

FINANCIAL SYSTEM INQUIRY PHASE TWO

CHAPTER FOUR

INTERNATIONAL INTEGRATION

CHAPTER 4 - INTERNATIONAL INTEGRATION

OUTLINE

The FSC commends the Inquiry on the inclusion of the international integration chapter in the interim report. Given the importance of this sector to the Australian economy and future growth prospects, a much greater focus is required in the final report, including recommendations on regulatory changes.

This section focuses largely on funds management, which as the world's third largest market gives Australia a considerable comparative advantage.

We outline recommendations on:

1. Australian policymaking and regulation impeding integration;
2. An Australian coordination and promotion body;
3. Continued support for the Asia Region Funds Passport (ARFP);
4. Australian regulatory changes required for ARFP success; and
5. National trust law reform.

While Australia has a large financial services sector, contributing 8.7% to GDP in 2012-13 and containing the third largest pool of managed funds globally, the level of funds sourced internationally at just 3.4% is very low by global and regional standards.

There is significant scope for growth in exporting Australia's financial services given our comparative advantage of a highly skilled workforce, proximity to Asia and economies of scale due to our large superannuation system.

The industry's external growth prospects have been cruelled by regulation and taxation arrangements. The Wallis Inquiry acknowledged this was a problem as globalisation started to provide opportunities for Australia.

It stated: "In the face of globalising markets, every effort should be

made to ensure that Australia's financial system is able to compete without the impediments of outdated, inadequate or costly regulations or discriminatory taxes."

In the 17 years following the Wallis Inquiry, little progress has been made on this agenda despite the rapid pace of globalisation.

Modelling by Deloitte Access Economics¹ shows that exports in managed funds could increase GDP by \$4.2 billion by 2029-30 if we reached the level of exports equivalent to Hong Kong or Singapore.

Australia needs to implement competitive regulation and tax rates in order to attract foreign investment in the sector. Improving the domestic regulatory process to better consider international regulatory developments is paramount.

In order for this to occur, an effective government body should be established to coordinate government agencies, review financial regulation to ensure international competitiveness and to integrate our financial services sector with Asia. Currently, no such coordination body exists.

Responsibilities relating to international integration and regulation are split between several government bodies, which has led to the slow progress of the Johnson Review recommendations.² This is evidenced in our low export rate of managed funds and minimal take-up of mutual recognition arrangements.

The Government's newly launched 'economic diplomacy' policy outlines the need for increased focus on trade and investment and greater coordination within Australia on international engagement.

Future growth prospects for Australia will be centred on increasing trade in services where we have a comparative advantage.

Expanding this sector by increasing trade (especially in the region) will be critical to sustaining growth and working towards the G20's target for developed countries to collectively grow 2% above current trajectory over the next five years. Increasing international integration in financial services should be a priority for both government and industry.

According to a recently released McKinsey and Co report³, Australia needs new sources of growth to sustain jobs and living standards.

¹ Deloitte Access Economics 'The economic impact of increasing Australian funds management exports' May 2014

² Mark Johnson AO - Building on our Strengths - Australia as a Financial Centre 2009

³ McKinsey and Co 'Compete to prosper: Improving Australia's global competitiveness' 2014

These new sources will primarily come from improving competitiveness in order to increase trade. The report looks at trade flows in all sectors of the economy, and concludes that Australia is much less trade driven than most other developed nations.

While Australia's financial services industry is large, exports make up a small proportion of the sector. Regulation has prevented Australia's industry from competing strongly against other jurisdictions with more attractive regulatory settings.

As discussed earlier, approximately 3.4% of total funds under collective management in Australia are sourced offshore. This compares to other countries in our region which have significantly higher levels of exports (Singapore with 80% and Hong Kong with 60% of funds sourced offshore).

Regulation impacts the competitiveness of the financial services industry. The 2009 Johnson Review into 'Australia as a financial centre' provided a framework to resolve many of the issues which were making it difficult for foreign investors to access Australian managed funds.

Major impediments include: tax arrangements, collective investment vehicle legislation, regulatory settings, a lack of understanding of our system within Asia and a lack of coordination of international issues by various government agencies.

The recommendations in the Johnson Review cover the existing impediments to international integration and should be considered carefully in light of the policy options outlined in the Interim Report.

1. AUSTRALIAN POLICYMAKING AND REGULATION IMPEDING INTEGRATION

Deloitte Access Economics

According to Deloitte⁴, increasing exports of funds management services would have notable flow-on effects to the economy, increasing GDP and jobs and adding to tax revenues. The increased supply of additional funds from abroad in effect would also lower the cost of capital in Australia.

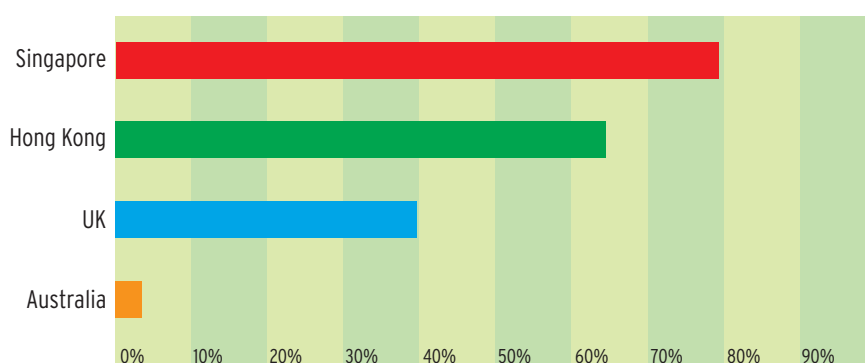
The size of the potential gains to key economic indicators (from Deloitte's modelling) indicates that there would be significant benefits to the Australian economy from increasing exports of fund management services.

⁴ Deloitte Access Economics 'The economic impact of increasing Australian funds management exports' May 2014

There is significant scope for growth in exports of managed funds, from a very low base, given Australia's comparative advantage of a highly skilled workforce, proximity to Asia, and economies of scale due to our large superannuation system.

The report notes that, looking at the broader measure of financial services, exports of financial services were \$1.6b in 2012. As a percentage of GDP this is 0.11% compared to 5.76% for Hong Kong and 5.58% for Singapore. This highlights the gains that could potentially be made in this area.

Figure 4.1: Funds under management sourced offshore



Source: ABC Cat. No. 5655.00, Monetary Authority of Singapore 2013, Hong Kong Securities and Futures Commission 2013, Investment Management Association 2013

The above chart shows the proportion of funds sourced offshore in Singapore, Hong Kong, the UK and Australia. This shows the very low export base from which Australia must grow in order to reap the benefits from increased financial services trade.

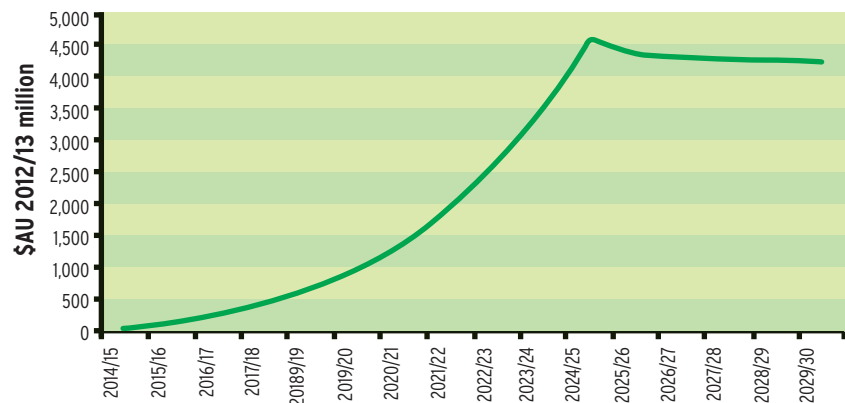
The report's analysis shows that the industry has a relatively high level of direct value added as a proportion of revenue. This indicates the majority of revenue in the sector goes either to wages or gross operating surplus in the fund management firms themselves and remains in Australia. Including other indirect economic contributions and flow-on effects to other sectors of the economy, 98% of industry revenue is converted to value added.

There are also positive tax implications and increased government revenue from increasing exports of managed funds which would also be the case for financial services in general.

The report's modelling shows that a doubling in the value of funds management exports is estimated to lead to an increase in GDP of \$362m (as the peak in 2020-21). It was also estimated to lead to an increase of more than 1400 extra jobs in 2020-21.

If the level of funds management exports were to grow more rapidly such that they reached the levels of fund management exports in Hong Kong by 2023-24, it would lead to a \$4.2b increase in GDP above baseline levels in 2029-30 and 10,000 full-time jobs⁵.

Figure 4.2: Projected increase in GDP (\$AU 2012/13 million)



Source: Deloitte Access Economics

The above graph shows Australia's projected GDP increase if we were to increase the level of overseas funds under management to the projected level of Hong Kong. GDP would peak in 2024/25 at an increase of \$4.6 billion and then stabilise off at an increase of \$4.2b thereafter.

Australia's financial regulatory system is principles-based, in comparison to rules-based systems in most of Asia and other jurisdictions. This can, and has, presented challenges when increasing financial sector integration with Asia.

It is critical that differences in regulatory philosophy and approach between Australia and countries in our region does not impede our efforts to integrate.

Free trade agreements

Several major free trade agreements (FTAs) have recently been negotiated by the Department of Foreign Affairs and Trade (DFAT) with major Asian trading nations.

Both the Korean and Japanese agreements have excellent chapters on financial services, however many of the previous commitments in financial services have never been implemented or established within Australia so they can actually be used by businesses.

This is largely because there is no agency responsible for the implementation of the agreements. This could explain the lack of

⁵ Deloitte Access Economics 'The economic impact of increasing Australian funds management exports' May 2014

impact of FTAs in financial services and the low functional usefulness of the mutual recognition arrangements negotiated thus far.

Where market access commitments are made within the financial services chapter of an agreement, it is essential that a whole-of-government implementation occurs. ASIC and DFAT should develop an implementation policy for financial services chapters of free trade agreements and mutual recognition agreements.

The Government should look to further strengthen financial services trade with both Korea and Japan following the successful negotiation of the KAFTA and the JAEPA. It is essential that these agreements are fully implemented so that both jurisdictions can capitalise on these cross border relationships.

Accordingly, ASIC must be tasked with enacting these market access commitments in order for Australian fund managers to capitalise on the agreements. Commencement of discussions with the relevant Korean and Japanese regulators should be progressed as soon as possible.

In particular, investigation of the potential for mutual recognition of financial service licensing and investment product offerings should be undertaken in conjunction with ASIC's counterparts in Korea and Japan.

RECOMMENDATIONS

Australian regulators take international regulatory systems, especially those of Asian countries, into account when implementing regulations and policies that may affect trade in financial services. An international regulatory impact statement should be adopted for new regulation.

ASIC should ensure market access is gained through implementation of current free trade agreements, and commence discussions with the relevant regulators as soon as possible (in particular Japan and Korea). Further, DFAT and ASIC should develop an implementation policy for financial services chapters of free trade agreements and mutual recognition agreements.

Domestic policymaking and coordination

As Australia looks to increase financial integration particularly with Asia, we must re-assess our regulatory and tax settings to ensure we are competitive as a financial centre.

The Government's recently launched 'economic diplomacy' policy aims to support Australia's prosperity through promoting trade, encouraging growth, attracting investment and supporting Australian business. In a response to the policy, The Lowy Institute noted:

“Because economic diplomacy requires domestic policy settings which reduce barriers to trade, economic growth and investment, DFAT, along with its two ministers, will need to lead a whole-of-government, whole-of-society effort to achieve positive economic outcomes through diplomacy.⁶”

RECOMMENDATION

Establish a permanent dialogue of Asian region regulators to harmonise financial regulation. Regional harmonisation should form part of the government's newly launched 'economic diplomacy' policy.

Australia's regulatory and international relations process is governed by several government bodies - Treasury (international financial organisations), DFAT (International organisations & FTA negotiation), ASIC (mutual recognition & domestic regulation), Austrade (trade promotion), the RBA and APRA.

While many of these bodies successfully coordinate domestic financial services matters, they are not tasked with ensuring the international competitiveness and capacity for trade of the industry. There is no sole body responsible for coordinating Australia's regulation and trade issues in the financial sector. This lack of coordination historically has led to inadequate progress in trade of Australia's financial services.

As an example, the recently negotiated mutual recognition arrangement for managed funds with Hong Kong has had no take-up from either country since it began in 2009. This is an indictment on both jurisdictions for drafting a mutual recognition arrangement which neither jurisdiction has been able to put to use.

In many jurisdictions, regulators have begun to coordinate through formal arrangements and legislation. This has been the case in the US, the UK, the EU, Sweden and Norway.

RECOMMENDATION

- Cooperation of the various regulatory agencies should be legislated and international competitiveness issues included in their mandates.
- An ASIC commissioner should be appointed to specifically deal with international regulatory issues.

Australia's Council of Financial Regulators (CFR) is an advisory body comprising representatives of ASIC, RBA, Treasury and APRA and coordination is mandated through MOUs rather than through legislation. The CFR sits on some international boards relating to financial regulation.

Neither international integration nor Australian competitiveness is in CFR's mandate, and as it is an advisory body it does not fit the necessary model for a coordination body as described in the FSI interim report.

⁶ Lowy Interpreter, 'Australia's economic diplomacy: Enlightened self interest?', August 2014, <http://www.lowyinterpreter.org/post/2014/08/18/Australias-economic-diplomacy-risks-and-opportunities.aspx>

Australian regulators' cooperation arrangements need to be enshrined in legislation and international integration issues should be included in their mandates. Under this new international mandate for the regulators, an ASIC commissioner should be appointed to specifically deal with these issues.

Policy coordination in other jurisdictions

Financial services policy coordination occurs in many other jurisdictions. Examples which could be adopted in Australia are outlined below.

United Kingdom

The regulators in the UK include the Prudential Regulation Authority, the Financial Conduct Authority, the Financial Policy Committee and the Bank of England. Coordination between these bodies is mandated in legislation and also through MOUs.

The Financial Services Trade and Investment Board was created to strengthen the competitiveness of the UK financial and related professional services industry and to help UK based firms secure access to markets around the world. FSTIB is chaired by HM Treasury and comprises senior representatives from the Department for Business, Innovation and Skills, the Foreign and Commonwealth Office and UK Trade and Investment. The board has five independent external members. TheCityUK is the representative for the industry on the board.

City of London

The City of London supports and promotes the City as the world leader in international finance and business services.

TheCityUK is an independent practitioner-led body set up to co-ordinate the promotion of the UK-based financial and professional services industry.

The City of London supports and promotes 'the City' (UK-based financial and related business services) in international markets; develops the City's presence overseas; assists in the organisation of overseas; activity encourages foreign investment into the City and facilitates inward visits by key overseas contacts.

The International Regulatory Strategy Group is a practitioner-led body comprising leading UK-based figures from the financial and professional services industry. It aims to contribute to the shaping of the international regulatory regime, at global, regional and national

levels, so that it promotes open, competitive and fair capital markets globally, supporting sustainable economic growth.

Hong Kong

The Hong Kong Financial Services Development Board (FSDB) was established by the government in January 2013 in response to the need for a high-level government advisory body to 'support the sustained development of the industry'.

The FSDB advises the HK government on policies and strategies to enhance the competitiveness of the financial services industry as well as promoting Hong Kong as a financial centre abroad. It is comprised of a council with representatives from industry, government and academia, several committees and a secretariat.

Korea

In Korea, interagency cooperation between the Bank of Korea, the Financial Services Commission and the Financial Supervisory Service is required by law.

The Financial Services Commission's mandate includes 'protecting the integration of Korea's financial markets'. It is a consolidated policy making body. One of Financial Services Commission's policy goals is Financial Industry Global Competitiveness - 'to foster a market environment for sound competition and revise financial regulation on a regular basis'. The Financial Services Commission also explores new growth opportunities for the financial sector seeking to globalise Korea's financial industry.

Japan

The Financial Services Agency in Japan is comprised of the Ministerial team: Minister of State for Financial Services, Senior Vice-Minister of Cabinet Office and a Parliamentary Secretary.

The policy coordinating committee for the financial services industry is formal and chaired by the Prime Minister.

Singapore

The Economic Development Board in Singapore is responsible for enhancing Singapore's position as a global business centre. Sitting under this is the International Advisory Council (made up of government and industry).

2. AUSTRALIAN COORDINATION AND PROMOTION BODY

Australia urgently requires a coordination body to be established to progress international financial integration and promote Australia's financial services in the region. This will involve improving the regulatory process to better take account of global regulatory systems and changes.

The various coordination and promotion bodies in the region and beyond indicate Australia is lagging behind in this area. The low level of our financial services exports also demonstrates this.

Australia's new economic diplomacy policy recognises the need for heightened coordination in international engagement:

"Effective economic diplomacy requires a 'Team Australia' approach to international engagement: inclusive, coordinated, and outcomes-focused". Australia's economic diplomacy will be most effective when government and business work collaboratively to support "Australia's international economic and commercial interests."⁷

A lack of coordination in international integration has meant a lack of progress. This body should be modelled on the ideas of the City of London and the Hong Kong Financial Services Development Board, and actively promote our economy as a financial centre. Australia's comparative advantage in this sector needs to be capitalised on, so we are not left behind.

An Australian coordination body

The Australian coordination body should progress international integration issues covering mutual recognition arrangements, financial services sections of FTAs, double tax treaties, the Asia Region Funds Passport (ARFP) and coordination of government agencies. This government resource should be dedicated to focussing on international competitiveness issues with the authority to generate legislation quickly and effectively.

The body needs power in legislation to deal with tax and regulatory issues affecting the industry. The body should be partly government funded but have advisory representatives from industry. The industry could also fund the body via a levy. If ASIC's mandate was changed to include international competitiveness, a portion of the industry levy could be used accordingly. We canvass ASIC's structure and funding in chapter 3.

⁷ A Charter: Economic Diplomacy and Australian Business, Australia's Economic Diplomacy Policy 2014

The new Trade and Investment Policy Advisory Council (TIPAC) established by the Minister for Trade and Investment could serve as the agency's advisory body, with the creation of banking and finance sub-group.

Regulatory changes and policy decisions by the coordination body must be sufficiently transparent and well understood by Asian counterparts. The Government must prioritise lifting the level of financial services exports through the establishment of this new body.

This statutory agency should sit under the Treasurer so as to have whole-of-government oversight and senior ministerial control. For example, in Japan the policy coordinating committee for financial services is chaired by the Prime Minister, which reflects its importance. The agency should be based in Sydney to be close to industry and regulators.

Key features:

- ❖ High-level agency with senior officials that is responsible to the the Treasurer;
- ❖ Established by legislation and powers to influence regulatory issues; and
- ❖ An advisory committee with representatives from industry, government and academia (a potential advisory body being the new Trade and Investment Policy Advisory Council).

Its mandate should cover:

- ❖ Coordination and liaison of the various government bodies associated with international financial services (DFAT, Treasury, ASIC, ATO, Austrade, APRA);
- ❖ Regulatory review in relation to international and Asian trade;
- ❖ Promotion of Australia's financial services industry abroad;
- ❖ Policy control and policy coordination of financial services component of FTA's, mutual recognition and the Asia Region Funds Passport; and
- ❖ Development of an Asian region integration strategy for the financial services sector including increasing trade.

Table 4.1: Coordination body responsibilities

MANDATE	DESCRIPTION	MODELLED ON
Coordinate	Coordinate policy between government agencies as it relates to competitiveness and trade in financial services	HK
Promote	Promote Australia as a financial centre in the region and beyond	HK, City of London
Review	Review regulation in Australia, monitor global developments and advise on regulatory reform	HK, Korea
Liaise	Between the agencies, industry and other jurisdictions	HK, City of London
Strategise	Develop a strategy for the financial services sector in Australia	City of London

RECOMMENDATION

Establish a government agency through legislation that will progress international financial services competitiveness issues, coordinate the various government agencies, and review regulations taking into account international processes.

There should be more active and coordinated promotion of financial services through:

- ❖ Twice-yearly Asian delegations to be led by senior Cabinet Ministers, raising the profile of the industry offshore and seeking improved regulatory outcomes and market access;
- ❖ Greater involvement by financial regulators in promoting the strengths of Australia's regulatory regime and assessing Australia's competitiveness as part of their regulatory obligations. Relevant enabling/governing legislation should be amended to explicitly refer to their role in maintaining and improving Australia's international competitiveness; and
- ❖ An annual regional forum to be held in Australia involving leading financial services executives, regulators, and academics from across the Asia-Pacific. The event would rotate between Sydney and Melbourne and would serve as a platform to promote Australia and facilitate greater regulatory and financial collaboration across the region.

RECOMMENDATION

The Government more actively promote Australia's financial services through Ministerial delegations to Asia, greater involvement with regulators and the new coordination body and hosting regional forums in Australia.

3. CONTINUED SUPPORT OF THE ASIA REGION FUNDS PASSPORT

Removing the current impediments to international financial integration could have large benefits for Australia in the way of increased trade revenue, an expanded financial services sector, growth in jobs and increased tax revenue.

FSC believes the benefits outweigh the costs and that the potential downsides can be appropriately managed. This section will discuss the economic costs and benefits of increasing exports of managed funds and the impact of the ARFP to the Asian region.

We have a significant comparative advantage with our \$2.3 trillion managed funds industry measured by regional or global standards.

APEC Report - Asia Region Funds Passport

The ARFP is the APEC and six participating Asia-Pacific nations' preferred regional vehicle to increase regional integration for investment funds. It will not only increase choice for investors but will increase regional cross-border capital flows, trade and investment.

The ARFP will provide a multilaterally agreed framework allowing the cross border marketing of funds across participating economies in the Asia region. The ARFP is a mechanism that establishes, for the first time, integration of the managed funds industry and our region.

There are many tax and regulatory structure reforms which are required in the next 18 months if the ARFP is to deliver for Australia and for investors in our region. It is critical these reforms are implemented to ensure the ARFP is functional in Australia when it is launched in 2016.

Australia must be able to compete with other countries in our region, and the ARFP regime must be practical so as to compete with the European Undertaking for Collective Investment of Transferable Securities (UCITS) vehicle, otherwise it will never be commercially viable.

There is strong demand from Australian investors for exposure to offshore assets.

However, typically retail investors are unable to meet this demand due to structural barriers. If implemented correctly, the Passport should remove some of these structural barriers and allow access to this market.

In relation to the Passport, differences between jurisdictions include regulatory frameworks that require separate custody of fund assets, and legislative requirements that specify types of funds, outsourcing restrictions, diversification requirements, derivatives restricted and local currency required.

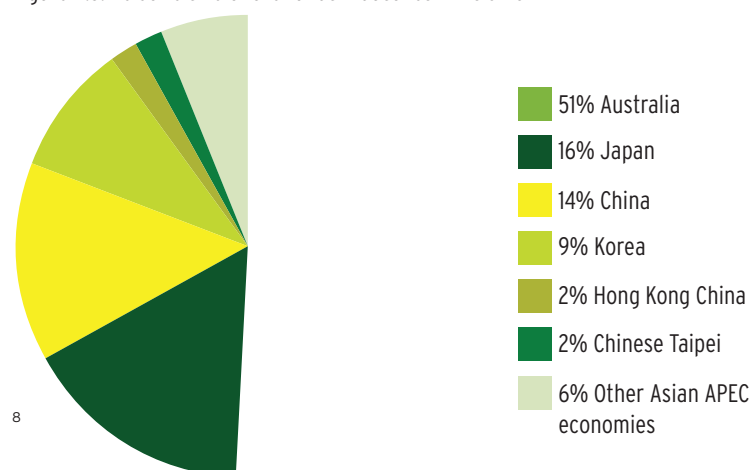
There are a variety of rules throughout Asia in relation to investments that are permitted, commonly (although not universally) prohibiting direct investment in infrastructure and real estate (in conflict with Australia) and limiting the use of derivatives.

The recent APEC report into the ARFP shows the comparative size of our industry in our own region:

RECOMMENDATION

The tax regimes in each jurisdiction are complex and represent a significant challenge to the success of an ARFP and also increased financial integration generally⁷. It is important that the FSI makes explicit recommendations on taxation as these issues are central to Australian competitiveness.

Figure 4.3: Relative size of the funds industries in Asia 2012*



The report demonstrates that the ARFP will have consumer and regional benefit by establishing an Asian vehicle for the management of investment funds.

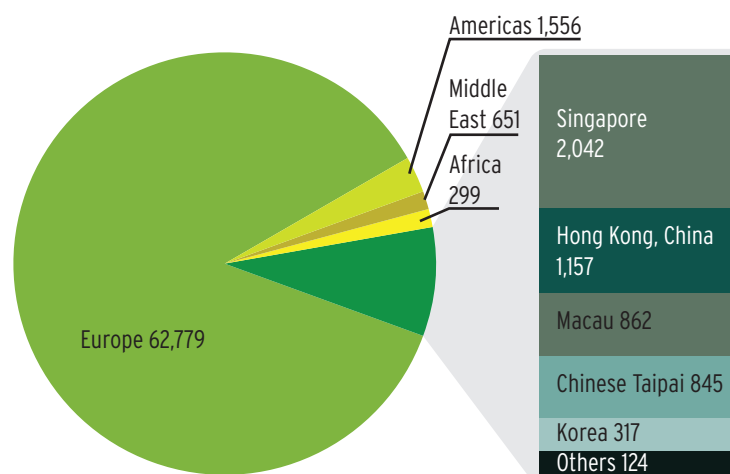
The ARFP vehicle would prevent the growth of European domiciled products which already have a significant foothold in our region.

⁷ PWC/FSC, 'Asia Region Funds Passport: The future of the funds management industry in Asia' 2010

⁸ APEC Policy Support Unit 'Asia Region Funds Passport: A study of potential economic benefits and costs' July 2014

The figure below demonstrates the pervasiveness of UCITS in Asia:

Figure 4.4: Global distribution of UCITS, July 2012



Source: PricewaterhouseCoopers, 2012

With almost 3,500 UCITS managed funds in the Singaporean and Hong Kong markets, UCITS penetration is incredibly high. This is almost the same amount of domestic investment funds in Australia (4100)⁹.

UCITS funds are European schemes which work against the objective of an Asian based vehicle with Australian involvement.

There would be significant benefits for consumers in our region if the ARFP is successfully implemented.

The ARFP scheme could save investors around US\$20 billion per year in fund management costs from increased efficiencies. The new APEC report notes:

“Once the ARFP is established, fund managers will be able to offer a single fund across multiple markets. It is expected the resulting larger client base will grow the fund size sufficiently to realise economies of scale. At the same time, increased competition, an increased number of funds and increased funds under management will help keep the fund size at an optimal level so as not to erode fund performance. Investors will also benefit from improved efficiency as direct access to offshore funds results in the elimination of an extra layer of fees and commissions charged by local operators.”

The report notes that the ARFP is likely to offer better fund performance in the form of higher returns for investment at the same or lower degree of risk. Investors in some Asian economies currently have limited products available to them, due partly to strict regulations in those economies.

⁹ ASIC Annual Report 2013

Investors will gain from diversifying their investments across markets and reducing correlation, that is, earning a higher return for the same level of risk or lowering risk for the same level of return.

The ARFP can also potentially create 170,000 jobs in Asia and promote sustainable economic development by directing the region's savings toward productive investment.

The ARFP will enable local funds industries to gain from foreign technical know-how, competitive pricing, and higher standards of disclosure and performance.

An essential feature of the ARFP is that it will increase the demand for funds to be domiciled in Asia which would lead to increased job opportunities in the region.

The report discusses the potential risk of heightened vulnerability to shocks with increased financial integration. However, it also notes that the Passport will increase efficiencies in Asian financial markets and that deepening the integration of financial markets will mitigate the risks associated with large and volatile capital flows into the region.

“Adopting the ARFP can bring risks which are inherent with any cross-border financing solution in which shocks in one market can be amplified and transmitted to other markets. Many Asian economies can no longer afford inefficient financial markets which since the mid-2000s have resulted in persistently low investment rates in the region. As the benefits of the ARFP can only be optimised if the region possesses the requisite infrastructure and institutions, Asian economies need to work together to upgrade and harmonise regulations and market practices, and develop mutually recognised regional standards. Regulators in Asia can learn from the European experience in striking the right balance between achieving market efficiency and investor protection. There is also an increasing impetus to put in place an institution that can coordinate the work of different regulatory agencies.”

It will be paramount for Australia's regulatory environment to take into account international regulations and developments, and ensure we can integrate with Asian economies in order to gain fully from the benefits the ARFP will bring. As the report notes, it will be important to establish an institution that can coordinate the work of various regulators.

RECOMMENDATION

Continue to promote the ARFP as the preferred regional vehicle for integration, supported by regulatory review, ensure that increasing trade in financial services for economic growth becomes a policy priority.

4. AUSTRALIAN REGULATORY CHANGES NEEDED FOR ARFP SUCCESS

The following will be required if the ARFP is to be commercially viable in Australia and if Australia is to successfully compete with other jurisdictions:

The Government needs to specifically establish an ARFP structure in the Corporations Act 2001 which is clearly demarcated from other legal vehicles. It must have a tax rate which is applicable solely to ARFP products. The following is an outline of the changes required for ARFP success.

Collective Investment Vehicles (CIVs)

Australia is limited in the type and number of CIVs that can be used by investors. Australia solely uses unit trusts, which are not well understood throughout Asia due to being structured differently to other jurisdictions' trusts. Below is the list of CIVs used in the Asian region:

- ❖ Australia: unit trusts and superannuation funds.
- ❖ Hong Kong: unit trusts e.g. equity fund, hedge fund, index fund, warrants fund, REIT etc.
- ❖ Japan: investment trusts (MIT funds). For alternative investments, other types of CIVs are used e.g. investment corporation, TK, TMK.
- ❖ Korea: investment trust, investment company, investment limited liability company, investment limited partnership company, investment limited partnership and investment undisclosed associations; and
- ❖ Singapore: Unit trusts and limited partnerships.

Australia's limitations in terms of CIVs could reduce the ability of Australian managed funds to sell to Asian investors. Paradoxically, the lack of restrictions on existing Australian trusts may conflict with Asian regulations on investment types, outsourcing, diversification, leverage, derivatives or local currency denomination.

World class Investment Manager Regime

The Johnson Report recommendation that Australia introduce an IMR for non-resident investors is designed to facilitate greater use of Australian investment managers. Fundamentally, the IMR seeks to ensure internationally consistent and unambiguous tax outcomes for non-resident investors who use Australian investment managers through adherence to the following key principles:

- ❖ non-resident investors should not be subject to Australian tax on non-Australian source income;
- ❖ non-resident investors should be exempt from Australian tax on profits on marketable securities whether dealing on capital or revenue account and whether they use an Australian manager or not; and
- ❖ investors should face the same tax outcomes for indirect investment through a collective investment vehicle as for direct investment.

Multi-currency collective investment funds

Current Australian tax rules make the issuing of multiple currency class investments ineffective because any currency gains or losses must be netted off across classes. The result is that managers wanting to offer different currency denominations must establish a separate fund for each currency class. This is expensive, results in unnecessary duplication and is inconsistent with the features available for funds in jurisdictions such as the United Kingdom and Luxembourg.

Further, the ability to offer multi-currency class investment funds will be necessary for Australian managers to fully capitalise on the opportunities presented by the ARFP. Without this functionality, managers will be unable to leverage existing Australian or US dollar denominated (Australian domiciled) managed funds into the Passport regime. Instead additional funds will need to be established in each of the relevant currencies (ie, Singapore dollar, South Korean won, New Zealand dollar).

Competitive tax rates

The Johnson Review recommended a reduction of the Managed Investment Trust (MIT) withholding tax rate. Whilst the rate was reduced to 7.5 per cent, it was subsequently increased to 15 per cent from 1 July 2012 and remains at 15% today. This rate is inconsistent with interest withholding tax rate of 10 per cent and is encouraging investment to be structured as debt instead of equity.

Further, compared to the equivalent rates in the region - especially those jurisdictions participating in the ARFP, a rate of 15% is uncompetitive.

The FSC also recommends that the government consider introduction of a special MIT withholding tax rate for funds participating in the Asia Region Funds Passport.

These recommendations will ensure that Australia remains an attractive destination for foreign capital to be invested as well as ensuring the competitiveness of Australian funds in the ARFP regime.

RECOMMENDATION

The Government should implement the necessary reforms associated with the Asia Region Funds Passport and those outstanding from the Johnson Review, including:

- establishing an ARFP structure in the Corporations Act 2001;
- introducing a CIV regime comprising a broader range of vehicles; and
- introducing an Investment Manager Regime for non-resident investors.

5. NATIONAL TRUST LAW REFORM

The Inquiry's interim report highlighted the need for greater codification of Australian trust law. In this submission, we elaborate on how this would serve the dual domestic and international objectives of enhanced consumer protection and increased financial services exports.

We present the findings of field research in Hong Kong and Singapore focusing on the political and economic context in which those nations achieved trust law reform. We then elaborate on how an Alternative Australian Trusts Act (Cth) (AATA) might work to enhance financial integration, especially in the Asia-Pacific region, and provide new legal infrastructure for Australian trusts.

Not only would an AATA strengthen corporate governance in the trust sector, it would also make a major contribution to the underlying regulatory infrastructure governing Australia's financial services markets. The AATA proposal is smart reform - instead of creating another layer of regulation it gives trust users a choice of legal infrastructure.

We suggest that three key benefits would flow from a modern, codified and nationally consistent trust law. The first is that an AATA regime would provide certainty where there is currently ambiguity and therefore a lack of confidence, especially in respect of foreign resident participants in Australia's financial markets. The certainty and stability of an AATA would attract offshore investors from the broader Asian-Pacific region and would bolster protections of domestic retail clients because the role and powers of the fiduciary intermediary would be more certain.

Secondly, an AATA could deal with trust insolvency, and regulate the proper distribution of risk amongst financial market participants. If trusts are to continue to be used as an instrument of commerce, it is critical that the risk profile of trust entities be determined by public policy.

Lastly, the AATA proposal would establish a specific regime to empower and regulate licensed, capital-backed, fiduciary financial institutions. Such fiduciary institutions could better serve as gatekeepers for the financial services industry by taking a more active role in protecting consumers, which in turn could relieve some of the regulatory burden on ASIC and APRA.

RECOMMENDATION

National trust law reform is needed for the dual purposes of increased consumer protection and enhancing financial services exports.