

Financial Centres of the Future – What Role for Australia?

**A Symposium organised by the Melbourne Centre for Financial Studies
in conjunction with: IFSA, ABA, AFMA, Finsia and
Sponsored by National Australia Bank**

*Tuesday May 20th 2008
Park Hyatt Hotel, Melbourne*

The objective of this symposium was to identify opportunities for further development of Australia as an international financial services centre and determine what issues need to be addressed by industry and government to facilitate that development. In a rapidly evolving global financial system, there are significant opportunities for Australia to build its financial services sector and provide financial services to the rest of the world (and particularly Asia). There are also substantial threats to maintaining our current position in world rankings.

The Group CEO of NAB, John Stewart, cited by many as initiating the debate on this topic in 2007, provided the opening keynote address to the symposium. He noted the current importance of the Australian financial sector in national output and employment, and highlighted its role as a significant contributor to tax revenue and high value added employment. Noting that future global economic growth and wealth accumulation is likely to be led by Asia, he argued that Australia is well placed to play a major role in providing financial services to this region. Particular competitive advantages include: a developed financial sector, stable democracy, a strong regulatory system, a strong legal framework, ease of establishing businesses, a quality education system, a flexible labour force, and the quality of life.

Now is an appropriate time to be focusing on this topic. The current Rudd Government has demonstrated its commitment to developing Australia into a financial services centre in the Asia-Pacific region through the recent Budget announcement to reduce the rate of Withholding Tax applying to certain distributions from Australian managed investment funds. This initiative is critical to the Government's view that it will be necessary for Australia to diversify its export industries post the resources boom).

Australia is a world leader in funds management capabilities, but with limited export orientation. Particular expertise exists in infrastructure financing and property. In the banking sector, the regulatory system has proved robust, and Australian banks have survived the subprime crisis well.

Identifying the key issues which the government needs to focus and act upon to facilitate further development as a financial centre needs to be a high priority agenda item for industry associations, industry and researchers.

A difficult question is the one surrounding the structure of the Australian banking sector, with Stewart arguing that Australian banks need to be substantially bigger to compete

effectively in international markets. Here the role of the “four pillars” policy was questioned (as was its long run viability in an increasingly competitive international banking world). A particular concern expressed was that restricted size may make Australian banks vulnerable to international takeover; with a potentially adverse implication of reduced head office presence and reduced focus on the Australian market should problems arise for the parent in the home market.

The task for policy-makers is to determine how to ensure adequate competition in domestic markets while facilitating growth in scale of Australian banks sufficient to enable worthwhile expansion offshore.

In introducing the discussion of International Banking Centres, David Bell, CEO of the ABA, highlighted the importance of tax changes, human capital development, access to overseas markets and regulatory system characteristics as the key issues. Professor Michael Skully (Monash University) highlighted how banking centres have evolved over time, both in terms of the changing relative importance of functions provided by financial institutions, and of different cities. He noted that co-location with customers had decreased in importance. He provided a taxonomy of different types of banking centres, ranging from purely domestic/local, through specialist offshore, tax havens, to regional and global international centres. He suggested that there may be particular opportunities in providing services and products meeting Islamic finance requirements which warrant exploration, noting that Kuala Lumpur had established a specific capability as an Islamic financial centre.

Identifying impediments, including regulatory or tax barriers, to use of Australian financial services by Islamic financial institutions (both in banking and funds management) warrants attention.

A similar taxonomy was also used by Stephen Gregg (McKinsey) who provided an overview of a new study commissioned by the ABA. Sydney and Melbourne rank among recognised international financial capitals, but are best characterised as being, he argued, in the regional/niche category. At best this places Sydney and Melbourne in a similar role as cities such as Zurich, Chicago, Toronto, Boston, Dublin, Edinburgh, where in each there is a clear concentration of activities and specialisation such as private banking, exchanges, commodities financing, resources financing, funds management etc. For Australia, activities such as funds management and infrastructure financing were mentioned at various stages as particular specialisations.

Gregg observed that the natural order is changing in international finance, with New York losing some of its dominance to London and Asia growing rapidly. Australia is well placed (via its position in the region and current status and reputation of its finance sector) to take advantage of this growing market although Asian centres Hong Kong and Singapore are now well established as top financial centres by most criteria. He noted that competition is fierce, and pointed to studies commissioned by a large number of cities aimed at identifying strategies for growth as financial centres – indicating the risks if Australia sits on its laurels.

Understanding why Hong Kong and Singapore rank ahead of Australian cities in indices of global financial centres, despite having lower employment in the sector and smaller domestic markets, warrants further study.

Professor Ian Harper (Melbourne Business School) noted that the positive attitude of the Rudd Government towards building Australia as a financial sector hub provided significant opportunities, and that the planned increase in skilled immigration was a positive development in this regard. He called for a new inquiry into financial regulation (ten years having passed since the Wallis Report) as a way of signalling to the rest of the world that Australia has a sound regulatory structure and is concerned to ensure that it maintains best practice regulation. He raised the role of government in marketing Australia's financial services capacity to the rest of the world, and noted that the decision to abolish AXISS (and incorporate its functions into Austrade) could potentially weaken this role (although some others saw potential synergies from the merger).

Understanding how best to promote Australian financial services capabilities and building the "Australian brand" in overseas markets, and the appropriate role and activities of government in this process should be an agenda item for future study.

Dr Martin Fahy (Finsia) in introducing the session on the Export Potential of the Funds Management Sector, and drawing on his experience from Dublin's development as a financial centre, reiterated the importance of brand and innovation. Barrie Dunstan (AFR) provided a sceptical view as to whether export of funds management services was a likely growth industry for Australia. Dr Don Russell (BNY Mellon) noted that Luxembourg and Dublin specialise in investment services businesses associated with funds management (middle/back office and ancillary services) rather than asset management. He outlined how his company's business model provided for the export of funds management services, via a multi-manager team in London seeking out overseas boutique fund managers. He also noted that large individual international clients often have their own custodians and other administrative functions available, such that they can employ foreign fund managers without having to interact substantially with the regulatory or tax systems of that manager's country. In the case of collective investments he noted that tax issues were important considerations for foreign investors investing in Australian trusts, and welcomed the recent withholding tax changes announced in the budget.

Ongoing analysis of how the domestic tax and regulatory system interacts with those overseas and consequences for the development of the export capability of the financial sector is required.

Stephen Dunne (AMP Capital Investors) outlined how his company had set up funds in offshore locations as part of their export of funds management services. He saw three levels of opportunity in the funds management industry: the capacity to manage Australian dollar portfolios, the export of investment capability, and the opportunity to become a funds management hub. He noted in particular that his company had successfully exported the capability to manage property funds.

The development of a library of case-studies of how Australian financial services companies have developed export capability and the impediments faced would be valuable for understanding key issues. Because of the large potential export market, it should also assist other Australian institutions to benefit from understanding the experience of the “first movers”, without eroding the gains made by the latter.

Professor Kevin Davis (MCFS) noted that exporting funds management services involves getting investors in one country to employ a manager in a second country to purchase and manage assets in a third country or countries, and that this is an important activity internationally, but not a significant part of the Australian funds management sector. He noted that this is a growth industry, reflecting international integration, increasing role and development of capital markets (particularly in Asia) and an increasing size of funds available for investment (including Asia) – possibly magnified by likely decline in “home bias” in investments. Davis noted that a key consideration is what determines location choices of fund managers and of the geographical allocation of different components of the value chain which are: marketing/distribution (around 23% of employment on some estimates); core asset management (26%) ; middle/back office (53%). Also potentially important is the domicile of funds. He argued for the importance of agglomeration economies, good regulation / tax / quality of financial infrastructure, and time zone advantages noting that Australia possesses these in regard to dealing with the Asian region. He suggested that it was important to continually review whether there were changes in institutional and regulatory arrangements which might generate different types of fund management vehicles which are particularly suitable for export activities.

A study of how regulation and tax affect the particular organizational and legal structures used for funds management vehicles in Australia, and how they influence fund domicile, could assist in identifying impediments to export of funds management services.

In discussing Regional growth and Financial Service Opportunities, Philip Gardner (GSJBW) emphasized the importance of establishing a local presence in attempting to sell funds management services overseas. He argued that Asia is a complicated region in which to do business, but that over some longer term horizon there is perhaps some possibility of an integrated Asian financial market (along the lines of the EU). In the short term, he emphasized the opportunities for property and infrastructure fund management exports, but noted the necessity for large scale and resource commitments. There are many government impediments or complications involved in the process of building a presence in these markets. He saw the opportunities as being greatest for large organisations with local representation.

Identifying specific problems which host governments create for Australian firms in exporting financial services to specific target markets would be valuable.

Jeremy Duffield (Vanguard Investments) focused upon the export of retail financial services, emphasizing that this involves Australian manufacturing capacity (global investments run from Australia) together with marketing and client servicing staff in the

region. He argued that Australia has a strong capability and that there is a large potential market in Asia. He suggested that mutual fund penetration grows largely by discovery. He also emphasized that Asia is a large number of different countries with different characteristics – such that each market needs to be considered individually. He saw particular opportunities in exporting investment management talent – such as by white-labelling funds for distribution by local entities. He noted that joint ventures were an opportunity – and necessary in some countries such as China. Establishing wholly owned operations either by acquisition or de novo entry was also possible. He saw further opportunities from Australian distribution expertise and capability, noting that financial product distribution in Asia is primarily via banks. Opportunities for exporting financial planning services, platforms, private banking were also highlighted. Finally, he emphasized that the focus should be on “doing business” rather than “exporting”.

A study of how retail funds management services can be exported, and the role and means of establishing a local presence in target markets is warranted.

Stuart Crosby (Computershare) provided a perspective from a provider of technology and fund administration services. He noted that outsourcing has been the key driver of efficiency gains in funds management back office activities. He suggested that there is too much fragmentation in both the Australian and overseas markets regarding back office systems and hence opportunities to achieve scale exist. Stuart also challenged the industry to act on the opportunities noting that often Australian firms were “paralysed by analysis”.

Sally Capp (Committee for Melbourne) identified several factors providing potential competitive advantage for cities such as Melbourne and Sydney. The large alumni of Asian students who have studied at Australian Universities provide a potential resource as employees for Australian companies seeking to establish a local presence in Australian markets. She presented the finding that Melbourne and Sydney rank 4th and 5th on the global University cities index, highlighting the potential opportunities for research based development of financial products and processes as well as supporting services. Capp noted that Australia has a comparative advantage in languages. While the ability to speak English is starting point, it is the diversity of languages spoken by finance graduates from Australian universities which has been a key attraction for recent entrants from foreign markets.

Whether Australia capitalizes adequately on its large Asian business sector alumni (arising from its export of higher education services) is warrants further study.

The Hon Dr Craig Emerson MP, Minister for Small Business, Independent Contractors and the Service Economy made the closing keynote address in what was his first major ministerial speech on financial services.

Also in his capacity as the Minister Assisting the Finance Minister on Deregulation, Dr Emerson indicated that the Henry Review of tax arrangements would seek to simplify arrangements covering the financial services industry. He noted that complexity rather

than the actual rates had been highlighted as major issues by bodies such as IFSA. Dr Emerson, in referring to an OECD report, mentioned that there was more work to be done in the harmonisation of regulation of services.

He said the Government would remove impediments to and enhance the capacity of the financial services industry to form a financial hub in the Asia-Pacific region. He also noted capacity-building via education policies including Asian languages and through greater skilled migration.

Key Conclusions

A core message from most speakers to the Symposium was that Australia should recognise the pivotal role of services in the Australian economy (75% of GDP compared to 7-8% for mining) and that the onus for Australia is to be well prepared for the end of the current “commodity boom” by investing in capacity to provide high value-adding export of services such as asset management.

A major question mark against this endeavour is the willingness of Australian financial service companies to sacrifice short term profits by investing now in the long process of building an offshore profile and tailoring financial product manufacturing capacity to service regional markets. It was commented that the guaranteed growth from mandated superannuation had the potential to make the Australian industry “fat, dumb and happy”.

Australia’s regulatory environment is generally considered to be a positive factor in its bid to host offices of more foreign-based finance firms and in encouraging domestic investment by local firms. However, in Asia, Australia is competing with the smaller population centres such as Hong Kong and Singapore which are much more able and willing to tailor their tax and corporate oversight regimes to attract financial businesses.

The recent Budget measure to reduce the rate of withholding tax on certain distributions to non-residents from Australian managed funds sends an important signal to the Australian industry and overseas investors – that the Australian Government is committed to developing Australia into an international financial centre.

Several speakers observed that there is a tendency for Treasury and the Australian Tax Office to be suspicious of any arrangements which may permit tax avoidance notwithstanding that potential volume benefits at least in the longer term may well outweigh any erosion of the tax base short term. In this light it is incumbent upon Government to articulate and enforce within the bureaucracy the intentions of its enabling tax legislation. Applying cost benefit analysis to regulatory change (as recommended by the Task force on Reducing Regulatory Burdens on Business) should involve comparing benefits from change with the potential magnitude of possible tax evasion, rather than rejecting changes simply because tax evasion is a possibility. Government needs to ensure that policy is not subverted by selective regulation at an administrative level. Arguably a case in point (made by Stephen Dunne of AMP Capital Investors) is the decision not to lower withholding tax for investors domiciled in certain jurisdictions

which do not have the necessary “information sharing arrangements” in place with the ATO such as Luxembourg. This is despite Luxembourg being a globally recognised centre for cross-border distribution of funds.

Most speakers agreed that regulatory change can be supportive of efforts to raise exports of financial services but that the change has to be driven by business adopting a long term commercial focus. Moreover, getting started now rather than waiting for someone else to take the lead will yield the greater long term benefits.

However, it was observed that historically, and hence culturally, Australians including our business leaders tend to take their lead from government. Hence there is value in Government reinforcing its message that services will no longer be treated as a residual and that financial service exports are intended to be a growing source of prosperity going forward.

Potential research directions (in addition to items italicized in above text)

1. Survey suitability of current higher education offerings to the development of financial service export capability e.g. Are Asian language and cultural studies readily able to be undertaken together with finance (and marketing) degrees at Australian universities? Are the resulting career opportunities being adequately promoted?
2. Develop a database of key finance sector leaders (and potential future leaders) in Asian countries who are alumni of Australian Universities.
3. Promote research into the value of longer term investment in Asia (e.g. Vanguard Australia as first case study)
4. Prepare unique Australian academic research into the characteristics of global/regional finance centres e.g. correlation analysis across a range of factors.
5. Explore the suitability of available domestic “vehicles” for managing funds on behalf of off-shore investors. Also explore whether other vehicles such as contractual funds and corporate structures – with different tax treatment to trusts – would be desirable to facilitate greater exports.
6. Independent review of Australia’s DTA coverage and outcomes compared to that of major financial centres such as Singapore, Hong Kong, Dublin & Luxembourg.

For more information please contact:

Melbourne Centre for Financial Studies
 Kevin Davis, Director and Commonwealth Bank Professor of Finance
 David Michell, Business Development Manager
 Ph. + 61 3 9666 1050; info@melbournecentre.com.au