

## ‘POSITIONING FOR EMERGING OPPORTUNITIES’

### PRESENTATION TO MELBOURNE FINANCIAL SERVICES SYMPOSIUM 2011

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#### INTRODUCTORY COMMENTS

- Thanks to the Australian Centre for Financial Studies for the opportunity to talk to you today on “Positioning for Emerging Opportunities”
- I’ll be focussing in particular on offshore opportunities for Australian fund managers.
- The Chairman of the Centre for Financial Studies and your next Speaker today, Jeremy Duffield, is also a member of the Financial Centre Task Force:
  - And Jeremy has been very actively involved in the policy issues I want to focus on today.

#### STRUCTURE

- I’d like to begin my presentation by talking briefly about offshore opportunities for the Australian financial sector, particularly in Asia;
- I’ll then make some observations on how Australia is currently positioned to take advantage of these opportunities;
- The remainder of my presentation will be more forward looking, focussing on three key funds management recommendations in the Johnson Report on “Australia as a Financial Centre”, and where they’ve got to.

## ASIA: LEADING THE GLOBAL RECOVERY

- The Asian region, notably the so-called Newly Industrialised Economies (Korea, Taiwan, Hong Kong and Singapore) and Emerging Asia, was for the most part much less adversely affected by the financial crisis than the western industrialised economies;
- In addition, the Asia region has been leading the world out of the financial crisis, in terms of its growth prospects over the next few years and beyond
- There are a range of consequences flowing from this very uneven pattern of global growth. Most of them are positive, but being an economist I should also mention a couple of potentially negative ones:
  - such as the associated trade and currency tensions; and
  - risks of rising inflation in the region resulting from very accommodative policy settings and strong capital inflows.
- One very clear consequence of the uneven growth is that Asia's share of global GDP is likely to go on rising, indeed at an accelerated pace:
  - Based on IMF forecasts, developing Asia's share of global GDP on a purchasing power parity basis is forecast to rise from around 8% in 1980 to almost 30% by 2015.
  - And when you add in the Newly Industrialised Economies, then Asia ex Japan's share is forecast to rise from around 10% to around one third of global GDP over the same time period
- Associated with this will be a further rapid rise in the region's share of global wealth, global trade and global savings.
- The Johnson Report on 'Australia as a Financial Centre ', which the Government released in early 2010 and responded to in last year's Budget, focussed on some of the offshore opportunities for Australia flowing from this massive increase in income and wealth in the Asian region.

- One particular area of opportunity for Australia lies in funds management.
- The Report included some data on the pool of global savings in pension, mutual and sovereign funds.
  - While the data are now a couple of years out of date, the underlying picture remains the same.
  - In 2007, that pool of global savings was around \$52 trillion.
- Australian based fund managers manage a tiny proportion of this global savings pool: around 0.1%, worth a bit over \$50 billion;
- When you consider the size of our financial sector, and in particular the size of our funds management sector - on some measures the fourth largest in the world- this tiny proportion of offshore sourced funds under management is very surprising, a point I'll return to shortly
- Even on conservative assumptions, this pool of global savings is projected to triple from 2007 to 2017;
- If the Australian funds management sector was able to raise its managed share of this savings pool to just 0.2% - still tiny - that would represent an increase in funds under management of some \$250 billion by 2017:
  - With all the associated gains to Australia in income, tax receipts, jobs, and economies of scale - and hence potentially lower fees domestically.
- Currently, Asia's share of this global savings pool is small compared to say Europe or the US,
  - but it's growing rapidly;
  - and it will rise even faster in coming years, in line with the relative rise in income and wealth in the region I referred to earlier.
  - In addition, some detailed analysis done by McKinsey's shows that, within this global savings pool, potential opportunities for external fund managers are particularly large in the Asian region.

## How is Australia Positioned to Take Advantage of These Offshore Opportunities?

- One of the central findings of the Johnson Report is the very low level of exports and imports of financial services in Australia compared to other countries:
  - Examples of exports: offshore sourced funds, banks dealing with offshore counterparties.
  - amongst those countries with a similar definition of financial services, only Japan and New Zealand export less relative to the size of their financial services sectors than we do.
- I mentioned earlier that this inward focus was very noticeable in our funds management sector:
  - We have a \$1.7 trillion funds management sector, arguably the fourth largest in the world, yet still only about 3% , or a bit over \$50 billion, is sourced offshore.
- The Johnson Report found a number of reasons for this inward focus, such as:
  - brand recognition and marketing difficulties for Australian financial services companies offshore;
  - Market access difficulties, including regulatory constraints; and
  - The fact that our superannuation system has provided a wide range of domestic opportunities.
- However, in our discussions with a wide range of financial market participants, by far the most widespread and strongly expressed comments regarding barriers to offshore opportunities related to tax uncertainty:
  - That is, uncertainty with respect to the tax treatment in Australia of a range of cross border financial transactions

- We're talking here about issues such as: what constitutes Australian source income, what constitutes a permanent establishment, capital versus revenue account issues, and so on:
- When we were writing our Report, we came across many examples of how these tax uncertainties were preventing companies from taking full advantage of offshore opportunities and discouraging offshore investors from investing via Australian entities.
- These are all lost opportunities.
- By most people's reckoning and indeed in most international surveys, Australia also has a very competitive and efficient financial sector- arguably the most efficient, full service financial sector in the region.
- Yet unlike in other areas where we excel, such as mining, agriculture, or education services, we're not maximising our economic welfare as a nation by exporting many financial services.
- Just to make it clear: we're not suggesting that all Australian domiciled fund managers should be looking to source a high proportion of their funds offshore:
  - That's entirely a commercial decision, and it may make perfect sense for many funds management companies to just focus on the domestic market, be it managing super money or non-super money.
- However, what we are suggesting is that, for those companies who would like to reap the economies of scale and other benefits flowing from offshore sourced growth in FUM, policy settings - whether they be tax or regulatory- should not be inhibiting that objective.
- The Government, both prior to and since the release of the Johnson Report, is well aware of this and has been focussed on removing policy constraints that prevent Australian financial services companies from taking advantage of these offshore opportunities:
- That's reflected in:
  - A number of policy reforms in recent years, such as the capital account election measure in the most recent budget and the changes to the MIT regime; and

- The Government's positive response to nearly all the 19 recommendations in the Johnson Report, including:
- its establishment of the Financial Centre Task Force, focussed on implementation of the recommendations in the Johnson report and providing ongoing policy advice in this area
- Three of the five main areas of focus for the Task Force at present are directed primarily at the funds management sector: IMR; alternative collective investment vehicles; and negotiation of an Asian Passport:
  - Time permitting I'd like to discuss each of these in turn.

## INVESTMENT MANAGER REGIME

- Arguably the most important of the 19 recommendations in the Johnson Report related to the establishment of an Investment Manager Regime or Investment Manager Exemption
- This was focussed on providing much greater certainty and clarity with respect to the tax treatment of cross border financial transactions, especially in the funds management space.
- In essence, the recommendation with respect to funds management is that, for non resident investors using an independent Australian fund manager, broker or exchange:
  - Investment in foreign assets would be totally exempt from any Australian tax liabilities; and
  - Investment in Australian assets would only be liable to any existing withholding tax obligations.
- The report also recommended the establishment of a wider range of collective investment vehicles that are taxed on a flow-through basis, to deal with the fact that the typical Australian vehicle, the MIT, is not widely used or recognised in many other countries in the region (PTO)
- The Government accepted both of these recommendations in principle and referred them to the Board of Tax, which must report by the end of 2011.

- The Government has in addition recently announced a couple of measures which go part way towards the establishment of a full IMR:
- Last December, in response to pressures emanating from the US FIN 48 Accounting rules which required US based funds to make disclosures in their financial accounts relating to uncertain tax positions, the Government announced moves to ensure that:
  - where a foreign fund (US based or otherwise) that has invested in Australia has not lodged an Australian tax return for the 2009/10 or prior financial years in respect of certain investment income, the ATO will not be permitted raise an assessment in respect of that income;
  - This holds irrespective of whether profits are Australian sourced or are attributable to an Australian permanent establishment
- In January this year, it also announced that relevant investment income of offshore funds that use Australian based investment advisers and are deemed to have a “permanent establishment” in Australia will, from 2010/11 onwards, be exempt from income tax or CGT simply due to the existence of this Permanent Establishment:
  - But note this measure does not exempt Australian sourced income
- What these two measures mean in effect are that, on a backward looking basis, we have a full funds management IMR; and on a forward looking basis, we have a partial IMR - which covers issues relating to permanent establishment but not other areas of tax uncertainty such as source.
- The Task Force is consulting closely with the Board of Tax on its broader examination of a full IMR:
  - and we’re hopeful, given the measures already taken by the Government, that such a regime will be put in place soon after receipt of the Board of Tax Report.

## ASIA REGION FUNDS MANAGEMENT PASSPORT

- Let me turn now to the third element of the funds management package that the Task Force is currently focussed on : an Asian Funds Management Passport
- Probably the most ambitious recommendation in the Johnson Report was the negotiation, amongst like - minded countries in the region, of a common funds management regulatory framework that allows locally domiciled retail and wholesale funds registered in any one member country to be passported across borders and sold in all other member countries.
- At present, UCITS funds that are domiciled in Europe are gaining a major market share in a number of Asian countries.
- The UCITS regulatory structure was designed by EU countries, for passporting across EU countries, but sales have subsequently spread internationally, in particular in Asia.
- Because these UCITS funds have to be domiciled in an EU country, all the skills and jobs associated with the full range of funds management support services - fund accounting and admin, custody, compliance, taxation, legal- are going to Europe
- The idea of the Asia Passport is to provide a local regulatory framework that can compete against UCITS and allow locally domiciled funds to sell their products more easily in the region
- Such an Asian Passport could bring a number of substantial benefits to the region, including:
  - Greater investor choice;
  - Greater regional control over funds management regulations;
  - Increased capital flows and liquidity in the region; and
  - The growth of skills and jobs in the region in support services.

## PROGRESS REPORT ON PASSPORT

- I mentioned before that this proposal is very ambitious and difficult, for a whole range of reasons:
  - However, we've been very pleasantly surprised at the extent of regional support that's already been generated.
- Very briefly:
- This Passport proposal was discussed at a regional APEC meeting in October and received a very favourable hearing;
- It was then officially welcomed by APEC Finance Ministers in November, and the initiative was subsequently officially launched by Prime Minister Gillard in Kyoto in November.
- Further meetings of officials are planned for this year, with the first likely to be this month, to start fleshing out the framework, with the possibility of this leading into a pilot project
- These negotiations will be difficult and time consuming:
  - They'll need a lot of input from industry, which we're co-ordinating through a Working Group we've set up.
  - They'll also need to cover a wide range of issues including eligible investment asset classes, custody arrangements, offer document conditions, registration and licensing arrangements and consumer protection issues
- But as I mentioned, the extent of support and enthusiasm for the idea to date has been extremely encouraging.
- One final observation I'd make on these three funds management policy measures
- The IMR, alternative funds management vehicles and Asia Passport recommendations I've just discussed need to be seen as a funds management package: if you take away any one of the three elements, the other two will be a good deal less effective.

- Indeed , if we negotiated an Asian Passport with other countries in the region but failed to implement an effective IMR, the result would be that overseas funds managers would find it a lot easier to sell their products here but we would continue to struggle to sell ours overseas, because of the ongoing tax uncertainties
- In other words, Australian fund managers looking to sell product in the region need the right vehicles, they need tax certainty for the offshore investor, and they also need ease of access to those offshore markets

## CONCLUDING COMMENTS

- There are some real opportunities at present for the Australian financial sector to shape the policy framework that will apply going forward:
- But there are also some real challenges
- At present, over 80% of non \$A portfolios held by Australian domiciled funds management companies are simply contracted out to offshore managers, rather than managed in house.
- As the pool of super money grows rapidly to an estimated \$5 trillion in 20 years time, Australian managers will need to be allocating a lot more to non \$A assets in line with the usual risk/return and diversification objectives;
- If in addition we have ambitions to manage more offshore sourced assets, why would offshore investors invest via an Australian fund manager if all he or she then does is contract it out to big offshore players?
- We need to get much better at managing global and regional portfolios in house.

Many thanks.