Investment & Financial Services Association Ltd
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Secretariat
Review of Export Policies and Programs
c/- Department of Foreign Affairs and Trade
BARTON ACT 0221

Review of Export Policies and Programs

Thank you for this opportunity to comment on this timely and important review.

Fundamentally, our submission seeks a strategic rethink of the manner in which trade policy is approached, especially for financial services.

It is our belief that if Australia is to achieve meaningful financial services export outcomes, our approach to trade policy will need to expand to encompass the removal/mitigation of regulatory and taxation barriers – both at home and abroad.

Australia has a genuine opportunity to become a major exporter of financial services. Economic research commissioned by IFSA has shown that lifting finance and insurance exports as a share of Australian GDP from the current 2.9 per cent to 5 per cent would involve an eventual $3.7 billion stimulus to the Australian economy in today's prices, while lifting the export share to 10 per cent would translate into a $13 billion boost.

Our submission focuses on the export potential of the Australian financial services industry; deficiencies in the current approach to trade policy; the current challenges faced by the funds management industry in exporting more of its output; and on measures that could be implemented to address these challenges.

I look forward to discussing these matters with you in more detail.

Yours sincerely

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Investment & Financial Services Association Ltd

REVIEW OF EXPORT POLICIES AND PROGRAMS

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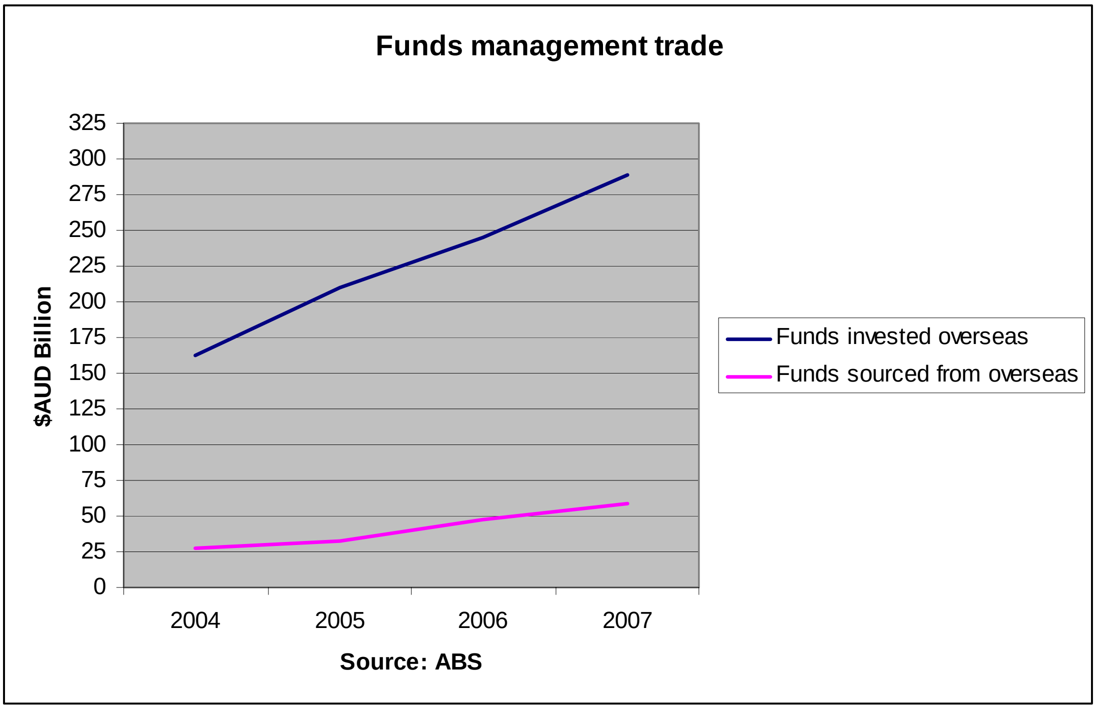
1. Assessing the level of cross-border funds management activity

Australian fund managers professionally invest funds on behalf of domestic and foreign clients such as other fund managers, pension funds, superannuation funds, insurance companies, corporates, individuals, governments and sovereign wealth funds.

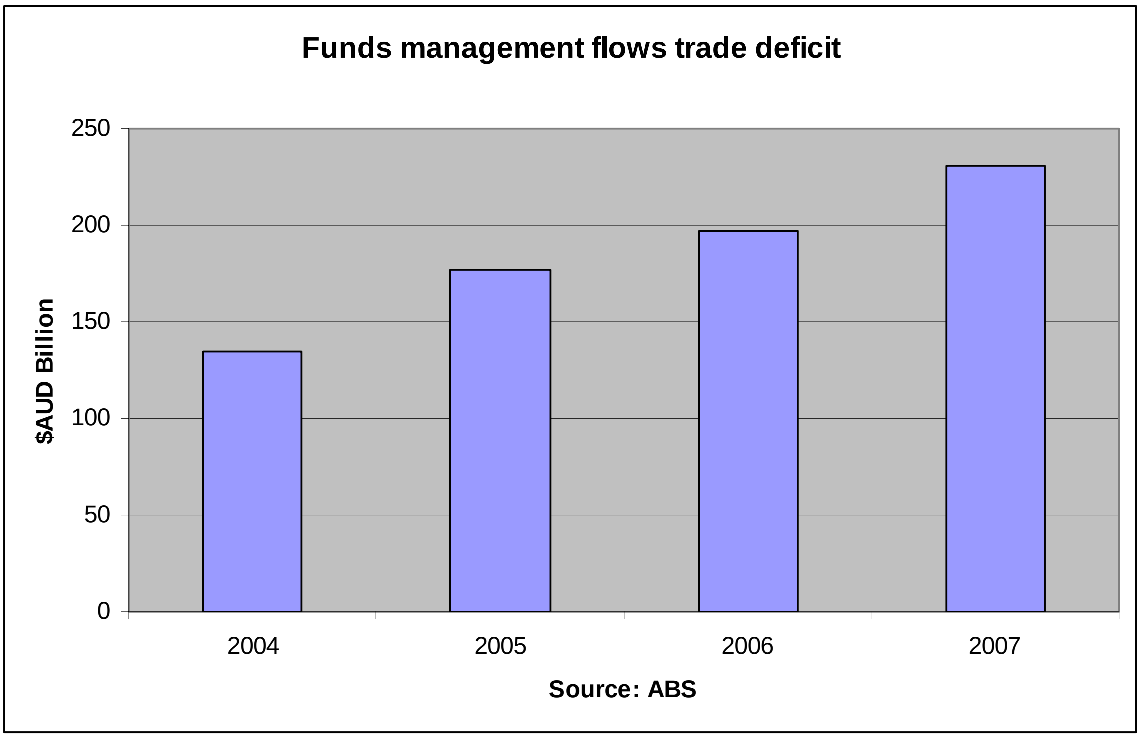
These funds are invested into domestic and foreign markets/assets such as listed equities, derivatives, bonds, debt instruments, property, infrastructure, private equity etc.

The extent of cross-border activity in funds management is highlighted in the chart below which compares the level of funds which are *invested* overseas by Australian fund managers with the level of funds which are *sourced* from overseas and managed by Australian fund managers.



The comparison can also be considered a kind of proxy for the level of cross-border trade in funds management services – where funds invested overseas constitute an ‘import’ and funds sourced from overseas constitute an ‘export’.

Interpreting the chart in this manner illustrates the significant ‘trade gap’ in funds management. Further, as can be seen from the chart below, the size of the deficit is increasing – meaning that the rate of growth of ‘imports’ is exceeding the rate of growth of ‘exports’.



The existence of this trade deficit has significant implications for national investment and for the financial services industry more broadly.

Collective investment vehicles invest heavily in domestic equity, property and infrastructure assets – comprising over 50% of total funds under management as at December 2007 (or $715 billion). These funds effectively represent an investment in the future productive capacity of the Australian economy.

One way of addressing this trade deficit and attracting an increased share of foreign portfolio investment into Australia is to remove barriers to foreigners accessing Australian fund managers.

Barriers that presently exist include:

- foreign limits on off-shore capital/investment flows;
- foreign regulatory requirements limiting the operations of Australian fund managers in off-shore markets such as through foreign equity caps and other requirements for joint ventures;
- discriminatory tax settings for off-shore funds discouraging off-shore investment; and
- non-recognition of Australian Financial Services Licenses and Managed Investment Scheme registration off-shore.

Removing these barriers will result in Australian fund managers being able to more effectively compete off-shore and will also allow foreign investors to more freely invest with Australian fund managers – translating into increased portfolio investment into Australia.

In addition to attracting greater portfolio investment, there is also much to gain from improving the level of access for Australian fund managers to foreign markets/investments. Improved access to foreign markets/investments results in:

- increased efficiencies and reduced costs for domestic fund managers, increasing their competitiveness;
- new investment opportunities for Australian investors; and
- increasing the attractiveness of Australian fund managers to manage funds on behalf of foreign investors.

In summary, improving the flow of cross-border funds benefits the Australian economy through:

1. Australian firms earning increased revenue from the management of overseas funds. Given funds management activity is highly specialised and segmented, a broader range of complementary/enabling services such as custody, technology providers, legal and accounting as well as compliance and risk monitoring services will also benefit.

2. Increased employment opportunities in high value, sustainable 'knowledge sectors' of the economy.

3. An increased share of foreign portfolio investment into a broad range of Australian assets.

Supporting these conclusions, modelling by Access Economics (attached) indicates that increasing the financial services sector's share of exports from the current 3.1% to 10% by 2010 would result in:

- $3.3bn additional export income;
- an increase in GDP of 0.3% or $19bn; and
- up to an additional 25,000 new jobs in the economy.

2. The export potential of Australian funds management services

This section briefly explores the competitive advantages that Australia possesses in funds management and examines in more detail the export opportunities for the industry in the Asian region.

Australia's funds management industry is the 4th largest in the world. Over the past 10 years, the volume of funds under management has increased three-fold, at a compound annual growth rate of 12.3 per cent, reaching in excess of $1 trillion.

The growth of the managed funds industry in Australia has been largely underpinned by a number of domestic driven factors: a sophisticated investor base, mature markets, participation by leading global financial institutions, innovative investment products, an efficient regulatory environment and our superannuation system.

The Australian funds industry now represents a high value, sophisticated sector in the Australian economy with a comparative advantage due to domestic scale, location/time zone, sound financial regulatory underpinning, cost-competitiveness vis-à-vis major regional competitors and a large domestic multi-lingual talent pool.

It is therefore not surprising that our managed funds industry has been described by international market analysts, Cerulli Associates, as "the most sophisticated retail funds management marketplace outside of the US."[1]

Assessment of export opportunities in the Asian region

It is generally accepted that the major drivers of growth for the funds management industry around the world include:

- Ageing populations in mature and developing economies coupled with pension system reforms/liberalisation
- Growing middle and affluent classes
- Pressure to fund commitments to defined benefit and corporate pension schemes
- Shift away from banking deposit products to wealth management products
- Sovereign wealth funds

The fundamental trade policy conclusion that flows from these drivers is that ease of access to investors (i.e. the free flow of capital across borders) in markets with these characteristics will be a major driver of Australian funds management exports.

[1] The strengths of the industry are outlined in detail in attachments to this submission.

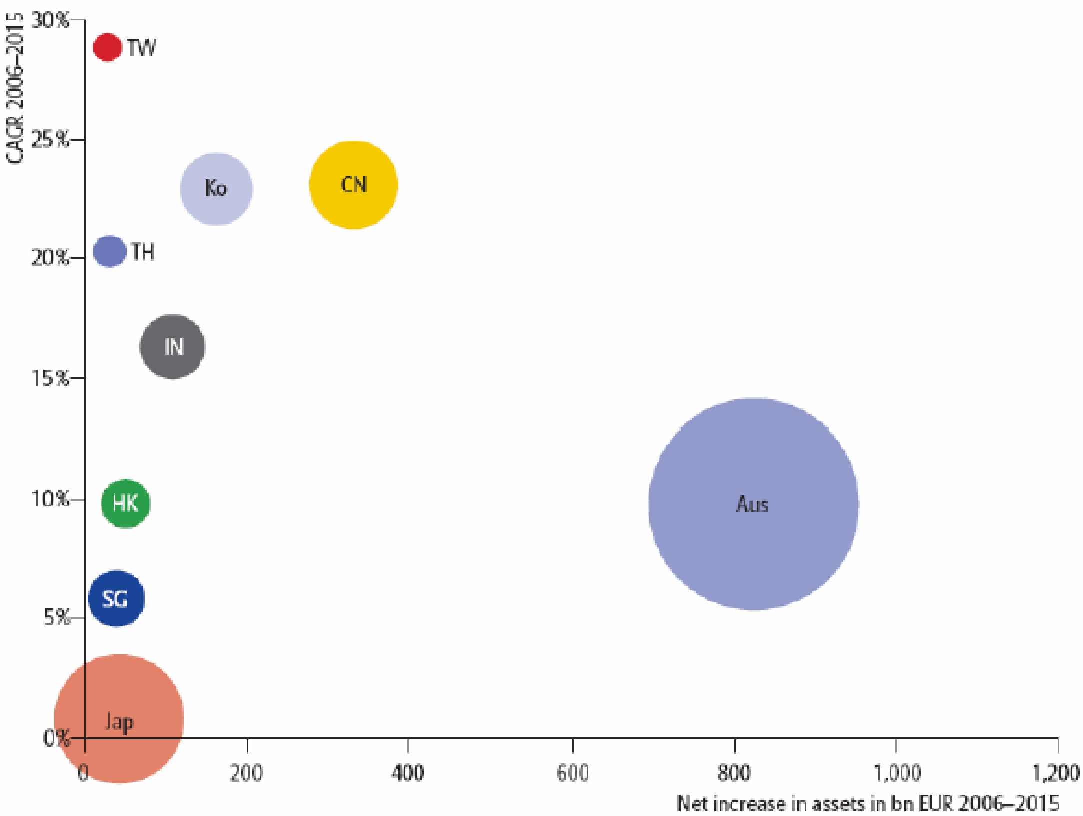
Driver 1: Ageing populations in mature and developing economies coupled with pension system reforms/liberalization

A recent study by Allianz Global Investors[2] examined the macroeconomic and demographic developments and trends in Asian pension systems and markets.

Taking as an aggregate the Asia-Pacific countries covered in the study, Allianz projects that assets under management will increase by EUR 1.7 trillion, at a compound annual growth rate of 9.2%, to EUR 3.1 trillion by 2015.

The chart below highlights Allianz's assessment of the expected rate of growth in pension fund assets in a number of Asian markets. While Australia remains one of the most attractive pension markets in the world, markets such as South Korea, China and India will outpace our domestic growth rate – in some cases by more than double.

Development of pension assets under management



The size of the bubbles reflects the estimated asset volume in 2015

Source: Allianz Global Investors, Allianz Dresdner Economic Research

Commenting on India's prospects, Allianz found that positive demographic trends and a burgeoning middle class will result in India becoming the growth driver of Asian pension markets in 10 to 15 years.

Importantly, Allianz also examined the need for reform in various Asian markets over the same period, taking into account demographic and current pension system design.

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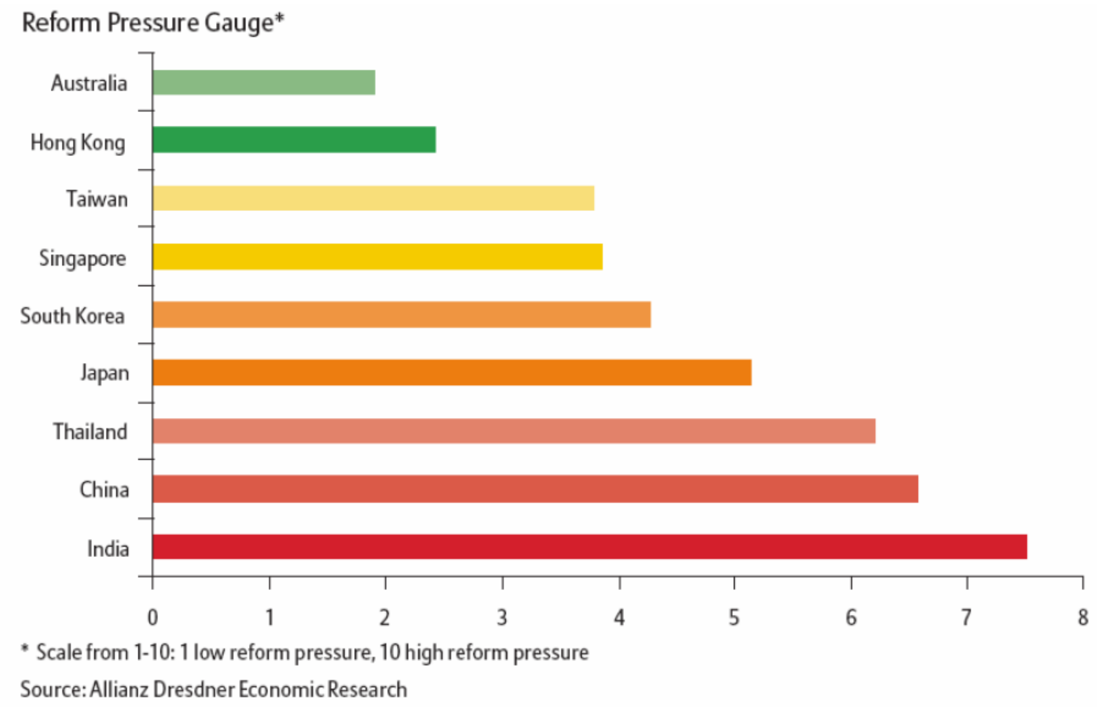
[2] Allianz Global Investors, 'Asia-Pacific Pensions 2007: Systems and Markets'.

Given the size of their current populations and in China's case their aging population, it is not surprising that both countries are considered to be facing the biggest pressure to reform their current systems.



Many countries in the region are now considering reforms and Australia is in an excellent position to provide assistance. Assisting in the development of retirement schemes in the region will place Australian financial services firms in good standing to provide retirement products to these markets following the reforms.

Driver 2: Growing middle and affluent classes

Boston Consulting Group has indicated that by 2010, there will be more than 57 million households with assets under management in excess of $100,000 in the Asia-Pacific region.[3]

The same report noted that in Japan, there are already several million millionaires.

Similarly, according to McKinsey & Company, the Indian middle class currently numbers some 50 million people, but by 2025 will have expanded dramatically to 583 million people – some 41 percent of the population.[4]

Driver 3: Pressure to fund commitments to defined benefit and corporate pension schemes

Many countries are yet to transition away from defined benefit arrangements towards more modern private pension systems based on defined contribution schemes.

As a result, countries such as Japan have significant unfunded pension liabilities which will need to be met as the population reaches retirement. According to recent

[3] Boston Consulting Group, 'The growth dilemma', 2007.
[4] McKinsey & Company, 'Next big Spenders: India's Middle Class', 2007.

reports, only 1% of Japan's US$2.5 trillion in pension assets are in defined contribution plans.[5]

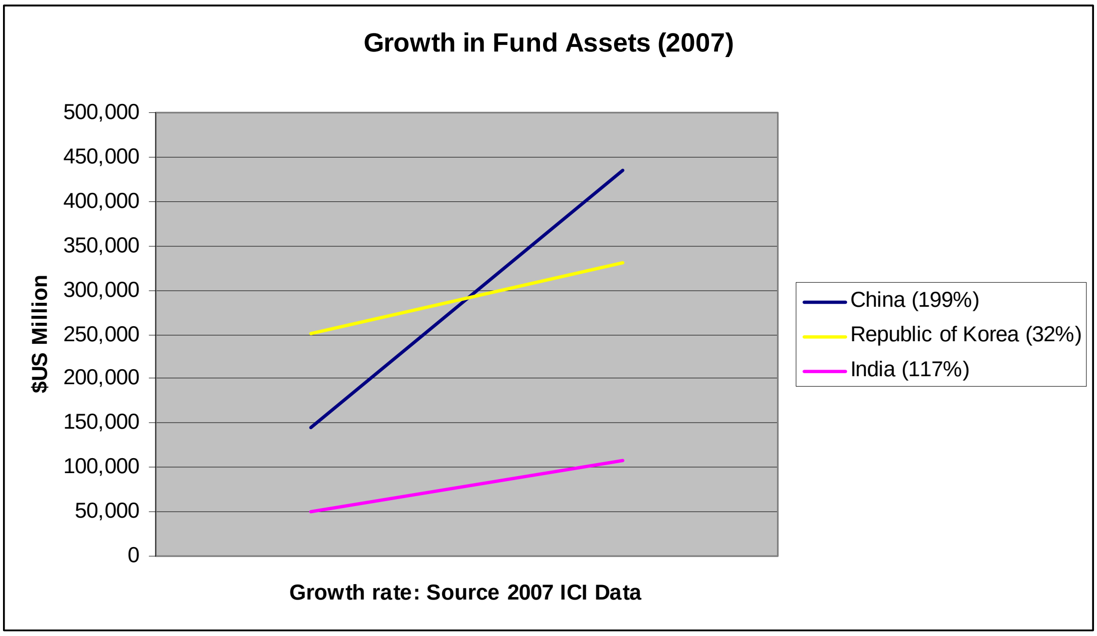
Driver 4: Shift away from banking deposit products to wealth management products

Many countries in the region have significant financial assets outside of their pension and managed fund sectors.

Japan's household sector, for example, has more than US$14 trillion in financial assets. The need for wealth management services will dramatically increase as countries such as Japan and China, with significant national savings held in less productive financial products, begin to seek out more productive savings vehicles such as managed funds.

These trends are expected to drive regional growth to around 14% per annum over the next decade – significantly greater than North America and Europe. Mutual Fund assets in Asia are expected to reach US$2 trillion by 2011.[6]

The chart below shows the growth in fund assets during 2007 in 3 major emerging funds markets in the Asian region.



In many Asian markets, this growth is expected to increase as the drivers noted above continue to drive an increase in managed fund assets.

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[5] Putnam Lovell, 'After the Belle Epoque, The future of fund management' and State Street Global Advisers, 'The Pensions Industry - Bridging the Gap found', 2008.

[6] Cerrulli Associates, 2007

Driver 5: Sovereign wealth funds

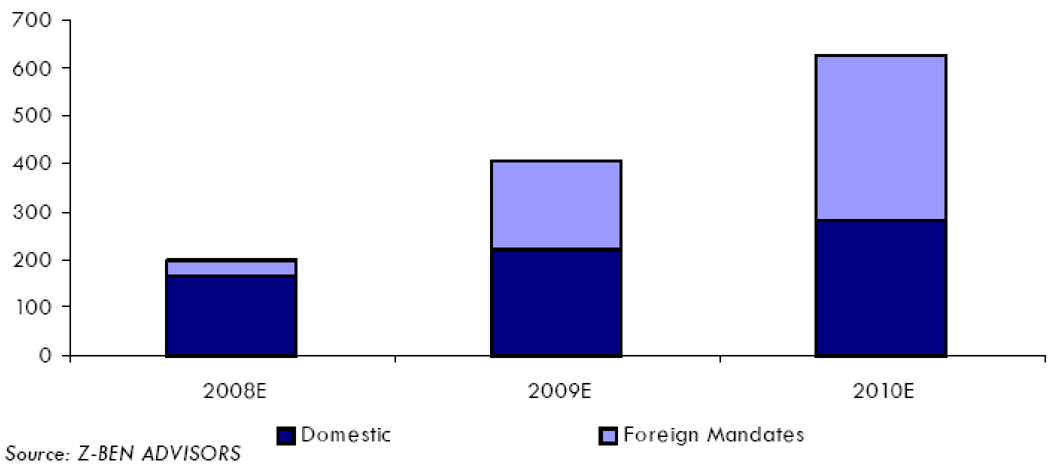
At present, it is estimated that sovereign wealth funds have some US$3 trillion in funds under management, growing by 18 per cent last year.[7]

According to Morgan Stanley data, these funds are expected to grow to more than $18.4 trillion in 10 years.

In the region, major funds are operated by Singapore (US$320 billion), China (US$200 billion) and the Gulf states (US$625 billion) – with a number of other countries in the region also looking to establish funds of there own.

A recent report by Z-Ben advisers forecast that the Chinese Investment Corporation's assets under management would rise from US$200 billion today to US$625 billion by 2010, with around 70% of those new funds to be outsourced to foreign third-party managers.

CHINA INVESTMENT CORP: Projected AUM (USD Billions)



Source: Z-BEN ADVISORS

[7] International Financial Services London.

3. Reviewing the current approach to trade policy

For many years, financial services, and funds management specifically, have been a low order of priority to those negotiating multi-lateral and bi-lateral trade agreements.

Encouragingly, IFSA welcomes recent developments such as the creation of the 'Financial Services Reference Group' in January 2008, established in partnership between the Department of Foreign Affairs and Trade (DFAT) and the financial services industry.

Critically, the Reference Group includes representatives from the ABS, ASIC, AUSTRADE and Treasury – ensuring that all relevant Government agencies able to play a role in facilitating the export of financial services are involved.

The Reference Group provides an ideal forum for DFAT to brief industry on the state of play of their ongoing FTA and other negotiations. It also allowed industry to provide input on trade barriers and concerns as well as trade priorities across markets and regions.

IFSA sees the Reference Group as a catalyst to an ongoing whole of Government approach to lifting the level of financial services exports. Industry strongly believes that the nature of financial services trade means optimal outcomes will only be delivered where all relevant Government agencies are engaged in the trade process.

Role of regulatory recognition in delivering improved trade outcomes

Australian fund managers are generally unable to offer investment products to clients in the region without establishing a commercial presence in the foreign market and also obtaining a license to offer such products. Additionally, even where such a license is obtained, Australian domiciled funds are often not permitted to be offered as they are not recognised for sale in foreign jurisdictions.

Regulatory recognition is therefore critical to Australian fund managers being able to offer 'domestic' investment products to foreign investors in their home market.

Similarly, increasing the utility of an Australian Managed Investment Scheme in the region makes Australia more attractive to global funds management firms as they are able to establish a regional presence in Australia.

In the absence of broader regulatory recognition for Australian funds, Australian and global fund managers based in Australia will instead establish funds in jurisdictions which are widely recognised for cross-border distribution such as Luxembourg and Dublin.

Where fund managers locate a fund outside of Australia, Australia misses out on the revenue that would otherwise be derived from the broader range of complementary/enabling services that underpin management of the fund, such as custody, technology providers, legal and accounting as well as compliance and risk monitoring services.

As a result, IFSA recommends that regulatory mutual recognition discussions be driven from a broader trade policy perspective as compared to the current, more narrow, regulatory policy perspective. Additionally, mutual recognition discussions should be pursued at the same time as negotiating other trade related agreements.

At a more technical level, Australia now has a legislative mechanism under which to pursue mutual recognition arrangements – Chapter 8 of the *Corporations Act 2001* ‘Mutual recognition of securities offers’.

However, at the same time, ASIC also has the ability to grant relief to Foreign Collective Investment Scheme operators where they are authorised under a sufficiently equivalent regulatory regime in their home jurisdiction and satisfy certain other criteria.

Under ASIC 'Regulatory Guide 178 Foreign Collective Investment Schemes', relief from Managed Investment Scheme registration, Australian Financial Services Licensing, and some financial product disclosure requirements is able to be provided.

An important point of difference with the Corporations Act mutual recognition mechanism is that the ASIC relief is not predicated on mutual recognition – that is, it only provides for access to foreign schemes, without requiring reciprocal access for Australian schemes.

Over time, ASIC has provided scheme registration and certain licensing relief to foreign schemes from Hong Kong, Singapore, New Zealand, USA, UK, Jersey and Isle of Man.

On the basis that this relief was provided on a unilateral basis, IFSA would strongly support efforts to now pursue mutual recognition arrangements with these jurisdictions given the new legislative framework that exists.

Utilising the new arrangements would also make such relief more robust and transparent compared to the current arrangements which are subject to regulatory discretion and which in the past were implemented without the input of stakeholders such as the local financial services industry (itself made up of Australian and foreign participants).

Role of Double Tax Agreements in delivering improved trade outcomes

Tax treaties play an important role in ensuring Australian domiciled businesses are able to compete and expand internationally.

While tax treaties have traditionally served to remove inefficiencies and alleviate instances of double taxation between countries’ tax systems, it is now appropriate that a more strategic approach be adopted consistent with the Government’s policy to promote Australia as a global financial services hub.

Accordingly, IFSA recommends a number of changes to the negotiation framework to ensure our tax treaties contribute to this objective.

Going forward, IFSA considers that there would be clear benefits in tax treaty negotiations forming part of broader trade negotiations. This approach would facilitate improved trade outcomes through more closely aligning trade priorities with tax treaty negotiation outcomes.

It is important to recognise that even the most successful trade negotiations which liberalise financial services trade between two countries can turn out to be ineffectual as a result of undesirable tax outcomes that act as a barrier to the liberalisation otherwise achieved.

Consequently, IFSA recommends that the Australian Government attempt to deal with tax treaty negotiations concurrently with FTA negotiations. This approach would ensure that both trade and tax treaty negotiations are handled in a more holistic fashion. Such an approach would also allow for tax treaties to be reviewed at the same time an FTA is being reviewed.

At a more technical level, the recognition of managed funds under tax treaties is also of critical importance.

Australian managed funds make substantial investments into offshore entities on behalf of Australian resident and non-resident investors. It is critical that managed funds are able to access treaty benefits that apply to distributions or interest payments from these offshore entities.

Generally, for an entity to get the benefit of reduced interest, dividend and royalty withholding tax rates under tax treaties it must be a resident and it must be beneficially entitled to the income.

Australian managed funds operate on a trust model. There is presently uncertainty as to whether Australian created, managed and owned widely held trusts are resident of Australia for the purposes of tax treaties and whether they are beneficially entitled to income.

To remove this concern, IFSA recommends that future tax treaties:

a) include widely held collective investment schemes within the definition of resident of Australia; and

b) specifically provide that for the purpose of the treaty a listed or widely held collective investment scheme is the beneficial owner of income.

4. Other measures necessary to grow the export of funds management services

More active and coordinated promotion of financial services

While Australia is starting to become more widely recognised in the region for its financial services capability, more can be done, at all levels, to raise the profile of the industry off-shore.

In particular, IFSA believes that there is a clear role for government to expound the virtues of Australia's regulatory regime to other countries in the region with a view to not placing artificial barriers on investors seeking to invest in Australian funds.

More active promotion of financial services should include consideration of:

- Government missions raising the profile of the industry off-shore, and especially in the Asian region. In this regard, the leadership demonstrated by the Prime Minister on his recent trip to the US, UK and China is seen as a watershed by the industry.
- Senior Ministers and Departmental official's participation in off-shore industry delegations seeking improved regulatory outcomes and market access.
- Improved coordination of existing resources and efforts. This includes more effective leveraging of existing Treasury and DFAT Posts off-shore through greater collaboration between industry and these Posts.[8] Additionally, greater use could be made of existing promotional material developed in association with industry, such as the 'Managed funds in Australia' publication, released this year by the Department of Innovation, Industry, Science and Research.
- More active involvement by financial regulators in promoting the strengths of Australia's regulatory regime including through their participation in international forums.
- Appropriate resourcing for AUSTRADE and other promotional agencies to ensure they are able to effectively assist the industry.

Promotional activities will be most effective where Government and industry work in partnership.

Better information on services and financial services exports

There is currently very little data available on the cross-border flow of funds.

In respect of managed funds, the only official data available is that provided in the Australian Bureau of Statistics (ABS) Catalogue 5655.0 Managed Funds, Australia.

In terms of tracking cross-border capital flows, this Catalogue uses aggregated categories titled 'funds from overseas' and 'assets overseas' (as seen in an earlier chart) for total assets derived from overseas sources and total assets held overseas respectively.

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[8] IFSA has had a very positive experience in working with Government Posts in the region including in Beijing, Hong Kong, Seoul, Taipei, and Tokyo.

This limited aggregation means that there are considerable gaps in understanding the cross-border flows in the managed funds sector. For example:

- The data does not capture *flows*; rather, just the total *stock* at a given point in time, meaning it is not possible to meaningfully assess trends in cross-border fund movements.

- The Catalogue does not currently provide details on the asset classes into which these funds are invested (either domestically or overseas). For example, there is no breakdown of either flows or the stock of funds according to: equities, property, fixed interest, private equity, alternatives, etc.

- In relation to the aggregate 'funds from overseas' and 'assets overseas', neither the country source nor country destination is currently disclosed. This information would be particularly useful in assessing the success of government initiatives to facilitate Australia's export of financial services across different markets. More specifically, it would allow vital information on funds flows to be utilised for the benefit of negotiations around mutual recognition agreements between country regulators, free trade agreements and double tax agreements.

- Further transparency with respect to the form of the cross-border flows would also be desirable beyond merely "direct" and "indirect" classifications. This would provide a more in-depth understanding of the investment vehicles being used by foreign investors investing in the Australian market and vice-versa.

Additionally, the data published by the ABS relating to cross-border capital flows has been questioned by research houses who believe it is a considerable under-estimate of the actual activity taking place.

In summary, improving the quality of cross-border funds flow statistics should be seen as a priority.

5. Recommendations to improve the level of funds management and related exports

IFSA recommends:

1. An ongoing 'whole of Government' approach to lifting the level of financial services exports. The nature of financial services trade means optimal outcomes will only be delivered where all relevant Government agencies are engaged in the trade process.

2. The portability/recognition of Australian Managed Investment Schemes (i.e. managed funds) be enhanced throughout the region by:

    a. Regulatory mutual recognition discussions being driven from a broader trade policy perspective and pursued at the same time as negotiating other trade related agreements.

    b. Mutual recognition arrangements with jurisdictions who have previously been granted unilateral regulatory relief by ASIC be pursued as a priority.

3. Tax treaty negotiations form part of broader trade negotiations.

4. Collective investment vehicles be explicitly recognised under tax treaties to remove uncertainty.

5. More active and coordinated promotion of financial services occur through:

    a. Government missions raising the profile of the industry off-shore, and especially in the Asian region.

    b. Senior Ministers and Departmental official's participating in off-shore industry delegations seeking improved regulatory outcomes and market access.

    c. Improved coordination of existing resources and efforts such as the more effective leveraging of existing off-shore Posts and via greater use of existing promotional material.

    d. Greater involvement by financial regulators in promoting the strengths of Australia's regulatory regime including through their participation in international forums.

6. Appropriate resourcing be provided to AUSTRADE and other promotional agencies to ensure they are able to effectively assist the financial services industry.

7. The quality of ABS statistics on Managed Funds be improved to include information about:

    a. Fund flows rather just the total stock at a given point in time.
    b. The country source of the 'funds from overseas'.
    c. The asset classes into which the 'funds from overseas' are invested.
    d. The asset classes into which the 'funds invested overseas' are invested.