Colonial First State
Global Asset Management

Australia as a Financial Centre: Some thoughts

Economic research paper

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- The Australia as a Financial Centre report details the benefits to Australian institutions and the Australian economy from promoting Australia as a key regional financial centre.
- The report makes specific recommendations in the areas of regulation, taxation and marketing to help achieve this goal.
- The report also highlights the fact that, to date, Australia's involvement in cross-border financial flows has been very limited – a fact that is hard to rationalise given the strength of Australia's financial system and the relative size of the Australian funds management industry.
- While the challenges are many, the benefits to Australia and, especially, the Australian funds management industry are likely to out-weigh the threats and suggest that a co-ordinated and concerted response from both the government and industry would be a significant step forward.

Highlights:

Early in 2010 the Commonwealth government released the "Australia as a Financial Centre: Building on our Strengths" report by the Australian Financial Centre Forum (AFCF), which was originally delivered in November 2009. The report was delivered to the Minister for Financial Services, Superannuation and Corporate Law and formed part of a 2007 election commitment from the government. This report found that while Australia's financial sector "has emerged from the global financial crisis strong, well regulated and highly regarded around the world" the level of engagement of the Australian financial system "in cross-border activities within the Asia-Pacific region and beyond is much less developed" and "this is reflected in low levels of imports and exports of financial services."

The idea of promoting Australia's role as a key Asia-Pacific financial centre is not new. Indeed, this author was involved in a committee that met every month on this very topic in the early 1990s and, at the time, involved a number of the key players in financial markets and banking services based in Sydney. However, what is different about the latest report is the level of detail on the opportunities that could flow to Australia and Australian financial institutions (including fund managers) from an expanded and globally orientated financial system. A key issue here is the opportunity to diversify Australia's export base (ie. supplementing the obvious significant role for resource exports) and to more effectively leverage Australia's current strong links to the Asian region. The report also, most importantly, provides details on the policy changes needed to support the goal of Australia as a financial centre.

While the Australian funds management industry is the largest in the Asia-Pacific region, funds sourced from offshore currently account for only around 5% of all funds under management in Australia (based on the most recent ABS data) and even more dramatically, Australian fund managers only account for around 0.2% of the total value of funds available in global markets. Given the level of skill, experience, relative stability and history of solid performance, it would seem that the benefits to the Australian financial system as a whole, and especially the funds management industry, from Australia becoming a key financial centre are significant – and certainly would likely outweigh the threats.

What is clearly needed, however, is a co-ordinated and concerted response from both the government and industry to push through the regulatory, taxation and marketing changes that will be needed to ensure this long-held goal moves closer to becoming a reality.

In this regard it is encouraging to note that Minister Bowen has welcomed the report and has indicated that the government will consider the report's recommendations – along with those of the Henry Tax Review – and will respond later in the year.

Benefits to Australia in being a financial centre:
The AFCF report makes the point that the strength of Australia's financial system was one of the key reasons why the Australian economy was able to outperform most other developed nations though the financial crisis. While this view has been widely observed[1], the report also quotes international research[2] that states "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." In terms of its size the AFCF report states that the financial "sector directly accounts for around 7.5% of GDP, and employs directly …. around 3.6% of total employment."

In setting up the case for Australia to become a financial centre, the AFCF report notes that:

- "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"
- "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."
- "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."

As such, the AFCF report states that "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."

The AFCF report then states that, "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
- "through greater financial integration, enhance Australia's broader national interests within the Asia-Pacific region."

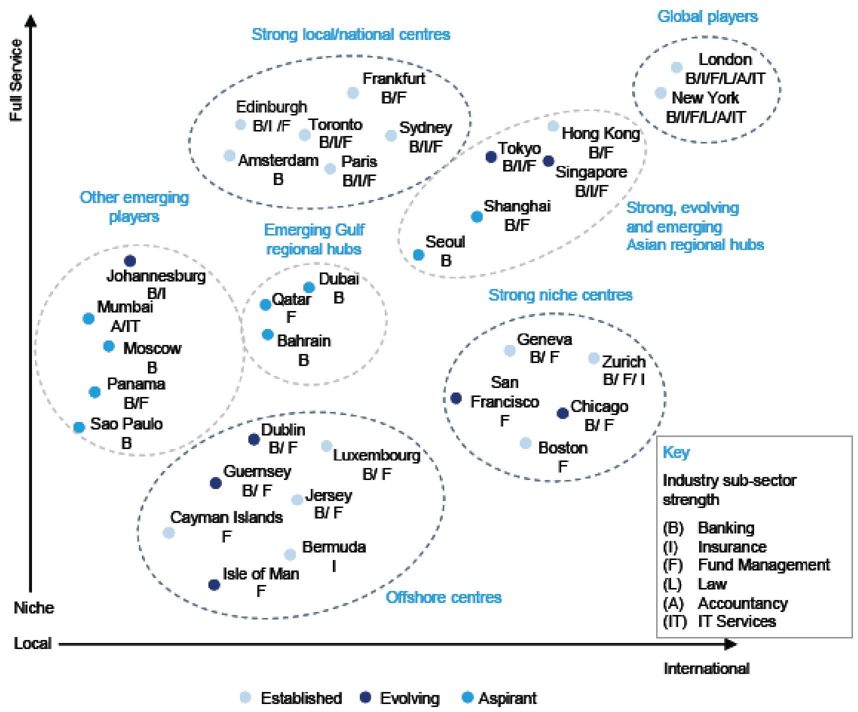
Australia in context:
The AFCF makes the point that currently there are only two truly global financial centres – London and New York (see chart 1). Sydney is placed in the "strong local/national centres", along with Frankfurt, Paris, Toronto, Edinburgh and Amsterdam. As per Chart 1, it seems logical to suggest that the goal of the AFCF recommendations is to move Sydney to the right of the chart, joining those classified as "strong, evolving and emerging Asian regional hubs", which currently includes HK, Singapore, Tokyo, Shanghai and Seoul.

[1] See RBA, "The Road to Prosperity", RBA Governor, Glenn Stevens, Melbourne, 5 November 2009
[2] R. Levine "Finance and Growth. Theory and Evidence", The Netherlands, 2005

The AFCF report highlights two key factors for Australia from our current status in global markets:

- “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.”

Chart 1: Categorisation of financial centres

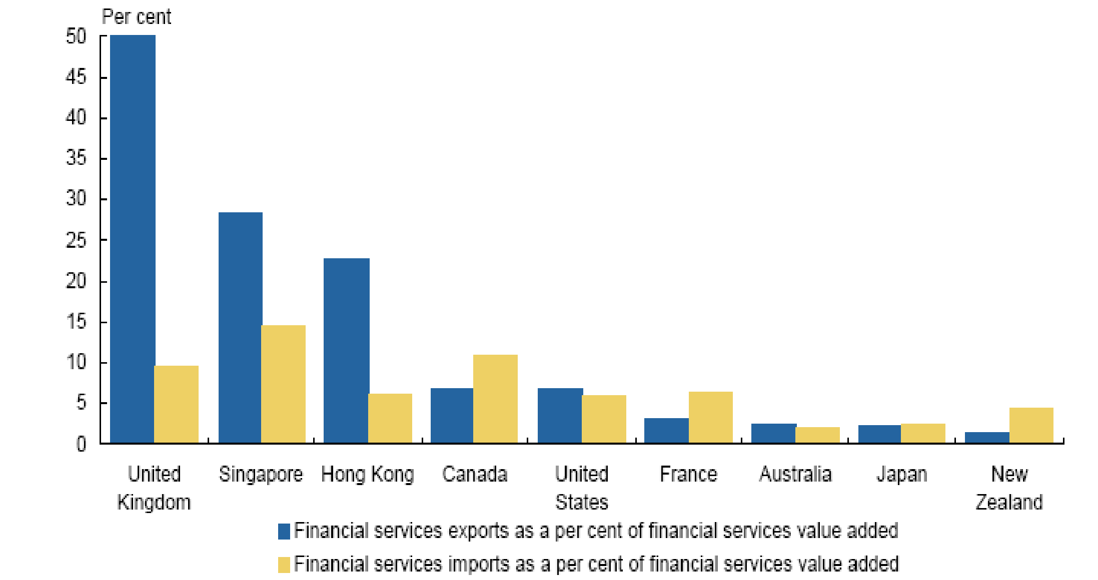


Source: Oliver Wyman, Citi, published in *UK International Financial Services — The Future, A Report From UK Based Financial Service Leaders to the Government*, May 2009.

As noted, the AFCF report highlights the fact that Australia has a very low level of both export and import of financial services, as shown in Chart 2.

Indeed, Australian Bureau of Statistics (ABS) data shows that of the $A1.1tr currently (as at September qtr 2009) in Managed Funds in Australia, only $A52.2bn or 4.7% of that is sourced from outside the country. The AFCF report notes that Australia’s share of funds sourced from offshore is very low by international standards.

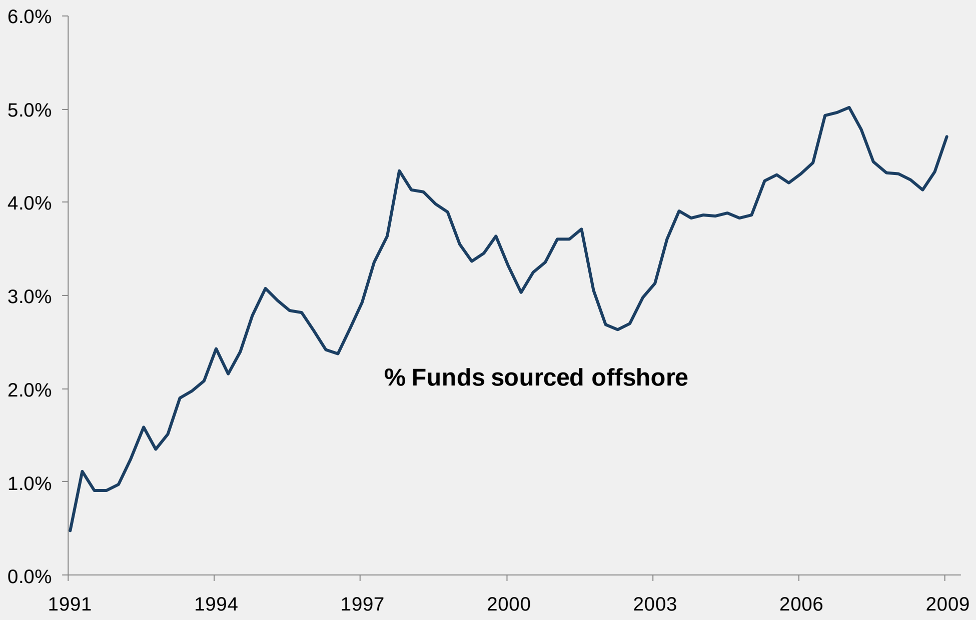
Chart 2: Internationalisation of financial service centres



Source: UN and OECD data.

In the UK, around 34% of funds are sourced offshore, while in HK and Singapore, our two big Asian competitors, the share is substantially higher at 64% and 80%, respectively. This very low level of foreign sourced funds in the Australian managed funds industry remains the case, even with a general trend of growth evident over the past two decades – see Chart 3.

Chart 3: Share of Australian Managed Funds sources from offshore

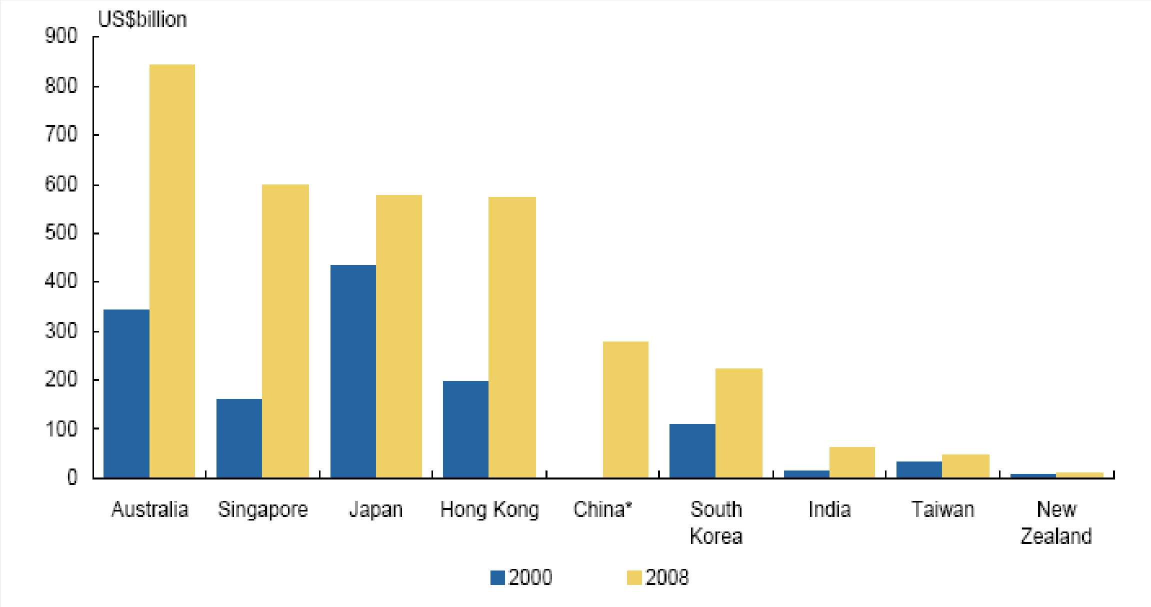


Source: Australian Bureau of Statistics

This lack of internationalisation of Australia's financial services is all the more surprising given the strength of Australia's funds management industry.

As shown in Chart 4, within the Asian region, Australia has the largest funds under management, with the value of these investments more than doubling over the past decade. The primary driver behind this growth is, of course, Australia's compulsory superannuation guarantee charge (SGC), currently set at 9%.

Chart 4: Net assets of investment funds – Asia Pacific



Source: Australia as a Financial Centre report, November 2009

The AFCF report quotes a report on the Australian funds management industry by Rainmaker (as at June 2008). This report states that "the top four Australian based managers of offshore sourced funds are Australian companies. 87% 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% was sourced from Asia. Of this, 13% was from Japan and 11% from China."

The opportunities available to Australia in the funds management industry can easily be illustrated by other data noted in the Rainmaker report – namely that "Australia's share of global pension, mutual and sovereign funds is around 0.2%, an exceptionally low number given the size of our funds management industry." In addition, the size of this global pool was estimated, in the Rainmaker report, to increase form $US52tr in 2007 to around $US150tr over the next decade.

Key policy recommendations:
To achieve its aim of helping to develop Australia as a key financial centre, especially for the Asia-Pacific region, the AFCF report makes a number of specific policy recommendations. These are as follows:

Taxation:

1. **Investment Manager Regime (IMR):** The report states that the investment management regime would have wide ranging application, to both retail and wholesale funds, but would be confined to the financial sector. For non-resident investors who satisfied certain criteria "investments in all foreign assets would be except from any tax liabilities in Australia" and for those offshore investors who used an "independent resident investment advisor, fund manager, broker, exchange or agent, 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."
2. **Offshore Banking Units (OBU):** The report looks for the government to show support for the current OBU arrangements and make the necessary changes to ensure greater commitment by eligible organisations to the OBU licences they already hold.
3. **Funds management vehicles:** The report notes that there is the need for regulatory and taxation changes that will help fund managers' development for offshore clients "investment vehicles(s) that provide a flow-through of any tax liabilities from the vehicle to the end investor."
4. **Withholding tax changes:** For a country that relies heavily on offshore funding sources for our banking needs, the current complicated withholding tax arrangements could act as an impediment and/or act to raise the cost of funds. To ensure a level playing field and to help maximise the ability of Australian financial institutions to access cheaper funds globally, the AFCF report recommends the abolition of withholding tax "on interest paid on foreign-raised funding by Australian banks, including offshore deposits and deposits in Australia by non-residents, on interest paid to foreign banks by their Australian branches and on financial institutions' related party borrowing."
5. **LIBOR cap on deductibility to be removed.** Currently Australian branches of foreign banks can only claim deductibility for interest paid at the LIBOR rate and not the actual market rate. As the global financial crisis clearly demonstrated, market rates can diverge significantly from LIBOR for long periods and so this arrangement needs to be modified to allow deductibility of the actual market rate.

Note: the AFCF report remarks that it is aware of the fiscal pressures, ie. lower revenue, that these recommendations would make to the Commonwealth government and States, and that for that reason they are best to be part of a broader array of taxation changes that might flow from the Commonwealth's Tax Review (the Henry Review).

6. **Islamic finance products:** The report recommends the Commonwealth take a look at any taxation provisions that could help Australian financial institutions access greater funding by products that comply with Islamic financing needs.
7. **Remove State taxes and levies on insurance:** The report states that State taxes and levies on insurance add significantly to the cost of insurance, leading to under-insurance, a greater demand on public spending and act as a barrier to new entrants to the market. The AFCF acknowledges, however, that this source of State government revenue would need to be replaced and that this change would also likely occur in the context of broader changes recommended by the Henry review.
8. **Monitoring and advising on financial service tax issues:** The Financial Centre Task Force should monitor progress on the implementation of the tax recommendations and report every six months and then make further recommendations.

Regulation and regulatory supervision:

9. **Avoiding unnecessary regulation:** The AFCF report states that "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 than any new regulations are clearly necessary in Australia's circumstances, and are implemented efficiently, avoiding undue costs to the corporate sector".
10. **Periodic review of the regulatory rules and framework:** This review would be designed to ensure "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."
11. **The Asia Region Funds Passport:** Through a series on bilateral and multilateral agreements, the Asia Region Funds Passport 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."
12. **Regulatory online gateway:** The AFCF recommends that Austrade develop a website that acts as the initial point of contact for all foreign direct investment inquiries into Australia, providing regulatory information and links to the appropriate government bodies.
13. **Increased competition on exchange traded markets:** via consideration for new trading platforms and exchanges.
14. **Reduce regulatory requirements on corporate debt issuance to retail investors:** as part of the goal of increasing the size of the retail corporate bond market to lower the cost of funds and provide a wider spectrum of investment opportunities.
15. **Standardise non-prudential regulation of the insurance sector:** to ensure a more competitive and efficient domestic insurance industry.
16. **Removal of regulatory barriers to Islamic finance:** to ensure a level playing field.

Promotion:

17. **Declaration of intent:** a strong statement from the government is seen as a positive, outlining the governments "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."
18. **Financial services missions:** to regional and international financial participants, which would include "appropriate policy and regulatory agencies and industry representation."
19. **Financial Centre Task Force:** a combined government, taxation, commercial banking, investment banking, funds management and insurance committee, with consultation to industry group representatives, financial market practitioners, official sector contacts, academics and retired experts.

Implications for the Australian funds management industry:

Expanding Australia's role as an important regional financial centre would likely prove to be a positive for the Australian funds management industry. A greater focus in the Asian region on the strengths and abilities of the Australian financial system and professionals working in the industry should help provide a positive message to potential international clients.

The AFCF report notes that "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."

It would seem, therefore, that any development that elevates the brand recognition of Australia and the successful management of a growing pool of funds over many years would be a positive for Australian fund managers looking to increase their funds sourced offshore.

One key issue in this context is whether Australian fund managers have more to gain by expanding offshore, than they could potentially lose in domestic funds by allowing greater access to the Australian superannuation pool for international fund managers.

However, given the extremely low level of exposure by Australian fund managers to international funds, it would seem logical to assume that the potential for Australian fund managers to expand offshore is greater than the threat to the domestic savings pool from international entrants to the market.

Of course, time will tell on this and Australian fund managers would likely not want to lose focus on their domestic client base, but the opportunities would seem to outweigh the threats.

Another key issue for Australian fund managers is tax. The AFCF states that 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."

The AFCF report states that "these concerns were 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 citied 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."

The AFCF report also noted that many Australian fund managers used special "vehicles" to manage funds raised offshore, due to taxation or other reasons, and that the management of these funds was often under-taken outside Australia – denying Australia the job and revenue benefits that could flow.

It seems clear, therefore, that a simplification, clarification and development of a better taxation treatment of funds raised offshore but managed by Australian fund managers will be a critical part of any policy framework to promote Australia as a financial centre and to exploit the advantages Australian fund managers have to offer the world.

Implications for the Australian economy:
One of the key focuses for the AFCF report is the benefits that are expected to flow to the Australian economy. A key positive in creating a financial centre in Australia that is export orientated is that this will help broaden Australia's export base. Clearly the focus for Australian exports over recent years, and likely for many years to come, has been on resources and this is likely to be a significant positive for the Australian economy for a long time. However, developing a larger financial services export industry will help provide a good diversification for the Australia economy that could prove valuable if/when the resources sector goes through the inevitable cycles.

Apart from the diversification and export benefits to the economy from creating a regional financial centre, the other positives are likely to be: increased job creation is an area of relatively high skill, increased income growth that will flow from this, increased government taxation revenue and a lowering of financial service costs as competition increases.

One risk, however, is that given the increased volatility in financial markets/services relative to the overall economy, a great share of economic activity from the financial sector could lead to slightly higher economic volatility and the costs involved with this. A good example in the current environment is London, where the impact of the financial crisis on the London City (and Canary Wharf) has had a significant impact on the overall UK economy.

Next steps:
Significantly, the production of the AFCF report was the fulfilment of a pre-election commitment by the government. The report has the strong support of both the Prime Minister and the Minister for Financial Services, Superannuation and Corporate Law, Chris Bowen. The report also has the support of the Commonwealth Treasury and the panel of experts that worked on the report. The Minister has stated that he welcomed the report and that the government will consider the recommendations and will respond later in the year.

Importantly, however, the recommendations of the AFCF report that relate to taxation issues will need to be considered in the context of the "Australia's Future Tax Sydney Review" (the Henry report). A number of the AFCF recommendations may have some, short-term, negative implications for government taxation revenue that will need to be analysed and placed in the context of overall reform to the taxation system.

It is also worth noting, however, that even prior to the release of the AFCF report that the government has implemented or announced some changes that will support the goal of creating a larger financial centre in Australia; such as the progressive reduction of the withholding tax on distributions from managed funds, the abolition of the 10% interest withholding tax on Commonwealth government bonds held by offshore investors, recognition under China's QDII (qualified domestic institutional investor) regime, the transfer of market supervision responsibilities to ASIC, the repeal of foreign investment rules, clarification over capital account taxation for managed investment scheme and various mutual recognition arrangements."

The Australian Financial Centre Forum and financial market participants in general will need, however, to maintain the momentum in the AFCF report to ensure that its many strong recommendations are followed-through and implemented so that the long-held goal of helping Australia create a strong and vibrant financial centre can be fulfilled.

For further information

Stephen Halmarick	Head of Investment Markets Research	+61 2 9303 3030	shalmarick@colonialfirststate.com.au
Belinda Allen	Analyst, Investment Markets Research	+61 2 9303 3110	ballen@colonialfirststate.com.au
James White	Analyst, Investment Markets Research	+61 2 9303 2645	jwhite@colonialfirststate.com.au