the foreign multinational being listed on an Australian stock exchange.

In each case, Australian companies would in effect maintain two dividend distribution accounts: a domestic income account and a foreign income account.

- Dividends from the domestic income account, which would track Australian source income, would be preferentially allocated to Australian resident shareholders who provide a tax file number or Australian Business Number.
- Dividends from the foreign income account, which would track foreign income, would be preferentially allocated to non-resident shareholders.

The first of these proposals is designed to avoid imputation credits being wasted. It would allow domestic shareholders to receive a greater portion of available franking credits, and allow non-resident shareholders in Australian companies to receive proportionately more unfranked dividends. To the extent that this proposal reduces the effective tax rate faced by resident shareholders, it could decrease the cost of capital for Australian companies.

Box 3.1: Dividend imputation — benefits and proposals (continued)

The second proposal would extend dividend streaming to Australian resident investors in multinational corporations that have a wholly-owned resident subsidiary operating in Australia. While Australia benefits significantly from the operations of overseas based multinational corporations with large operations in Australia, many such corporations seek to minimise the amount of Australian tax paid through various means, such as interest paid on parent company loans (subject to the thin capitalisation rules) and royalty payments on the licensing of brands to Australian subsidiaries. It has been suggested to the Forum that, over time, proposal (b) above would see multinational corporations with significant operations in Australia having their Australian subsidiaries pay more tax in Australia.

It has also been suggested with respect to proposal (b) that, given its conditionality on the parent multinational listing on an Australian exchange, this would encourage many such foreign multinationals to have a secondary listing in Australia, resulting in an increase in turnover and brokerage on Australia's equity markets. There could also be greater use of Australian financial services by the Australian subsidiary and possibly the parent company.

The Forum is very conscious that the above proposals would, if implemented, extend not just to the financial sector, which is the focus of this Report, but to the whole Australian corporate sector. In addition, the cost of the proposals would be substantial, requiring significant offsetting measures elsewhere in the tax system. A full evaluation of the proposals, including these broader ramifications beyond the financial sector, extends beyond the scope of this Report. Consequently, while it does not wish to make a formal recommendation on the above proposals, the Forum has had detailed discussions with the secretariat of the AFTS review on the proposals and has encouraged the review secretariat to evaluate them.

The remainder of this Chapter focuses on specific areas where the tax system is unduly and unnecessarily inhibiting the development of Australia as a financial centre.

The Government also asked the AFTS review to take into account the Government's objective of developing Australia as a financial centre. The Forum has maintained a dialogue with the AFTS review secretariat to inform it of the AFTS review's general thinking and directions on the key tax issues, and to ensure that the recommendations in this Report do not cut across the broad principles being considered by the AFTS review.

3.1 TAX AND CROSS-BORDER ACTIVITIES

The opportunity

The Forum's vision includes a financial sector that exhibits a high volume of cross-border transactions. Financial centres with a comparative advantage in terms of skills, experience, reputation and liquid markets will typically maximise those advantages by exporting their skills and services to other countries.

Such cross-border transactions may include Australian based funds managing offshore sourced funds; foreign competitors marketing their financial products in Australia; offshore companies raising debt or equity capital in Australia; Australian banks engaged in trade financing, foreign exchange or other transactional business with offshore counterparties; financial institutions accessing offshore pools of saving to finance either domestic or offshore investment; or the Australian based treasury operations of a financial services company managing its offshore assets out of Australia.

Attracting financial services transactions to Australia that would otherwise occur offshore, or in some cases not occur at all, is likely to result in net gains to the Australian economy in terms of income and employment. However, it requires having clear and reasonable rules as to how such transactions will be taxed in Australia.

Tax impediments

In its discussions with financial market participants, the Forum encountered a widespread view that tax uncertainties and the scope of the tax system act as a significant constraint on cross-border activities. These concerns were put strongly to the Forum by many market participants, and were supported by examples of financial services companies as a consequence either conducting more of their overall activities offshore or simply choosing not to undertake cross-border activities at all.

Industry's desire for greater tax certainty can at times conflict with its desire for flexibility and discretion. These potentially conflicting requirements create innate difficulties for the Australian Taxation Office (ATO), which, in addition, is attempting to protect the revenue base in the context of continual financial innovation and internationalisation.

While the Forum has laid out some key recommendations designed to overcome tax uncertainty and scope issues as they relate to the development of Australia as a financial centre, it wishes to stress that it fully recognises the inherent difficulties faced by the ATO in balancing conflicting objectives, and also the time and resources which the ATO puts into industry consultation.

The main areas of concern regarding the lack of clarity and scope of the tax system as it applies to cross-border financial transactions relate to:

- what determines, for tax purposes, where an organisation carries on its business;
- what determines where it earns its income;
- what determines what type of income it is deemed to have earned, in particular whether that income is a capital gain or revenue; and
- the tax implications of where management decisions are taken.

These issues are discussed in more technical detail in Box 3.2.

Box 3.2: Tax constraints to cross-border transactions

Some of the key areas of tax uncertainty and scope raised with the Forum, which were seen as impinging on Australia's capacity to fully engage in cross-border activities, are:

- (a) *Permanent establishment* (where an organisation carries on its business): depending on the level of activity in Australia, a foreign fund or a foreign entity may be deemed to have a 'permanent establishment' in Australia, and hence be subject to Australian income tax, if it uses an Australian investment adviser or fund manager or has a similar decision making presence in Australia. If the foreign fund is deemed to have a permanent establishment in Australia, this may result in the fund paying Australian income tax or losing the benefit of the capital gains tax exemption for non-resident investors.

Box 3.2: Tax constraints to cross-border transactions (continued)

- (b) *Source* (where the organisation earns its money): there can be considerable uncertainty as to what constitutes Australian sourced income, for two main reasons. The first is the lack of any statutory rules in this area, and the complex and at times antiquated set of common law principles that are relied on. The second and related factor is the continuous innovation and internationalisation of financial markets. The interaction of these factors means that the determination of source can depend on where key investment decisions were made or just on the place where the contract was concluded, which may in turn depend on whether a local broker, manager or agent has been used.
- (c) *Australian tax residency* (where decisions are actually made): under current Australian law, a company or other entity (for example, a trustee) could be deemed to be an Australian tax resident even though it is not incorporated or established under the law of Australia if the 'central management and control' of that entity is based in Australia.² As a result, it is standard practice – and has been for many years – for offshore entities to avoid Australian tax residency by ensuring that their central management and control is not in Australia. That has typically required that all important board decisions not be made in Australia and that only a minority of board directors are Australian residents.
- (d) *Capital versus revenue* (what the organisation actually earns): the imprecise distinction as to what constitutes a capital gain as against revenue for tax purposes has been a major issue for the financial sector, and the funds management sector in particular. This is particularly relevant for offshore investors as there is a tax exemption for most capital gains paid to offshore investors. The Government has recently sought to address uncertainties in this area by way of the measures announced in the 2009-10 Budget to allow managed investment trusts to elect capital account treatment for gains and losses from disposal of their investments. This measure was welcomed by the financial sector. However, substantial uncertainties remain as to which domestic funds will be able to opt for capital account treatment and, in particular, whether it will apply to wholesale as well as retail funds.

Some of the consequences of these tax scope and uncertainty issues, which have been highlighted in the Panel's discussions, are:

- The tax law works against having important decisions about a financial entity's offshore funds management or asset allocation policies being made in Australia, and therefore discourages international financial services companies looking to establish regional headquarters or parts of their regional operations in Australia.

2 Although there is also a requirement that the entity carries on business in Australia, case law suggests that the mere conduct of the 'central management and control' of an entity in Australia is deemed to satisfy the test of carrying on a business.

Box 3.2: Tax constraints to cross-border transactions (continued)

- They result in a wide variety of behavioural responses by financial entities designed to ensure that particular financial transactions or decisions that could have occurred through an Australian based broker, exchange or other intermediary (and hence may be taxable in Australia), are instead transacted offshore or not at all. In the case of offshore funds, this behavioural distortion arises in particular for funds investing globally using fund vehicles that are not domiciled in countries with which Australia has a double tax treaty.³
- They result in an unwillingness on the part of many potential offshore investors to invest via Australian based vehicles or to use Australian based investment advisers, along with an unwillingness by tax advisers and tax counsel to give the 'all clear' to their clients to so invest.
- They result in an unwillingness on the part of some Australian fund managers to actively seek to expand their funds under management from offshore clients, or alternatively a decision to do so by setting up offshore vehicles which are run offshore, resulting in additional compliance costs and a loss of potential jobs in Australia.

The combined effect of these industry uncertainties and concerns as to how cross-border transactions will be taxed is that potential financial transactions, investment flows and new business opportunities are driven away from Australia. This has negative implications for the liquidity of domestic markets, job opportunities and, ultimately, for revenue from the fees that would otherwise be generated by the Australian based investment adviser, broker or other intermediary. This runs contrary to the objective of developing Australia as a leading financial centre.

With respect to the impact of the above tax uncertainty and scope issues on the funds management industry and its ability and willingness to source funds from offshore, it is worth noting that, in its 2003 report on international tax arrangements, the Board of Taxation recommended that the law be amended to ensure that a non-resident investor in an Australian managed fund is not deemed to be carrying on a business in Australia.⁴ Tax legislation introduced in 2004⁵ was designed to give effect to this recommendation. The relevant explanatory memorandum stated:

The amendments will align the tax treatment of foreign residents investing through managed funds that derive some or all of their income from sources outside Australia with the tax treatment that would apply if those foreign residents made such investments directly. In removing Australian tax in these cases the amendments will improve Australia's international competitiveness in providing funds management services to foreign investors. This gives effect to Board of Taxation Recommendation 4.6(2).⁶

However, the ongoing lack of clarity on the range of issues referred to above has undermined the effectiveness of these provisions.

3 This issue was raised with the Forum in a submission from the Managed Funds Association, a US based alternative investment industry body. Its concerns with respect to its US members, whose funds are typically domiciled in countries with which Australia does not have a double tax treaty, have been further heightened by *Interpretation No. 48, Accounting for Uncertainty in Income Taxes of FASB Statement No. 109 'FIN 48'*, which going forward will require that US private enterprises account for such uncertainties in their income tax reporting.

4 See Board of Taxation, *International Taxation: a Report to the Treasurer*, Commonwealth of Australia, Canberra, 2003, Recommendation 4.6(2).

5 New International Tax Arrangements (Managed Funds and Other Measures) Bill 2004.

6 Explanatory Memorandum, New International Tax Arrangements (Managed Funds and Other Measures) Bill 2004, p 4.

Another area in which tax uncertainties are discouraging a greater volume of cross-border financial transactions relates to Offshore Banking Units (OBUs). The purpose of the OBU regime is to encourage offshore financial transactions between non-residents to be conducted by an Australian institution, rather than by an offshore financial institution. An OBU is subject to a concessional tax rate for eligible offshore activities. The concessional rate is an effective 10 per cent income tax rate on eligible activities and an exemption from interest withholding tax.

Singapore has a similar but broader scheme in place in the form of the Financial Sector Incentive Scheme, which provides for concessional tax rates on eligible transactions of 5 and 10 per cent depending on the activities undertaken. Singapore also provides a withholding tax exemption for approved banks on specified transactions. Hong Kong does not have an equivalent OBU regime but provides low corporate income tax rates and no withholding tax on transactions with non-residents.

The key features of Australia's OBU regime are summarised in Box 3.3.

Box 3.3: Key OBU provisions

Eligible entities

An OBU is an entity that is declared by the Treasurer to be an OBU, and can be an authorised deposit-taking institution or state bank; a life insurance company; a fund manager; or other entity that the Treasurer declares to be an OBU ('other company').

Eligible activities

An OBU is eligible for a tax concession when it undertakes an 'eligible activity'. There is a wide range of eligible activities, including borrowing or lending; trading; investing; and hedging. The Minister can declare additional 'eligible activities' in regulations, but to date no other activity has been declared. The above transactions must generally be with an offshore entity, except in some limited circumstances where the transaction can be with a domestic entity but must be in a non-Australian currency.

History

OBUs were first introduced in Australia in 1986 and were designed at the time to provide only withholding tax exemptions for OBU transactions. OBU legislation has evolved since then. The most important amendments were to legislate a concessional effective 10 per cent income tax rate and specify eligible OBU activities (1992) and then to allow inclusion of funds management and insurance companies in OBU activities (1999). In announcing these subsequent amendments, the then Government emphasised the need to enable the Australian OBU regime to be competitive with those in other countries, such as Singapore.

Application process

Through the ATO, an eligible entity applies to the Treasurer for an OBU licence. The Treasurer, by notice in the *Gazette*, can designate that entity as an OBU. Eleven separate guidelines and information requirements need to be addressed by companies that fall into the 'other company' category.

Box 3.3: Key OBU provisions (continued)

OBU usage

As at August 2009, there were 132 gazetted OBUs. This figure reduces to less than 100 after excluding multiple licences from related entities. It would seem from discussions the Forum has held and an examination of the list of registered OBUs that many are not active. Most of the active OBU licensees are investment banks, deposit-taking institutions or fund managers.

There is considerable and widespread uncertainty among existing OBU users relating to the issue of whether industry has a 'choice' as to whether all OBU-eligible activities have to be treated as OBU transactions. A 1993 determination by the ATO has for many years been interpreted by the industry as meaning that OBU users have a choice in determining whether to book offshore transactions on domestic or offshore (OBU) accounts.⁷ In December 2007, the ATO issued a consultation document which suggested that it might withdraw this taxation determination, and sought industry reactions.

The Forum commends the ATO for this consultative approach on the issue. The difficulty for industry is that, having received a number of submissions very critical of the proposal and pointing out its widespread adverse (and presumably unintended) consequences, the ATO has still not clarified its position and has not officially withdrawn or confirmed the 1993 determination. Many existing OBU users informed the Forum that, without the ability to choose whether to book transactions to the OBU or the domestic account, the OBU regime would be unworkable.

In addition, in the face of continued product innovation, the list and descriptions of eligible activities in the tax legislation have become out of date and unclear. As conveyed to the Forum, many potential and actual OBU licensees feel they are trying to fit 'square pegs in round holes'.

It is the strong view of the Forum that changes in the tax system designed to deal with the tax uncertainty and scope issues raised above are likely to yield substantial benefits to Australia, by encouraging a range of financial transactions to take place through Australia that are currently being transacted offshore. Such changes are critical to achievement of the Government's objectives and ambitions for Australia's financial sector. They have the potential to generate additional taxable income, jobs and benefits to domestic consumers from greater economies of scale and lower fees.

Recommendations

Investment Manager Regime

The recommendation below is designed to provide much greater clarity and certainty regarding the tax treatment of offshore transactions undertaken through Australia. A number of overseas financial centres, including Hong Kong, Singapore, New York, Tokyo and London, have legislative 'investment manager regimes' (IMRs) or their equivalents covering non-resident investors designed to provide clarity and certainty regarding the tax treatment of the funds management sector with respect to assets sourced offshore. Further changes designed to increase the attractiveness of the UK to offshore investors were introduced in the most recent UK Budget. While the breadth of these investment manager regimes, in terms of whether they represent simply a clarification of general tax principles or in addition a concessional tax treatment, varies from country to country, they are all designed to allow for greater 'internationalisation' of the domestic funds management business. Australia has not kept pace with these reforms.

⁷ See Taxation Determination 93/135.

In late January 2009, the Forum Chairman wrote to the then Assistant Treasurer and Minister for Competition Policy and Consumer Affairs outlining a number of preliminary recommendations arising from the Forum's early consultations. These included a recommendation from the Investment and Financial Services Association (IFSA) that a tax exemption for offshore funds that use Australian investment advisers be introduced, similar to those offered in competing jurisdictions. On 27 May 2009, the Minister announced that he had asked Treasury to examine this issue and provide advice on the proposal to introduce an IMR.

The Forum is of the view that the IMR should be wide enough to cover 'in-house' arrangements and so ensure that 'in-house' financial intermediaries of either foreign or Australian resident financial services companies should not be discouraged from operating in Australia as a result of the tax scope and uncertainty issues raised above. Within the funds management sector, the IMR should apply as widely as possible: it should encompass wholesale funds, including hedge funds and private equity funds, as well as retail funds. Australia has expertise in a wide range of funds and asset classes, at the retail and wholesale level, and the Forum can see no argument for limiting the potential for fully utilising this expertise by restricting the types of funds it applies to. It is also worth noting that, for the same reasons, the Forum strongly supports a wide application of the Budget decision on capital account election.⁸

The Forum's views on the broad principles and desirable scope of the proposed IMR were sent to Treasury for its consideration in formulating its advice to the Minister. They are set out in Appendix 5 to this Report and reflected in the recommendation below.

Recommendation 3.1: Investment Manager Regime

The Forum recommends the introduction of an Investment Manager Regime (IMR), based on the following principles:

- The IMR would have wide application, to both retail and wholesale funds and to other areas of financial services beyond funds management, but would be confined to entities operating within the financial sector.
- For non-resident investors using an *independent* resident investment adviser, fund manager, broker, exchange or agent:
 - investments in all foreign assets would be exempt from any tax liabilities in Australia;
 - investments in Australian assets would for tax purposes be treated the same as if the investments were made directly by the non-resident without the use of any Australian intermediary.

8 Following the announcement of this measure in the 2009-10 Budget and industry concerns that the capital account election option would be available only to a narrowly defined set of fund managers, Treasury released a discussion paper and called for industry submissions on the details of the measure.

Recommendation 3.1: Investment Manager Regime (continued)

- For non-resident investors using a *dependent intermediary acting at arm's length*:
 - investments in all foreign assets would be exempt from any tax liabilities in Australia;
 - investments in Australian assets would be treated as they are currently, subject to an agreed *de minimis* exemption to cater for global investment strategies that may include a nominal portion of Australian assets. Any Australian assets under this *de minimis* exemption would for tax purposes be treated the same as if the investments were made directly by the non-resident without the use of any Australian intermediary.
- The location of central management and control in Australia of entities that are part of the regime will not of itself give rise to Australian tax residency of those entities.

Offshore Banking Units

The Forum held widespread discussions with industry groups, OBU licensees and potential OBU licensees seeking their views on the current OBU regime. Some of the potential users suggested that the reason they have not used them, or not used them more extensively, is because they are far too complex, unclear and not user-friendly. However, based on the range of discussions held, the Forum is of the view that quite a few of these criticisms of the OBU regime reflect internal corporate issues, in particular:

- a lack of clearly defined ownership of the OBU within the organisation. Knowledge of OBUs can be concentrated in the company's tax area, with a more limited understanding of the OBU concessions by those in the various profit centres;
- a lack of properly structured remuneration arrangements to provide the relevant profit centres with the tax-adjusted incentives to increase their understanding of the OBU regime and, where appropriate, use it;
- a lack of effective internal control and compliance systems within companies to check and approve transactions as eligible for OBU status; and
- accounting systems that do not distinguish clearly enough between offshore and domestic transactions.

These are all issues for companies themselves to deal with, rather than policy related constraints. However, overriding some of the above factors is a concern by OBU licensees or potential licensees that the ATO will heavily penalise any inadvertent transgression of the boundaries between what can be transacted through an OBU and what cannot.⁹ Such concerns are reinforced by the list of eligible activities not being updated since 1999.

The Forum has examined a range of issues raised by existing users of OBUs as to how the regime could be made more widely accessible and effective. The key issues raised were the two areas of

⁹ There are penalty provisions which impose an additional tax on offshore borrowing by the OBU that is used for domestic purposes. Further, if more than 10 per cent of the OBU's assessable income is attributable to lending, investing or other use of non-OBU money, then the income tax concession does not apply to the entire OBU activity in that income year (the 'purity test').

uncertainty outlined earlier, namely the issue of 'choice' and the issue of what is an OBU eligible activity.

A third issue concerns the process for assessing new OBU applications, which can be complex and extremely slow, particularly for applicants in the 'other company' category where additional guidelines must be addressed, including a requirement to provide details of the applicant's business experience, financial accounts and business plan for the OBU licence.¹⁰

Finally, the Forum was struck by the lack of awareness amongst many financial market participants of the objectives and potential benefits of the OBU regime. A Government statement of support for and commitment to the regime, in the context of its objective of encouraging a greater flow of cross-border financial transactions to take place through Australia, would be very worthwhile.

The Forum believes that an effective OBU regime is a key element in ensuring that Australia's financial sector takes full advantage of opportunities to participate in international transactions. The recommendation below is designed to ensure our OBU regime and its objectives are well understood and that the regime is effective. It is significant that, despite over 20 years of that regime being in place in Australia, OBU usage has been relatively limited.

Recommendation 3.2: Offshore Banking Units

To give full effect to the Government's policy intentions for OBUs, the Forum recommends that:

- The Government, in its response to the Forum's Report, include a statement of support for, and commitment to, the OBU regime. Such a statement could also refer to arrangements to ensure the ongoing competitiveness of OBUs.
- The tax uncertainty about 'choice' be removed, if necessary by legislation.
- Division 9A of the *Income Tax Assessment Act 1936*, which details the list of eligible OBU activities, be updated and regularly reviewed. The Forum's preferred option is for much of the detail in this Division to be replaced with Regulations. Regulations would contain an updated list of eligible OBU activities, developed with advice from the Treasury and the ATO, and following consultation with industry. These Regulations would be updated periodically on advice from the proposed Financial Centre Task Force, which would also make periodic recommendations on any other changes to the OBU regime necessary to ensure that it remained internationally competitive.

¹⁰ Until recently, APRA assisted the ATO in assessing these particular guidelines in the application. However, APRA has understandably taken the position that where it is not the regulator for a financial services company it is not in the best position to assess such details. The Forum understands that ASIC does not believe it is appropriate to be involved in this process because the guidelines go beyond the requirements of the Australian financial services licence, as administered by ASIC. While this process remains unresolved, there are considerable delays in assessing applications in the 'other' category.

Recommendation 3.2: Offshore Banking Units (continued)

- A streamlined process for vetting new OBU applications be put in place:
 - with a requirement that an application be approved or denied within six months of its receipt, subject to all the appropriate application material being lodged;
 - with revised administrative changes for the 'other company' category. The Forum proposes that the guidelines 4(q), 4 (r) and 4(s) in the *Income Tax Assessment (Determination of Offshore Banking Activities) Guidelines 1999* be satisfied by an external auditor (or equivalent) verification; and
 - that these new arrangements be reviewed by Treasury 18 months after their adoption to ensure they are working effectively.

Funds management vehicles

Some of the features of Australia's tax and regulatory framework applying to the funds management sector inadvertently put the sector at a competitive disadvantage in terms of managing funds out of Australia for offshore clients. Clients and fund managers require an investment vehicle that provides a flow-through of any tax liabilities from the vehicle to the end investor, and has other investor protection and commercial needs. Australia's tax law in effect limits the range of commercial vehicles that can be used to manage funds to that of a unit trust, because only unit trusts provide tax flow-through and only unit trusts typically meet investor protection and commercial needs.¹¹

Many potential non-resident investors in Australian funds, particularly in the Asia-Pacific region, do not come from common law jurisdictions. Neither they nor investment advisers in the region are typically familiar or comfortable with trust structures. They are more familiar with managed funds structured as a corporate vehicle or a limited partnership. The lack of widespread use or recognition of unit trusts in the region contributes to Australian based funds management companies typically using collective investment vehicles that are established and administered offshore, such as in Luxembourg, Dublin or the Cayman Islands, and in some cases also basing their fund managers offshore. This is expensive, time consuming and not in Australia's interests. It results in employment in areas such as fund administration, accounting, legal, custody and other services being lost to offshore centres, with consequent loss of tax revenue in Australia.

There is also additional complexity and uncertainty with respect to the extent to which funds structured as unit trusts can benefit under some of Australia's double tax treaties.

Discussions the Forum has held with a range of funds management companies suggest strongly that, if Australia had access to a broader set of appropriate vehicles to sell into Asia which were taxed on a flow-through basis, then more funds management vehicles would be managed and administered out of Australia. The flow-on employment and income effects in fund administration and related support services are potentially significant.

There are two separate issues involved here. Firstly, there is the tax and legal structure issue. It is generally essential for a fund manager that the fund is, for tax purposes, treated on a flow-through basis; as noted above, in Australia such tax treatment is typically limited to trusts. It does not apply to

¹¹ While tax flow-through provisions also apply in some cases to partnership structures, other factors make this an unattractive vehicle for funds management purposes.

corporate or (except in very narrow cases) limited partnership structures, which are more familiar legal structures for many foreign investors.

Secondly, there is an issue regarding the lack of familiar Undertakings for Collective Investment in Transferable Securities (UCITS) frameworks in Australia. Most of the funds being sold into Asia out of Luxembourg or Dublin are using UCITS frameworks. These frameworks, which have inbuilt investment restrictions that are attractive to many of the regulatory agencies in the region, can incorporate a wide range of legal structures, including a unit trust. The lack of UCITS-type frameworks in Australia is also an important issue and is addressed in Chapter 4. Appendix 8 provides more background on UCITS frameworks.

In order to better facilitate Australian fund managers managing assets for non-resident investors, consideration needs to be given to alternative flow-through vehicles beyond unit trusts. The Forum wrote to the Board of Taxation Chairman on 6 May 2009, in the context of the Board's Review of the Tax Treatment of Managed Investment Trusts, raising this issue and foreshadowing that the Forum, after further consideration, may 'decide to discuss the matter with the Assistant Treasurer and raise with him the option of referring it to a separate Board of Taxation review'.

The Forum is conscious of the need, in developing a wider range of potential funds management vehicles, to both protect the integrity of the tax system and to ensure continued high standards of consumer protection. There are some potentially complex taxation and regulatory issues involved here.

An additional complexity is that a corporate collective investment vehicle may not allow the investor to access credits for tax paid in the country of source of income. There may be legislative or other solutions to this problem.

With the above comments in mind, the Forum sees considerable merit in a detailed analysis being undertaken of how best to accommodate industry needs and Australia's interests on this matter. Given the complexities, the Board of Taxation would seem the appropriate body to undertake such a review.¹²

A further example of where the lack of an appropriate and usable vehicle has had an adverse impact on the capacity to attract foreign investors into Australian based funds is in the venture capital area. Some background material on this sector was provided in Chapter 2.

By far the most commonly used and recognised investment vehicle globally in the private equity/venture capital area is the limited partnership. This vehicle allows for a flow-through of both profits and losses to its investors. By way of contrast, unit trusts in Australia allow for the flow-through of income but not of losses to investors. Given that many venture capital and private equity investments generate losses in the early years, the lack of flow-through of losses within the unit trust vehicle is a critical limitation.

There is an Australian limited partnership vehicle, namely the Venture Capital Limited Partnership (VCLP). However, there are a wide range of restrictions regarding the use of VCLPs. These restrictions were imposed to limit the benefits of the vehicle to those areas perceived as delivering a net public benefit. Some of the main restrictions are that the VCLP can only invest in companies with a gross

¹² The Board has been established under charter to advise the Treasurer on:

- the quality and effectiveness of tax legislation and the processes for its development, including the processes of community consultation and other aspects of tax design;
- improvements to the general integrity and functioning of the taxation system;
- research and other studies commissioned by the Board on topics approved or referred by the Treasurer; and
- other taxation matters referred to the Board by the Treasurer.

value of up to \$250 million; that the company a VCLP has invested in may then not invest any money in another company, unless it is a related company; and that a company will generally not be considered an eligible VCLP investment if it engages in activities relating to banking, providing capital to others, leasing, factoring, securitisation or insurance, among others.

The venture capital industry has made submissions to the Forum arguing that the combined effect of these restrictions is to make the vehicle of very limited use. It also suggested that increased competition from other jurisdictions is adding to potentially lost opportunities. Newly introduced tax rules in New Zealand for limited partnership structures that have few, if any, of the thresholds or limits to investment which exist in the Australian VCLP regime are a recent case in point.

To some extent at least, the revenue integrity restrictions on the use of VCLPs may have lost their relevance. This is most notable in the area of capital gains tax as it applies to non-residents, as capital gains made by non-residents are now typically not taxable (unless the underlying investment is land rich).

The Forum has discussed these issues with the industry and with Treasury, and sees merit in an examination of the restrictions placed on VCLPs to assess whether they are all still necessary and consistent with the Government's objectives for Australia's financial sector.

Recommendation 3.3: Funds management vehicles

The Forum recommends that the Treasurer request the Board of Taxation to review the scope for providing a broader range of tax flow-through collective investment vehicles.

The Forum recommends that, as part of this review, restrictions on the Venture Capital Limited Partnership vehicle be examined to see if they are all necessary and consistent with the Government's objective of developing Australia as a leading financial centre.

3.2 TAX AND DOMESTIC COMPETITIVENESS, EFFICIENCY AND STABILITY

Accessing offshore capital

The opportunity

Chapter 2 outlined a number of 'structural' reasons why Australia is, and is likely to remain, a capital importing country. As such, Australia needs access to a diverse range of offshore savings pools to finance domestic investment needs. Any tax measures that raise the cost of imported capital thus warrant close scrutiny. Sensible policy changes that improve access to offshore pools of capital at competitive rates are clearly in Australia's interest, as they lower investment financing costs.

Looking beyond financing of the current account deficit, one of the lessons of the financial crisis has been the desirability of maintaining a diversity of potential funding sources, both on and offshore. The traditional heavy reliance of the larger and more creditworthy Australian companies on local bank borrowing has been an important factor behind the growth of syndicated loans, involving foreign as well as the large domestic banks. Recent funding pressures on some foreign banks in Australia resulting from difficulties in wholesale credit markets has impacted on the capacity of many smaller and medium sized companies to raise debt capital in Australia, and reinforced the need for more diversified funding sources.

Funding difficulties in wholesale credit markets necessitated the Government introducing a guarantee on such bank borrowing to allow domestic banks to compete with overseas banks that had been granted such a guarantee. Both of these factors, together with some consolidation in the banking sector, have resulted in a significant increase in the four major banks' market share of lending activity, and a sharp reduction in competition from other sources. While, in the context of the financial crisis, policy makers and regulators may for good reasons decide to take measures which increase systemic stability but do so at the cost of less competition, that balance may well need to be revisited once the crisis has passed. Maintaining a strong and competitive foreign bank and broader foreign financial institution presence is desirable. The extent to which market forces will by themselves bring about these outcomes once bank guarantees are lifted remains to be seen.

Access to offshore savings pools is not only desirable and sensible for Australia as a capital importing country, it can also help to further the Government's objective of greater international engagement of our financial sector. Given that Australia does not have excess capital domestically to invest offshore, greater offshore investment necessitates open access to offshore capital. This point can be illustrated by examining Australia's overseas assets and liabilities. As a nation we have built up not just a stock of overseas liabilities but also a sizeable pool of offshore assets, which are a reflection of our broader engagement with the global economy. As of June 2009, those foreign assets were \$1.05 trillion, or about 87 per cent of GDP, as against foreign liabilities of \$1.78 trillion, or about 148 per cent of GDP. Within these figures, non official sector assets and liabilities were 94 per cent and 97 per cent of total assets and liabilities respectively.¹³

The constraint: taxation of offshore borrowings

Australia, unlike many other financial centres, levies interest withholding tax on most forms of offshore borrowing by financial institutions. Box 3.4 provides some background.

Box 3.4: Interest Withholding Tax

Rationale

When interest withholding tax was introduced in 1967, the then Treasurer explained that the purpose was to ensure that a reasonable amount of tax was paid by overseas lenders in relation to interest drawn from Australia, and to provide a relatively simple method of collection of the tax.¹⁴ Prior to the introduction of interest withholding tax, interest income paid to non-residents was subject to tax at a rate of 42.5 per cent. Withholding tax allows the government to collect tax at the source, without needing to directly tax interest income in the hands of non-residents. For countries that provide foreign tax credits, withholding taxes have the advantage of ensuring that tax is paid in Australia, rather than overseas, without (in theory) imposing any additional cost on the payer (other than administrative costs).

¹³ RBA, *Bulletin Statistical Tables*, Table H4, June 2009.

¹⁴ Second Reading Speech, Income Tax Assessment Bill (No. 4) 1967, House of Representatives.

Box 3.4: Interest Withholding Tax (continued)

Application of interest withholding tax to financial institutions

Subject to any existing exemptions, interest withholding tax is levied (broadly speaking) on any interest paid by an Australian borrower to a non-resident lender. This includes interest paid overseas by Australian financial institutions when they borrow offshore or raise deposits directly from offshore customers. Interest withholding tax is imposed on non-residents at a rate of 10 per cent of gross interest, but is reduced to 5 per cent in the case of interest paid by an Australian branch of a foreign bank to its parent. Interest paid by offshore banking units is exempt from withholding tax.

An Australian financial institution does not have to pay interest withholding tax if the interest is wholly incurred in carrying on business outside Australia through a permanent establishment. However, where a financial institution borrows money through its offshore permanent establishment and uses that money in its Australian business (rather than its offshore business), then it will be required to pay interest withholding tax. An exception to this rule exists in some circumstances where the funds raised in the permanent establishment are placed in a pool of funds and it is not possible to trace the end use of those funds.

The application of interest withholding tax on offshore commercial and retail borrowing by banks has had a number of effects, which were further amplified by the financial crisis.

Firstly, in the few cases where it is actually levied (see below), it has raised the cost of capital for Australian banks borrowing offshore, and hence for Australian businesses and households that borrow from banks. This is because, in order to raise funds offshore, Australian banks have to be prepared to pay non-resident lenders after-tax rates of return on their investments that are at least as high as the rates of return that those lenders can earn on investments in other countries.¹⁵ This cost is in turn likely to be passed on to the banks' clients in the form of higher borrowing costs.

Secondly, the application of withholding tax to some but not all offshore borrowings by Australian based banks for use in Australia has resulted in significant competitive distortions and inconsistencies.¹⁶ This reflects the fact that the application of withholding tax to offshore capital raisings by banks is subject to a number of important exemptions:

- the exemption in section 128F of the Income Tax Assessment Act 1936 (ITAA) from withholding tax on widely distributed offshore capital raisings that satisfy the 'public offer test';¹⁷ and
- where it is not possible to trace the end use of borrowings because they have been placed in a pool of funds and the funds were borrowed through an offshore branch. This exemption still applies if the offshore branch's surplus pool of funds is on-lent to the bank's Australian business in certain circumstances.

15 The Australian Bankers' Association (ABA) has informed the Forum that it is market practice for the foreign lenders to require withholding tax gross-up clauses in the terms of the borrowings to compensate them for any Australian withholding tax. The withholding tax thus becomes a cost which is borne by the Australian banks and therefore adds to the cost of funds.

16 Funds raised offshore for carrying on business offshore at or through a permanent establishment are exempt from interest withholding tax.

17 An offer generally satisfies the 'public offer test' if it is made to at least 10 persons who were carrying on the business of providing finance, or investing or dealing in securities; or at least 100 persons who have previously acquired securities or were interested in acquiring securities.

When the exemption in section 128F was introduced in 1971, the then Government referred to ‘the importance it attaches to flows of capital from abroad for the development of our resources and of the economy generally’. The Government was of the view that, ‘in so far as the burden of the interest withholding tax on overseas borrowings is passed on, in whole or in part, to the borrower in Australia, it is thought that its effect could be detrimental to the achievement of these objectives’.¹⁸ Similarly, when the exemption was extended in 1996, the then Government referred to the amendment ‘increasing competitive pressures in lending for home buyers and consumers by allowing all lenders to access the cheapest overseas funds free of withholding tax’.¹⁹ In both cases, the rationale for the exemption could be applied equally to any overseas borrowing that is or could be subject to interest withholding tax.

These exemptions, moreover, result in inconsistent treatment of financial institutions. Perhaps the clearest example of this relates to the case of offshore deposits raised where it is not possible to trace the end use of borrowings because they have been placed in a pool of funds. Australian banks have access to pools of overseas savings through their offshore banking operations. In a number of cases, these potential offshore savings pools are well beyond what they can use in the country of source, and hence could be used to support their lending and leasing arrangements conducted out of Australia. For Australian banks with a substantial presence in the region and a large number of retail deposit bases across a number of countries, this source of funds can be accessed and will avoid withholding tax due to the bank’s ability to pool the funds. For other banks with a more limited network of retail depositors in the region, this may not be possible or, at best, the tax consequences may be ambiguous. In the Forum’s view, these differences in tax treatment are arbitrary and undesirable.

Thirdly, Australian banks do not access offshore retail and wholesale deposits nearly as widely as they could. This reflects the fact that the burden of interest withholding tax is ultimately borne by the borrower. It also reflects the inherent difficulty in levying withholding tax on only those offshore deposits that are not pooled or do not satisfy the public offer test. Removal of interest withholding tax on offshore financing by financial institutions would thus have significant volume as well as price effects: more funds would be available, at cheaper rates.

In the case of foreign bank branches and subsidiaries of foreign owned financial institutions, similar considerations apply. Payments of interest to a foreign bank by its Australian branch are subject to withholding tax at half of the standard rate. This still acts as a cost impediment to efficient funding and liquidity management and inhibits cross-border capital flows. Subsidiaries of foreign-owned financial institutions are subject to 10 per cent withholding tax on interest paid on funding from their overseas parent. Because this funding is related-party funding, the interest withholding tax relief available under international tax treaties and in domestic tax law does not apply. In the absence of a withholding tax exemption in this circumstance, a foreign bank may choose not to do some business through its intermediary in Australia, as it is more competitive to lend directly from overseas to Australian business (free of withholding tax under international tax treaties). In other cases, the business may not be done at all if it cannot be facilitated by the Australian subsidiary.

Discussions with senior banking executives have reinforced the Forum’s view that the application of interest withholding tax to offshore borrowings by Australian based banks is inconsistent with Australia’s need, as a capital importing country, to access a diversity of offshore sources of funding. The Prime Minister has made a similar point:

18 Second Reading, Speech, Income Tax Assessment Bill (No. 2), 1971.

19 The Hon P Costello (Treasurer), *Interest Withholding Tax Measures*, press release, Canberra, 25 June 1996.

We need to ensure our tax system remains internationally competitive. As a capital importing country, we need to be mindful of the impact domestic tax laws have on global investment decisions and our ability to attract investment and international business.²⁰

The above considerations have been reflected in a number of recent policy decisions. Actual and prospective reductions have recently been made in withholding tax rates on distributions to offshore investors from managed investment trusts. In addition, recent international tax treaties renegotiated by Australia with the UK, US, France, Finland, South Africa, Japan, Norway and New Zealand have – in line with an international trend – provided exemptions from interest withholding tax for interest paid to financial institutions.²¹ However, the continuing application of interest withholding tax on financial institutions’ borrowing offshore sits uneasily with the Government’s desire to develop Australia as a leading financial centre and is putting Australia at a competitive disadvantage with respect to overseas financial centres, which increasingly do not charge interest withholding tax on such transactions (Box 3.5).

Box 3.5: Overseas tax treatment of offshore borrowing by banks

| Country | Interest withholding tax exemption |
|----------------|---|
| United Kingdom | An exemption is available for payments of interest made by a bank in the ordinary course of its business. This covers borrowings from overseas related parties to the extent that the payment of interest is made by a bank in the ordinary course of its business. |
| Ireland | Similar to the United Kingdom, interest paid by or to a bank in the ordinary course of business is exempt from interest withholding tax. |
| Singapore | Interest payments from a bank in Singapore to a bank outside Singapore (whether related or otherwise) are exempt from Singapore interest withholding tax. In addition, interest on deposits with approved banks is also exempt from withholding tax. |
| United States | An interest withholding tax exemption is available for all interest paid with respect to deposits placed with persons carrying on a banking business so long as the interest is not effectively connected to a US trade or business of the recipient. |
| Hong Kong | Does not impose interest withholding tax. |
| Canada | Payments of interest by a Canadian payer to an overseas arm’s length lender are exempt from withholding tax. |

Reflecting the above considerations, the Forum recommends the abolition of interest withholding tax in the following areas.

Recommendation 3.4: Withholding tax on interest paid on foreign-raised funding by Australian banks; on interest paid to foreign banks by Australian branches; and on financial institutions’ related party borrowing

- Remove withholding tax on interest paid on foreign-raised funding by Australian banks, including offshore deposits and deposits in Australia by non-residents.
- Remove withholding tax on interest paid to foreign banks by their Australian branches.
- Remove withholding tax on financial institutions’ related party borrowing.

20 The Hon K Rudd MP (Prime Minister), ‘The Road to Recovery’, *The Sydney Morning Herald*, 25 July 2009.
 21 See the list of Australia’s international tax treaties available at:
<http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=625>.

Another constraint related to taxation of offshore borrowing is that, under the foreign bank branch rules of the income tax law, deductibility for interest paid by the Australian branches of foreign banks on funds borrowed from their offshore parents is limited to the London Interbank Offered Rate (LIBOR). That is, where funds are provided at a rate above LIBOR, the branch will be denied a deduction for those excess amounts.

As the financial crisis clearly demonstrated, in periods of stress in credit markets there can be appreciable differences between the LIBOR rate and the rates that parent banks are able to offer their Australian branches on a commercial basis. While conditions in credit markets have eased significantly, Australia needs policies to ensure access to alternative funding sources at competitive rates should such tensions re-emerge. The Forum believes that any tax avoidance concerns resulting from removing the LIBOR cap could be adequately dealt with by applying the usual transfer pricing guidelines in respect of interest paid to foreign banks by their Australian branches. Transfer pricing rules aim to avoid the underpayment of tax by requiring businesses to price related party international dealings according to what independent parties would reasonably be expected to have done in the same situation (the 'arm's length principle').²²

Recommendation 3.5: LIBOR cap on deductibility of interest paid on branch-parent funding

Remove the LIBOR cap on deductibility of interest paid on branch-parent funding.

The Forum is aware of the substantial pressures on the Commonwealth Budget and hence the need to consider these proposals in a broader fiscal context. It is worth noting that the costs of the proposal to abolish withholding tax on interest paid to foreign banks by Australian branches and financial institutions' related party borrowings and to abolish the LIBOR cap on deductibility would have peaked at the height of the financial crisis, when the freezing up of wholesale funding markets forced a number of Australian bank branches and subsidiaries to borrow from their parent companies. As the effects of the financial crisis continue to dissipate, the cost of withholding tax abolition will continue to fall. However, it remains vital to put these policy changes in place so as to ensure that such institutions can more easily access alternative funding sources in the future, should conditions in credit markets deteriorate sharply again.

Similarly, in the case of withholding tax on offshore bank deposits, as noted above, the primary effect is that a potentially cheaper source of capital for use in Australia is not sought as actively as it would be in the absence of the tax. Removing withholding tax on offshore deposits is thus likely to have some revenue offsetting effects as greater use of offshore deposits at cheaper rates leads to lower borrowing costs and hence increased taxable profits for domestic borrowers from the banks.

Nonetheless, given the cost to revenue from the Forum's recommendations above, it is aware that its recommendations are much more likely to be implemented if they are part of a wider set of tax reforms that entail cost offsets elsewhere. It is for that reason that the Forum submitted its recommendations on withholding tax in May 2009 to the Chair of the AFTS review, and has had subsequent discussions with the review secretariat to stress the importance it attaches to this issue.

²² Australia's transfer pricing rules are found in Division 13 of the ITAA. Since 1979, the OECD has published the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations which provide guidance on implementing the 'arm's length' principle.

The constraint: Islamic finance and taxation of economic substance

As mentioned in Chapter 2, in addition to Asia another major source of offshore capital is the Middle East, reflecting the sharp rise in the world price of oil. The greatest opportunity for Australia in terms of accessing offshore capital pools at competitive rates would appear to be in the area of developing Sharia compliant wholesale investment products.

The global market for Islamic financial services has grown rapidly and was estimated at US\$729 billion at the end of 2007.²³ The largest portion of this market was held by Islamic banks and conventional banks that offer Sharia compliant investments. The next largest portion of the market was in *sukuk*, the Islamic alternative to conventional bonds, with global sukuk issuance in 2007 in excess of US\$45 billion.²⁴

Accessing this market could increase the diversity of sources of capital available to Australian business and consumers.

The key characteristics that distinguish Islamic financial products and services from others are:

- the payment or receipt of interest is prohibited;
- speculation or uncertainty is prohibited;
- investment in some sectors is not allowed (such as gambling, pornography, and alcohol);
- both parties to a financial transaction must share the risk; and
- financial transactions should be underpinned by an identifiable and tangible underlying asset.

The facilitation and development of Islamic finance is a matter that has commanded the attention of governments around the world, with the UK particularly active in this area.²⁵

Islamic financial products are often structured very differently to non-Islamic financial products. This can result in adverse tax treatment of them. The UK has made various amendments to its taxation provisions in order to achieve parity of treatment for Islamic finance products.

The Forum conducted a roundtable focused on taxation of Islamic finance, with representatives of the Treasury, the ATO, Austrade, the Department of Foreign Affairs and Trade, and industry representatives including the Australian Bankers' Association (ABA) and IFSA. The roundtable, and the Forum, framed their discussion around the principle that it is appropriate for Australia to adopt an approach to taxation and regulation of Islamic financial products that should present 'no obstacles,

23 International Financial Services London (IFSL) Research, *Islamic Finance 2009*, IFSL Research, London, February 2009, p 1.

24 *ibid*, p 4.

25 In 2001 the UK Government formed a high-level working group together with representatives from industry, the Muslim community and the regulator to 'examine the barriers to Islamic finance in the UK.' One of the main impediments identified was the potential for Islamic mortgages to attract double stamp duty, first on the purchase of the property by the financier and again on transfer of the property back to the customer at the end of the mortgage term. The UK legislated in 2003 to address this anomaly. The UK has also accommodated Islamic banking. The FSA, the UK regulatory equivalent to APRA, announced in 2003 that its approach to Islamic banking could be summed up as 'no obstacles, but no special favours'. The FSA has now authorised five Islamic banks to carry on business within the UK. Source: M Ainley, A Mashayekhi, R Hicks, A Rahman, A Ravalia, *Islamic finance in the UK: Regulation and challenges*, Financial Services Authority, London, 2007; and IFSL, *op cit*.

but no special treatment': in other words, a 'level playing field'. It considered two possible approaches: a 'legal' (or form based) approach or an 'economic' (or substance based) approach.

The Forum agrees with the view expressed by the UN Committee's Working Group that 'the adoption of the legal approach would lead to 'anomalies' in the tax treatment of Islamic instruments that adversely affect their development'.²⁶ The Forum considers that an approach based on economic substance should be preferred in determining tax policy on Islamic finance products.

At the broadest level, there are both Commonwealth and State and Territory taxation issues involved in this area. For example, at the Commonwealth level, there are issues about the eligibility for withholding tax relief on widely distributed Sukuk bonds (available for conventional bonds) and the possibility that capital gains tax could inappropriately apply to the disposal or transfer of assets (an essential feature of a sukuk). At the state level, there is potential for stamp duties to be inappropriately applied to those transfers.

Consistent with the Forum's overarching view that Islamic finance should be taxed by reference to its economic substance, the Forum encourages State and Territory governments to, if necessary, amend their legislation to ensure that Islamic finance transactions are taxed according to their economic substance, rather than their legal form.

At the Commonwealth level, Australia has, especially through its work on the Taxation of Financial Arrangements (TOFA) regime, been concerned in general to adopt a more economic or substance based approach to taxation. It may be that this leaves the Australian taxation framework better placed than some to accommodate Islamic finance with parity of treatment without substantial amendment to its provisions.

The questions surrounding Commonwealth taxation of Islamic finance products are not straightforward. The complexity and uncertainty surrounding the interaction of Australian taxation provisions and Islamic finance lead the Forum to conclude that it is necessary for the Government to consider whether any amendments to existing Commonwealth taxation provisions are necessary in order to ensure parity for Islamic finance products; and, that the Government should be guided in its consideration of this issue by a specialist body equipped to deal with the associated complexity. The Forum considers an appropriate body would be the Board of Taxation.²⁷

Recommendation 3.6: Islamic finance products

The Forum recommends that the Treasurer refer to the Board of Taxation the question of whether any amendments to existing Commonwealth taxation provisions are necessary in order to ensure that Islamic finance products have parity of treatment with conventional products, having regard to their economic substance.

Some regulatory issues relating to Islamic financial products are considered in Chapter 4.

²⁶ UN, Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, 'Treatment of Islamic financial instruments under the United Nations Model Double Taxation Convention between Developed and Developing Countries', Note by the Working Group on Treatment of Islamic Financial Instruments, 21 August 2007.

²⁷ See footnote 12, above.

The insurance sector and state taxes and levies

The opportunity

Chapter 2 provided some background on the Australian general insurance (such as home and contents, and motor vehicle), life insurance and reinsurance industries. The Australian insurance industry in general is strong, efficient, innovative and well managed. As is the case with the funds management industry, economies of scale are important in this sector. A number of the leading insurance companies are actively expanding their offshore operations as a source of growth.

In the Forum's discussion with the sector, the Insurance Council of Australia (ICA) (which covers general insurance) has stressed that its first priority is with domestic policy issues: 'If our members can operate their businesses profitably, this puts them in a strong position to compete for offshore business.'²⁸ The primary policy issues and constraints ICA members saw facing the industry related to taxation and, to a lesser extent, differences in state (non-prudential) regulation (see Chapter 4).

The constraint: state taxes and levies

Insurance policies, unlike most other financial services, are subject to various state indirect taxes and levies, such as stamp duty, Insurance Protection Tax and fire service levies (Box 3.6). Further, there is no consistency in the application of these imposts across the States.

In 2007-08 total state taxes on insurance amounted to \$4.25 billion.²⁹ The ICA notes that the States now raise one in twelve tax dollars from insurance. The ICA argues such taxes and levies lead to underinsurance in the business and consumer sectors. International comparisons show that the take-up of non-life insurance is below European and North American countries.³⁰ These taxes and levies are also regressive.

28 ICA, Submission to the Review of Australia's Future Tax System, October 2008.

29 ABS, *Taxation Revenue Australia, 2007-08*, cat. no. 5506.0, ABS, Canberra.

30 ICA, Submission to the Review of Australia's Future Tax System, October 2008.

Box 3.6: State stamp duties and levies on insurance

Insurance policies are subject to the following state taxes and levies:

Life and general insurance: stamp duty (in all States and Territories)

Stamp duty is applied selectively to various assets or services and acts like a selective turnover tax (unlike a broad based, value added tax). The tax rates vary from 7.5 per cent in Queensland to 11 per cent in South Australia.

General Insurance: statutory contributions to the fire services

This is applied in NSW, Victoria and Tasmania, according to a statutory formula. The cost is then passed on to insurance policy holders via a levy. The levy is usually applied only to household and commercial insurance.

General insurance: NSW Insurance Protection Tax (IPT)

This tax was introduced in NSW following the collapse of HIH. The proceeds of the IPT are set aside for a Policyholders' Protection Fund.

A key feature of the IPT Act is that it prohibits any insurer from charging an insured person for the amount attributable to the tax. It is therefore intended to be a tax on the company shareholders.

On the overall issue of general insurance taxes, the ICA quotes the NSW Independent Pricing & Regulatory Tribunal (June 2008): 'stamp duties on insurance and asset transactions are among the State's most inefficient taxes ...'

The Forum believes that the domestic tax impost on the insurance sector should be addressed as a matter of priority. The range and diversity of state taxes adds significantly to the cost of insurance, especially for those businesses operating on a national level.³¹ They are undoubtedly a factor contributing to underinsurance, with consequent increased demands on the public purse. Along with the variety of state non-prudential regulations, they also act as a barrier to new entrants to our insurance sector.

The Forum is conscious that the cost of removing state taxes and levies is substantial. It is, therefore, likely to occur only in the context of a much broader tax review such as the AFTS review. The Forum has had discussion with the AFTS review on this issue and understands that the impact of these taxes, including on possible underinsurance, is specifically on their agenda.

Recommendation 3.7: Remove state taxes and levies on insurance

The Forum recommends that all state taxes and levies on the insurance sector be removed.

³¹ In discussions with the Forum, one life insurance company referred to the following issues: the rules vary across states; the rules are open to interpretation in regard to what level of duty applies and what state has jurisdiction; different states can interpret the same word in different ways; and interpretations can change over time. This can mean that clients can seek compensation, some times long after a policy is written, because of these changes and ambiguities.

Tax review processes

The opportunity

Progress towards achievement of the Government's objective of developing Australia as a leading financial centre will take a considerable amount of time. It will entail not only some discrete policy changes now, designed to remove existing impediments, but also establishing a number of institutional arrangements to ensure ongoing policy changes and policy reviews occur that are focused on maintaining the momentum towards achieving the Government's objective.

The constraint

With respect to taxation issues, the lack of any existing institutional arrangements for periodically reviewing and updating tax legislation applying to financial markets adds to uncertainty as to how evolving financial instruments and/or practices fit within existing but often outmoded legislation. The Forum thus sees a clear need for a body to be in place that monitors implementation of tax changes applying to the financial sector; examines relevant changes in tax legislation in overseas financial centres; and makes recommendations where it sees a case for reviewing existing tax legislation.

The Forum supports the Government's appointment of a private sector panel of tax experts to provide input on the practical and commercial issues arising from proposed tax changes. It also welcomes the use where appropriate of a tri-partite team led by Treasury and including ATO representatives and panel members to monitor the early implementation of tax measures, identify any legislative refinements needed and ensure that the ATO has provided appropriate administrative guidance. The Forum sees its recommendations below as adding to the effectiveness of these new arrangements with respect to the financial sector.

The Forum is also very much aware of the expertise, track record and high standing of the Board of Taxation, and has consulted with the Board in drawing up its recommendation below. Neither the Forum nor the Board sees the recommendation as overlapping with the functions and remit of the Board, but rather as complementing them.

The recommendation needs to be read in conjunction with Recommendation 6.3 in Chapter 6 for establishing a Task Force designed to help carry forward the policy changes necessary to achieve the Government's objectives for the financial sector. The proposed structure and terms of reference of this Financial Centre Task Force are spelt out in Chapter 6. The proposed terms of reference include for the Task Force to report every six months to the Government on progress towards developing Australia as a leading financial centre.

The recommendation below delineates the taxation aspects of the work of the proposed Financial Centre Task Force.

Recommendation 3.8: Monitoring and advising on financial services tax issues

The Forum recommends that, as part of its six monthly reports to the Government on progress towards positioning Australia as a leading financial centre, the Financial Centre Task Force:

- monitors progress on implementation of those tax recommendations in this Report that are accepted by the Government, and reports on any significant concerns from the financial sector as to the details of their implementation;
- monitors any relevant changes in taxation legislation or in tax administration in overseas financial centres, with a view to identifying any measures which it considers worthy of closer examination for possible adoption in Australia; and
- makes recommendations in other areas where it sees a case for a review of existing tax legislation that may significantly conflict with the Government's objective of developing Australia as a financial centre.

4. REGULATION AND REGULATORY SUPERVISION

Countries such as Australia whose financial sectors and regulatory systems have emerged from the crisis in relatively good shape are now at a competitive advantage. The focus of this Chapter is on how to ensure that Australia maintains a first rate regulatory system. The Chapter also examines areas where there may be scope for some regulatory initiatives to improve the efficiency, competitiveness and overseas market access of the financial sector.

4.1 THE OPPORTUNITY

The regulatory system is vital to the objectives of ensuring an efficient, competitive and stable financial system while at the same time providing protection for domestic consumers of financial products sold in Australia. This is the best base from which to engage with the rest of the world. Its importance has been dramatically highlighted by concerns arising from the financial crisis. While the causes of the financial crisis were multidimensional, few would doubt that regulatory gaps and failures in a number of countries were an important contributor.

Inevitably, the Australian financial sector has not escaped untouched from the global financial crisis. However, without losing sight of the corporate failures and substantial investor losses resulting from the financial crisis, the Australian financial system in general, and the banking and insurance sectors in particular, have emerged from the crisis in relatively good shape. No government capital injections have been required in contrast to many other countries. Australia's regulatory system and – equally important – the way in which it has been administered and supervised have been very important amongst the list of factors that have contributed to this outcome.¹

Appendix 6 provides an overview and assessment of Australia's regulatory system and supervision. The assessment is, overwhelmingly, positive. While there are a range of important regulatory issues arising out of the financial crisis, some of which are discussed further below, they are being actively debated and addressed.

The Forum sees Australia's regulatory system and the quality of senior regulatory staff as one of the strengths of our financial system, which has been highlighted both domestically and internationally by the financial crisis. It is already bearing fruit: in the environment of heightened concern about counterparty risk in the midst of the financial crisis, Australian banks started picking up new business in the region from clients they had been trying unsuccessfully to deal with for years.

1 The distinction between regulation and supervision is an important one. To quote from a recent speech by Dr John Laker, Chairman of APRA: '... regulation is the set of rules ... Supervision refers to the direct oversight of financial institutions to ensure the rules are being properly applied ... A distinction, simply put, between the rules of the game and how they are refereed.' J Laker, 'Enhancing the competitiveness of financial services – lessons learnt and opportunities for improvement', speech to the IFSA annual conference, Gold Coast, Queensland, 6 August 2009. Both aspects are crucial to the overall effectiveness of a country's regulatory system, and both are evaluated in Appendix 6.

4.2 MAINTAINING AUSTRALIA'S REGULATORY ADVANTAGES

Some regulatory issues arising out of the financial crisis

The financial crisis has highlighted some of the major areas where getting the balance right between potentially competing objectives is critical to a good regulatory system. It also demonstrated that, at times, regulators and governments may need to change that balance, at least for a period.

One example of this was discussed in Chapter 3, namely how the balance between stability and competitiveness was affected by the financial crisis and by policy measures taken to ensure financial market stability. Chapter 3 set out a number of tax proposals focused on this issue.

The financial crisis has also highlighted the issue of appropriate balance between consumer protection on the one hand, and supporting innovation and efficiency on the other. Australia's regulatory approach is not designed to pursue a 'zero failure' policy. There are very sound reasons for this, that go beyond the need not to stifle innovation. Overreliance on regulation and underemphasising the importance of financial literacy and consumer understanding of risk increases the risk of moral hazard, as consumers build in unrealistic expectations as to what regulation can achieve and lose sight of what they need to know and understand themselves.

Nonetheless, the financial crisis had a substantial impact on many individual investors and superannuants planning for retirement. Some consumers of financial products suffered major losses. The role and responsibility of financial advisers, and the incentive structures they face, are being examined in an inquiry by the Parliamentary Joint Committee on Corporations and Financial Services, which will report by 23 November 2009.

Against the background of these recent, high profile episodes, four issues have received significant public comment. These are: the basis on which financial advisers are remunerated; the need for greater understanding by retail investors of such issues as risk/reward tradeoffs and financial leverage; the responsibilities that should apply to lenders when making credit available to consumers; and executive remuneration.

The first of these issues was discussed in Chapter 2.

On the issue of consumer understanding of risk and leverage, the Forum stresses the importance of ongoing work and initiatives with respect to financial literacy, both by government and industry. It is an essential complement to a best practice regulatory system that gets the right balance between consumer protection on the one hand, and innovation and efficiency on the other. Box 4.1 summarises Government initiatives on financial literacy.

Box 4.1: Financial literacy initiatives

The Australian Government has a number of initiatives designed to improve financial literacy among consumers. Since July 2008, ASIC has had primary responsibility for the Government's financial literacy agenda, taking over the functions of the Australian Government Financial Literacy Foundation. A major achievement of the Foundation was leading the development of the National Consumer and Financial Literacy Framework, under which all school sectors will integrate financial literacy into the curriculum across the compulsory years of schooling.

ASIC promotes financial literacy through several initiatives, including by:

- delivering financial literacy programs through schools, the higher education system, employer and union sponsored programs, and community based programs;
- working to ensure that financial literacy is included in the new national school curriculum;
- implementing a Professional Learning Package as part of the National Professional Learning Strategy for teachers of financial literacy education;
- maintaining a dedicated website for consumers and investors, known as FIDO, and the 'Understanding Money' website, which provides financial literacy resources for the community; and
- developing new financial literacy resources such as seminars and a booklet on the theme of 'Investing Between the Flags'.²

Other Commonwealth agencies, including Centrelink, are involved in promoting financial literacy, as are state and territory fair trading agencies, community organisations and private financial sector businesses.

Looking beyond financial literacy, one of the lessons from the financial crisis is the need for regulatory scrutiny as to whether some financial products are so complex and opaque that they should not be available to retail investors. It would also seem desirable for governments to closely examine investment schemes that would not exist in the absence of substantial and distorting tax incentives. The first of these matters is under active consideration.³

The Australian Government, in consultation with the States and Territories and industry and consumer group representatives, has recently implemented or is pursuing reforms and initiatives intended to increase market efficiency, protect consumer interests and promote effective consumer participation. Examples of some of the more important recent reforms and initiatives are at Appendix 7. ASIC is also actively engaged in the public debate about the correct balance between consumer protection and market efficiency. This process is welcome, and is testimony to the flexibility and quality of our regulatory framework and those administering it.

It is important that 'sophisticated' investors, both personal and institutional, continue to have access to the full 'risk spectrum' of financial products, including high risk, high return, lightly regulated investment opportunities such as hedge funds and private equity.

2 Parliamentary Joint Committee Inquiry into Financial Products and Services in Australia, Submission by the Australian Securities and Investments Commission, August 2009, pp 79-81.

3 This issue is under consideration by the Parliamentary Joint Committee on Corporations and Financial Services.

On the third issue referred to above, namely the responsibilities of lenders, the Government has already acted by introducing the National Consumer Credit Protection legislation, and this matter is subject to further review by the Parliamentary Joint Committee on Corporations and Financial Services.

On the fourth issue of executive remuneration, the global financial crisis has highlighted public concerns in Australia and overseas. Executive incentive structures may in some cases have led to excessive short term risk-taking, to the detriment of individual companies and, potentially, of broader financial stability. Public concern has also been focused on cases of 'reward for failure'.

In response to these concerns, the Australian Prudential Regulation Authority (APRA) released a consultation paper on remuneration for authorised deposit-taking institutions and general and life insurance companies.⁴ This followed APRA's participation in the Financial Stability Board's initiative on executive remuneration, which culminated in the Group of Twenty's (G20's) endorsement in April 2009 of the Financial Stability Board's *Principles for Sound Compensation Practices*. APRA's proposals follow these principles. Submissions received during the consultation process agreed that risks could arise through unsound remuneration practices and supported a principles based framework to encourage alignment of remuneration practices with prudent risk-taking.⁵

In addition, following a reference from the Government, the Productivity Commission has released a draft discussion paper, 'Executive Remuneration in Australia', proposing reforms to improve the accountability of boards, remove conflicts of interest and enhance shareholder engagement with remuneration.⁶ This would require boards to face re-election if shareholders' concerns on consecutive remuneration reports were ignored – a 'two strikes' rule. The Commission does not support imposing caps or other prescriptive measures.

The Forum welcomes the focus on this important issue by the Government and the regulators. It does not wish to comment on or endorse any particular set of proposals for more closely aligning executive remuneration with the interests of shareholders and the broader community. However, as a general observation, the Forum is of the view that corporate governance provisions that strengthen shareholder influence on executive remuneration are the best mechanism for addressing the issue in a manner consistent with the Government's objective of developing Australia as a leading financial centre.

Maintaining a world class regulatory system

Overreaction to the global financial crisis

An enormous amount of work is underway in individual countries and in multinational bodies such as the G20, the Financial Stability Board and elsewhere concerning regulatory lessons arising from the crisis and any regulatory changes that may be desirable, both at the national and international level. Australia is an active participant in these international discussions, and it is critical that it remains so, both to listen to and influence the international debate and, where necessary, to differentiate Australia's needs and circumstances from those of other countries. Such close engagement in the international debate is vital to ensuring Australia has, and maintains, a regulatory system with the right balance.

4 APRA, *APRA consults on remuneration*, media release, 28 May 2009.

5 APRA, *APRA undertakes additional consultation on remuneration*, media release, 7 September 2009.

6 Productivity Commission, *Government action on executive pay*, media release, 30 September 2009.

In Australia, as in other countries, there will be lessons learnt from the financial crisis that suggest that some changes in regulatory arrangements or in information gathering and monitoring are needed. However, care needs to be taken to ensure that any new regulations are clearly necessary in Australia's circumstances, and are implemented efficiently and effectively, avoiding undue costs to the corporate sector.

Concerns about a possible overreaction to the financial crisis, in terms of unnecessary and costly new regulations, surfaced in many discussions which the Forum held with market participants. The concern was that pressures from overseas for a more comprehensive and global approach to regulation, when combined with Australia's desire to be seen as a 'good global citizen', may result in Australia adopting additional regulatory layers and requirements which are neither necessary nor relevant to our circumstances.⁷

The Forum has discussed these industry concerns widely with the official sector. The Government, its advisers and the regulators are very much aware of the need not to introduce unnecessary regulations. In its most recent Financial Stability Review, the RBA stated the following:

The current focus is turning to how best to implement the reforms as they are developed, in order to accommodate different country experiences and capacities to implement changes. The need to distinguish country circumstances is particularly relevant for Australia, where regulatory arrangements have worked effectively over recent years and the financial system has weathered the past year or so better than many others.⁸

Nonetheless, concerns on this issue coming from the financial sector were widespread. Given the importance to Australia of maintaining a best practice regulatory system, the Forum considered them worth highlighting.

Maintaining a best practice regulatory system

A number of industry representatives told the Forum that, over time, an excessive amount of regulation builds up that needs to be periodically reviewed. This was seen by some as an inevitable result of a largely one-sided incentive system facing governments and regulators: incentives are heavily skewed towards not missing anything, rather than removing unnecessary regulations. The consequence, it was suggested, was that 'the regulatory ship had to be taken out of the water every now and then and all the barnacles scraped off.' It is worth noting that the 1997 Financial System Inquiry (Wallis Inquiry) also made reference to the 'incentive bias' towards excessive regulation building up over time.

Maintenance of a 'best practice' regulatory framework, however, requires much more than guarding against an accumulation of unnecessary regulations. One of the key features of financial markets is the rapid and constant process of financial innovation, which can create difficulties for both regulators and consumers of financial products. The financial crisis highlighted the critical importance of regulatory systems keeping on top of such developments, both in terms of systemic risk issues and with respect to consumer protection. Maintaining a best practice regulatory system necessitates

⁷ One specific area of concern with respect to 'importing' unnecessary regulations relates to alternative investments such as hedge funds and private equity. The tendency in some European countries to hold hedge funds and other alternative asset classes as partly responsible for the financial crisis has resulted in proposals in some quarters to impose stringent new regulations on those sectors. In the Forum's view, such judgments and proposals are ill considered and should be avoided. As noted earlier, there is an important place in any financial system for lightly regulated, higher risk financial products that are restricted to sophisticated institutional and high net worth investors.

⁸ RBA, 'Developments in the Financial System Architecture', *Financial Stability Review*, September 2009, p 63.

ensuring such developments are fully accounted for in the regulatory framework, the regulatory rules and their administration.

Recommendations

Avoiding unnecessary new regulations

With respect to the risk of an overreaction to the financial crisis, the Australian Government has some mechanisms in place to prevent unnecessary regulation. For example, the Government's Best Practice Regulation Handbook requires that all new regulatory proposals which might impose a significant regulatory burden or compliance cost be accompanied by a Regulation Impact Statement (RIS), which sets out the costs and benefits of the proposed regulatory change. The Office of Best Practice Regulation (OBPR) is responsible for assessing the adequacy of RISs and certifying that compliance costs have been quantified where necessary.

A recent study has criticised the regulatory impact analysis process.⁹ Although this process was strengthened in 2007, the study suggests that the practice of regulatory impact assessment is significantly less rigorous than the Government's best practice guidelines require. For example, the study refers to an independent assessment that around three-quarters of risk-related RISs do not provide the required estimate of net benefits.¹⁰ Despite this, only a small proportion of RISs are declared inadequate. As the study comments: 'Some recent evidence on OBPR decisions suggests that if improving the regulatory process is to be more than wishful thinking, the process must take account of, and improve, the incentives and constraints that face decision makers, including those in the OBPR.'¹¹

While the Forum does not have any specific recommendation to make with respect to the existing processes for assessing new regulations, which it is aware have already been reviewed a number of times, it is of the view that perceived inadequacies in these processes reinforce the importance of consulting wherever possible with industry on proposed regulatory changes.

Recommendation 4.1: Avoiding unnecessary regulation

The Forum recommends that any significant regulatory proposals applying to the financial services sector be fully tested and evaluated, in particular and wherever possible by way of detailed industry consultation, to ensure that they are necessary, effective and impose as small a compliance burden on industry as possible.

Maintaining a best practice regulatory framework

The Forum is also of the view that periodic review and reassessment of the regulatory framework to ensure it remains best practice has clear merit. Indeed, it is at least arguable that one of the reasons we have a very good regulatory framework which has stood up well through the current financial crisis is that it has been the subject of periodic review in recent decades: the Committee of Inquiry into the Australian Financial System (Campbell Inquiry) in 1981 and the Wallis Inquiry in 1997.

The Australian Government has some existing mechanisms to prevent the accumulation of unnecessary regulation. Its deregulation agenda sits within the portfolio of the Minister for Finance

9 M Harrison, 'Assessing the Impact of Regulatory Impact Assessments', *Agenda*, vol 16, no. 3, pp 41-49.

10 *ibid*, p 46.

11 *ibid*.

and Deregulation. As part of this agenda, the Government has established a Financial Services Working Group, which is attempting, alongside other issues, to simplify the regulation surrounding financial services advice and disclosure. The Council of Australian Governments (COAG) also has a Business Regulation and Competition Working Group, which aims to reduce and harmonise regulation in areas of shared Commonwealth and State responsibility.

The Forum welcomes the above mechanisms and processes but still sees a need for periodic and much broader reviews. A key aspect of this is ensuring that the regulatory system keeps fully abreast of all the implications of ongoing financial innovation, both in terms of systemic risk and also maintaining adequate consumer protection. This would include such reviews taking into account emerging domestic and global developments in financial systems, and the capacity of Australia's regulatory framework to accommodate those developments. Australia's regulatory system is, as this Report has stressed, an important area of comparative advantage, particularly in the wake of the global financial crisis; periodic reviews are vital to ensuring it remains so.

This proposal was discussed with ASIC and APRA at a senior level. They also saw merit in it, but stressed that now would be a bad time to do it, due to other demands on their staff (in part, flowing from the current financial crisis) and the risk that conducting such a review now would probably result in an excessive preoccupation with that crisis. The Forum fully agrees with this view. While the timing and terms of reference for such inquiries would be a matter for the government of the day, the Forum sees merit in the first such review not being conducted until conditions in financial markets have clearly returned to normal and international regulatory reactions to the crisis are much more settled.

The Forum also welcomes the IMF Financial Sector Assessment Programs, which are designed to help countries identify and remedy any weaknesses in their overall regulatory system with respect to systemic risk issues. These programs are discussed further in Appendix 6.

Recommendation 4.2: Periodic reviews of the regulatory rules and framework

The Forum recommends that there be periodic reviews of the regulatory rules and framework applying to the financial sector, focused on:

- ensuring that excessive and unnecessary regulatory rules and requirements do not build up over time; and that
- Australia's regulatory rules and framework remain best practice in the face of changing circumstances, products and market practices.

While the timing and terms of reference for such reviews would be a matter for the government of the day, the Forum suggests that the first review not be conducted until it is clear that conditions in financial markets have returned to normal and international regulatory reactions to the crisis are more settled.

4.3 REGULATION AND INTERNATIONAL ENGAGEMENT

An Asia region funds management passport

The opportunity

Chapter 2 outlined the opportunities potentially available to Australia's large and sophisticated funds management sector to access offshore investors as a source of growth. The Asia-Pacific region is growing rapidly, with massive pools of investible funds potentially available for both domestic and offshore fund managers to access. This is, to a large extent, an untapped opportunity for Australia: only a relatively small volume of offshore sourced funds are managed out of Australia.

Chapter 2 included discussion on a range of constraints faced by Australian based fund managers trying to expand into offshore markets, including tax uncertainty and scope issues which were addressed in Chapter 3. Regulatory and market access restrictions in many offshore markets were also referred to earlier as a major impediment. These are discussed further below.

Improving market access for Australian fund managers overseas, and at the same time for overseas fund managers in Australia, offers a number of benefits both to financial services businesses and to investors in Australia and overseas. With respect to Australian based fund managers looking to sell their products offshore, improved market access would provide opportunities for lower costs through increased scale; Australian fund managers could also build up greater regional expertise, which they may then be able to export outside the region. These benefits can have flow-on consequences to the wider Australian economy, including lower fees, increased employment of Australian fund managers, fund administrators and support staff, and increased tax revenue.

By way of example, one Australian company the Forum held discussions with is focusing on the higher net worth end of the Asia-Pacific market, with the objective of becoming a significant regional player. It believes that if it can achieve this then it will also be able to attract business managing regional assets for non-regional investors such as in Europe. It was also of the view that the more Australia can build up business in the region, the more we will be able to attract back expatriate talent and prevent the best talent from leaving.

Improved market access would also have benefits flowing from offshore fund managers selling their products in Australia. For example, investors in Australia would enjoy greater investment choice; broader funds management expertise; and greater competition leading to lower fees.

Regulatory mechanisms for improving market access

Investors and the financial system are protected by regulatory restrictions on who may offer products to investors, which products may be offered and the information that must be provided when offering those products.

Differences and duplication in regulatory requirements across countries can add significantly to the difficulties faced by financial services companies selling their products across borders. In some countries, regulatory requirements are so stringent as to make it almost impossible for an Australian fund manager to market a retail managed investment scheme.

One way to deal with at least some of these difficulties, without sacrificing consumer protection and market integrity, is by negotiating mutual recognition agreements with other countries. Under such agreements, two jurisdictions agree to recognise aspects of each other's regulatory systems. Box 4.2 provides some background on how such agreements work, and on current agreements that are in place.

Box 4.2: Australia's mutual recognition agreements

Australia has a limited number of unilateral and mutual recognition arrangements with foreign jurisdictions to facilitate greater cross-border activity. 'Mutual recognition' involves two sufficiently equivalent jurisdictions agreeing to recognise aspects of each other's regulatory systems.

Mutual recognition agreements can cover a number of possible areas, including but not limited to funds management. Mutual recognition can also cover, for example, the regulation of financial services companies and stock exchanges. ASIC and the Government have signed an arrangement with the US Securities Exchange Commission which covers the mutual recognition of stock exchanges and broker dealers.¹² However, there is still work to be done to make it operative. Australia also has an agreement with New Zealand which covers the cross-border offering of securities (including shares and debentures) and interests in managed investment schemes.¹³ This is a government-to-government agreement (rather than an agreement between regulators) and is part of a broader scheme of trans-Tasman mutual recognition which also covers professional qualifications and regulations on the sale of goods.

The Government also offers a form of unilateral recognition to certain foreign market operators, by providing a more streamlined approach to obtaining an Australian market licence; and ASIC grants relief from the requirement to hold an Australian financial services licence to certain foreign financial services providers who provide services only to wholesale clients.¹⁴

In terms of managed investment schemes, a mutual recognition agreement allows a fund that meets the requirements of its home jurisdiction to be deemed to comply with some or all of the regulatory requirements in the host jurisdiction, generally subject to the fulfillment of a number of conditions. Australia has a mutual recognition agreement with Hong Kong covering the cross-border offering of collective investment schemes¹⁵, and collective investment schemes are covered by the New Zealand agreement mentioned above. ASIC also extends unilateral recognition to collective investment schemes from Singapore, and has the power to extend relief to schemes from other jurisdictions outside the Asian region. ASIC is currently discussing a possible mutual recognition agreement with Singapore.

Mutual recognition offers a number of benefits to financial services businesses and investors in Australia and overseas. These include benefits to consumers from greater investment choice and from more competition. While such increased domestic competition may offset some of the gains to the domestic industry, the Australian funds management sector is well aware of this but remains strongly supportive of both recently negotiated mutual recognition agreements and the negotiation of a wider network of mutual recognition treaties in the region and beyond.

As set out in Box 4.2, Australia's mutual recognition framework extends beyond funds management. However, the Forum's recommendations are focused on the mutual recognition of managed investment schemes, as this is where the Forum sees the greatest scope for new opportunities in the region. This is because of existing initiatives in this area (such as Australia's agreement with

12 Mutual Recognition Arrangement Between the United States Securities and Exchange Commission and the Australian Securities and Investments Commission, together with the Australian Minister for Superannuation and Corporate Law, signed in Washington on 25 August 2008.

13 The Agreement between the Government of Australia and the Government of New Zealand in relation to Mutual Recognition of Securities Offerings, signed 22 February 2006.

14 See section 795B(2) of the *Corporations Act 2001* and ASIC Regulatory Guide 177; section 911A(2)(h) of the *Corporations Act 2001* and ASIC Regulatory Guide 176.

15 Declaration on Mutual Recognition of Cross-Border Offering of Collective Investment Schemes, signed by ASIC and the Hong Kong Securities and Futures Commission on 7 July 2008.

Hong Kong and a mutual agreement with Singapore, which is in discussion), as well as the role of UCITS in the region, discussed further below.

Recommendation

In its submission to the Forum, IFSA proposed the development of a regional funds management 'passport', which would allow eligible funds from eligible jurisdictions to be marketed across borders, with minimal additional host jurisdiction regulatory requirements.¹⁶ The Asia Region Funds Passport proposal would go beyond a series of bilateral mutual recognition treaties, by providing a multilaterally agreed framework allowing the cross-border marketing of funds amongst member countries.

Under the current system, there is no consistency between different mutual recognition agreements, so that an Australian fund manager must comply with a different set of structural requirements, offer conditions and investment restrictions depending on where the fund is offered. A multilateral framework would, as far as possible, set out a commonly agreed set of structural requirements (such as arrangements for registration of the fund and licensing of the manager); investment restrictions (such as limitations on leverage or asset classes) and, where feasible, offer conditions (such as prospectus requirements). The Passport would streamline the process of offering a managed fund in any country within the Passport group.

A successful example of a multilateral funds passport arrangement is Europe's UCITS framework. Appendix 8 contains more detail on UCITS. The regime consists of a number of European Commission directives which allow complying managed investment schemes registered in one EU member country to be marketed throughout the EU. The Directives set out requirements on funds management companies and depositaries (custodians), as well as criteria for the types of funds eligible for cross-border offering.

The UCITS framework is already very popular in key jurisdictions in the Asian region. For example, at the end of 2008 there were 2,420 UCITS funds registered in Singapore.¹⁷ There are a number of possible reasons for their popularity in the region, including similarities between UCITS investment restrictions and those in a number of countries in the region.

An Asian multilateral passport arrangement could well provide the framework for developing a regionally based vehicle to challenge the strong position of UCITS in the region. This could also provide a platform through which Asia-Pacific based funds gain greater access to the European market. The proposal should thus be a very appealing one not just for Australian based fund managers, but also for fund managers elsewhere in the region who compete against UCITS vehicles being administered out of Europe.

The Forum and the funds management sector recognise that negotiating a multilateral Passport arrangement will take considerable effort and time, along with political commitment. Achievement of these objectives will also require a greater degree of regulatory consistency across a number of jurisdictions.

However, the potential longer-term benefits are enormous – to domestic investors, offshore investors, and funds management companies here and elsewhere in the region. For the region as a whole, it provides an opportunity to create a brand that, like UCITS, could be exported outside the region. It

¹⁶ IFSA, submission to the Australian Financial Centre Forum, 4 March 2009.

¹⁷ PricewaterhouseCoopers, *Global Fund Distribution 2009*, PricewaterhouseCoopers Luxembourg, 2009, viewed 17 August 2009, <http://www.pwc.com/lu/>.

represents a key part of the Forum's overall set of proposals for internationalising Australia's financial sector in areas of comparative advantage.

The Forum established an industry Working Group to consider IFSA's proposals and further develop the idea of an Asia Region Funds Passport. The Forum also discussed the proposals in detail with ASIC. The analysis and conclusions flowing from the Working Group and the Forum's consideration of the issues are set out in detail in Appendix 8.

The Forum's proposal for an Asia Region Funds Passport must be seen as one part of a package of interdependent proposals in this Report. In particular, it needs to be seen in conjunction with Recommendation 3.1 relating to an Investment Manager Regime. Without the tax certainty provided by such a regime, many domestic fund managers will be reluctant to manage offshore funds out of Australia, and offshore investors will be wary about investing in such vehicles.

It is also critical that fund managers have appropriate vehicles for marketing their products that are widely recognised in the relevant offshore markets. For this reason, the Asian Passport must also be seen in conjunction with Recommendation 3.3 relating to introducing a range of funds management vehicles that are taxed on a 'flow-through' basis.

Recommendation 4.3: The Asia Region Funds Passport

The Forum recommends that the Asia Region Funds Passport be developed as set out in Appendix 8. Broadly, this would involve a two-stage process:

- Stage one: ASIC negotiates bilateral mutual recognition agreements with key jurisdictions in the region. In doing this, the Forum recommends that ASIC attempt to ensure that investment restrictions allow a relatively broad range of funds to be offered across borders, and that licensing requirements are as streamlined as possible.
- Stage two: once bilateral agreements are in place, regional governments and agencies work together in the appropriate forums to develop these into a multilateral Passport regime. This would involve:
 - developing a commonly agreed set of licensing arrangements, investment restrictions and, where possible, offer conditions that would allow complying funds registered in one Passport country to be offered in each of the other passport countries; and
 - putting in place mechanisms for the continued administration of the Passport regime at national and regional levels.

While the Forum's recommendation is largely focused on the retail level, it is also vital that Australian fund managers have access to wholesale markets overseas. The regulatory restrictions on the cross-border marketing of wholesale funds are not as onerous as those in the retail space. However, there is still room for considerable improvement. The Forum strongly supports the Asia-Pacific Regional Committee of the International Organization of Securities Commissions examining proposals to streamline the regulatory requirements for cross-border sales of funds at the wholesale level.

The Forum also encourages the negotiation of mutual recognition arrangements at the wholesale level, rather than just unilateral ones. As at the retail level, the potential benefits to Australia of wholesale mutual agreements far outweigh those of just unilateral access into Australia by offshore fund managers.

The Asian Passport is an ambitious proposal which will require a commitment from the Australian Government and from other countries in the region. The Forum sees merit in building support for the project at the industry level as well as among regulators and governments in the region. The Forum considers that relevant industry groups should, through their memberships of international and regional industry bodies, also seek to build support for the development of the Passport.

The potential role for the Australian Government in building political support for the Passport in the region, through its involvement in regional forums and bilateral discussions, is considered in Chapter 6.

Foreign direct investment

The opportunity

Chapter 2 discussed the importance to Australia of accessing offshore sources of capital as efficiently and competitively as possible, in order to help fund domestic investment requirements. Direct foreign investment is an important part of that funding. Looking at Australia's reliance on offshore capital, of the \$1.8 trillion stock of foreign liabilities, debt represents around 70 per cent of the total, while equity is roughly 30 per cent.¹⁸ Within the equity component, around 55 per cent is direct investment.¹⁹

Direct investment by overseas companies also plays a broader role, as a key source of competition, innovation and efficiency. This is reflected in the Forum's vision statement, which refers to a financial sector which '*... exhibits the lowest possible barriers to entry consistent with the maintenance of financial stability and integrity, so as to encourage new entrants and foster price competition and innovation.*'

Regulatory issues

Australia's foreign investment policy, which sets out the main criteria used to determine which proposals will be accepted or rejected, is, by international standards, quite liberal, as is reflected in the high level of foreign investment in Australia (see below). However, the policy framework does restrict foreign persons from acquiring control of an Australian company or business if it is deemed to be contrary to the 'national interest'. There are particular sensitivities around the banking sector and real estate.

The Forum received feedback to the effect that the lack of clarity and high degree of discretion in Australia's foreign investment rules has contributed to a perception by some potential overseas investors that Australia does not have a liberal foreign ownership regime. This perception is also reflected in some international surveys.²⁰

The Forum believes that such perceptions are largely unwarranted, given the high level of overall foreign direct investment (FDI) in Australia and the high approval rate for applications processed through the Foreign Investment Review Board (FIRB). International comparisons show that Australia's FDI stock as a proportion of GDP, at 27.4 per cent in 2008, is above average for developed

18 RBA, *Bulletin Statistical Tables*, 'Australia's Gross Foreign Assets and Liabilities', Table H4, June 2009.

19 *ibid.*

20 For example, the OECD's *FDI Regulatory Restrictiveness Index*, Working Paper Number 2006/4, December 2006, placed Australia fifth last out of 42 countries. Another example comes from the World Economic Forum, *The Global Competitiveness Report, 2009-10* which ranked Australia fifty-fifth out of 133 countries for 'Business impact of rules on FDI'.

countries.²¹ In terms of FIRB applications, in 2007-08, \$192 billion of applications were approved, with only \$0.2 billion rejected.²²

However, the Forum emphasises the need for all restrictions relating to both portfolio and direct investment to be periodically reviewed to ensure that they remain in Australia's interest, and for Australia's foreign investment guidelines and their administration to be as transparent as possible.

Ensuring that offshore investors have a clear understanding of Australia's regulatory system can facilitate access to offshore capital. International competitiveness surveys are generally positive about the ease of dealing with Australia's regulatory system.²³ Nevertheless, the Forum understands that navigating Australia's regulatory system can still prove difficult for some offshore businesses looking to establish an operation in Australia. Our federal system, and the consequent need in some cases to deal with both State and Commonwealth authorities and regulatory requirements, adds substantially to the burden. This is perhaps particularly true in relation to insurance, an issue discussed later in this Chapter.

To the extent that regulatory complexities inhibit offshore investors from supporting a new or expanded business, this can result in reduced competition, innovation and consumer choice in Australia. In the financial sector, these potential businesses may also provide access to new sources of offshore savings. It is therefore critical that Australia's regulatory system does not create any unnecessary barriers to foreign direct investment.

The Australian Trade Commission (Austrade) plays an important role in facilitating inward investment, including by providing information and assistance to foreign businesses looking to invest or establish an operation in Australia. State governments also provide assistance to potential offshore investors in Australia. Austrade's website provides a number of fact sheets for potential investors or market entrants on Australia's regulatory and tax systems. While this website contains basic introductory information, an investor looking for more detailed information on regulatory requirements or contact details in each of the regulatory authorities would need to go beyond the Austrade website and navigate their way through a number of other websites.

21 United Nations Conference on Trade and Development, *World Investment Report 2009*, UN, New York and Geneva, 2009, Annex Table B.3.

22 FIRB, *Annual Report 200708*, Canberra, 2008.

23 For example, the World Bank's *Doing Business 2009* ranks Australia third in the world for ease of starting a business (behind New Zealand and Canada) and ninth for overall ease of doing business. See World Bank, *Doing Business 2009: comparing regulation in 181 economies*, World Bank, International Finance Corporation and Palgrave Macmillan, Washington DC, 2009.

Recommendation

The Forum considers that it would be beneficial to develop a central website which incorporates both introductory and more detailed information from regulators. This website would allow a potential market entrant to access basic information about the Australian market, as well as more detailed information about regulatory requirements as they apply to specific entities. In addition, they would be able to download relevant forms, consolidating the information currently available on Austrade's website and information separately available on each of the regulators' websites. This website would, in short, be a one-stop 'gateway'. Two submissions to the Forum recommended the development of such a gateway to assist foreign entrants into the Australian market.²⁴

Austrade also provides more tailored assistance to potential market entrants, where required, by email, phone and in person. This can include putting companies in touch with the relevant regulators to answer specific questions about licensing, registration and other regulatory requirements in Australia. This coordination between Austrade and the regulators operates on an informal basis, with designated contact people in APRA and ASIC. The Forum understands that, given APRA's prudential role, it is usually more willing to deal directly with new applicants to the APRA supervised sectors. By contrast, ASIC's role is far broader and there has been less engagement historically between ASIC and potential new entrants that fall under ASIC's scope, for example, applicants for Australian financial services licences.

While, in some cases, coordination between Austrade and regulators has been very successful, the informal nature of this arrangement has in other cases resulted in regulators being unavailable to provide the information or assistance requested.

The Forum recognises that corporate advisers and legal firms have an important intermediary role to play in providing guidance and interpretation, as well as facilitating the necessary documentation. Nevertheless, in the Forum's view the regulators can also play an important role in facilitating information flow to prospective new entrants.

The Forum recommends formalising the relationship between Austrade and the regulators, to ensure that regulators are able to make resources available to assist potential entrants into the Australian market to navigate the requirements of Australia's regulatory system. In the Forum's view, Austrade remains the most appropriate first point of contact for offshore entities looking to operate in Australia, given its experience, expertise and focus on facilitating inward investment. Nonetheless, the Forum considers that there should be dedicated contacts within ASIC, APRA, the RBA, the Australian Transaction Reports and Analysis Centre (AUSTRAC), FIRB, the Australian Competition and Consumer Commission (ACCC) and relevant state agencies, whose roles could include working with Austrade to provide information and assistance to potential market entrants.

One possible concern with this approach is that facilitation of inward investment is not an activity falling within the central mandate of the regulators. Were regulators to take on a greater facilitation role, this could divert resources from core supervision activities. The Forum fully understands such concerns and stresses that, for the recommendation below to be effective, it will be necessary to ensure that the project is adequately resourced, in a manner which does not divert resources from the regulators' central responsibilities. The Forum considers that it is consistent with the regulators' current objectives to assist new market entrants to understand the regulatory requirements they will

²⁴ See the Finance Industry Council of Australia (FICA) submission to the Australian Financial Centre Forum, December 2008, Recommendation 1, page 3 (FICA is comprised of: Abacus - Australian Mutuals, the ABA, IFSA, the Australian Finance Conference, the Financial Planning Association and the ICA). See also Property Council of Australia submission to the Australian Financial Centre Forum, 23 December 2008.

be working within. Indeed, in the long run, having new market entrants that are properly aware of their responsibilities may make market supervision easier.

The Finance Industry Council of Australia's (FICA's) submission to the Forum recommended that, should regulators be given a greater role in facilitating new market entrants, the Government could amend the respective enabling legislation of each financial regulator to ensure that 'facilitation of cross-border activity' is a core element of their mandate.²⁵ While it may not be necessary to go this far, the Forum sees benefit in some formal commitment by the regulators to assist potential market entrants to obtain information about the regulatory system.

Under the proposed arrangements, Austrade, as the first point of contact, would continue to handle initial inquiries and provide information. For more advanced inquiries or more complex issues, Austrade would act as a filter, before connecting the external parties with the dedicated regulators. Before proceeding to invest or establish a new business, the external parties would still be expected to require assistance from other intermediaries, such as legal and accounting firms, but would do so from a much sounder understanding of the regulatory environment and their regulatory responsibilities.

Potential domestic investors would also have access to the proposed gateway.

Recommendation 4.4: Regulatory online gateway

The Forum recommends that:

- Austrade develop, in close consultation with APRA, ASIC, the RBA, FIRB, the ACCC, AUSTRAC and the relevant state agencies, an online gateway for potential overseas investors in Australia;
- Austrade administer and continually update the website, and provide the initial point of contact for offshore inquiries; and
- APRA, ASIC, the RBA, FIRB, the ACCC, AUSTRAC and the relevant state agencies be encouraged to put in place formal arrangements for a central contact person charged with facilitating offshore enquiries relating to their organisation.

4.4 REGULATION AND DOMESTIC EFFICIENCY AND COMPETITIVENESS

Equity market: competition and the ASX's supervision role

The opportunity

Chapter 2 referred to the depth and liquidity of Australia's equity capital market as a strength of the financial sector. This has helped to cushion the effect of the global financial crisis as companies raised equity capital, even at the height of the crisis.

One of a number of factors underpinning the depth and efficiency of our equity capital market is that Australia's regulatory framework relating to equity issuance is sound and flexible. In particular, Australia's combination of a rights issue focus, accelerated offer structures, trading halts during

²⁵ FICA submission to the Australian Financial Centre Forum, December 2008, Recommendation 1, p 3.

capital raisings, and 'non-prospectus' rights issues sets it apart from many other financial centres, including the UK and the US.²⁶ Within the Asia-Pacific region, Australia's strong corporate governance and continuous disclosure regime are relative strengths.

As with all other markets, equity trading and settlement arrangements need to be as competitive, efficient and innovative as possible. As discussed below, as new niche markets develop and provide opportunities for both exchange traded and OTC products, Australia also needs to ensure it is able to respond to such opportunities quickly and effectively, including where appropriate by way of providing licences to new market entrants who can introduce new skills, technology and experience.

Regulatory issues

An unusual feature of Australia's equity market, which was touched on in Chapter 2, is that the ASX is the sole service provider in the market and also performs a supervisory role alongside ASIC's regulation of this sector. It also operates central clearing and settlement facilities.

An important regulatory development with respect to exchange traded instruments in a number of major economies, particularly in North America and Europe, has been the promotion of competition between market operators in order to enhance market efficiency and innovation. These developments in the global regulatory environment have led to an increase in the number of trading platforms being made available to market participants in many other major economies.

The Treasurer and the Minister for Financial Services, Superannuation and Corporate Law on 24 August 2009 announced changes in the regulatory arrangements relating to Australia's financial markets which provide for ASIC to perform supervision of real time trading on all of Australia's domestic licensed markets.²⁷ These changes will allow for the introduction of competition.

Recommendation

The Forum's general position with respect to exchange traded products – as with all other aspects of the financial markets – is that openness to new entrants is an essential condition for competition, efficiency and innovation. Evidence from other countries where traditional exchanges are now competing with new trading platforms suggests that competition has resulted in innovation and generally lower transaction costs.²⁸

The Forum thus strongly supports the Government's announcement and the introduction of competition between market operators. This competition could extend beyond just the platform stage as new, niche markets develop, such as carbon trading. It is less clear whether the introduction of

26 A **trading halt** is an interruption to trading at the request of the listed entity that is not a suspension from quotation. It is usually a precursor to significant market sensitive information being publicly released or where market sensitive information needs to be clarified. A **rights issue** is a privilege extended to existing shareholders to buy new shares in the same company, usually at a discount to the market price. In an **accelerated rights issue**, institutional shareholders are required to deal with their rights before other shareholders and are generally allotted their securities first. The offer proceeds in two tranches: institutional and retail. This allows issuers to receive a significant proportion of their offer proceeds from their institutional holders in a very short timeframe. A **non-prospectus rights issue** can be made if the issuer provides a 'cleansing statement' that includes all material information to a prospective investor, including information that, up until that time, was regarded as confidential and therefore may not have been subject to continuous disclosure requirements.

27 The Hon C Bowen MP (Minister for Financial Services, Superannuation and Corporate Law) and the Hon W Swan MP (Treasurer), *Reforms to the supervision of Australia's financial markets*, media release, 24 August 2009.

28 See for example: Oxera, *Monitoring prices, costs and volumes of trading and post-trading services: report prepared for European Commission DG Internal Market and Services*, Oxera Consulting Ltd, Oxford, 2009.

competing exchanges covering existing listed products would improve efficiency and liquidity, given increased administrative and other costs for investment banks and other market participants in maintaining links with multiple exchanges.

As part of facilitating a multi-operator environment for financial markets, it is important to ensure the appropriate clearance and settlement facilities are accessible on fair terms, whether they are located in or outside Australia.

In addition, as a result of the global financial crisis, the Financial Stability Board has recognised the systemic importance of central counterparty clearing facilities²⁹ and the desirability of greater reliance by financial markets on them.³⁰

While the Forum does not wish to make a formal recommendation on this matter, the above considerations suggest there may be merit in the relevant authorities examining the case for the clearance mechanism in Australia becoming an industry owned and funded facility.

Recommendation 4.5: Increased competition on exchange traded markets

The Forum encourages the early consideration of licences for new trading platforms and exchanges, with a view to introducing competition as soon as possible once the recently announced financial market regulatory changes are in place.

Debt market: lack of liquidity and retail regulation

The opportunity

Chapter 2 discussed the lack of liquidity and diversity in Australia's corporate bond market. It also discussed why this lack of liquidity was a significant weakness in the overall assessment of Australia's financial system.

Discussions with debt capital market participants on both the buy and sell side have suggested that, at the wholesale level, there is little that the Government could do to encourage institutional demand for corporate bonds, beyond perhaps encouraging the development of a wider range of 'capital stable' and annuity type products more suited to investors close to retirement. At the retail level, while the size of the market is substantially smaller, discussions which the Forum held with market participants suggested that there may be scope for further developing the market, including by way of some regulatory changes.

²⁹ For background on central counterparty clearing facilities, see footnote 77, Chapter 2.

³⁰ See, for example, Financial Stability Board, *Improving Financial Regulation: report of the Financial Stability Board to the G20 leaders*, Financial Stability Board, September 2009.

Regulatory issues

Under the current regulatory regime there are significant requirements imposed on issuers of corporate debt (both listed and unlisted) to retail investors.³¹ For listed securities, there are additional requirements imposed by the ASX.³²

It has been suggested that the costs associated with issuing debt securities to retail investors discourage such issues and make it difficult to compete with bank deposits and other asset classes. These relate in particular to the expense and short life of prospectuses. Further difficulties arise from the inability to offer a debt product to potential retail clients over an extended period of time. Under recent legislative reforms and relief provided by ASIC for certain forms of equity issuance, the gap between requirements on the issuance of debt securities as against listed shares to retail investors by an ASX listed company is now even wider.³³ Given the relatively higher risks associated with investing in shares, the Forum does not believe this disparity in disclosure standards is appropriate.

Recommendation

A number of submissions to the Forum suggested that, while the retail component of the debt securities market is small, there is significant capacity for its development. The Forum received a number of proposals about measures the Government and regulators could take to facilitate corporate debt issuance to retail clients.

In developing any proposal for expanding the retail debt market, the Forum considers that the prospectus requirements for listed companies issuing *listed* debt securities to retail investors should not be more onerous than for the same companies issuing further shares to retail investors. More generally, the Forum's objectives are:

- to ensure that standards of consumer protection are maintained;
- to ease the regulatory path for relatively higher quality issues. This would also significantly improve timely issuance to market, allowing issuers to take advantage of market opportunities and respond to their own internal funding needs in a more timely fashion;
- to expand investment opportunities for retail investors, especially those looking for a high quality alternative to bank deposits but without the investment risk of equities; and
- to broaden and deepen the Australian debt market, commensurate with Australia's ambitions as a leading financial centre.

The Forum proposes a simplified process for issuers that satisfy all the criteria set out above. The proposed process would be as follows:

31 For the issue of a retail debt security, an issuer must:

- (a) have a Corporations Act complying trust deed;
- (b) appoint a statutory trustee corporation or similar entity as trustee;
- (c) publish a prospectus complying with the same form and content as an initial public offering of shares.

Prospectus requirements can be substantial. Two recent examples of prospectuses were 83 and 122 pages long.

32 Listed securities are required to have an investment grade rating or the listing entity (or its guarantor) must have net tangible assets of at least \$10 million. In addition, there are some additional requirements for 'retail securities'. The listed securities are subject to continuous disclosure requirements. Despite these prudential requirements, the ASX listing of a corporate issuer of a listed debt security does not reduce the initial disclosure requirements.

33 See, in particular, Class Order 09/425, Class Order 09/459 and Consultation Paper 105 *Facilitating Equity Capital Raisings*, issued 24 February 2009.

- An issuer would provide a simplified prospectus, covering the terms of the debt securities and their risks, and cross-referencing all relevant documents already lodged with ASIC and the market operator. In addition, the issuer would provide any additional information that had been excluded from the continuous disclosure requirements. Once issued, the continuous disclosure applying to listed securities would ensure that the market was updated. No additional disclosure documents would be required for that issue.
- For those issuers planning a program of multiple debt issues, they provide a base prospectus, prior to the first issue, and then a brief supplementary prospectus for each new issue (with the particular terms and conditions for the issue and incorporating any new information on the issuer).
- A trustee and complying trust deed would still be required to provide appropriate consumer protection.

In order to broaden the market further, and consistent with the objective of restricting any regulatory concessions to a high quality group of issuers, the Forum also proposes that simplified issuance be extended to a broader range of bodies, as set out in Recommendation 4.6.

One other means to expand the opportunities for retail debt investors would be for the Commonwealth as well as the State and Territory governments to list their debt securities on an exchange. While the decision to list will need to be largely driven by the associated costs and benefits, the Forum notes that such action would have the added benefit of raising retail investor interest and confidence in the retail bond market.

In framing these proposals, the Forum is conscious of the collapse in recent years of a number of corporate debenture issuers, with resultant significant losses to retail investors, and the associated need for proposals in this area to provide adequate consumer protection. The recommendation below has been framed with this consideration in mind.

Recommendation 4.6: Reduce regulatory requirements on corporate debt issuance to retail investors

The Forum recommends that the regulatory requirements for listed companies that issue high quality corporate debt to retail investors be reduced.

- An exemption to existing requirements would apply for those issuers:
 - with listed Australian dollar debt securities that also have listed shares and hence are already required to provide continuous disclosure and comply with the market operator’s listing rules; and
 - with investment grade securities that have a reasonably simple structure (that is, fixed or floating rate securities paying a margin relative to the bank bill swap rate; and with no credit exposure to entities other than the issuer or, if applicable, the guarantor).
- Such issuers would no longer be required to issue a detailed prospectus. Rather, a shorter prospectus could be issued, cross-referencing all relevant documents already lodged with ASIC or the market operator.
- Those companies with a program of issues over time could use a base prospectus with a supplementary prospectus for each new issue.
- Subject to satisfying the relevant criteria, these simplified procedures would also be available for Commonwealth and State government (or government guaranteed) bodies; OECD government (or government guaranteed) bodies; supranational entities; and offshore corporates listed on a recognised offshore stock exchange.

Insurance and state regulation

The opportunity

The Insurance Council of Australia (ICA) (which covers general insurance) has stressed that the primary policy issues and constraints they saw facing the industry related to domestic taxation and, to a lesser extent, differences in state (non-prudential) regulation.

The tax issues relating to insurance were considered in Chapter 3. The regulatory issues are considered below.

In the Forum’s view, resolving these tax and regulatory issues will provide the basis for a more competitive and efficient domestic insurance industry, by providing growth opportunities, economies of scale, lower costs (through less administrative and compliance complexity) and, potentially, more competition.

A stronger and more competitive domestic industry may also provide a stronger base from which to expand offshore.

Regulatory issues

Although prudential regulation is now handled by the Commonwealth (through APRA), non-prudential state regulations cover various sectors of the economy, including importantly the insurance industry. For example, the States regulate the licensing of the building industry, including

home builders warranty insurance (HBWI), with the States adopting different approaches to regulating this sector. It is therefore difficult to examine insurance issues in isolation from the regulatory framework applied to the broader economic sector, such as building. As noted by the Ministerial Council on Consumer Affairs, ‘... the success of a HBWI scheme depends largely on containing insurance claims by having a regulatory framework that encourages a good standard of building and provides a mechanism for quickly resolving disputes.’³⁴

Motor vehicle licensing and workcover regulations are other examples where the States adopt different approaches that affect the general insurance sector. This lack of consistency across the States complicates the operation of an Australia-wide business for national insurance companies. The resultant higher cost structure would tend to be passed on to consumers. The complexity of these regulations may also act as a barrier to entry and therefore limit competition.

Recommendation

The Forum understands that it is difficult to address non-prudential state regulations affecting the insurance industry in isolation from state regulations that apply more broadly, such as for the building sector. That said, the Forum is of the view that COAG should address these issues, with the objective of identifying insurance regulations that could be harmonised without the need for a broader review of the relevant sector. COAG could identify those state regulations that are most readily standardised, especially those that do not require a much broader regulatory review and agreement.

For those insurance matters that cannot be isolated from broader arrangements, the Forum would welcome COAG undertaking a broader review over time, with a view to removing unnecessary regulations and harmonising necessary regulations across the States.

Recommendation 4.7: Standardise non-prudential regulation of the insurance sector

The Forum recommends that state regulations relating to the insurance sector be standardised, wherever possible.

Islamic finance

The opportunity

As mentioned in Chapter 3, a major source of offshore capital is the Middle East, reflecting the sharp rise in the world price of oil. The greatest opportunity for Australia, in terms of accessing offshore capital pools to finance domestic investment needs as competitively as possible, would appear to be in the area of developing Sharia compliant wholesale investment products.

Regulatory issues

In addition to the tax issues relating to Sharia compliant financial instruments discussed in Chapter 3 and addressed in Recommendation 3.6, Islamic finance presents a number of regulatory challenges. For example, certain types of Islamic product often have multiple investors and take forms that could potentially bring them within the definition of a managed investment scheme or other regulated entity under the *Corporations Act 2001*, with a range of substantial legal consequences. Whether this is the

³⁴ Professor Percy Allan AM, *National Review of Home Builders Warranty Insurance and Consumer Protection*, Ministerial Council on Consumer Affairs, Canberra, 2002.

case and, if so, whether it is consistent with the economic form of such products is a matter that would need to be considered in the broader context of ensuring fairness in the regulation of Islamic finance.

Another regulatory issue is the relationship of any Islamic bank to Sharia scholars and Sharia Supervisory Boards. Such entities examine proposed financial products and decide whether or not they are to be approved as 'Sharia compliant'. Sharia scholars have such influence that they could potentially be considered to be shadow directors on the Boards of Islamic banks. APRA would need to be satisfied that the prudential requirements relating to directors of financial entities could be met in those circumstances. This may depend on the proposed role of Sharia scholars or supervisory boards in the running of the bank in question.

Recommendation

The Forum sees a need for the removal of any regulatory barriers to the development of Islamic financial products in Australia. As a first step, the Forum sees merit in the establishment of an interdepartmental committee comprised of all Commonwealth Government departments and agencies having responsibilities in this area, which could draw on industry and academic sources as required, in order to delineate more clearly the barriers to Islamic finance in Australia.

Recommendation 4.8: Removal of regulatory barriers to Islamic finance

The Forum recommends the removal of any regulatory barriers to the development of Islamic financial products in Australia, guided by the principle that there should be a 'level playing field' for such products.

5. HUMAN CAPITAL

Chapter 1 noted that international surveys of financial centres emphasise the availability of skilled labour as one of the most important success factors. As was noted in Chapter 2 and is returned to in more detail later in this Chapter, Australia's skilled workforce is one of its greatest strengths, as demonstrated by international surveys of workforce skills and in the global rankings of our universities. This is also consistent with feedback to the Forum, including from financial services companies using Australia as a regional base.

The Forum did not identify a need for change in government policy in this area. However, it does have a number of observations to make about areas for improved operation of existing policies relating to the workforce and education; better coordination between government, academia and industry; and areas where industry could play a stronger role. Those observations are summarised in Box 5.4 at the end of this Chapter.

5.1 GOVERNMENT AND INDUSTRY RESPONSIBILITIES

Government policy with respect to education, training and skilled immigration has a critical role to play in ensuring the availability of a highly skilled workforce within the financial sector. There is also a central role for employers and employees. Where the dividing line lies between the responsibilities of government on the one hand and employers and employees on the other in terms of maintaining a highly skilled, well informed and ethical workforce is a moot point. Many of the submissions and suggestions put to the Forum on workforce and education issues were, in the Forum's view, more issues for the industry itself to address rather than government.

The dividing line between the two may not always be apparent. The ABA highlighted this point in a 2008 skills shortages survey that forecast significant shortages for financial planners, customer-facing (branch) staff, customer-contact (phone) staff and business bankers.¹ However, as the ABA and the survey highlighted, a major reason for these likely future skills shortages was the forecast continuation of high resignation rates. High turnover was also highlighted in an Australian Financial Markets Association (AFMA) survey of operations² that referred to a perceived lack of career paths as a major factor behind the high turnover rate – an issue primarily for industry, not for government.

Box 5.1 summarises the Forum's thinking on the responsibilities of government and industry for maintaining a highly skilled, well informed and ethical workforce.

1 ABA, Workforce Management Plan, 2008.

2 AFMA, *Operations Committee Member Survey*, AFMA, 2008.

Box 5.1: A highly skilled workforce – governments' role and industry's role

In the Forum's view, there is a critical role for government – Commonwealth as well as State and Territory – in meeting the objective of a highly skilled financial services workforce, by ensuring:

- adequate basic skills from the secondary education system;
- adequate funding for the vocational and higher education sectors;
- proper oversight of the quality of training and education in the vocational and higher education institutions;
- effective coordination between industry and education officials:
 - to identify possible skills shortages;
 - to ensure appropriate training and course content;
- administratively simple access to skilled migration (both permanent and temporary) as a means to relieve skills shortages and to transfer skills to Australian workers;
- appropriate professional education and training programs on compliance and integrity issues, with input from industry regulators;
- continued emphasis on financial literacy through the education and training system and supported by regulatory initiatives; and
- financial support for collaborative research between the financial services industry and academia, particularly where there is a broader community benefit from that research.

These government roles should complement the responsibilities of the financial sector, including the industry's professional organisations, to:

- identify current and potential skills shortages;
- improve skill levels, ensure compliance with regulations and ensure businesses operate with the highest levels of integrity, through their own internal training programs;
- support employees undertaking formal external coursework and practical training;
- develop clear career development paths designed, amongst other things, to reduce staff turnover levels;
- develop appropriate course content by working directly with vocational and higher education institutions; and
- support financial sector research.

5.2 OVERALL ASSESSMENT

Both international comparative surveys and anecdotal evidence suggest that, for the most part, Australia rates highly in terms of workforce skills. Chart 5.1 provides a summary of some of the relevant surveys.

Chart 5.1: Workforce skill base comparisons

| | Australia | Hong Kong | Japan | Singapore | US | UK |
|--|-----------|-----------|-------|-----------|----|----|
| World Competitiveness Yearbook 2009 ranking in: | | | | | | |
| Foreign highly skilled people | 4 | 7 | 44 | 2 | 3 | 8 |
| Finance skills | 5 | 9 | 30 | 7 | 11 | 23 |
| University education | 9 | 20 | 34 | 3 | 10 | 17 |
| Management education | 11 | 20 | 34 | 4 | 10 | 21 |
| Global Competitiveness Report 2008-09 ranking in: | | | | | | |
| Secondary enrolment rate | 1 | 72 | 22 | 21 | 48 | 34 |
| Reliance on professional management | 4 | 27 | 17 | 8 | 10 | 19 |
| Quality of scientific research institutions | 8 | 29 | 15 | 13 | 1 | 7 |
| Quality of the educational system | 9 | 22 | 31 | 2 | 19 | 28 |
| UNDP's Human Development Report 2008 ranking in: | | | | | | |
| Human development index (HDI) | 4 | 22 | 8 | 28 | 15 | 21 |

Sources: Austrade, *Benchmark Report 2009*, using sources from IMD, Switzerland, World Competitiveness Yearbook 2009 (57 economies); World Economic Forum, Switzerland and Harvard University, Global Competitiveness Report 2008-09 (134 economies); The United Nations Development Programme (UNDP) online Human Development Indices; A statistical update 2008 (179 economies).

Access to a high quality workforce was cited by industry in discussions with the Forum as one of the principal reasons offshore companies base their regional operations in Australia. For some companies, Australia is an 'incubator' of skills, and these companies transfer some of their Australian staff to other international financial centres.

There is also an important link between the Government's objectives for the financial sector and the availability of a skilled and experienced workforce. The more Australia develops as a financial centre, the more attractive it is for expatriates working in offshore financial markets to return to Australia and contribute to that development. More information on Australian expatriates is in Box 5.2.

Box 5.2: Australian expatriates in the financial services industry

Around one million Australians live overseas.³ Australian expatriates are, on average, younger and more highly educated compared with the general population.⁴ It is estimated that 31 per cent reside in the UK, nine per cent in the US and at least 20 per cent in Asia. At the time of departure, 83 per cent intended to return to Australia within three years.⁵ In separate surveys, Australia's expatriates indicate that they retain a strong identification with Australia.

There are no detailed estimates of the proportion of expatriates working in the financial services industry, although one survey based estimate suggested a figure of around one quarter.⁶

For many financial services companies, particularly those with a global presence, Australia is seen as a source of skilled labour that can support their offshore operations. Australian workers enjoy a very high reputation for skills and work ethic.

In a narrow sense, this relocation of skills overseas can be regarded as a 'loss' to Australia. Looking more broadly, however, Australian expatriates improve links into overseas financial sectors which can facilitate Australian financial institutions entering offshore markets or participating in offshore transactions. Some Australian expatriates are also employed by foreign regulators, reflecting Australia's solid reputation in that area.

Through their overseas experience, Australian expatriates develop new skills. On their return to Australia, those expatriates will transfer some of their new skills to resident Australian workers.

The generally high standing of Australia's education sector is reflected in educational services now ranking as Australia's fourth largest export category. Australian universities continue to enjoy a strong international reputation for quality.⁷ In 2008, higher education exports were valued at \$8.9 billion.⁸ As at July 2009, there were 199,000 international students in higher education in Australia, of which 47 per cent were enrolled in management and commerce courses.⁹

3 G J Hugo, 'An Australian Diaspora?', *International Migration*, vol 44, no. 3, 2006, pp 105-132.

4 G J Hugo, 'Returning Youthful Nationals to Australia: Brain Gain or Brain Circulation', 2009, in D Conway and R B Potter, *Return Migration of the Next Generations: 21st Century Transnational Mobility*, Ashgate, 2009, pp 185-219. Fifty five per cent of long-term or permanent departees are classified as 'professionals' or 'managers and administrators', as against 29 per cent in the overall Australian workforce. Based on unpublished data from the Department of Immigration and Citizenship (DIAC) from 1997-98 to 2002-03.

5 *ibid*, based on 2006 unpublished data from DIAC.

6 Based on an on-line survey of 9,529 Australian expatriates to coincide with the 2006 Australian population census (the 'One Million More' study). The authors acknowledge that the sample is not representative and is biased towards more higher skilled groups.

7 Six of Australia's universities ranked in the first 50 in the 2009 Times Higher Education Supplement World University Rankings 2009. See: Times Higher Education, UK, viewed 9 October 2009, www.timeshighereducation.co.uk/Rankings2009-Top200.html.

8 Exports of total education services (including vocational education and training (VET) and schools sectors) were \$15.5 billion. Source: Australian Education International, *Export Income to Australia from Education Services in 2008*, Department of Education, Employment and Workplace Relations (DEEWR), Canberra, June 2009.

9 Of this total, 24,000 were enrolled in accounting; 6,500 in banking, finance and related fields; 34,000 in business and management; and 29,000 in management and commerce. The share of enrolments for management and commerce studies increased from 44 per cent in July 2006 to 47 per cent in July 2009. Source: Data provided to the Forum by Australian Education International, DEEWR, August 2009.

5.3 SPECIFIC ISSUES

How do we maintain and build on our comparative strength with respect to education and training, and are there areas of weakness where policy changes are desirable? With respect to exports of education services generally, there have been some very public concerns expressed recently about the quality of some of the education courses being provided in Australia for foreign students. While these issues are outside the scope of this Report, it is essential that they be addressed and that Australia's reputation for quality higher education be preserved and strengthened.

Based on submissions and other feedback from industry, the Forum identified a number of specific issues with respect to education, training, immigration and research. As part of its assessment of these issues, which is set out below, the Forum held a meeting in Canberra in August 2009, chaired by Treasury, with representatives from the financial services industry, the Finance Sector Union, education sectors (vocational education and training (VET) and higher education), Commonwealth skills authorities (Skills Australia, as well as Innovation and Business Skills Australia (IBSA)¹⁰) and relevant Commonwealth and State departments.

Skills shortages and coordination between industry and government

Industry remains concerned about potential skills shortages, despite the impact of the global financial crisis.

The Forum notes that industry and government conduct separate surveys and may be developing separate strategies to address these shortages. In addition to industry surveys¹¹, the Department of Education, Employment and Workplace Relations (DEEWR) conducts regular surveys to assess skills shortages. These surveys also inform the Department of Immigration and Citizenship (DIAC) for the purpose of administering skilled migration.¹² Separately, IBSA conducts its own survey of skills shortages.

There is only limited coordination between industry and government on these surveys.¹³ The IBSA survey is informed by the Financial Services Advisory Committee comprised of representatives from the industry. However, and as recognised by IBSA and industry representatives, this Committee needs much broader industry representation, particularly from the major industry employers, in order to be of greater use to industry and government.¹⁴ Inadequate industry representation and participation in official surveys can also lead to the use of outdated occupational classifications.¹⁵

10 **Skills Australia** is responsible for providing advice to government on (economy wide) skills issues, particularly skills development. In June 2009, Skills Australia's mandate was extended to encompass the full scope of Australia's labour market needs, including the university sector, in addition to the VET sector.

Innovation and Business Skills Australia (IBSA) is one of the eleven industry skills councils that provide advice to Skills Australia. As part of that role, IBSA identifies skills shortages and develops the nationally accredited financial services training package for the VET sector. The training package defines 32 qualifications, including for accounting, banking, financial planning, superannuation, insurance and risk management.

11 Examples noted above from ABA and AFMA.

12 Skilled migration is designed to target migrants who have skills, proven entrepreneurial capability or outstanding abilities that will contribute to the Australian economy.

13 One outcome of the Canberra meeting on workforce skills was that DEEWR and industry representatives agreed to work together on a survey to identify shortages in particular occupations and skill categories of greatest concern to the financial services industry. The survey results are expected in March 2010.

14 Broader industry representation could also assure greater relevance of the financial services training package for the VET sector.

15 Industry representatives consider that some of the ANZSCO (Australian and New Zealand Standard Classification of Occupations) classifications have not kept pace with industry developments.

Strategies to address skills shortages could also be better coordinated between industry and government. For example, the ABA report cited earlier proposed a set of joint industry/government programs to address skills shortages, including by improving the participation of under-represented groups.

In the Forum's view, there should be greater coordination between industry and government on skill surveys and on strategies to deal with identified skills shortages. Industry development of such strategies could also benefit from collaboration with government authorities, such as Skills Australia, that are working on economy-wide initiatives in this area.

Such coordination could be facilitated by the Forum's proposed Financial Centre Task Force (see Chapter 6). The Task Force could help to bring together industry representatives, relevant policy departments and authorities (such as DEEWR, DIAC, Skills Australia, IBSA) and representatives from the higher education and VET sectors, with a view to addressing industry concerns in relation to identification of skill shortages and training needs.

Industry links with the university sector

In considering skills shortages and the need for a highly skilled workforce, the Forum also examined the links between the financial services industry and the universities.

The Forum understands that, for many universities, there are already effective links with industry. Those links encompass university advisory committees with high-level industry representatives that advise on course content; participation by university staff in employers' in-house training programs and in developing customised training; consultancy arrangements by academics with particular industry groups or companies; and research collaboration, including through industry funding of projects. (Financial services research is separately discussed below.)

This is a competitive field for universities, concerned to ensure that they are meeting industry requirements for course content and quality of graduates. Both the university sector and financial sector employers have significant incentives to ensure effective coordination. That said, any improved coordination mechanisms between the industry and the Government on skills shortages and strategies to tackle them could also benefit from input by the university sector.

Financial services research

The Forum believes that a significant and well recognised capacity for financial sector research is an integral part of the credentials of a leading financial centre.

There are a range of institutions and cooperative ventures that conduct or fund financial services research and commercialisation, with varying degrees of Government involvement. These include:

- collaborative arrangements between universities and industry groups (or individual companies) on particular research projects. An interesting example of such collaboration is SIRCA¹⁶, a not-for-profit company providing finance-related data and technology to universities, public sector agencies and financial market participants world-wide. In turn, SIRCA supports academic research, including on government regulations and market functioning;
- the Australian Research Council (ARC), which provides direct grants for particular projects. In the five years to 2008, there were 150 proposals considered by the ARC classified as 'banking, finance

16 SIRCA members include more than 25 Australian and international universities.

and investment'. Of these, 44 were approved, a success rate of 29 per cent, about the same success rate as for all proposals considered in that period. Total funding for the approved proposals was \$8.2 million, representing around 0.4 per cent of total ARC funding in that period¹⁷;

- Cooperative Research Centres (CRCs), which usually involve a joint venture between researchers and industry for the commercialisation and utilisation of certain technologies or intellectual property. Of the 48 CRCs currently being funded, the Capital Markets CRC is the only one that primarily relates to financial services.¹⁸ The Capital Markets CRC was allocated \$26 million in 2007, over its seven years of operation¹⁹; and
- dedicated financial sector research institutions²⁰, which are usually a joint venture between one or more universities with industry and government (Commonwealth and/or State) funding.

The Forum received a number of submissions calling for Commonwealth funding support for existing research institutions, namely the Melbourne Centre for Financial Studies and the Melbourne APEC Finance Centre²¹; and Commonwealth involvement in the feasibility study for the proposed Sydney based Institute of Advanced Finance.²² In addition, the Forum received feedback indicating that the financial services industry was not receiving an appropriate share of ARC funding.

The Forum fully supports the concept of a number of financial sector research institutions that may compete, collaborate or complement each other. It acknowledges the very useful work of the Melbourne Centre for Financial Studies and the Melbourne APEC Finance Centre, and also welcomes the initiative of the NSW Government to establish an Institute of Advanced Finance. It would encourage industry to fully support such initiatives, including by way of contributing to their funding.

In relation to the adequacy of funding for financial services research, ARC and CRC data reviewed by the Forum indicated that funding was less than commensurate with the sector's share of the economy. However, particularly in the case of ARC funding, this reflected a relatively low number of proposals submitted.

What are the underlying reasons for this under-representation? The Forum heard one view that there was a lack of collaboration between the universities that prevented the formation of a critical mass of researchers. Such a critical mass would be better able to identify the key issues in the industry and develop more substantive proposals, with greater likelihood of funding success. Collaboration may also be impeded by the way in which ARC funding 'recognition' was accorded to the lead academic institution, rather than to a collaborative group. Another factor may be that academics in financial services are focused on consultancy projects with industry, rather than collaborative research. High course workloads for academics were also cited. Another comment was that the nature of the financial

17 Data provided by the ARC to the Forum, August 2009.

18 In addition, Smart Services CRC undertakes activities across a range of service industries, including financial services.

19 Through the applied research of its post-graduate students, the Capital Markets CRC is concerned with the commercialisation of technology, focused on the efficiency and integrity of capital markets. In 2008-09 Capital Markets CRC received \$3.4 million, representing around 2 per cent of total CRC funding in that year. Source: Department of Innovation, Industry, Science and Research, data supplied to the Forum, August 2009.

20 Such as the Melbourne Centre for Financial Studies. In addition there is the Melbourne APEC Finance Centre which is focused on education and training for financial regulators from the Asia-Pacific Economic Cooperation (APEC) region.

21 Department of Innovation, Industry and Regional Development (Vic), letter to the Forum, December 2008.

22 Department of State and Regional Development (NSW), letter to the Forum, December 2008. The NSW Government aims to establish an Institute of Advanced Finance in Sydney in early 2010. The Institute will facilitate education, training and research in finance. It will also facilitate greater collaboration between university/training sectors and the financial services industry.

services industry, and its focus on short term outcomes, meant a reluctance to support a number of long-term research projects.

While the Forum understands the natural competition between universities for research projects, it is concerned that this may be preventing greater collaboration on more complex and longer term research projects, especially those that would qualify for ARC funding. Closer collaboration could help to improve the number and quality of research proposals submitted and funded.

Existing cross-university academic groups (such as Universities Australia²³ and the Australian Business Deans Council) already play a role in promoting collaborative research in some areas. The universities also, as noted earlier, have a number of effective coordination arrangements with the financial services industry, including on course content and individual research projects. While there may well be scope for better coordination of research proposals relating to financial services, the Forum cannot see a case for additional government intervention in this area.

Skilled migration

Skilled migration has historically played an important role in complementing the Australian workforce. Such migration, by filling skill gaps, not only allows business to expand but also facilitates the transfer of skills to local employees. An overview of the Skilled Migration Program is in Box 5.3.

Box 5.3: The skilled migration program

Within the permanent migration program, skilled migration is a very significant component, contributing 114,777, or 67 per cent, of the overall migration program in 2008-09. One third of the skilled migration program was sponsored by Australian employers. In addition, as at June 2009, there were 110,570 people under the temporary migration program ('457' visas).²⁴

While education and training of the local workforce will always be the primary means of addressing Australia's skills needs, this temporary program is designed to ensure that companies can access international skilled labour to top up their skills base, maintain efficient domestic operations and compete internationally. This will often be associated with the introduction of new skills to the Australian workforce.

The 457 visas apply for a period of up to four years. Where there is an ongoing need for these skilled workers, employers can sponsor them under the permanent skilled migration program. In 2008-09, there were 37,250 sub-class 457 visa holders sponsored for permanent migration by Australian employers.

In assessing the suitability of 457 applications, DIAC, which administers Australia's migration program, will have regard to the applicant's skill levels and will seek to ensure that the working conditions are no less favourable than those applying to an equivalent Australian worker at that workplace. Streamlined processing is provided to the low risk and highly skilled groups.

As at 30 June 2009, there were 3680 primary 457 visa holders classified to the financial services industry. This represents around 1 per cent of the financial services workforce. The majority were business and information professionals, specialist managers, accountants and computing professionals.

23 Universities Australia is the peak industry body representing Australia's 39 universities.

24 Data in Box 5.3 provided to the Forum by DIAC, September 2009.

Submissions to the Forum focused on the need for an expanded, more flexible and less administratively complex 457 visa program. In addition, for exceptional cases, it was argued that there should be greater flexibility in allowing conversion from the 457 visa to a permanent visa category. Related to that, there was also concern that the imposition, after four years, of tax on the global income of visa holders would present a barrier to transferring key people to Australia.

In administering the 457 scheme, DIAC is balancing the need for flexibility with the need to maintain integrity of the program. That can lead to some concerns by industry about certain rules and tests for eligibility. Some administrative changes have recently been introduced and others are in train, including in response to industry concerns.²⁵

Overall, the Forum considers that the existing arrangements for the finance sector are working reasonably well, in part reflecting the fact that the vast majority of applications are in the higher skilled categories of workers where more flexible arrangements are in place. DIAC has been responsive to industry concerns and the Forum expects that administrative arrangements will continue to evolve.

From industry submissions and discussions, there were a number of specific proposals and comments dealing with skilled migration. The Forum raised these issues with DIAC, which in the Forum's view has responded constructively.

Box 5.4: Summary of observations

Concerns about the quality of education provided in Australia for foreign students. While these issues are outside the scope of this Report, it is essential that they be addressed and that Australia's reputation for quality higher education be preserved and strengthened.

Skills shortages and coordination between industry and government. There should be greater coordination between industry and government on skill surveys and on strategies to deal with identified skills shortages. Industry development of such strategies could also benefit from collaboration with government authorities, such as Skills Australia, that are working on economy-wide initiatives in this area. Coordination could be facilitated by the Forum's proposed Financial Centre Task Force (see Chapter 6).

Industry links with the university sector. Coordination mechanisms between industry and Government on skills shortages and strategies to tackle those shortages could also benefit from input by the university sector.

Financial services research. While there may well be scope for better coordination of research proposals relating to financial services, the Forum cannot see a case for additional government intervention in this area.

²⁵ For example, in 2010 an accredited employer sponsorship scheme will provide fast tracking for high volume, low risk sponsors who have a good record of complying with the immigration requirements. Other measures include electronic lodgment and electronic processing of applications.

6. THE WAY FORWARD

This Report has stressed the enormous opportunities available to Australia as a result of the likely ongoing growth, development and opening up of financial markets in the region.¹ The key recommendations need to be seen as a package, designed to remove obstacles to Australian based companies engaging in more cross-border business and also to offshore companies and investors conducting more business in and through Australia:

- the Investment Manager Regime (IMR), funds management vehicles and Asian Passport package of proposals is designed to make it easier for Australian fund managers to attract overseas investors into funds run and administered out of Australia;
- the IMR recommendation is also designed to remove obstacles to both local and international companies using Australia as a regional base from which to manage offshore assets;
- the recommendations on withholding tax on foreign raised funding by Australian banks and on Islamic finance are designed to improve Australia's access to offshore pools of savings at competitive rates, so as to provide more diversified and cheaper funding for Australia's investment needs;
- the Offshore Banking Unit recommendations are designed to increase the volume of offshore financial transactions that are channelled through Australia; and
- the regulatory review recommendations are designed to maintain and strengthen Australia's first class regulatory framework, which will both increase the confidence of offshore investors to invest in or transact through Australia's financial centre and also protect the interests of domestic consumers of financial products.

In addition to these recommendations focused on greater internationalisation of our financial sector, the Report also contains a number of recommendations designed to reduce the cost and/or increase the range of financial products available to consumers and business in Australia. These include proposals on an online gateway; interest withholding tax on offshore borrowing by foreign banks and other financial intermediaries; state taxation and regulation of the insurance sector; increased competition on exchange traded markets; corporate debt issuance; and the Asian Passport.

All of the above recommendations can provide substantial benefits to Australian consumers of financial products and the Australian workforce. However, implementation of these measures, in the absence of a number of supporting initiatives, may at best have limited impact, for a number of reasons.

Recent and prospective policy measures focused on developing Australia as a financial centre are taking place against a continually evolving background. In Australia as overseas, the rapid pace of innovation and globalisation in financial markets requires ongoing adaptation and updating with respect to both taxation and regulatory arrangements. A key part of this is providing clarity with respect to the tax treatment of financial transactions between onshore and offshore counterparties.

1 While, inevitably given its terms of reference, this Report has focused on financial market access impediments in many countries in the region, it is important not to lose sight of the major progress in terms of market access that has occurred in most regional economies over the last decade, both with respect to marketing of financial services and also direct investment opportunities.

In addition, established overseas financial centres are continually introducing policy changes designed to attract more offshore business and are actively promoting themselves, and new competitors are emerging.

If the Government's objectives for Australia's financial sector are to be met over time and the full benefits to consumers, business and the workforce reaped, then the recommendations in this Report need to be seen as part of an ongoing policy adjustment and refinement process. Further policy changes will, inevitably, be required.

Finally, many financial sector participants overseas would not appear to be fully aware of the range of very supportive policy changes focused on developing Australia as a leading financial centre that have been made by successive governments in recent years. In addition, feedback from a number of financial institutions engaged in recent marketing in the region indicates a degree of scepticism overseas about the benefits of some recent policy changes.²

Australia needs to more actively and effectively promote the strengths of its financial sector and the advantages to overseas investors of recent and prospective policy changes. It also needs to ensure that the details of policy changes, and the way in which they are implemented, are consistent with the original intention.

The remainder of this Chapter focuses on important supporting measures designed to facilitate effective policy implementation; monitor overseas policy changes in competing financial markets; provide advice on any further sensible policy changes that may be necessary; and raise awareness of Australia's financial sector, including recent and prospective policy changes.

6.1 PROMOTING AUSTRALIA AS A FINANCIAL CENTRE

The focus: mutual benefits

Recent and prospective policy changes designed to help develop Australia as a financial centre need to be complemented by actions to raise Australia's profile in the region, increase familiarity with and confidence in our regulatory framework, and showcase our capabilities.

Austrade is doing a good deal of valuable promotional work in the region with respect to financial services.³ The Forum believes it needs to be fully supported by a significant effort at the official level – through regional initiatives, financial service missions and capacity building – and at the industry level.

Such promotional activity should also emphasise the mutual advantages to countries in the region from closer engagement in each other's financial markets. It is widely understood, both in developed and developing economies, that well developed financial markets play a key role in facilitating economic growth, both with respect to private sector growth and also financing public sector

2 By way of example, potential overseas investors expressed concerns about the abolition of the foreign investment fund (FIF) rules, and what general anti tax avoidance provision will replace them; and about the recent decision to reduce withholding tax rates on certain distributions paid by Australian managed investment trusts to foreign investors from 30 per cent to 7.5 per cent over time. Concerns on this last measure centred on the fact that it applied only to countries that have an effective Exchange of Information with Australia, and also to the lack of clarity as to how narrowly a 'managed investment trust' would be defined.

3 For example, Austrade has worked closely with IFSA in promoting Australia as a funds management hub for the region through support for trade missions to China, Taiwan, Japan and South Korea in the past two years. Austrade also recently worked with the Australia Japan Business Council on a two-way infrastructure mission which showcased Australia's strengths in infrastructure financing.

infrastructure and other areas of government policy. The need to broaden and deepen financial markets is recognised as a key policy objective in each of the significant regional groupings – the Association of Southeast Asian Nations (ASEAN), ASEAN+3, the East Asia Summit and APEC.

Many countries in the region are looking to develop their private capital markets; improve their corporate governance practices and regulatory systems; develop pension and insurance systems; and diversify the range of assets in which their pension schemes are invested away from just government bonds and bank deposits. Box 6.1 provides more background on these financial market development needs in the region.

In all these areas, Australia can contribute to the development of financial markets in the region and benefit over time from such engagement. Australia already supports capacity building in the region's financial systems (see Box 6.1). More could be done to highlight that fact: the work going on in this area would not appear to be well publicised or well documented. That is not to Australia's advantage, either in terms of its broader interests in the region or, more narrowly, in terms of improving market access opportunities over time for Australian financial services companies in the region.

Box 6.1: Financial market development needs in the region⁴

Emerging economies in the Asia-Pacific region have devoted considerable time and resources to developing their capital markets – corporate bonds, equity, foreign exchange, derivative markets – particularly since the 1997 financial crisis, and have made substantial progress. However, many challenges remain. Emerging market economies in the Asia-Pacific region are still very dependent on bank financing and generally have underdeveloped private capital markets. Private capital markets are equivalent to less than two-thirds of GDP in emerging APEC economies as against more than two and half times GDP in mature APEC economies.

In emerging APEC economies, bank finance comprises around two-thirds of total private funding, compared with around one-third in mature APEC economies. Corporate bond and derivatives markets remain underdeveloped. While emerging equity markets have been growing rapidly, there is a wide variance among emerging market economies in terms of capitalisation, liquidity and foreign access.

Most Asian economies have very high savings ratios. Many lack a wide range of opportunities for investment of these savings. As private wealth increases and with it aspirations for social security in the form of pensions, insurance and healthcare, many countries in the region will need to develop both a broader and more diverse investor base – not just banks but also pension funds, mutual funds and insurance companies – and a wider range of financial instruments in which to invest. Australia has a full array of 'life cycle' institutions: banks, superannuation funds, general and life insurance, and a sophisticated securities industry.

4 This box draws on publicly available background material prepared by Treasury for the APEC Finance Ministers Meeting, Coolom, 2-3 August 2007, as well as other APEC background material.

Box 6.1: Financial market development needs in the region (continued)

Financial infrastructure necessary to support capital markets includes: sound corporate governance practices; transparent and effective legal and regulatory systems to ensure investor confidence; reliable accounting and auditing standards; information disclosure requirements; effective market supervisory agencies; and efficient settlement and payment systems. Australia has a comparative advantage in most of these areas. For example, Australia has been ranked fourth in the world and highest in the region for its corporate governance⁵; and as discussed earlier in this Report, its financial markets regulatory structure is arguably second to none.

Most pension systems in the Asian region are controlled by the state and offer only limited portfolio discretion for pension plan participants, limited management by private asset managers, and limited choice of asset classes. They are heavily invested in government bonds and bank deposits.⁶ These restrictions are likely to ease over time. Australia's strength with respect to asset management has been stressed throughout this Report.

The Australian Agency for International Development (AusAID) funds programs to support capacity building in the region's financial systems, including regional programs under the Public Sector Linkages Program, bilateral programs and through contributions to regional and international development agencies, such as the World Bank and the Asian Development Bank. This aid is broadly aimed at strengthening the institutional capacities of policy and regulatory agencies and as such is generally well focused in identifying and meeting regional needs.

Given the recent financial crisis, authorities in the region are likely to be cautious about taking advice from those countries perceived as having been at the centre of the financial crisis. This provides an opportunity for Australia in terms of publicly stating its commitment to greater official and unofficial engagement and assistance in the region with respect to financial market development and integration.

More broadly, Australia has been building support for the concept of an Asia-Pacific Community, focused on regional economic and security issues.⁷ Greater integration of financial markets is an important aspect of the concept of an Asia-Pacific Community, and can contribute to Australia's broader national economic and security objectives in the region. A number of the recommendations in this Report will make it easier for financial services companies in the region to do business in Australia. This is particularly true of the Asian Passport proposal. As was emphasised in Chapter 4, this is a very ambitious and long-term proposal, and will require a good deal of work within the region by both the Government and the regulators in order to build support. It could be promoted within the broader context of Australia's effort to build support for greater regional integration.

The Forum has set out below a proposed agenda for the official sector which would require Ministerial and official involvement.

5 Governance Metrics International, *Global Corporate Governance Ratings*, September 2008.

6 I Walter and S Esli, 'The Asset Management Industry in Asia: Dynamics of Growth, Structure and Performance', Working Papers, Leonard N Stern School of Business, New York University, New York, 2006, p 41.

7 The Hon Kevin Rudd MP, 'Address to the Asia Society, Australasia Centre, Sydney: It's Time to Build an Asia Pacific Community', Sydney, 4 June 2009.

Recommendations

Declaration of intent

The Forum sees considerable merit in the Government declaring its objective of greater engagement of Australia's financial sector within the region. The declaration could include reference to the following:

- the mutual benefits from greater integration of regional financial sectors;
- the value Australia places on foreign participation in its financial system, and recent and prospective policy measures designed to facilitate this;
- the quality of Australia's regulatory and legal systems in terms of ensuring fair and equitable treatment for foreign and domestic firms;
- the importance the Government attaches to providing greater clarity as to the tax treatment of offshore participants in our financial system – including investors, brokers and multinational companies – and recent policy initiatives focused on this issue; and
- the importance Australia places on strengthening regional integration and cooperation on economic and security matters, and on greater regional integration of financial markets as part of this objective. Within this context, a grouping of regional G20 members to consider and develop the application of global regulatory initiatives could help to deepen regional financial sector engagement.

Tangible steps to demonstrate commitment to the declaration could include expressing a willingness to become a participant in the Chiang Mai Initiative.⁸ If accomplished, such a step would be a major commitment to ensuring the financial stability of the region. Similarly, additional resources could be committed to financial system capacity building under the East Asia Summit structure, where this is already an established priority.

Existing institutional initiatives could also merit increased support. ASIC's very successful 'summer school' for market regulators attracts strong regional interest. Without distracting from the prime responsibilities of the regulators, official support for regulator training and capacity building through the 'summer school' and similar initiatives by APRA, the RBA, AusAID's existing program and other institutions such as the Melbourne APEC Finance Centre are potentially very valuable.

Recommendation 6.1: Declaration of intent

The Forum recommends that the Australian Government make a declaration of its intent to maintain and improve the openness, competitiveness and regional engagement of Australia's financial sector, including within the broader context of greater regional integration and cooperation.

8 The Chiang Mai Initiative consists of 17 bilateral swap agreements and is a mechanism that ASEAN+3 countries can draw on to address short-term external liquidity problems and to supplement existing international financial arrangements. A multilateral agreement is being negotiated to replace this web of bilateral agreements.

Financial services missions

The Forum proposes greater Ministerial and agency involvement in financial services missions to selected economies in the region, with the objective of encouraging two-way investment in financial services. Similar attention should be given to sovereign wealth funds, some of which may lack familiarity with the Australian financial sector. In the Forum's view, official financial services missions are increasingly necessary, given the international competition aimed at attracting offshore financial business; the substantial changes that have been made in Australia in recent years designed to facilitate greater offshore engagement; the prospective changes that may come from consideration of this Report; and the Government's objectives for greater international engagement. Evidence from the Forum's discussions with industry confirms the effectiveness of such missions.

Missions should include appropriate policy and regulatory agencies and industry representation.

Recommendation 6.2: Financial services missions

The Forum recommends greater Ministerial and agency involvement in tailored financial services missions to selected economies in the region, focused on:

- promoting the recent and prospective policy changes in Australia designed to increase financial sector engagement in the region;
- encouraging two-way investment in financial services with a view to expanding economic linkages and opportunities;
- promoting the capacity building initiatives that Australia is engaged in within the region;
- deepening understanding of Australia's regulatory and prudential policies and strengths; and
- at an appropriate time, promoting mutual recognition and the concept of a regional funds management 'passport'.

6.2 AN ONGOING PARTNERSHIP BETWEEN GOVERNMENT AND THE INDUSTRY

The objective

Chapter 1 noted that a number of initiatives over past decades focused on objectives similar to this Report have met with limited success. Some of the reasons for this included:

- policies with good intent have not always been implemented or administered as effectively as they might have been;
- policies have often not been regularly updated to ensure that they remain as relevant and effective as intended in a world of rapid financial innovation and change; and
- policy changes in Australia are taking place against a background of rapid policy change in other countries and financial centres in the region.

The Forum sees a central role for an ongoing body focused on helping to ensure that policy measures directed at achieving the Government's objective of establishing Australia as a leading financial centre are effectively implemented; on monitoring policy developments in overseas financial centres; and on

providing advice about future policy measures that may be necessary in the light of evolving domestic and international developments, including reviews or updates of existing policies.

In setting up the Australian Financial Centre Forum in September 2008, the then Assistant Treasurer and Minister for Competition Policy and Consumer Affairs, the Hon Chris Bowen MP, emphasised that the initiative was to be a joint one between the Government and industry, recognising that ‘successful expansion into global markets requires a partnership between Government and the financial services sector.’⁹ That observation, which has been reflected both in the structure of the Forum and its *modus operandi*, has also heavily influenced the details of the Forum’s recommendation below.

Recommendation

The Forum recommends the establishment of a Financial Centre Task Force charged with maintaining a close dialogue between the financial sector on the one hand, and Treasury and the Government on the other, on all policy issues of relevance to the Government’s objective of developing Australia as a leading financial services centre. The body should consist of a Committee of senior financial market participants to act as a filter for views, feedback and suggestions coming from the financial sector; and a dedicated secretariat.

In order to ensure effectiveness and accountability, Committee positions should be reviewed annually and, if appropriate, rotated; and the Task Force should be subject to a three year sunset clause.

The Forum is aware that the Government already has a financial sector advisory body in the form of the Financial Sector Advisory Council (FSAC). A key difference between FSAC and the proposed Task Force is that the Task Force would be focused on consulting widely within the financial sector, so as to act as a conduit between the sector, the Government and its advisers. The work of the Task Force would complement that of both FSAC and the financial services industry bodies, with which it would work closely and seek to develop common industry positions and recommendations on industry-wide issues.

Reflecting this different role and *modus operandi*, a necessary institutional distinction between the proposed Task Force and FSAC is that the Task Force would have a dedicated secretariat with close links to the financial sector.

Recommendation 6.3: Financial Centre Task Force

The Forum recommends the establishment of a Financial Centre Task Force along the following lines:

Chair: Three year appointment.

Committee: Five to seven members including a financial services taxation expert and CEOs or their delegates from commercial banking; investment banking; funds management; and insurance.

Consultative Group: A wide range of industry group representatives; financial market practitioners; official sector contacts; academics; and retired experts.

9 The Hon Chris Bowen MP (Assistant Treasurer and Minister for Competition Policy and Consumer Affairs), *Appointment of the Chair and Panel of Experts to Lead the Government’s Initiative to Position Australia as a Leading Financial Services Centre in the Asia-Pacific Region*, media release, 26 September 2008.

Recommendation 6.3: Financial Centre Task Force (continued)

Dedicated Secretariat: Director; Project Officer.

Terms of Reference:

- To act as a conduit for dialogue and feedback between the financial services sector on the one hand, and Treasury and the Government on the other, on all policy issues of relevance to the Government's objective of developing Australia as a leading financial services centre.
- To monitor progress on implementation of those recommendations in this Report that are accepted by the Government, by providing industry input on design prior to legislation being finalised and, following legislative enactment, feedback on any concerns regarding their implementation and administration.
- To report every six months to the Government on progress towards developing Australia as a leading financial centre. These reports will cover, inter alia:
 - progress in implementing all those recommendations in the Forum's Report that are accepted by the Government;
 - issues relating to the regional promotion of Australia as a financial centre, including private sector involvement in the proposed financial services missions and in capacity building initiatives in the region;
 - changes in taxation legislation, tax administration or regulatory arrangements in overseas financial centres that it considers may be worth closer examination for possible adoption in Australia; and
 - more generally, recommendations in any areas where it sees a case for a review of existing tax legislation, tax administration, regulatory arrangements or other policy related issues pertaining to the financial sector.

Modus Operandi: The Committee will be responsible for all material, both six monthly reports and ad hoc material, that is sent to the Minister.

The Committee may appoint working groups from its consultative group to prepare material for the Committee's consideration.

The Minister for Financial Services, Superannuation and Corporate Law may refer matters to the Task Force for its consideration.

The Secretariat will report to the Executive Director, Markets Group, Treasury.

Sunset Clause: The role and usefulness of the Financial Centre Task Force will be reviewed by the Government after three years to determine whether it should be continued, restructured or abolished.

7. SUMMARY OF RECOMMENDATIONS

TAXATION

Issue: Tax scope and uncertainty issues are limiting the growth of offshore funds under management in Australia and the attractiveness of Australia as a regional headquarters.

Recommendation 3.1: Investment Manager Regime

The Forum recommends the introduction of an Investment Manager Regime (IMR), based on the following principles:

- The IMR would have wide application, to both retail and wholesale funds and to other areas of financial services beyond funds management, but would be confined to entities operating within the financial sector.
- For non-resident investors using an *independent* resident investment adviser, fund manager, broker, exchange or agent:
 - investments in all foreign assets would be exempt from any tax liabilities in Australia;
 - investments in Australian assets would for tax purposes be treated the same as if the investments were made directly by the non-resident without the use of any Australian intermediary.
- For non-resident investors using a *dependent intermediary acting at arms length*:
 - investments in all foreign assets would be exempt from any tax liabilities in Australia;
 - investments in Australian assets would be treated as they are currently, subject to an agreed de minimis exemption to cater for global investment strategies that may include a nominal portion of Australian assets. Any Australian assets under this de minimis exemption would for tax purposes be treated the same as if the investments were made directly by the non-resident without the use of any Australian intermediary.
- The location of central management and control in Australia of entities that are part of the regime will not of itself give rise to Australian tax residency of those entities.

Issue: The Offshore Banking Unit regime is underutilised, due amongst other things to lack of recognition, various uncertainties in its administration and problems with the application process.

Recommendation 3.2: Offshore Banking Units

To give full effect to the Government's policy intentions for OBUs, the Forum recommends that:

- The Government, in its response to the Forum's Report, include a statement of support for, and commitment to, the OBU regime. Such a statement could also refer to arrangements to ensure the ongoing competitiveness of OBUs.
- The tax uncertainty about 'choice' be removed, if necessary by legislation.
- Division 9A of the *Income Tax Assessment Act 1936*, which details the list of eligible OBU activities, be updated and regularly reviewed. The Forum's preferred option is for much of the detail in this Division to be replaced with Regulations. Regulations would contain an updated list of eligible OBU activities, developed with advice from the Treasury and the ATO, and following consultation with industry. These Regulations would be updated periodically on advice from the proposed Financial Centre Task Force, which would also make periodic recommendations on any other changes to the OBU regime necessary to ensure that it remained internationally competitive.
- A streamlined process for vetting new OBU applications be put in place:
 - with a requirement that an application be approved or denied within six months of its receipt, subject to all the appropriate application material being lodged;
 - with revised administrative changes for the 'other company' category. The Forum proposes that the guidelines 4(q), 4 (r) and 4(s) in the *Income Tax Assessment (Determination of Offshore Banking Activities) Guidelines 1999* be satisfied by an external auditor (or equivalent) verification; and
 - that these new arrangements be reviewed by Treasury 18 months after their adoption to ensure they are working effectively.

Issue: Lack of an appropriate funds management vehicle is inhibiting the management of offshore funds out of Australia.

Recommendation 3.3: Funds management vehicles

The Forum recommends that the Treasurer request the Board of Taxation to review the scope for providing a broader range of tax flow-through collective investment vehicles.

The Forum recommends that, as part of this review, restrictions on the Venture Capital Limited Partnership vehicle be examined to see if they are all necessary and consistent with the Government's objective of developing Australia as a leading financial centre.

Issue: The imposition of withholding tax on offshore borrowings by banks and other financial institutions, as well as the LIBOR cap on deductibility of interest paid on branch-parent funding, are impediments to Australia's access to offshore savings pools at competitive rates.

Recommendation 3.4: Withholding tax on interest paid on foreign-raised funding by Australian banks; on interest paid to foreign banks by Australian branches; and on financial institutions' related party borrowing

- Remove withholding tax on interest paid on foreign-raised funding by Australian banks, including offshore deposits and deposits in Australia by non-residents.
- Remove withholding tax on interest paid to foreign banks by their Australian branches.
- Remove withholding tax on financial institutions' related party borrowing.

Recommendation 3.5: LIBOR cap on deductibility of interest paid on branch-parent funding

Remove the LIBOR cap on deductibility of interest paid on branch-parent funding.

Issue: Lack of Islamic finance products in Australia is limiting our access to offshore savings pools.

Recommendation 3.6: Islamic finance products

The Forum recommends that the Treasurer refer to the Board of Taxation the question of whether any amendments to existing Commonwealth taxation provisions are necessary in order to ensure that Islamic finance products have parity of treatment with conventional products, having regard to their economic substance.

Issue: Insurance providers are subject to high and inconsistent State taxes.

Recommendation 3.7: Remove state taxes and levies on insurance

The Forum recommends that all state taxes and levies on the insurance sector be removed.

Issue: Uncertainties relating to Australia's tax system and its administration are leading to increased costs and loss of potential new business in the financial services industry.

Recommendation 3.8: Monitoring and advising on financial services tax issues

The Forum recommends that, as part of its six monthly reports to the Government on progress towards positioning Australia as a leading financial centre, the Financial Centre Task Force:

- monitors progress on implementation of those tax recommendations in this Report that are accepted by the Government, and reports on any significant concerns from the financial sector as to the details of their implementation;

Recommendation 3.8: Monitoring and advising on financial services tax issues (continued)

- monitors any relevant changes in taxation legislation or in tax administration in overseas financial centres, with a view to identifying any measures which it considers worthy of closer examination for possible adoption in Australia; and
- makes recommendations in other areas where it sees a case for a review of existing tax legislation that may significantly conflict with the Government's objective of developing Australia as a financial centre.

REGULATION AND REGULATORY SUPERVISION

Issue: There may be a risk of overregulation due to international pressures flowing from the current global financial crisis.

Recommendation 4.1: Avoiding unnecessary regulation

The Forum recommends that any significant regulatory proposals applying to the financial services sector be fully tested and evaluated, in particular and wherever possible by way of detailed industry consultation, to ensure that they are necessary, effective and impose as small a compliance burden on industry as possible.

Issue: Australia needs to ensure that its regulatory system remains 'best practice'.

Recommendation 4.2: Periodic reviews of the regulatory rules and framework

The Forum recommends that there be periodic reviews of the regulatory rules and framework applying to the financial sector, focused on:

- ensuring that excessive and unnecessary regulatory rules and requirements do not build up over time; and that
- Australia's regulatory rules and framework remain best practice in the face of changing circumstances, products and market practices.

While the timing and terms of reference for such reviews would be a matter for the government of the day, the Forum suggests that the first review not be conducted until it is clear that conditions in financial markets have returned to normal and international regulatory reactions to the crisis are more settled.

Issue: The ability of Australian funds managers to market collective investment schemes overseas is made more difficult by the variety and at times complexity of overseas regulatory requirements.

Recommendation 4.3: The Asia Region Funds Passport

The Forum recommends that the Asia Region Funds Passport be developed as set out in Appendix 8. Broadly, this would involve a two-stage process:

- Stage one: ASIC negotiates bilateral mutual recognition agreements with key jurisdictions in the region. In doing this, the Forum recommends that ASIC attempt to ensure that investment restrictions allow a relatively broad range of funds to be offered across borders, and that licensing requirements are as streamlined as possible.
- Stage two: once bilateral agreements are in place, regional governments and agencies work together in the appropriate forums to develop these into a multilateral Passport regime. This would involve:
 - developing a commonly agreed set of licensing arrangements, investment restrictions and, where possible, offer conditions that would allow complying funds registered in one Passport country to be offered in each of the other passport countries; and
 - putting in place mechanisms for the continued administration of the Passport regime at national and regional levels.

Issue: Navigating the Australian regulatory system can be difficult for potential foreign entrants into the Australian market.

Recommendation 4.4: Regulatory online gateway

The Forum recommends that:

- Austrade develop, in close consultation with APRA, ASIC, the RBA, FIRB, the ACCC, AUSTRAC and the relevant state agencies, an online gateway for potential overseas investors in Australia;
- Austrade administer and continually update the website, and provide the initial point of contact for offshore inquiries; and
- APRA, ASIC, the RBA, FIRB, the ACCC, AUSTRAC and the relevant state agencies be encouraged to put in place formal arrangements for a central contact person charged with facilitating offshore enquiries relating to their organisation.

Issue: Lack of competition on exchange traded markets may potentially lead to higher trading costs and inhibit market development and innovation.

Recommendation 4.5: Increased competition on exchange traded markets

The Forum encourages the early consideration of licences for new trading platforms and exchanges, with a view to introducing competition as soon as possible once the recently announced financial market regulatory changes are in place.

Issue: A more diversified and liquid bond market would benefit Australia's domestic economy and could over time assist Australia in playing a larger role in the region.

Recommendation 4.6: Reduce regulatory requirements on corporate debt issuance to retail investors

The Forum recommends that the regulatory requirements for listed companies that issue high quality corporate debt to retail investors be reduced.

- An exemption to existing requirements would apply for those issuers:
 - with listed Australian dollar debt securities that also have listed shares and hence are already required to provide continuous disclosure and comply with the market operator's listing rules; and
 - with investment grade securities that have a reasonably simple structure (that is, fixed or floating rate securities paying a margin relative to the bank bill swap rate; and with no credit exposure to entities other than the issuer or, if applicable, the guarantor).
- Such issuers would no longer be required to issue a detailed prospectus. Rather, a shorter prospectus could be issued, cross-referencing all relevant documents already lodged with ASIC or the market operator.
- Those companies with a program of issues over time could use a base prospectus with a supplementary prospectus for each new issue.
- Subject to satisfying the relevant criteria, these simplified procedures would also be available for Commonwealth and State government (or government guaranteed) bodies; OECD government (or government guaranteed) bodies; supranational entities; and offshore corporates listed on a recognised offshore stock exchange.

Issue: Insurance providers are subject to inconsistent State regulation.

Recommendation 4.7: Standardise non-prudential regulation of the insurance sector

The Forum recommends that state regulations relating to the insurance sector be standardised, wherever possible.

Issue: Lack of Islamic finance products in Australia is limiting our access to offshore savings pools.

Recommendation 4.8: Removal of regulatory barriers to Islamic finance

The Forum recommends the removal of any regulatory barriers to the development of Islamic financial products in Australia, guided by the principle that there should be a 'level playing field' for such products.

PROMOTING AUSTRALIA AS A FINANCIAL CENTRE

Issue: There is a lack of awareness and understanding in many overseas countries of the strengths of Australia's financial sector and of recent and prospective policy changes of benefit to offshore investors.

Recommendations: Government and official sector regional initiatives

Recommendation 6.1: Declaration of intent

The Forum recommends that the Australian Government make a declaration of its intent to maintain and improve the openness, competitiveness and regional engagement of Australia's financial sector, including within the broader context of greater regional integration and cooperation.

Recommendation 6.2: Financial services missions

The Forum recommends greater Ministerial and agency involvement in tailored financial services missions to selected economies in the region, focused on:

- promoting the recent and prospective policy changes in Australia designed to increase financial sector engagement in the region;
- encouraging two-way investment in financial services with a view to expanding economic linkages and opportunities;
- promoting the capacity building initiatives that Australia is engaged in within the region;
- deepening understanding of Australia's regulatory and prudential policies and strengths; and
- at an appropriate time, promoting mutual recognition and the concept of a regional funds management 'passport'.

AN ONGOING PARTNERSHIP BETWEEN GOVERNMENT AND THE INDUSTRY

Issue: Policy initiatives focused on establishing Australia as a financial centre have not always been effectively implemented, and are taking place against the background of ongoing policy changes in other countries looking to develop financial centres.

Recommendation 6.3: Financial Centre Task Force

The Forum recommends the establishment of a Financial Centre Task Force along the following lines:

Chair: Three year appointment.

Committee: Five to seven members including a financial services taxation expert and CEOs or their delegates from commercial banking; investment banking; funds management; and insurance.

Consultative Group: A wide range of industry group representatives; financial market practitioners; official sector contacts; academics; and retired experts.

Recommendation 6.3: Financial Centre Task Force (continued)

Dedicated Secretariat: Director; Project Officer.

Terms of Reference:

- To act as a conduit for dialogue and feedback between the financial services sector on the one hand, and Treasury and the Government on the other, on all policy issues of relevance to the Government's objective of developing Australia as a leading financial services centre.
- To monitor progress on implementation of those recommendations in this Report that are accepted by the Government, by providing industry input on design prior to legislation being finalised and, following legislative enactment, feedback on any concerns regarding their implementation and administration.
- To report every six months to the Government on progress towards developing Australia as a leading financial centre. These reports will cover, inter alia:
 - progress in implementing all those recommendations in the Forum's Report that are accepted by the Government;
 - issues relating to the regional promotion of Australia as a financial centre, including private sector involvement in the proposed financial services missions and in capacity building initiatives in the region;
 - changes in taxation legislation, tax administration or regulatory arrangements in overseas financial centres that it considers may be worth closer examination for possible adoption in Australia; and
 - more generally, recommendations in any areas where it sees a case for a review of existing tax legislation, tax administration, regulatory arrangements or other policy related issues pertaining to the financial sector.

Modus Operandi: The Committee will be responsible for all material, both six monthly reports and ad hoc material, that is sent to the Minister.

The Committee may appoint working groups from its consultative group to prepare material for the Committee's consideration.

The Minister for Financial Services, Superannuation and Corporate Law may refer matters to the Task Force for its consideration.

The Secretariat will report to the Executive Director, Markets Group, Treasury.

Sunset Clause: The role and usefulness of the Financial Centre Task Force will be reviewed by the Government after three years to determine whether it should be continued, restructured or abolished.

APPENDIX 1: PANEL OF EXPERTS, REFERENCE GROUP, MUTUAL RECOGNITION WORKING GROUP AND TREASURY SECRETARIAT

PANEL OF EXPERTS

Mr Paul Binsted, Chairman, Sydney Ports Corporation; Deputy Chairman, Donaldson Coal Holdings

Mr Alf Capito, Partner, International Tax; Tax Policy Group Leader, Oceania and Far East, Ernst & Young

Mrs Patricia Cross, Director, National Australia Bank; Wesfarmers; Qantas Airways

Mr Jeremy Duffield, Chairman, Vanguard Investments Australia; Managing Director, Vanguard International Planning and Development

Mr Craig Dunn, Managing Director and Chief Executive Officer, AMP

Mr John Story, Chairman, Suncorp Metway Limited

REFERENCE GROUP PARTICIPANTS

Abacus – Australian Mutuals

Asia Pacific Loan Market Association

The Association of Superannuation Funds of Australia

Austrade

Australian Bankers' Association

Australian Custodial Services Association

Australian Finance Conference

Australian Financial Markets Association

Australian Reinsurance Pool Corporation

Australian Services Roundtable

CPA Australia

Department of Foreign Affairs and Trade

Department of Innovation, Industry and Regional Development (Victoria)

Department of State and Regional Development (NSW)

Finance Sector Union

Financial Planning Association

Financial Services Institute of Australia

Friendly Societies of Australia

The Institute of Chartered Accountants in Australia

Insurance Council of Australia

Investment and Financial Services Association

National Institute of Accountants

National Insurance Brokers Association

Securities and Derivatives Industry Association

MUTUAL RECOGNITION WORKING GROUP

Philip Barlin, Colonial First State Investments

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Coralee Rough, AMP Capital Investors

Andrew Sliper, Macquarie Bank

Ken Woo, PricewaterhouseCoopers

John Yeo, Investment and Financial Services Association

TREASURY SECRETARIAT

Jim Murphy

David Martine

Vicki Wilkinson

Jerome Davidson

Susan Richardson

The Forum also consulted extensively with Treasury, in particular the Markets Group and the Revenue Group.

APPENDIX 2: ORGANISATIONS CONSULTED

Excluding members of the Reference Group.

Access Capital Advisers

Access Economics

Allens Arthur Robinson

Alliance Bernstein

Alternative Investment Management Association

AMP

ANZ Banking Group

Australian APEC Study Centre, RMIT University

Australian Competition and Consumer Commission

Australian National University

Australian Private Equity & Venture Capital Association

Australian Prudential Regulation Authority

Australian Securities Exchange

Australian Securities and Investments Commission

Australian Securitisation Forum

Australian Super

Australian Taxation Office

Aviva Investors

AXA Asia Pacific

Barclays Global Investors

Basis Point Consulting

Board of Taxation

Boronia Capital

Brambles

BrandMatters

Business Council of Australia

Cameron Partners

Challenger Financial Services Group

Chi-X

Citigroup

Clayton Utz

Coca-Cola Amatil

Commonwealth Bank of Australia

Colonial First State

Credit Suisse

Department of Education, Employment and Workplace Relations

Department of Immigration and Citizenship

Deutsche Bank

EAC Partners

Ernst & Young

Fidelity International

Financial Education Professionals

Financial Energy Exchange Group

Finance Industry Council of Australia

Fixed Income Investment Group

Future Fund

The Global Foundation

Goldman Sachs JBWere

Greenwoods & Freehills

Group of 100

Holmesglen TAFE

IBM Australia

IMC Pacific

Incitec Pivot

Industry Funds Management
ING Australia
Innovation and Business Skills Australia
Insurance Australia Group
Invest Victoria
IPAC
JP Morgan
Kuwait Finance House Australia
Lazard Carnegie Wylie
Law Council of Australia
The Lowy Institute for International Policy
Luxottica Group
Macquarie Bank
Mallesons Stephen Jaques
Managed Funds Association, United States
Massey University – College of Business
McKinsey & Company
Melbourne Centre for Financial Studies
Mercer Investment Consulting
Mitsubishi UFJ – Bank of Tokyo
MLC
Ministry of Economic Development, New Zealand
Mizuho Corporate Bank
Morgan Stanley
Munich Re Group
National Australia Bank
Nomura Australia
Oliver Wyman
OneSteel

Orica

Perennial Investment Partners

Perpetual

Platinum Asset Management

PricewaterhouseCoopers

Principal Global Investors

Property Council of Australia

QBE Insurance Group

QIC

Reserve Bank of Australia

RMIT University

Russell Investments

SAS Trustee Corporation (State Super)

Skills Australia

State Street Australia

Stockley-Smith & Associates

Suncorp Metway

Swiss Re

TAFE NSW

Telstra

TNT Express

Trust Company

UBS Australia

University of New South Wales

University of Queensland

Vanguard Investments

Victorian Funds Management Corporation

Westpac

APPENDIX 3: VISION AND PRINCIPLES

It is in the long-term national interest of Australia to have a stable, secure and efficient financial sector. This requires an environment where financial services companies are confident they can continue to do business today, tomorrow and into the long term. A policy framework that sets out the broad principles which should apply to the sector, and that is used to evaluate policy proposals consistently over time, can greatly contribute to the long-term stability and health of the financial sector and the security and economic wellbeing of the country.

VISION

A financial sector which is open, competitive and underpinned by strong, stable and sound institutions. It exhibits the lowest possible barriers to entry consistent with the maintenance of financial stability and integrity, so as to encourage new entrants and foster price competition and innovation. It is a sector with a reputation for transparency, integrity and efficiency. It is a sector where the critical mass of skills, experience and reputation encourages both domestic and overseas participants to do business. It thus exhibits a high volume of cross-border transactions in a wide variety of financial products, services and currencies.

PRINCIPLES

Existing and proposed policy measures that impact on the financial services sector should not only be consistent with but also, where possible, contribute to realisation of the above vision. At the broadest level, such a policy framework should therefore be focused on ensuring an open, competitive, technologically advanced and highly skilled financial sector, supported by best practice regulatory and tax systems.

More specifically, policies that impact on the sector should be consistent with the following policy principles.

(a) Development and maintenance of a competitive, efficient and consistent taxation and tax administration system

Undoubtedly one of the central factors impacting on the competitiveness of a financial sector, its capacity to attract and retain talented people, and its capacity to attract a high volume of cross-border transactions is the tax system. There are a number of key elements to this:

- *The level of taxes needs to be as low as possible, consistent with, on the one hand, the broader revenue raising and resource allocation requirements of the country and, on the other, the need to compete against other financial centres. In a world of highly mobile capital, the need to keep taxation rates on capital, in particular, but also on labour, as low as possible, consistent with broader national objectives is all the more acute.*
- *The structure of the taxation system should not inhibit the free flow of capital into and out of the financial sector. Nor should it artificially distort decisions as to whether to raise capital via debt versus equity issuance, or in offshore versus domestic markets. This principle is particularly important for a capital importing country such as Australia.*

- *The tax system needs to be administered in a way that provides a high degree of certainty as to tax obligations for both domestic and offshore participants.* Lack of certainty as to how different financial instruments or transactions will be taxed, and/or lack of confidence that the approach taken will be consistently applied over time, can be major constraints to more offshore financial transactions taking place through Australia and to creating related financial services jobs.

(b) Maintenance of a best practice, principles based regulatory framework

A critical element in any policy framework is a *best practice regulatory system which gets the right balance between market efficiency, competition and freedom to innovate, on the one hand, and consumer protection and systemic stability on the other.* In order to achieve this, the regulatory framework needs to be:

- **Comprehensive.** There should be no major gaps in coverage and scope. In addition to covering all relevant parts of financial services, the regulatory system should also be able to identify and manage broader systemic risks. There should also be no ambiguity as to which regulatory agency or set of regulations covers different areas of financial services activities.
- **Balanced.** Regulation should never be an end in itself but rather tightly focused on the desired outcome. Getting the regulatory rules and framework right inevitably involves judgments about the best balance between potentially conflicting objectives.
- **Efficiently administered.** The financial crisis has reinforced the importance of distinguishing between a country's regulatory rules and requirements on the one hand, and the implementation of those rules and requirements on the other. Both are critical.
- **Principles based.** Where possible the regulatory framework should be principles based rather than rules based, focusing on the objectives sought in general terms rather than prescribing in considerable detail exactly what companies must and must not do to meet their obligations. Such an approach is more likely to respond to innovations in a consistent and predictable manner.

(c) Maintaining world class education, training and immigration programs which ensure the continuous availability of a highly skilled and innovative workforce

Government policies in this area need to be:

- **Targeted.** In addition to meeting broader social and economic objectives, Australia's education, training and immigration policies should be targeted to addressing skills shortages (at the occupational level) and skills gaps (at the individual worker level).
- **Coordinated.** Education and training initiatives should be well coordinated between the financial services industry and the relevant educational and skills authorities. This is particularly important for identification of skills shortages; measures to address those shortages (including retention strategies and skilled migration); and development of curricula and training packages. Course content should respond to changes in industry needs.
- **Quality oriented.** The content of our education and training should be world class. This is not just about acquiring technical abilities: it is also about embedding the highest standards of industry professionalism, through compliance with regulations and ethical behaviour. Financial centres require a reputation for *integrity and transparency*. While to a large extent this comes down to the character and attitudes of the individual players in the financial sector, there is also an important role for the regulators, the educational system and financial services industry bodies.

- **Research oriented.** A significant and well recognised capacity for financial sector research supports innovation and development of financial services. Government financial support for research is appropriate, particularly where there is a broader community benefit.

(d) Removal of barriers to the competitiveness, efficiency and liquidity of domestic financial markets

Policies impacting on the financial sector should ensure an *open, competitive financial system which places minimal restrictions on, or barriers to, foreign ownership*. This is critical not only in terms of ensuring the sector is internationally competitive but also for attracting and retaining talent and providing the 'critical mass' which attracts offshore business.

The policy framework applying to the financial sector should also be consistent with, and where possible encourage, the ongoing development of *very liquid, diverse and sophisticated markets across all segments: bonds, equities, currencies, commodities and derivatives*. Many aspects of policy may be affected by this policy principle: the need for open and transparent approaches to capital inflow into the financial sector; a regulatory framework which encourages innovation and the development of new financial instruments; an education system that provides an innovative and highly skilled workforce; and a tax system that is both competitive and provides a high degree of certainty.

APPENDIX 4: SECURITIES EXCHANGES AND THE OVER THE COUNTER (OTC) MARKET

A **securities exchange** is a facility for listing/quoting and trading equities and other financial instruments, including derivatives (futures, options, warrants) and fixed income products. Transactions that are executed on the exchange enter a clearing and settlement process involving a central clearing counterparty and the change of ownership is recorded on the relevant securities register. Post-trade services may be offered by the exchange itself or by other providers. In some jurisdictions, exchanges may have a market supervision role. Institutional and retail investors transact through financial intermediaries which are members of exchanges. A securities exchange manages the initial and subsequent offering of securities (the primary market) and associated trading in those securities (the secondary market).

An **alternative market operator** generally provides a narrower range of services compared with an exchange. It typically only provides a **trading platform** to facilitate the trading of securities listed on an exchange and does not provide listing facilities or clearing and settlement. Such trading platforms may trade in a broad range of financial instruments, including equities, futures, options and warrants.

An **over the counter (OTC) market** is a bilateral trading arrangement that may cover a range of financial instruments such as foreign exchange, debt securities, derivatives (equity and debt) and currency options. Frequently traded OTC instruments are relatively standardised but some OTC contracts may be highly customised to meet the specific needs of the parties involved. However, as a result of the global financial crisis, there is a trend towards greater standardisation of OTC contracts and the use of central clearing counterparties in the post-trade management of transactions.

The **Australian Securities Exchange (ASX)** is the pre-eminent stock and derivatives market in Australia, created by the merger of the Australian Stock Exchange and the Sydney Futures Exchange in July 2006. ASX-listed products include equities, options, warrants, futures, listed managed investments and interest rate securities. The ASX functions as a market operator, supervisor, clearing house and payments system facilitator. All ASX-listed shares are registered electronically on either the Clearing House Electronic Sub-register System (CHESS) operated by a subsidiary of the ASX Group on behalf of listed companies, or on the companies' own sub-registers.

The Commonwealth Government is considering applications from a number of alternative market operators seeking to offer secondary trading in ASX-listed securities. The Government also announced in August 2009 that the ASX's supervisory function would be transferred to ASIC in 2010, in order to facilitate the entry of new market operators.

APPENDIX 5: PRINCIPLES AND SCOPE UNDERLYING THE INVESTMENT MANAGER REGIME RECOMMENDATION

The Forum's views on the key elements of an investment manager regime (IMR) are as follows.

Scope of the IMR

With respect to the *scope* of the regime, the Forum is of the view that, within the funds management sector, the IMR should apply widely: it should encompass wholesale funds, including hedge funds and private equity funds, as well as retail funds. Australia has expertise in a wide range of funds and asset classes at the retail and wholesale level, and the Forum can see no argument for limiting the potential for building on this expertise by restricting the types of funds to which the IMR applies.

A key part of Australia's comparative advantage is our expertise on asset allocation and risk management for banking, insurance, funds management and, more generally, within the 'in-house' treasury and investment management operations of financial services companies. The IMR should, in the Forum's view, apply to these activities as well as to independent funds management activities.

By way of example, if an Australian owned bank or financial group is advising its Singapore branch on investment of that branch's capital outside Australia, such activities should come under the IMR; similarly, if the Australian based treasury operation of a foreign owned financial group was advising on investments held outside of Australia, this should also come under the IMR.

The recommendations are designed to cover all of these cases.

Underlying principles of the IMR

With respect to the underlying principles of the IMR, a starting point should be confirmation that non-resident investors should not be subject to any Australian tax on income earned on *offshore assets*.

For non-resident investors investing in *Australian assets* through an *independent* investment adviser, the investors should not be deemed to have Australian sourced income, or to have an Australian permanent establishment, merely as a result of using an Australian intermediary. This would make their tax treatment consistent with any non-resident investing directly in Australian assets without using an Australian intermediary. The income earned by the Australian intermediary would be taxable in Australia, as is currently the case.

With respect to any tax liabilities relating to Australian assets, the Forum proposes that the non-resident investor be treated for tax purposes the same as if they made the investment directly, rather than having used an Australian based intermediary. For example, if a direct investment currently results in liability for withholding tax on, say, interest or dividend flows to the non-resident investor, then the same would be true for that investor investing indirectly via a resident independent investment adviser or manager.

With respect to a non-resident investing via a *dependent* related party acting at arm's length in *offshore* assets, the investor would also be exempt from any tax liability within Australia. This is consistent with the notion that related party intermediaries should be included within the scope of an IMR where they are acting entirely at arm's length and in respect of global asset portfolios.

With respect to the same investor's investments in *Australian* assets, the Forum is conscious of integrity concerns that Treasury and the Tax Office may have. Reflecting those concerns, the Forum's recommendation is that such investments would be treated the same way as at present, subject to an agreed de minimis exemption which would cater for global portfolios with a minor Australian component.

Finally, to avoid discouraging companies from using Australia as their regional headquarters, the IMR should allow for board-related decision making in respect of offshore entities to be made in Australia without adverse tax consequences for the offshore entities or their investors. This will require ensuring that entities coming within the IMR are not regarded as Australian tax residents merely as a result of their central management and control residing in Australia.

APPENDIX 6: AUSTRALIA'S REGULATORY FRAMEWORK — OVERVIEW AND ASSESSMENT

OVERVIEW

Australia's regulatory framework consists of the various regulatory authorities; the statutory regulatory requirements they administer; and the financial supervisory powers vested in those regulatory authorities. This section focuses on the central regulatory agencies and their key responsibilities.

The main features of Australia's regulatory framework, in particular the existence of a dedicated prudential regulator, arose out of the 1997 Wallis Committee Report.¹ Three regulatory agencies have prime responsibility for maintaining the safety and soundness of Australian financial institutions, for protecting consumers, for ensuring market integrity, and for promoting systemic stability:

The Reserve Bank of Australia (RBA) has responsibility for the stability of the financial system as a whole, for monetary policy and for the payments system. The *Reserve Bank Act* states that the Reserve Bank Board is to ensure that the RBA's powers are exercised in such a way as will best contribute to the stability of the Australian currency, the maintenance of full employment and the economic prosperity and welfare of the Australian people.² The Payments System Board, which promotes competition, efficiency and stability in the payments system, sits within the RBA.

The Australian Prudential Regulation Authority (APRA) is responsible for prudential supervision of authorised deposit-taking institutions (ADIs), insurance companies and superannuation funds. APRA's major focus is on capital adequacy and on companies' internal risk monitoring and control mechanisms, with the objective of reducing the likelihood of institutional insolvency and consequential losses to depositors, policyholders and members. APRA currently supervises institutions holding approximately \$3.4 trillion in assets.³

The Australian Securities and Investments Commission (ASIC) is responsible for overseeing corporations and market integrity, including disclosure standards and consumer protection. ASIC regulates Australian companies, financial markets, financial services organisations and professionals who deal and advise in investments, superannuation, insurance, deposit taking and consumer credit. ASIC is also responsible for registering and supervising the operation of managed investment schemes.

1 Financial System Inquiry, *Financial System Inquiry Final Report* (S Wallis, Chairman), Australian Government Publishing Service, Canberra, 1997.

2 *Reserve Bank Act 1959*, section 10(2).

3 APRA, Annual Report 2008, APRA, Sydney, 2008.

As the corporate regulator, ASIC has responsibility for ensuring that company directors and officers carry out their duties honestly, diligently and in the best interests of their company. As the financial services regulator, ASIC licenses and monitors financial services businesses to ensure that they operate efficiently, honestly and fairly. These businesses typically deal in superannuation, managed funds, shares and company securities, derivatives, and insurance.⁴

Currently, ASIC and the Australian Securities Exchange (ASX) have concurrent roles in relation to financial market supervision. The ASX monitors compliance with the listing rules and market rules whereas ASIC's role is primarily in relation to the regulation of market licensees such as the ASX. ASIC is responsible for monitoring compliance by market operators, as well as monitoring clearing and settlement facility licensees within the relevant legislative frameworks. The RBA is responsible for issuing financial stability standards for clearing and settlement facilities and it monitors compliance with those standards.

On 24 August 2009, the Treasurer and the Minister for Financial Services, Superannuation and Corporate Law announced changes in the regulatory arrangements relating to Australia's financial markets, which provide for ASIC to perform supervision of real-time trading on all of Australia's domestic licensed markets. The change, which will come into effect in the third quarter of 2010, will mean that ASIC will be responsible for both supervision and enforcement of the laws against misconduct on Australia's financial markets. ASIC will become responsible for supervising trading activities by broker participants that take place on a licensed financial market, while individual markets – such as the ASX – will retain responsibility for supervising the entities listed on them. In introducing these changes, the Treasurer and Minister for Financial Services, Superannuation and Corporate Law noted that they would be a 'first step in the process towards considering competition between market operators'.⁵

The **Council of Financial Regulators** is the coordinating body for these financial regulatory agencies and Treasury. Members share information and views, discuss regulatory reforms or issues where responsibilities overlap and, if the need arises, coordinate responses to potential threats to financial stability. The Council also has a role in advising the Government on the adequacy of Australia's financial system architecture. The Council is non-statutory and has no regulatory functions separate from those of its members.⁶

In addition to these three primary financial sector regulators, the **Australian Competition and Consumer Commission (ACCC)** has responsibility for competition regulation across the entire economy, including the financial sector. It is responsible for administering the *Trade Practices Act 1974*, which prohibits anti-competitive arrangements between competitors, such as price fixing, market sharing and boycotts, as well as other conduct such as exclusive dealing and misuse of market power. The ACCC also has the ability to apply to a court to prevent mergers which have the effect of substantially lessening competition.

The Australian Treasury provides advice to the Government on financial sector policy and the overall regulatory framework.

4 ASIC, *Our Role*, ASIC, viewed 3 November 2009, www.asic.gov.au/asic/ASIC.NSF/byHeadline/Our%20role.

5 The Hon W Swan MP (Treasurer) and the Hon C Bowen MP (Minister for Financial Services, Superannuation and Corporate Law), *Reforms to the Supervision of Australia's Financial Markets*, media release, 24 August 2009.

6 RBA, *The Council of Financial Regulators*, RBA, Sydney, 2009, viewed 9 October 2009, <http://www.rba.gov.au/FinancialSystemStability/AustralianRegulatoryFramework/cfr.html>.

BEST PRACTICE REGULATORY SYSTEMS: SOME OBSERVATIONS

Best practice regulatory systems involve judgments as to the appropriate trade-off between competing factors. While the three main objectives of financial market regulation – financial market integrity and stability, consumer protection and competition – are all laudable, they can also involve considerable costs beyond the direct costs of compliance: higher costs of capital and financial services more generally for business and consumers; barriers to entry; moral hazard problems; and a stifling of innovation and efficiency, to name just some.

These trade-offs have long been recognised and are widely discussed in the literature on ‘best practice’ regulatory systems. Most of them were dealt with in detail in the 1997 Wallis Report referred to earlier, which also set out guiding principles for ‘best practice’ financial regulation and guidelines for the operation of the regulatory framework which it recommended, and which was subsequently put in place.

The Wallis Report also stressed the importance of taking into account the severity of any possible market failure in determining the appropriate regulatory response. If the impact of a market failure is not severe, then a lighter touch regulatory approach should be preferred.

It is inevitable to some extent that views on the appropriate balance between the trade-offs referred to above will be influenced by economic and market cycles, but in the wake of a major financial crisis and a very severe market downturn, the issue of the appropriate balance between systemic stability and consumer protection on the one hand, and not stifling market innovation and efficiency on the other, has been brought into sharper focus.

STRESS TESTING THE SYSTEM: THE FINANCIAL CRISIS

Inevitably, the Australian financial sector has not escaped untouched from the global financial crisis. The main aspects of that shock were increased levels of default and the significant widening of spreads and/or disappearance of liquidity across a range of financial markets, particularly wholesale debt, asset backed commercial paper and asset-backed securities, and credit default swap markets.

Other shocks have come about through the failure of globally interconnected financial institutions active in OTC and derivative markets; and some withdrawal of capital by foreign institutions as they sought to shore up weakened financial positions in their home countries.

Australian banks have traditionally relied on offshore wholesale funding, but at the height of the crisis this source of funding became almost completely inaccessible. The Government’s wholesale debt and large deposit guarantees ensured the offshore wholesale market continued to be accessible to Australian banks.

While the macroeconomic impact on the Australian economy has been less than on other advanced economies, the associated economic slowdown and rise in unemployment has still been substantial. There were a number of high profile corporate collapses; pressures on corporate balance sheets that required significant capital injections; and very large losses for many investors in financial products. The collapse of a number of financial product and service providers received widespread publicity. While significantly less than the pressures felt in many other countries, Australia’s financial system has certainly been put under some stress.

Without losing sight of the corporate failures and investor losses resulting from the financial crisis, the Australian financial system in general, and the banking and insurance system in particular, have emerged from the financial crisis in relatively good shape, with no government capital injections being required as has been the case in many other countries. Discussions which the Forum held with the official sector and the financial industry identify a number of key contributing factors:

- a comprehensive regulatory system, with – in contrast to some other countries – no major gaps in coverage and scope;
- the absence of the very sharp fall in property prices experienced in a number of other countries, which in part reflected generally conservative lending practices in Australia;
- high quality and highly regarded senior regulators;
- good communication, interaction and respect between the main regulatory bodies and between the regulators and government, which has enabled the regulators to focus where necessary on macro systemic issues and government and regulators to respond quickly to perceived risks;
- lessons learned from previous corporate collapses;
- the capacity of the corporate sector, in particular larger companies, to raise new equity capital, even at the height of the financial crisis;
- improved corporate risk management systems and generally good governance practices by corporate Australia, including limited exposure to structured securities; and
- an extended period of very strong economic growth, which provided the banking sector with strong profit growth based largely on mainstream bank borrowing and lending activities, with little consequent need or inclination to engage in more speculative activities.

In short, while our regulatory framework is, in the above assessment, just one of a number of factors that have enabled the Australian financial sector to withstand a significant ‘stress test’ in arguably better shape than most, the regulatory framework and its administration have nonetheless been important elements in this outcome and have served Australia very well through this extremely difficult period.⁷

While Australia’s regulatory framework has dealt with systemic risk issues very effectively through the financial crisis, it is also fair to say that, for a range of reasons outlined earlier, our financial system did not face the extent of systemic risk many others faced, as evidenced in the fact that no publicly funded capital injections into financial institutions have been necessary in Australia. However, in the Forum’s assessment, it would be wrong to conclude that this may have led to complacency on the part of the authorities. The RBA and Treasury, in particular, have for some time, both prior to and since the financial crisis, worked to ensure that the authorities have all the necessary tools and legislative backing for more radical market intervention should it ever prove necessary. The September 2006 Financial Sector Assessment Program on Australia by the IMF strongly supported the work being done at that time to ‘... develop a formal process to manage the failure of individual institutions and more widespread crises’.⁸

This work is ongoing. Australian regulators continue to subject Australian ADIs to a range of rigorous scenario and stress-testing processes to ensure financial soundness from a capital and liquidity

7 One quite different perspective to this widely held view came from the alternative investment (hedge funds, managed futures and managed currency funds) sector, which viewed ASIC’s ban on short selling as unnecessary, highly damaging to Australia’s reputation and inconsistent with the Government’s objective of developing Australia as a leading financial centre.

8 J Caruana and D Burton, *Australia Financial System Stability Assessment*, International Monetary Fund, Washington DC, 2006 at p 6. In the words of the IMF: ‘FSAPs [Financial Sector Assessment Programs] are designed to assess the stability of the financial system as a whole and not that of individual institutions. They have been developed to help countries identify and remedy weaknesses in their financial sector structure, thereby enhancing their resilience to macroeconomic shocks and cross-border contagion. FSAPs do not cover risks that are specific to individual institutions such as asset quality, operational or legal risks, or fraud.’ (p. 1)

perspective. For example, under applicable APRA prudential standards, an ADI must have in place sound stress-testing processes for use in the assessment of its capital adequacy, including the sufficiency of the internal ratings based capital requirement. APRA's liquidity risk management requirements also include requirements for an ADI to conduct scenario analysis on a regular basis to assess and measure its liquidity position under different operating circumstances. Some of these requirements will be further strengthened under APRA proposals for enhancing liquidity standards currently published for consultation.

As well as ongoing institutional stress testing as required by prudential standards, system-wide stress tests are conducted from time to time in accordance with external review processes or regulatory decisions. The results of such stress tests have informed APRA's policy-making processes. As global bodies such as the Financial Stability Board increase their focus on stress testing, the Australian regulatory authorities have worked closely with overseas regulators in sharing practices.

Looking more specifically at Australia's regulatory framework through the set of principles set out in Appendix Three, the Forum would make the following observations.

Comprehensiveness

One particular feature of Australia's regulatory structure noted earlier is the separation of prudential and market behaviour regulation between, respectively, APRA and ASIC, and also the separation of prudential control from the RBA. In the Forum's view, this separation of responsibilities between the RBA, APRA and ASIC has served Australia well. It has allowed the RBA to focus on monetary policy issues and the overall stability of the financial system, including importantly through the work and analysis of its Financial Stability Department and through the RBA's representation, along with Treasury, APRA and ASIC, on the Council of Financial Regulators. This structure has meant that the perceived absence in a number of overseas jurisdictions of a regulatory body focusing on economy-wide systemic financial issues does not apply to Australia.

Similarly, the separation of APRA and ASIC overcomes to some extent the potential difficulty, which could arise if they were part of one regulatory agency, of determining how much management time and resources to spend on market behaviour as against prudential issues. This has been an issue in some countries.

The Australian 'tri-partite' structure works effectively not just because of the institutionalised coordination arrangements in place, such as the Memoranda of Understanding between the regulatory agencies and the Council of Financial Regulators, but also because of the close working relationship at a personal level between the heads of the agencies. In his introductory comments to APRA's 2008 Annual Report, the APRA Chairman, Dr John Laker, made the following remarks on this issue:

The relationship [between APRA and the RBA] has been underpinned by two key strengths. Firstly, there are longstanding professional and personal relationships across the two agencies that ensure that each agency has a good understanding at the operational level of the role, perspective and functions of the other. It is crucial that these personal linkages continue to be nurtured as familiar faces disappear over time. Secondly, there is a clear delineation of responsibilities between the two agencies. The RBA does not shadow APRA in its supervisory role and APRA, in turn, relies on regular and detailed briefings on financial stability issues from the RBA so as not to duplicate effort and resources.⁹

⁹ APRA, *Annual Report 2008*, op cit at p 5.

The Forum fully endorses the importance of maintaining this close working relationship between regulatory agencies.

Balance

The financial crisis has put in stark relief some of the major areas where balance between potentially competing objectives is critical to a good regulatory system. The crisis also demonstrated that, at times, regulators and governments may need to change the balance between objectives, at least for a period. Chapters Three and Four of the Report discussed in some detail two of these areas of conflicting objectives, namely between stability and competitiveness; and between consumer protection and not stifling innovation and efficiency.

Efficient administration

A number of larger financial services companies noted the substantial time that APRA spent in the companies' offices conducting reviews. While some questioned whether the amount of information requested by APRA staff during such reviews was really necessary, there was a general acknowledgement that APRA's risk based approach of assessing financial services companies in terms of the macro consequences of their failure, and then allocating resources to them accordingly, was very sensible. Indeed, the APRA approach of estimating the overall risk of failure of an institution and the systemic impact of that failure, and then determining the appropriate intensity of supervision, is fully consistent with the Wallis Report's recommended approach referred to earlier. In the Forum's view, it is a key element in the efficient administration of any regulatory system and is to be commended.

Efficient and effective administration also requires both a good understanding of financial markets on the part of the regulators, and effective consultation with industry. In discussions with industry representatives, the Forum observed that there is generally a favourable view of the interaction between regulators and the industry. In the case of APRA, the view is that this has been effective for some time, and that there is very little need for new institutional structures designed to improve such consultation.

In the case of ASIC, the general view is that relations with industry are now good and significantly better than they used to be. Internal organisational changes and the recruitment of senior staff with financial services industry backgrounds are seen as very positive developments.

With respect to understanding of markets, senior staff in particular at both APRA and ASIC were generally seen by industry participants with whom the Forum held discussions as having a good understanding of the industries they were regulating.¹⁰

Principles based

With strong support from industry, Australia's regulatory system has moved increasingly towards 'principles based' regulation rather than prescriptive regulation. Such an approach has the potential to improve the inevitable trade-off between the need for a comprehensive and effective regulatory framework and not unnecessarily impeding market efficiency and innovation.

10 These general findings by the Forum with respect to APRA are consistent with the results of a May 2009 APRA survey of its stakeholders, including regulated entities and 'knowledgeable observers'. The survey overall provided a strong industry endorsement of APRA's prudential framework and approach to supervision. See APRA, *APRA Stakeholder Survey 2009: Report of Overall Findings*, Australian Survey Research Pty Ltd, Ormond, 2009.

There is, however, an inherent tension between such a principles based system and industry's desire for clarity and certainty. This can in some cases result in a regulator publishing more detailed guidance on how it expects business to comply with a set of principles, often doing so at the request of industry, and then being criticised by some industry participants for introducing an unnecessary further layer of regulation.

There are always matters of judgment here. Less prescription can entail both companies and regulators having to make more judgments, and companies having to integrate regulatory principles more closely into their decision-making processes. From the discussions the Forum had with financial services companies on this issue, the overall assessment appeared to be that, for the most part, the Australian regulatory system has this balance about right.

APPENDIX 7: CONSUMER PARTICIPATION IN AUSTRALIA'S FINANCIAL SECTOR

Australia has a history of reforms directed at increasing consumer choice and understanding of financial products and protecting consumer interests. Successive governments have pursued initiatives aimed at enhancing competition and consumer choice, and this has been complemented by a shift in regulatory focus towards the conduct of market participants and the disclosure of information.

Ongoing technological and financial innovation provide substantial benefits to consumers and the wider economy but, when combined with inadequate financial literacy and poor information about product risks and features, can have a detrimental impact on some consumers and on market efficiency. Against this background, the Australian Government, in consultation with the States and Territories and industry and consumer group representatives, has recently implemented or is currently pursuing a number of reforms and initiatives intended to increase market efficiency, protect consumer interests and promote effective consumer participation.

Two important reforms to Australia's financial system currently under way are the **Australian Consumer Law** and the **Consumer Credit Protection Reform Package**. These reforms respond to shortcomings in the division of responsibility between the Commonwealth and State and Territory Governments.

The Australian Consumer Law will provide for a single national law based on the existing consumer protection provisions of the *Trade Practices Act 1974* and will include, amongst other things, provisions which regulate unfair terms in consumer contracts. It will also create new enforcement powers and redress options for consumers.

In the case of the Consumer Credit Protection Reform Package, the Commonwealth will assume responsibility for the regulation of consumer credit including mortgages, mortgage broking, margin lending and remaining areas of consumer credit such as pay-day lending. This will replace state based regulation that was inconsistent and lacked adequate protections for consumers.

A range of key consumer issues have arisen as a consequence of the financial crisis, including concerns about safety of deposits, financial hardship arising from financial product and service provider collapses, declines in the value of retirement savings and incomes, and borrowers experiencing financial difficulty as a result of the global recession. Both the Australian Government and industry have responded to these changed economic circumstances with a number of initiatives and reforms.

In June 2008, the Treasurer, the Hon Wayne Swan MP, announced the establishment of a **Financial Claims Scheme** and changes to the regulatory framework to allow better management of failing financial institutions. The Scheme, established in October 2008, ensures that consumers have timely access to at least some of their funds, enabling them to meet day-to-day costs while the institution is liquidated. The Scheme allows consumers to recover money in deposit accounts up to a specified cap, with the remainder to be recovered through the liquidation process. It also provides compensation to policyholders who have valid claims with a failed general insurer.

In June 2009, retail banks, building societies and credit unions signed up to a set of **principles to assist borrowers experiencing financial hardship**, developed by the Australian Government in consultation with industry. The principles, which apply to all consumer credit contracts including mortgages, personal loans and credit cards, establish temporary and standardised arrangements to assist

borrowers who are unable to meet their contractual obligations due to temporary financial hardship arising from unemployment or as a result of other (reasonable) causes.

A number of other initiatives directed at providing consumers with accessible and easy to understand information and raising financial literacy levels have been progressed in recent years. Chapter 4 of the Report detailed the key financial literacy initiatives.

An **account switching package** was announced in February 2008 in response to concerns that consumers faced too many administrative and other obstacles if they wanted to change banks. The package, which was developed by the Government in consultation with industry, makes it easier for consumers to switch banks if they are not satisfied with their current provider. It has four components: a listing and switching service that requires banks to provide information to make it easier for consumers to switch banks; a consumer complaints hotline; comprehensive consumer education resources on switching; and an ASIC-led industry review of entry and exit fees.

The Government's intention to reform **financial services disclosure requirements** was also announced in February 2008 as part of its deregulation agenda. Long and complex product disclosure documents are unreadable to many consumers. The Financial Services Working Group, in consultation with industry and consumers, is focusing on solutions that promote short, simple financial disclosure documents and improve consumer access to financial advice as matters that are important to both consumers and the economy.

Government and industry have also contributed to developments in relation to **exception fees**, that is, fees charged by banks when a customer's funds are insufficient to cover a transaction, credit card payments are late or credit card limits are exceeded. At the request of the Government, the RBA has started to collect and publish data on exception fees paid by consumers. Additionally, the national consumer protection framework includes a prohibition on unfair contract terms, including bank fees where they are unfair, and introduces new penalties, enforcement powers and options for consumer redress. Competition in this area is emerging, with banks acting to reduce exception fees and publishing information to assist consumers to avoid unnecessary costs.

Further consideration of the impact of the global recession on investors is occurring through the current **Parliamentary Joint Committee on Corporations and Financial Services inquiry into the issues associated with recent financial product and services provider collapses**. The issues being investigated include financial product design and suitability, information disclosure, product marketing, financial advice and adviser remuneration arrangements and consumer understanding.

The Joint Committee has received numerous submissions from individual consumers as well as consumer groups, industry and professional groups and government organisations. The Committee is due to report by 23 November 2009.

A review of **Australia's superannuation system** was announced in May 2009, focused on measures that will increase efficiency, reduce costs and fees and increase long-term rates of return for investors. The review is due to be completed by 30 June 2010.

APPENDIX 8: ASIA REGION FUNDS PASSPORT PROPOSAL

As discussed in Chapter 4, the Forum recommends that an Asia Region Funds Passport be developed. Broadly, this would involve a two-stage process:

- Stage one: ASIC negotiates bilateral mutual recognition agreements with key jurisdictions in the region.
- Stage two: once bilateral agreements are in place, governments and agencies in the region work together to develop these into a multilateral Passport regime.

Between these two stages it may be appropriate for a review stage to assess the benefits or otherwise of the existing bilateral regimes already in place.

This Appendix provides more detail on the recommendation, based on the proposals of the Mutual Recognition Working Group¹ and the Forum's consideration of those proposals.

STAGE ONE: NEGOTIATING FURTHER BILATERAL MUTUAL RECOGNITION AGREEMENTS

The Forum considers that increasing the number of jurisdictions with which ASIC negotiates mutual recognition agreements is a key element in providing greater access for Australian funds into overseas markets. This is in keeping with Recommendation 5.11 of the Government's recent review of export policies and programs, which recommended that 'relevant accredited bodies responsible for the regulation of financial services are encouraged to pursue mutual recognition arrangements with other countries in a manner consistent with Australia's national export and investment interests.'² Discussions with ASIC confirm that it places a priority on developing a wider network of mutual recognition treaties in the region.

From the regulator's perspective, mutual recognition must not undermine its capacity to maintain regulatory standards and the consistent application of those standards to both local and overseas funds offered in their country. It follows that mutual recognition treaties are only likely to be negotiated between countries with sufficiently equivalent regulatory regimes.

The Forum sees merit in ASIC in each case negotiating an agreement that allows the broadest range of funds and asset classes to be recognised in each jurisdiction, subject to what is possible in light of the differences between the domestic regime of the partner jurisdiction and Australia's principles based regulatory approach. Australia's regime allows a broader range of asset classes to be offered at the retail level than do many of the regulatory regimes in the region. On the other hand, Australia's regulatory system is highly regarded in the region, and regulatory changes in some other countries in the region may well, over time, increase the degree of convergence, allowing broader mutual recognition agreements to be negotiated. Existing mutual recognition agreements could also be

1 Membership of the Working Group is provided in Appendix 1.

2 D Mortimer and J Edwards (eds), *Winning in World Markets: meeting the competitive challenge of the new global economy*, Department of Foreign Affairs and Trade, 2008, p 87.

broadened in the course of periodic reviews of those agreements, as the relationship between regulators deepens and confidence in the system improves.³

The requirements of the European Undertakings for Collective Investment in Transferable Securities (UCITS) framework, discussed in greater detail below, should assist the transition from bilateral agreements to a multilateral Passport. As the UCITS framework is itself constantly evolving (including incorporating a broader range of asset classes) there may be scope for the Asian Passport regime, which will take considerable time to develop, to incorporate broader aspects than the current UCITS framework, such as with respect to asset class restrictions.

The Working Group was of the view that the priority jurisdictions with which Australia should be looking to develop mutual recognition agreements should be determined by reference to:

- economic benefit to Australia, including the size of the offshore market and investor appetite;
- regulatory and legal compatibility: jurisdictions with similar regulatory or legal systems are obvious priority targets for mutual recognition as regulators can be more readily assured that investors are subject to protections in both jurisdictions that are substantially equivalent in outcome;
- tax environment: although this is outside ASIC's area of responsibility, the tax arrangements applying to foreign managed investment schemes are likely to impact on the investor appetite for Australian funds in those jurisdictions; and
- reciprocity: Australia should only devote time and resources negotiating with jurisdictions that are clearly interested in reciprocal treatment with Australia.

Using these criteria, and based on the Working Group's consideration of this issue and discussions with ASIC, the Forum sees merit in prioritising the following countries in the region for the purposes of mutual recognition:

- Singapore is the highest priority jurisdiction in the immediate term, due primarily to the potential economic benefits and its relatively more advanced regulatory regime which has similarities with Australia's, as well as its access to other markets in the region.
- Over the medium term, mutual recognition with Taiwan and South Korea should be a priority.
- Mutual recognition with Malaysia and Thailand would also be desirable, but is likely to be a much longer-term goal.
- While Japan, China and India would appear high on the priority list on the basis of potential economic benefits given their market size and large pool of domestic savings, the significant complexity of their regulatory environments is likely to make mutual recognition with these countries a long-term goal as well.

³ Review mechanisms in mutual recognition treaties can provide an opportunity to revisit the scope and terms of the agreement. For example, Australia's agreement with New Zealand provides that the parties will review the effectiveness of the mutual recognition scheme within five years of the agreement's entry into force. ASIC's arrangement with the US Securities and Exchange Commission concerning markets and broker dealers also mandates a review within five years. While the agreement with the Hong Kong Securities and Futures Commission does not stipulate a review period, it requires the authorities to review the declaration periodically for the purpose of assessing its operation.

The Forum encourages the Government, ASIC and the funds management industry to continue to consult closely with respect to the priority list of countries with which Australia should seek to develop additional mutual recognition arrangements.

Stage one, the development of additional bilateral mutual recognition agreements, provides a foundation for the development of a regional Passport arrangement and allows better market access for fund managers in some countries while the Passport regime is being developed.

STAGE TWO: AN ASIA REGION FUNDS PASSPORT

A Passport regime would go beyond a series of bilateral mutual recognition treaties, to provide a multilaterally agreed framework allowing the cross-border marketing of funds across participating countries.

The benefit of a Passport arrangement, as opposed to a series of bilateral agreements, is that it would allow a fund registered in its home country to be offered in more than one overseas country, ideally without needing to meet different licensing requirements or investment restrictions in each country, but at the very least minimising the number of additional requirements or restrictions applicable. Currently, even with a mutual recognition agreement in place, Australian funds are subject to 'top up' regulatory requirements in the host jurisdiction. If these additional requirements or restrictions are substantial, then the benefits to Australian fund managers of easier market access and reduced compliance costs may be quite limited. For example, under Australia's mutual recognition agreement with Hong Kong, an Australian retail fund must still meet a long list of investment and licensing restrictions under Hong Kong regulations.⁴ If an agreement was entered into with a different jurisdiction, a different set of investment and licensing restrictions would probably be imposed on Australian funds. This may require fund managers to develop a new range of products for each jurisdiction. A Passport arrangement would reduce any additional regulatory requirements, to the extent that harmonisation of common rules across Passport countries proves achievable.

In the longer term, having a common agreed funds management regulatory framework for 'eligible funds' could also facilitate funds from the Asian region being marketed in Europe, by way of an Asian/European mutual recognition agreement.

The Forum's proposal for an Asia Region Funds Passport involves:

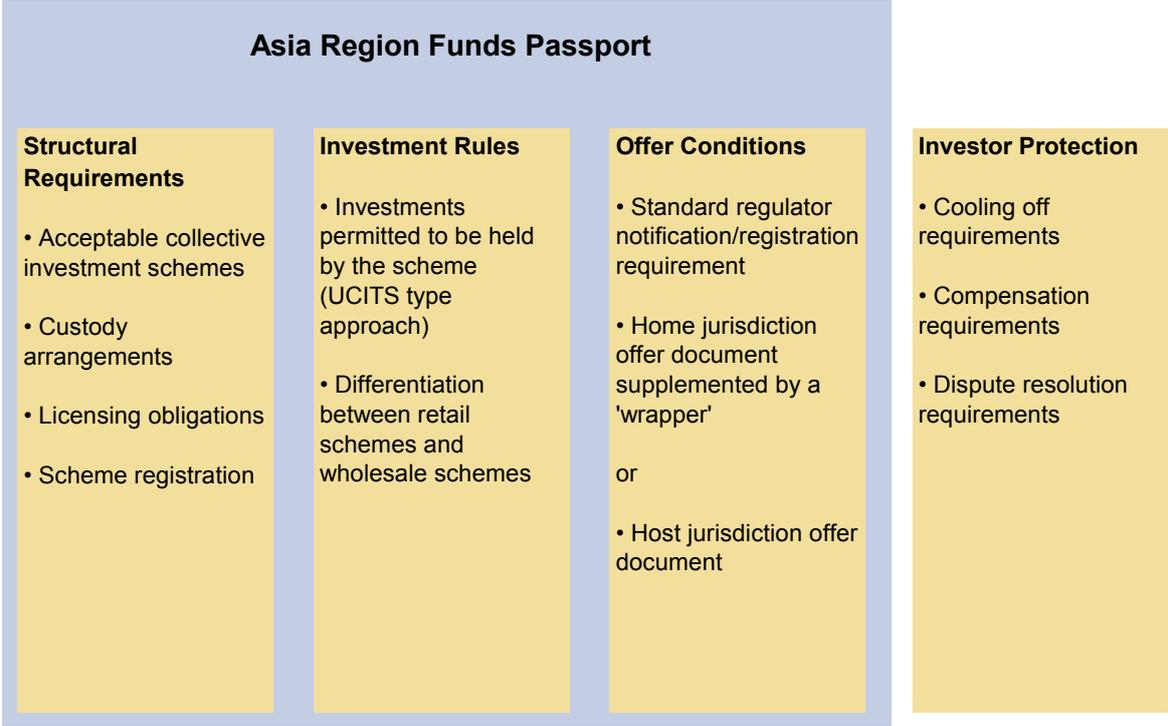
- developing a commonly agreed set of licensing arrangements, investment restrictions and, potentially, offer conditions, that would allow complying funds registered in one Passport country to be offered in each of the other Passport countries; and
- putting in place mechanisms for the continued administration of the Passport at national and regional levels.

Both of these matters are considered in detail below.

⁴ Importantly, these requirements are consistent with those that are imposed on a domestic Hong Kong fund.

Development of a common set of structural requirements, investment rules and offer conditions

As noted above, countries in the Passport regime would develop some common principles covering the areas set out in the diagram below, namely structural requirements, investment rules and, potentially, offer conditions that would allow funds complying with those rules to be ‘passport’ across jurisdictions. It is envisaged that each jurisdiction in the Passport arrangement would retain its own investor protection rules.



The structural requirements, investment rules and offer conditions developed for the Passport would apply only to funds being ‘passport’ed. It should be stressed that the Forum is not recommending that Passport countries amend the rules applying to their own domestic funds – unless they see reason for doing so – but rather that Passport countries develop a separate and commonly agreed set of rules governing foreign ‘Passport’ funds.

The UCITS framework represents a successful example of a group of countries developing a common set of funds management rules and conditions designed to facilitate the cross-border marketing of managed investment schemes within Europe. Many aspects of this regime provide a useful blueprint for the Asian Passport framework, although it is important to note that the development of the UCITS regime was aided significantly by established pan-European institutions and frameworks that do not exist in Asia.

The UCITS regime consists of a number of European Commission directives which allow complying managed investment schemes registered in one EU member country to be marketed throughout the EU. The Directives set out requirements on funds management companies and depositaries (custodians), as well as criteria for the types of funds eligible for cross-border offering. The UCITS directives have evolved considerably since the original directive was introduced in 1985, and the EU is implementing further changes.

The key features of funds constituted in accordance with the UCITS directives are:

- the fund must be available by means of an open offer to public retail investors in an EU member state;
- the fund must be open-ended;
- the fund may only invest in eligible assets (generally securities that are relatively liquid and negotiable);
- the fund generally may not borrow, along with other limitations on leverage; and
- the assets of the fund must be held by an independent trustee or custodian for the benefit of the investor.

The UCITS framework is already popular in key jurisdictions in the Asian region. Sales of European-domiciled UCITS compliant funds are growing rapidly in Singapore, Hong Kong and Taiwan. For example, sales of UCITS funds in Singapore grew by 33 per cent in 2007-08, with a total of 2,420 UCITS funds registered as at end December 2008.⁵

There are several key factors behind the popularity and wide acceptance of UCITS compliant funds, including:

- at the regulator level, the similarity between the investment restrictions built into the UCITS framework and the host country regulatory restrictions applicable to managed funds in a number of countries in the region mean that there is a higher 'comfort level' by the host regulator if the fund manager is offering a UCITS compliant fund. For example, the UCITS directives and Hong Kong law provide similar limitations on the proportion of a fund's net asset value that can be invested in securities issued by any single issuer;
- at the investor level, the restrictions in the UCITS framework give confidence to retail investors that UCITS compliant funds will contain adequate investor protection measures; and
- also at the investor level, the vast majority of UCITS funds sold internationally are domiciled in Dublin and Luxembourg, which exempt offshore investors from tax. For example, in the Asian region in 2008, approximately 70 per cent of all UCITS funds sold were Luxembourg-domiciled, with a further 16 per cent domiciled in Dublin.⁶

This last point reinforces the need to consider the proposals for the Passport in the context of the Forum's broader range of funds management proposals, in particular establishing an Investment Manager Regime.

The UCITS framework provides a model that is potentially very useful for developing the Asia Region Funds Passport proposal. Specific aspects of the UCITS framework are dealt with in more detail below.

⁵ PricewaterhouseCoopers, *Global Fund Distribution 2009*, viewed 17 August 2009, <http://www.pwc.com/lu/>.

⁶ *ibid.*

Structural requirements

The Asia Region Funds Passport would include a mutually agreed set of structural requirements, allowing a fund meeting those requirements to be passported across jurisdictions. These structural requirements include:

- Registration arrangements: a fund certified in its home jurisdiction as 'Passport compliant' would be offered relief from registration requirements in the other Passport countries.
- Licensing arrangements: a fund manager holding a licence in its home jurisdiction (and meeting certain agreed criteria) could offer 'Passport compliant' funds to investors in other Passport countries without obtaining a licence there, or be subject to minimal licensing requirements.
- Custodianship arrangements: the Passport regime could include requirements regarding separate custodianship of the fund assets.

The Passport should not specify a particular legal vehicle (for example, unit trust, corporate vehicle) for 'Passport compliant' funds.

The ability of regulators to exclude particular non-conforming funds from the arrangements on a case-by-case basis will be an important feature from an oversight, enforcement and investigation perspective. In addition, only those jurisdictions that have a strong track record in international regulatory cooperation in relation to investigation and enforcement processes would be eligible for participating in the Passport regime. The effective administration of the arrangement would also rely heavily on eligible funds submitting to the jurisdiction of the host country – a crucial precondition aimed at the protection of investors in terms of access to recourse channels where a foreign fund failed.

In terms of custodianship, Australia's regulatory approach differs from the UCITS framework and from the approach in some other countries in the region. In Australia, a single responsible entity may be both fund manager and custodian of the fund assets. A custodian may also be part of the same corporate group as the fund manager. Separation of the custodianship functions from management functions is achieved by requiring fund assets to be clearly identified and kept separate from other assets. Under the UCITS framework, however, a fund's assets must be held by a depositary (that is, a custodian) that is independent from the fund management company. Hong Kong and Singaporean domestic regulations also require funds to have a trustee or custodian that holds fund assets and is independent from the management company.

The Forum does not consider this issue will be a major impediment to development of a UCITS-like set of common structural requirements in the region. Preliminary inquiries by the Forum suggest that only a very small percentage of Australian funds have a single entity as custodian and manager, and only a minority of funds have related entities as custodian and manager. This matter was specifically considered during the mutual recognition agreement negotiations with Hong Kong and an attempt was made to solve the issue through the insertion of wording which provides that an Australian fund can be marketed in Hong Kong if the fund has appointed 'an ASIC-regulated custodian that holds an Australian financial services licence and is separate from the manager for safe custody of the scheme assets'.⁷

⁷ *Declaration on Mutual Recognition of Cross-Border Offering of Collective Investment Schemes*, signed 7 July 2008, between ASIC and the Hong Kong Securities and Futures Commission. As this agreement has not yet been used, it is unclear whether this clause will, in practice, allow funds to be marketed in Hong Kong if their assets are held by a custodian company that is related to the management company.

Investment rules

Given the UCITS framework imposes a number of investment restrictions on eligible funds, a key issue is the extent to which the Asia Region Funds Passport's common investment rules should largely replicate the European UCITS framework.

There are clear trade-offs involved here. On the one hand, there are a number of potential advantages in developing a set of common investment rules and restrictions for use in the Asian Passport bloc that is very similar to UCITS. To the extent that regulators across the Asian region have already allowed European-domiciled UCITS funds to be sold to retail investors in their jurisdictions, those regulators may be more attracted to the idea of developing and joining an Asian Passport bloc if the Passport framework incorporates a UCITS based set of investment rules.

On the other hand, it would be desirable for any framework adopted as part of the Passport to allow Australian fund managers to market as wide a range of retail funds as possible. The UCITS conditions are a good deal more restrictive, in terms of the range of funds and asset classes that could be offered, than Australia's domestic regulatory framework applying to the sale of retail funds.

The UCITS directives are lengthy and detailed. They impose, among other things, portfolio allocation restrictions, liquidity conditions (such as fortnightly redemption requirements), and leverage restrictions.⁸ The Working Group examined the impact that these UCITS conditions would have on the types of funds and asset classes that could be potentially offered under an 'Asian UCITS' framework. The Working Group came to the view that a number of Australia's registered managed investment schemes would not satisfy all of the UCITS investment restrictions. Specifically, the UCITS investment restrictions would be likely to exclude:

- funds that borrow, such as geared share funds and most real estate, infrastructure and private equity funds; and
- funds that invest in credit instruments that are not traded on a market.

It could be argued that, to some extent, Australia has particular strengths in the management of some of these 'alternative' asset classes which may not fit within the UCITS framework. Limiting the Asian Passport regime to the recognition of UCITS compliant funds would not allow Australian fund managers to market certain alternative funds to retail investors in the region. The Forum proposes that, initially, all funds that do not fit within a UCITS framework could fall into a 'second tier' which would only be eligible for cross-border marketing at a wholesale/institutional level. Over time, the Passport's investment restrictions could allow for a broader range of funds to be marketed at a retail level.

Offer conditions

While offer document requirements would, in all likelihood, continue to differ, one option would be for eligible Passport funds to continue to use their existing home offer document, supplemented by a cross-border 'wrapper' document, detailing such issues as the nature of any specific cross-border risks such as currency, dispute resolution mechanisms, and any significant tax implications. In most cases, the offer document, including its wrapper, will need to be bilingual. Each member jurisdiction is, realistically, also likely to maintain unique investor protection measures with which foreign funds will need to comply.

8 For more information on the specific requirements of the UCITS framework, see the UCITS directives, available at: http://ec.europa.eu/internal_market/investment/legal_texts/index_en.htm.

Other issues

In its submission to the Forum, IFSA proposed that the Passport would be ‘underpinned by the principle of ‘non-discrimination’ such that home and host jurisdiction funds were treated equally from a regulatory and tax perspective’.⁹ This means that the negotiating process would need to be government-to-government rather than just between regulators.

Discriminatory tax conditions, regulatory requirements or distribution requirements can provide major disincentives to cross-border marketing of funds, even if a mutual recognition agreement is in place. On the other hand, requiring non-discrimination clauses as a precondition to entering into a mutual recognition agreement could complicate or stall negotiations. Tax issues fall outside the responsibilities of regulators, which are typically the entities negotiating mutual recognition treaties. Accordingly, the Forum considers that, in the first phase of negotiation of bilateral mutual recognition treaties, tax should be kept to one side.

There are matters of judgment here. The Forum considers that tax neutrality between home and host funds is an important issue in the context of the principles that should govern an Asian Passport scheme and what it is trying to achieve, namely improving market access within the region. On the other hand, it is conscious of the inherent difficulty of incorporating taxation issues in such negotiations. The Forum thus suggests that, in the course of developing the Asia Region Funds Passport (the second phase), the broader government-to-government negotiations that will be a necessary part of such a process should, wherever possible, include on their agenda this issue of tax neutrality. The fact that Australia recently abolished its foreign investment fund (FIF) rules may help in such discussions and negotiations. Introduction in Australia of an investment manager regime would also assist any such discussions.

Administering the Asia Region Funds Passport

Development and implementation of the Asian Passport proposal and the set of common investment rules and licensing arrangements that underlie it will require a substantial amount of work and cooperation between the relevant countries over an extended period of time. Once the regime is fully operational, it would still require ongoing administration, from national regulators and at a regional level.

At a national level, the Forum envisages, as in the UCITS regime, that each country’s home regulator would be responsible for certifying that funds are compliant with the investment restrictions and structural requirements at the core of the Asia Region Funds Passport regime. In the Australian context, for example, ASIC would be responsible for certifying particular funds as falling within the ‘passport’ category, and this would form the basis of that fund’s recognition as a ‘passportable’ fund by other jurisdictions. As with the UCITS regime, the custodian or fund manager could be required to report periodically to ASIC on its investment composition and compliance with the restrictions.

At a regional level, there could well be a role for an ongoing regional cooperative body to help resolve any disputes or requests for clarification regarding the common set of investment rules; to deal with non-discrimination issues; and to ensure that dispute resolution procedures are working effectively. Such a body could also have the role of endeavouring, over time, to standardise other regulatory requirements beyond licensing and investment rules, in particular, offer conditions.

⁹ IFSA, submission to the Australian Financial Centre Forum, 4 March 2009, p 2.

BUILDING REGIONAL SUPPORT FOR THE PASSPORT

The EU's UCITS framework has been developed over 20 years, and is backed by a range of EU-wide institutional arrangements and bodies that have been in place for substantially longer. Putting in place an Asian Passport framework backed by a common set of investment rules, across a group of countries with diverse political and regulatory systems, and without well developed cross-border institutional arrangements, is an ambitious agenda that will take considerable time and political commitment.

The proposal is, however, very much in the long-term interests of those funds management companies throughout the region that are competing with UCITS funds sold out of Europe. It is also fully consistent with the recognised need for many countries in the region to develop coherent and comprehensive retirement income policies, enhance their regulatory frameworks and open up their capital markets further. A number of countries in the region, in recognition of the above domestic policy imperatives, have been looking closely in recent years at Australia's financial services regulatory framework.

With the presence already of large international fund managers in some of these countries, some governments may see little if any additional benefit in terms of competition and consumer choice by opening up further to Australian fund managers selling products in their jurisdictions.

A good deal of effort will thus be required in demonstrating the mutual benefit flowing from the proposal. As an initial step, the Forum sees merit in building support and momentum for the project at the industry and government level:

- relevant industry groups should, through their memberships of international and regional industry bodies, seek to build support for the development of a Passport arrangement. For example, IFSA could play a leading role within the International Investment Funds Association (of which it is a member) in promoting the Passport proposal; and
- the Government, through its bilateral discussions in the region and also in the appropriate multilateral forums, should seek to build political support for the Asian Passport concept as a regional initiative.

The Forum also sees considerable benefits in ASIC encouraging the Asia-Pacific Regional Committee of the International Organization of Securities Commissions (IOSCO) to consider the merit of drafting proposals to 'fast track' and facilitate cross-border sales of funds at the *wholesale* level. There are fewer barriers to the cross-border marketing of funds at the wholesale/institutional level than there are at the retail level. ASIC allows licensed wholesale fund managers from some foreign countries to offer their funds to Australian investors without requiring an Australian financial services licence. Some other countries in the region, including Singapore, also have exemptions from licensing requirements for managers offering wholesale funds in certain circumstances. However, there are inconsistencies between different jurisdictions in the region regarding the regulations that apply to wholesale funds and the definition of 'wholesale' or 'institutional' investors. Measures within and between Passport countries to streamline and harmonise these exemptions would have the benefit of reducing the number of regulatory requirements for fund managers and thus encouraging greater cross-border offering of funds to institutional investors. Facilitation of cross-border sales at the wholesale level would also be consistent with the proposal to seek over time to widen the range of funds and asset classes that can be marketed in overseas jurisdictions at the retail level as well.

This work could be undertaken as part of the Passport initiative (for example, common licensing rules developed as part of the Passport could apply to retail or wholesale funds), as well as through the IOSCO committee process.

LIST OF ABBREVIATIONS

| | |
|----------|---|
| ABA | Australian Bankers' Association |
| ABS | Australian Bureau of Statistics |
| ACCC | Australian Competition and Consumer Commission |
| ADI | Authorised deposit-taking institution |
| AFMA | Australian Financial Markets Association |
| AFTS | Australia's Future Tax System |
| ANZCO | Australian and New Zealand Standard Classification of Occupations |
| AOFM | Australian Office of Financial Management |
| APEC | Asia-Pacific Economic Cooperation |
| APRA | Australian Prudential Regulation Authority |
| ARC | Australian Research Council |
| ASEAN | The Association of Southeast Asian Nations |
| ASIC | Australian Securities and Investments Commission |
| ASX | Australian Securities Exchange |
| ATO | Australian Taxation Office |
| AVCAL | Australian Private Equity and Venture Capital Association |
| AusAID | The Australian Agency for International Development |
| AUSTRAC | Australian Transaction Reports and Analysis Centre |
| Austrade | Australian Trade Commission |
| BIS | Bank for International Settlements |
| CFP | Certified Financial Planner |
| CHESS | Clearing House Electronic Sub-register System |
| COAG | Council of Australian Governments |
| CPRS | Carbon Pollution Reduction Scheme |
| CRC | Cooperative Research Centre |
| DEEWR | Department of Education, Employment and Workplace Relations |
| DIAC | Department of Immigration and Citizenship |
| ETS | Emissions trading scheme |
| EU | European Union |
| FDI | Foreign direct investment |
| FICA | Finance Industry Council of Australia |
| FIF | Foreign investment fund |
| FIRB | Foreign Investment Review Board |
| FSA | Financial Services Authority (UK) |
| FSAC | Financial Sector Advisory Council |
| FY | Financial year |
| GDP | Gross domestic product |
| HBWI | Home builders warranty insurance |

| | |
|-------|---|
| IBSA | Innovation and Business Skills Australia |
| ICA | Insurance Council of Australia |
| IFSA | Investment and Financial Services Association |
| IMF | International Monetary Fund |
| IMR | Investment manager regime |
| IOSCO | International Organization of Securities Commissions |
| IPT | Insurance Protection Tax |
| ITAA | <i>Income Tax Assessment Act 1936</i> |
| LIBOR | London Interbank Offered Rate |
| M&A | Mergers and acquisitions |
| MP | Member of Parliament |
| OBPR | Office of Best Practice Regulation |
| OBU | Offshore Banking Unit |
| OECD | Organisation for Economic Cooperation and Development |
| OTC | Over the counter |
| PE | Private equity |
| REC | Renewable Energy Certificate |
| RBA | Reserve Bank of Australia |
| RIS | Regulation Impact Statement |
| RMBS | Residential mortgage backed security |
| TOFA | Taxation of Financial Arrangements |
| UCITS | Undertakings for Collective Investment in Transferable Securities |
| UK | United Kingdom |
| UN | United Nations |
| UNDP | United Nations Development Programme |
| US | United States of America |
| VCLP | Venture Capital Limited Partnership |
| VET | Vocational education and training |