Australian Services Roundtable

Building a Financial Services Centre

Attachment 1
ASR Submission to the Mortimer Review

Export Policies
and
Programs

June 2008

Summary

Australia is already a global financial services centre of some significance.[1] *Australia has globally recognized niche expertise in aspects of each of insurance, banking, securities and asset or funds management. Australians are also innovators in consumer credit and mortgage finance, including in the non-bank sector.*

Australian financial services providers deliver their services to non-resident customers via all 4 modes of delivery on an increasingly complementary basis.[2] *To encompass the full array of modern services activity, the concept of a "centre", traditionally understood to be geographically located on Australian soil, needs to be broadened to ensure an enlightened policy focus which also encompasses business opportunities to be reaped via commercial presence offshore.*

The fact that export data is still unavailable by mode of delivery considerably complicates formulation of an appropriate policy framework.. Nevertheless, the available data suggests that when mode 3 (commercial presence offshore) is taken into account, Australia's strongest financial services "export" performance has registered in insurance services, followed by banking, followed by asset management. All of these financial services exports could be considered, however, to be performing well below potential – all have strong business growth opportunities especially in emerging markets in Asia.

Funds management in particular, has the potential to bring new work to Australian shores. Industry projections suggest there will be, for example, US$2Trillion just of mutual fund assets in Asia by 2011. The financial services attached to these capital investments would be in the order on average of over 2%. The biggest growth opportunities are projected to lie in China, Taiwan, Korea, Japan, India, Indonesia, Vietnam and the Middle East. The Australian financial services sector must rise to the challenge of meeting this emerging demand or risk becoming marginalized in what is set to be the biggest period of wealth creation the Asian region has yet seen.

The Australian Services Roundtable calls on the Federal and State Governments to help industry to maximise Australia's share in these new emerging markets.

As for other services sectors, a new suite of innovative export-oriented policies and programs will be required. So will a whole-of-government approach to ensuring competitiveness via regulatory and taxation reform, education, training and immigration and knowledge economy infrastructure. Most importantly ASR calls on government to ensure that the domestic regulatory environment is neutral with respect to services mode of delivery.

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[1] ASR adopts the WTO GATS classification of "Financial services", namely all kinds of insurance, banking, securities and asset management. See Annex 1 for detail, including CPC classification.

[2] As set out in the main report; Mode 1 is cross-border (electronic); Mode 2 is sales onshore to non-residents; Mode 3 is commercial presence offshore; Mode 4 is fly-out to service customers offshore.

1. Present Performance

Sydney, and to a somewhat lesser extent Melbourne, already have a significant place among the financial capitals of the Asia-Pacific region. Sydney would generally be considered to be among the top 10 financial centres in the world. Sydney and Melbourne would both register in the top 5 in Asia. Financial services, including wholesale and retail banking, general insurance and infrastructure and property financing would generally register among the relatively faster growing of Australia's services exports, especially when mode 3 delivery of services, ie delivery via commercial presence offshore, is taken into account. Australia's insurance industry ranks 2nd in the region after Japan.

Australia's expertise in financial and related ancillary services has strengthened considerably since introduction of compulsory superannuation requirements for all Australian employees, a policy shift which stimulated rapid development of a innovative funds management industry focused initially on servicing the extensive local market. Over the last 5 years, during a period in which information technology has revolutionized the way in which financial investments are packaged and distributed, Australia has emerged with the largest pool of managed investment assets in Asia and the 4th largest in the world.

Combined with our geographic location and time zone, robust regulatory environment, general cost competitiveness and multi-lingual skills base, this rapid growth in the scale and efficiency of our own local market has significantly enhanced Australia's competitive advantage in doing business in financial services in Asia. Australia has recognized high value-add capabilities in asset management services design and delivery. Australian funds managers have proven track records in innovation in fund design, infrastructure funding, property trusts, financial planning, investment platforms, hedge funds, and retirement savings. Australia is a world leader in Real Estate Investment Trusts and Infrastructure Investment Funds. Australia's actuaries are acknowledged as world class.

Importantly, this expertise is not just at the big end of town – we are talking about a range of firms including many nimble small and medium-sized boutique players.

Despite these apparent strengths, Sydney's relative position among the top 10 financial centres in the world, has dropped a notch over the last year.[3] Like other services sectors, there is recent evidence that our relative export performance is under par. As is the case with other services sectors, this means, as a minimum, that closer policy attention is called for.

And there is clearly work to be done if Australia is to fully reap its potential even with respect to funds management. The fact is that more funds are still sent offshore to be invested in offshore-domiciled assets and managed by non-Australian residents, than the reverse. Australia's net export performance in funds management is poor.

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[3] The City of London's Global Financial Centres Index (March 2008) rated Sydney at no.10 in March 2008. Hong Kong is rated 3rd and Singapore 4th.

The question is sometimes asked, to what extent, and how, in building a centre, does activity for the local market matter. One reason it matters relates to the fact that every step in the local service supply chain needs to be competitive, in order for the entire sector to be competitive internationally. This is true at both the low and the high value-added end. Our local industry super funds have millions of members and generate strong ancillary and commoditised support services such as custodial and report keeping services. The depth of our local market has also permitted specialization in all sorts of sophisticated new products. This is where Australia's unique comparative advantage lies; in the clever product development team in the middle office.

2. Big New Opportunity

Meanwhile, something extraordinary is happening with respect to wealth creation throughout East Asia and more recently in South Asia, creating huge emerging retail interest in savings and new markets for wealth (including sovereign wealth and pension) management skills into existence. New pension systems are being built from the ground up.

Australia would seem well positioned to take advantage of this big new opportunity and to build its reputation in all kinds of financial services but especially in wealth and asset management. Some industry estimates predict growth of 14 percent in financial assets in the region over the next few years, far outstripping rates of growth in Europe or North America. China's mutual fund assets are set to increase by 75 % and India's by 100 % over the next 5 years. These Asian markets are increasingly seeking global equity management expertise.

The export opportunity is right in front of us and industry and government should be acting in partnership to harness it now. There is no question that Australia has the required expertise. But the competition is strong. Other countries are also positioning themselves to provide funds management and ancillary services to the global funds management industry. Luxembourg, Ireland, Singapore, and Dubai to name just a few.

We need to ensure Australia really has the capability and the will to match this competition. The export market is never easy. Australia's past experience on the banking front is sufficient testimony to that fact. Local market inertia is always strong. But in a globalizing world economy, it's ultimately a recipe for stagnation.

3. Policy Focus

Past tradition is for Federal and State Governments to focus on inward foreign investment attraction and in particular on attracting regional headquarter functions to Australia. This approach to services industry development involves attracting mode 3 commercial presence into Australia of foreign services firms in order, presumably, not so much to service the local market but to generate net Australian-resident mode 1 (and also mode 2 and mode 4) services exports.

Attracting regional headquarter work to Australia is part of, but potentially only a small part, of what is required to really build Australia as a financial services centre. The time has come to think bigger.

The time has come to aspire to much higher levels of mode 1, 2 and 4 financial services exports (eg management from Australia of businesses offshore, management in Australia of assets flowing into Australia from offshore, outsourcing by foreign firms established here to boutique Australian firms, and consultancy and advisory services delivered offshore on a fly in/fly out basis) but also explicitly to promote mode 3 financial services activity from Australia ie facilitate Australian commercial presence offshore, preferably on a 100% ownership basis. This critical ingredient has not previously been sufficiently on the policy radar.

Initial surveys of 100 % Australian-owned offshore affiliates were undertaken by the ABS in 2005 to try to get a grasp on mode 3 services delivery offshore. The results suggested that the official data on services exports as measured by the Balance of Payments has probably been measuring less than one third of Australia's actual delivery of services offshore, this being especially the case for insurance services.

Commercial presence is formally required, in many regulatory jurisdictions, for delivery of the full range of financial services to both the wholesale and retail markets. While our trade policy should be firmly geared to removing offshore regulatory impediments of this kind, and while it is true that electronic computerised data transmission has reduced significantly the need for geographic closeness to market, a degree of co-location with the client will likely remain of some marketing importance at least for certain retail markets.

Since the election, the Government has recognized the need for policy shift in this direction and has begun the process of combining in one organization the trade promotion functions of Austrade with both inward and outward investment promotion responsibilities.

This is a critical first step in expanding Australian financial services business offshore and in promoting Australia as a regional and global financial services centre. (And a regional and global every other kind of services centre.) But it is only a beginning. To identify what else needs to be done, we need to put some definition around what we mean by a financial services centre?

3.1 What is a financial services centre?

The idea of a services industry "centre" emerges from the notion that there are economies which arise from agglomeration of services activities, such as information signaling and spillover and access to expertise. For non-laboratory forms of innovation, clustering is also thought to help build the appropriate culture. As in all services sectors, realising these economies is all about building relationships.

Financial services are high value-added knowledge-intensive services which tend to be generated through complex services supply chains, packaged with a range of enabling and support services such as legal, accountancy, computer, software development and IT services, custodial, compliance and risk monitoring services, education and training services, portfolio administration services, actuarial services, platform delivery systems and investment performance research and reporting services.

The idea of a services “centre” implies a physical agglomeration in a geographic location of all aspects of this knowledge-intensive services supply chain, allowing efficient relationships to be built. The “centre” attracts all the players including the back and middle office but most importantly, the centre thrives and builds by encouraging a focus on the highest value-added activities. In funds management, for example, that means the innovative design process itself: the ultimate objective in the “centre” is not only to advertise, sell, distribute or manage the funds from that location, but to design and create (“manufacture”) the package. The location of this specific activity (the one to which ultimately the most valuable niche expertise is attached) is a function not only of quality of life and culture of innovation, but also, very importantly, of regulation as well as taxation and incentives.

The task of promoting a services “centre” located in Australia is therefore more complex than the single idea of helping a niche Australian services firm export into a global services supply chain, though that activity must also be part of the equation. Building a hub means ensuring the whole supply chain can operate effectively from or through the hub in all 4 modes of service delivery. And that we attract the highest value-added most innovative expertise. Because services industry reputation ultimately depends on talent.

Lets take funds management as an example. Australian funds managers have proven themselves to be effective innovators. The local market itself stimulates an active ongoing culture of innovation. We have demonstrated expertise in the highest value-add activities. But we are failing, for regulatory and taxation reasons, to export Australian-domiciled funds. Ultimately, for the reasons outlined above, the domicile really matters. We are cutting an innovative export industry off at the knees.

The main body of this report sets out a series of policy recommendations for the services sector as a whole, all of which are fully applicable to financial services exports. This attachment focuses on a selected number of additional issues specific to building a financial services centre. It should be read in conjunction with the report itself. This submission is not the place to elaborate in detail, so we confine ourselves to the use of a few noteworthy examples.

3.2 Taxation

The Taxation Review currently underway needs to ensure that Australia’s tax regime is globally competitive and is not unduly prejudicing our financial services export performance. A number of uncertainties and complexities in the existing system are currently adding to the industry’s compliance burden and hence impacting on cost competitiveness.

Example(Funds Management); *Non-resident investors are naturally reluctant to invest in vehicles to which any regulatory risk might attach, eg which might turn out to attract host country tax rather than allow all income and capital* *gains to be taxed in their own home jurisdictions. Investors are therefore likely to choose funds domiciled in the most transparent, most user-friendly no-surprise jurisdictions with which they have familiarity, where regulatory irritants are minimal and where investors are given the benefit of the doubt. This means that even where all the creative thinking has been done in Australia, Australian funds managers currently have a marketing incentive to pay the costs associated with choosing Dublin or Luxembourg as domiciles for their funds. This does not suggest that current Australian policy settings are as smart as they should be! Tax policy settings should be oriented to growing not stunting local expertise.*

3.3 Regulation

We need regular regulatory review processes to ensure our systems of financial services governance are genuinely up to date and consistent with global best practice. This includes prudential regulation. Importantly, we need to ensure that the regulatory environment is neutral with respect to business choice of mode of services delivery.

Anecdotal evidence and emerging academic literature suggests that most services firms, across every services sector, use all 4 modes of delivery.[4] Government intervention is emerging globally as a key factor determining the choice of mode at any particular location. One of our key objectives for the Doha Round is consequently to ensure that services trade is freed up in all 4 modes.

In the view of the Australian Services Roundtable, it is important that Australia's regulatory environment be similarly neutral with respect to the choice of international business model employed. Where it is not neutral, distortions and costly inefficiencies are created as industry is forced into a preference for one delivery mode over another.

The Australian Government seems to have internalized this policy principle when dealing with protectionist barriers offshore. We must remember to apply the same policy principle when reviewing our own domestic regulatory arrangements. We are especially concerned that our regulatory arrangements should not continue to prejudice mode 3 delivery of services offshore.

Example (Insurance); *Australian prudential regulations may be prejudicing the relative ability of Australian general insurers to achieve commercial presence offshore, compared with competitors based in other jurisdictions such as Europe. A competitive disadvantage is created, for example, when the minimum capital requirements in Australia are significantly higher than those of our competitors. Due to lower capital requirements, lower economic capital is needed to maintain a multiple of the minimum capital at a target level. As a result entities regulated in favourable jurisdictions can "pay up" for assets offshore, whilst maintaining an adequate return on capital (in monetary terms). Australian firms tend as a result, to be cut out of the competition for commercial presence in Asia. Prudential regulation*

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[4] This is a new insight, it being previously thought that any one services industry typically used only one mode eg education, health and tourism have tended to be seen as exported chiefly via mode 2, but this is nolonger so etc.

in Australia also tends not to cover mode 1 imports of insurance on a "level playing field" basis.

Example (Banking): *The 4 pillars policy may be prejudicing the participation of Australian banks in competing successfully for work offshore; it may also be putting them at a disadvantage in acting as lead banker for local transactions by Australia's largest corporations. Our banks are increasingly exposed to import competition.*

The Australian Services Roundtable has no debate with a robust competition policy; competition is the critical ingredient ensuring efficiency and productivity in the Australian economy.[5] *But proper judgement of market contestability requires first and foremost an accurate identification and definition of the relevant market. The fact is that Australia is nolonger a closed economy. Australia is an open, fast globalising services economy and the relevant market place is the global one. Corporate scale must be judged on a global not a local basis. And Australian Banks are dropping relatively on any international scale. Australia's largest Bank, the Commonwealth Bank of Australia, is one fifth the size of the largest Chinese Bank and one third the size of the largest European Bank. The National Australia Bank is 77th out of the top 100 in the world.*

In global banking, scale is an increasingly relevant factor. Other factors such as quality of assets and good management being held equal, credit ratings and funding costs do depend significantly on scale[6]*. No Australian bank has sufficient scale to be lead banker in the recent larger transactions or proposed transactions on the part of our largest companies. It would be difficult for Australian banks to take the lead in any M&A transaction among the larger Australian companies, say the ASX top 50.*

It is our view that it would be easier to build Australia as a financial services centre if Australian banks were able to grow. Our banks have important niche expertise, for example in agricultural banking. But they need to expand to a position where they can afford sufficient foreign acquisitions to externalize this local experience and grow a dedicated foreign clientele.

Size, we know, is not everything. Singapore is a successful financial center without any large global Singapore banks. But Singapore offers advantages on the tax front that Australia can not offer. If our banks do not have scale, the fact is they must offer other special qualities; they must be more agile and more innovative; they must have better people skills and better IT capability, they must have more supportive export promotional programs and a dedicated government effort to facilitate market access. We discuss each of these issues below.

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[5] Similarly important for a public policy perspective, for all infrastructural services, including financial services, is ensuring universality of service provision.

[6] Westpac's promotional material indicates, for example, that a merger with St George Bank would deliver a shift from an A to an AA rating and reduce funding costs appreciably. It also enables, according to the promotional material, lower unit costs as back office functions such as wholesale manufacture become combined.

3.4 Talent

As in so many other service sectors, Australia needs a top level elite academic financial services institution. We need to attract the right staff, create the right curricula, generate and retain the graduate body and we need to start now. At present, Australia retains fewer Asian graduates than we otherwise could if we had an Industry/Government international post-graduate strategy that would allow Australian firms to more easily employ these graduates or redeploy them in the region.
We also need to attract more skilled migration to Australia to help address the evident professional skills shortages.

3.5 Infrastructure

High quality, internationally cost-competitive broadband network access is a prerequisite in facilitating innovation and export in all of Australia's industries, and financial services is no exception.

3.6 Export Programs

As in all services sectors, building awareness of Australian-brand capabilities offshore is extremely important. In financial services, advertising the robustness of our regulatory system is essential. This must include promotion of the Australian taxation system itself as transparent, predictable and risk free.

There is scope for the design of new ground-breaking "innovate and compete" export incentives for financial services providers, in banking, insurance and funds management. The R&D tax concession is largely irrelevant for non-laboratory innovation in fast moving services markets such as asset management. And the Export Market Development Grant Scheme was designed with goods exporters in mind and is constrained in its design by the rules imposed by the WTO Subsidies Agreement. The time has come to think seriously about what Australia could be doing to encourage innovative services exporters across all 4 modes of delivery.

3.7 International Trade, Investment and Tax Negotiation

The Prime Minister has signaled that this Government will give priority to reducing the barriers to trade in financial services, including on a bilateral basis. But as with other services sectors, overcoming the barriers to trade in financial services presents a trade policy challenge of the highest order. There is little evidence that our trade negotiators really have the detailed understanding of the industry required. Nor any fluency with the business or regulatory language. There has been too great an onus on industry representatives to learn the trade policy jargon and too little effort in the other direction. The Treasury needs to accept a much higher level of responsibility and to be much more fully engaged than in the past.

3.7.1 Nature of the Barriers

As with other services sectors, the barriers to trade lie in investment and immigration regimes and in an array of often opaque domestic regulatory requirements.

Specifically the barriers take the form of border protection which limits commercial presence eg through foreign equity caps and requirements for joint ventures or limits visa access for foreign personnel and behind-the-border licensing, regulatory recognition and other regulations which constrain the operations and scope of business of foreign providers. Barriers also lie in the application of prudential controls and of professional eg actuarial standards and recognition of Australian trained professionals eg actuaries.

3.7.2 WTO

Australia chairs the Financial Services Working Group in the GATS. There is room for considerably more public advocacy and business consultation with respect to the work of this group. There are insufficient processes of regular consultation with or reporting back to industry on developments in financial services in the WTO.

The new Financial Services Reference Group, recently convened by DFAT, has the potential to fill this gap but it requires more active Treasury engagement, including for example, joint chairmanship. The Group should meet more often, at more senior levels and should pursue an active two-way consultation agenda. It could usefully facilitate more regular feedback to government from the Financial Services Leaders Working Group, to which the Australian Services Roundtable belongs, along with other core members of the Global Services Coalition.

We would like to propose a possible Australian initiative to reexamine the GATS definition of financial services to ensure it is up to date including fully inclusive of all funds management related services.

Post Doha, we would encourage the Government to become a more active champion for the addition of Investment to the multilateral negotiating agenda in the WTO. Australia should also be an active champion for the addition of Competition Policy to the negotiating agenda in the WTO. The Australian Services Roundtable was disappointed that the then Australian Government did not take a proactive position, at the Cancun WTO Ministerial meeting, to ensure that these two services-oriented issues secured their place in the Doha Development Agenda. This was a significant lost opportunity for Services which we would like to see rectified.

3.7.3 APEC

The new Structural Reform agenda in APEC is of deep interest to all services providers but it has special resonance for the financial services sector for the very simple reason that the Treasury has responsibility for it. This should provide the Treasury with another mechanism for broad and inclusive stakeholder consultation on business priorities for reform in the Asia-Pacific region. There is no evidence to date, however, that the Treasury is taking proper advantage of this local opportunity. The first Ministerial Meeting, in Australia, in August, risks coming and going without strong industry awareness. With some limited exceptions, APEC’s work on Services generally, on Financial Services specifically and on Investment is largely unfamiliar to the local financial services industry.

3.7.4 Free Trade Agreements (FTAs)

The main report sets out our basic requirements for the design and content of FTAs, noting that the FTA instrument has to date been a clumsy and inefficient mechanism for services trade and investment reform. We call for a new suite of trade policy tools more suited to and more specifically applied to the services sectors. We draw attention to our support for Services and Investment instruments, unencumbered by Goods trade issues. With respect to financial services, we add specifically;

- Any Services Chapter should always be supplemented by a separate chapter or annex on Financial Services, which should specifically cover funds management as well as banking, insurance and securities.

- Preferably, an FTA annex on Financial Services should go beyond the GATS to specifically cover aspects of mutual regulatory recognition, at least with respect to securities. As a minimum, mutual recognition issues should be negotiated on a simultaneous time frame to any FTA.

- The financial services market access commitments should always be based on a negative list; this is extremely important in new areas such as funds management where industry does not want to trigger any clawback of market access, via a specific request for positive listing of a market access binding,

- Where developing country trading partners resist the inclusion of robust Chapters on Investment, complete with solid market opening commitments, Australia should pursue an FTA architecture which preserves the GATS structure and hence provides services providers with a higher degree of certainty that WTO plus commitments on mode 3 commercial presence will be included in the FTA.

- Australia should always include specific mode 4 commitments with respect to skilled personnel in every FTA, whether or not by way of a Chapter on Movement of Natural Persons.

- Any Government Procurement Chapter should specifically cover commitments on Financial Services and cover all State entities and State Owned Enterprises which purchase financial services, including Sovereign Wealth funds and Central Banks.

3.7.5 Double Taxation

Just as the inclusion of an Investment Chapter of an FTA has tended to replace and override the requirement for a “Bilateral Investment Treaty”, we consider that taxation should similarly become an integral part of any bilateral trade negotiation. At the very least, FTA negotiations should not commence until a Double Taxation Treaty is either in place or simultaneously being negotiated with a particular trading partner. Where negotiating resources are scarce, industry priorities with respect to Double Taxation Treaties should take priority over geopolitical priorities with respect to FTAs. Bilateral Tax agreements should give explicit coverage to managed funds to ensure they are able to access tax treaty benefits.

Annex 1 Definition of Financial Services

WTO General Agreement on Trade in Services Services Sectoral Classification List (MTN.GNS/W/120)

7.	FINANCIAL SERVICES		CORRESPONDING CPC
A.	All insurance and insurance-related services		812**
a.	Life, accident and health insurance services		8121
b.	Non-life insurance services		8129
c.	Reinsurance and retrocession		81299*
d.	Services auxiliary to insurance (including broking and agency services)		8140
B.	Banking and other financial services (excl. insurance)		
a.	Acceptance of deposits and other repayable funds from the public		81115-81119
b.	Lending of all types, incl., inter alia, consumer credit, mortgage credit, factoring and financing of commercial transaction		8113
c.	Financial leasing		8112
d.	All payment and money transmission services		81339**
e.	Guarantees and commitments		81199**
f.	Trading for own account or for account of customers, whether on an exchange, in an over-the-counter market or otherwise, the following:		
	- money market instruments (cheques, bills, certificate of deposits, etc.)		81339**
	- foreign exchange		81333
	- derivative products incl., but not limited to, futures and options		81339**
	- exchange rate and interest rate instruments, inclu. products such as swaps, forward rate agreements, etc.		81339**
	- transferable securities		81321*
	- other negotiable instruments and financial assets, incl. bullion		81339**
g.	Participation in issues of all kinds of securities, incl. under-writing and placement as agent (whether publicly or privately) and provision of service related to such issues		8132
h.	Money broking		81339** i.
	management, all forms of collective investment management, pension fund management, custodial depository and trust services		81323*
j.	Settlement and clearing services for financial assets, incl. securities, derivative products, and other negotiable instruments	or	81339** 81319**
k.	Advisory and other auxiliary financial services on all the activities listed in Article 1B of MTN.TNC/W/50, incl. credit reference and analysis, investment and portfolio research and advice, advice on acquisitions and on corporate restructuring and strategy	or	8131 8133
l.	Provision and transfer of financial information, and financial data processing and related software by providers of other financial services		8131