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The Executive Officer  
Economic Development and Infrastructure Committee  
Parliament House  
Spring Street  
East Melbourne  
Vic 3002

Dear Sir/Madam

***Inquiry into Key Competitive Advantages and Recommendations for growth in  
Victoria's Financial Services Sector***

Please find a submission to this Inquiry. The Melbourne Centre for Financial Studies would be happy to provide further information or assistance as required. Please contact David Michell, Business Development Manager (03 9613 0906, [david.michell@melbournecentre.com.au](mailto:david.michell@melbournecentre.com.au)).

Yours sincerely

Kevin Davis  
Commonwealth Bank Chair of Finance  
Director, Melbourne Centre for Financial Studies.

## **Key Competitive Advantages and Recommendations for Growth in Victoria's Financial Services Sector**

*Melbourne Centre for Financial Studies*

10 May 2007

### **Executive Summary**

- The key focus of Government strategy towards the financial services sector should be as much upon the role of the financial services sector in generating economic growth and welfare through the economic services provided to the rest of the local economy – as upon the measured output of, or employment within, the sector.
- The main basis for any Government strategy should rest upon the importance of information, social networks, and knowledge capital as fundamental assets in the provision of financial services, and the potential agglomeration (or scale) economies arising from participants located in active and dynamic financial sectors. Government measures which assist in the development of pools of expertise, network opportunities, and marketing and branding of a financial centre may have favourable cost-benefit ratios because of the externality elements. Because many such activities have quasi-public good characteristics (such as joint consumption and non-excludability) they may be undersupplied by the private sector.
- There is little to be gained from Government measures to further develop the financial sector unless these measures capitalise upon existing or emerging characteristics and strengths of the local financial sector and economy, or can assist in identifying new opportunities for developing clusters of expertise in rapidly changing and evolving financial services delivery. There may be “first mover” advantages for a local government in those latter cases if location choices once made are “sticky” and agglomeration benefits follow.
- For Victoria, areas such as funds management (with an emphasis on pension fund management), corporate finance (with an emphasis on provision of financial services to emerging enterprises), and development of new financial markets (such as alternative stock exchanges and markets for other assets, claims, rights and environmental products), are all potential targets. With the growing role of self managed super funds (SMSFs) and their need to invest in a range of asset

classes, there is considerable scope for the development of new exchanges trading an increased range of financial claims, facilitating initial investment opportunities, and providing secondary market liquidity for these retail investments.

- An effective strategy will need to generate support and financial commitment by industry possibly through participation in its financing by industry bodies. Such a strategy should also aim to encourage the location of new finance sector industry associations in Melbourne, to generate knowledge and networking effects. Opportunities which currently appear as possibilities include associations for trustees of self-managed super funds and for those with interests in environmental/sustainable finance and trading of environmental products.
- Government policy should also consider areas where its actions will generate future benefits to the budget – such as through enhanced community financial literacy and consequent improved individual decision making which may lead to lower future social welfare expenditures. Financial literacy for those approaching retirement, where superannuation, medical insurance, and future accommodation decisions are interrelated and particularly important, is one such area. The growth of SMSFs also raises a potential future issue of problems of expertise and knowledge for surviving partners who have not been actively engaged in the management of the fund.
- The availability of financial services, including advice, to rural regions is an important social and economic issue. Electronic technology is enabling the provision of new cost-effective delivery mechanisms and information services in the finance sector. It may be that there is scope for some form of government facilitative action in this regard, such as provision of internet information portals for financial advice on superannuation, small business financing opportunities etc.

1. The financial services sector is an important contributor to national output, employment, economic growth and development. As Figure 1 shows the Australian finance and insurance sector accounts directly for nearly 8 per cent of total gross value added in the Australian economy. That sector's share of total employment has hovered in the 3.5 – 4.0 per cent range since 1994 (See Table 1), and this does not include employment in related business services areas associated with finance sector activities. At the end of June 2006, there were 129,646 of 1,963,907 businesses operating nationally which were classified by the ABS as operating in the finance and insurance sector. The sector is over-represented (compared to its overall share of employment) in both very small and very large firms, with an over 8 per cent share of the nation's single person businesses and a 5.9 per cent share of firms employing more than 200 employees (see Tables 2 and 3). As can be seen from the size of value added compared to employment, it is a high "value-added" sector.
2. Unfortunately, comprehensive data on financial sector output, employment and composition at a state level is not as readily available, partially reflecting the nation-wide spread of activities of many financial services firms. The relative size of the Victorian financial services sector is at least as large as the State's shares of national output and employment. Melbourne is clearly the second largest financial centre in Australia, and was ranked in the top 20 international financial centres by a recent study. While there is much fragmented information available about the structure and participants in the Victorian financial sector, there may be merit in developing (and maintaining up to date) a good public database on the sector – both for policy purposes but also for information provision to others..
3. The financial services sector's contribution to economic growth and output is, more important than direct measures suggest. The finance sector is at the core of the economic system, providing a range of services which are necessary for other industries to function efficiently and enabling consumers to effectively manage their consumption-savings requirements over time. Academic research has assembled a substantial body of evidence that financial sector development is a

contributor to economic growth.<sup>1</sup> While much of this evidence is based on international comparisons of country experiences, there is also some evidence indicating a similar relationship at a regional (or state) level.

4. Underpinning this causal effect of financial sector development on economic growth is a number of key functions performed by the financial sector. These include: ensuring the informed allocation of financial capital; monitoring and exerting corporate governance upon recipients of capital; risk management functions; accumulating pools of savings for investment; providing payments and exchange services. It is the economy-wide benefits arising from efficient performance of such functions, more so than the direct volume of employment or measured output in the financial services sector, which should be the main focus of government policies towards ongoing development of the sector.
5. At a State government level, it might be argued that there is little role or rationale for specific policies, given the integrated nature of the national financial system. Large financial institutions operate across state (and national) borders and, absent specific state-based regulation, taxes, or other impediments or inducements to business, financial service providers will emerge and locate to meet the demands of the end-users of financial services. Modern communications technology also enables them to locate various components of the financial services production process elsewhere (such as offshore). Value adding financial products and services developed in one market quickly get replicated elsewhere.
6. However, it is not correct to argue that there is no role for State Governments. The importance of information availability and agglomeration economies which influence financial sector development suggest that some government policies designed to further develop a local financial sector can pass a social cost-benefit test. State Governments do, however, need to avoid the temptation to attempt to “buy” financial services business by special deals and concessions.
7. Much of the business of finance involves the development and use of relationships both within the finance sector and with end users of financial services. Access to information, accumulated knowledge, and ability to assess the integrity and

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<sup>1</sup> For a recent survey of this literature see: Levine Ross (2005) “Finance and Growth: Theory and Evidence.” in Handbook of Economic Growth, Eds: Philippe Aghion and Steven Durlauf, The Netherlands: Elsevier Science.

honesty of potential counterparties are key ingredients of successful financial services firms. Consequently, the geographical location and social networks of key financial sector decision makers can be important in influencing the terms and conditions of financial services provided to end-users. There is some evidence that suggests that investors prefer to invest in local companies, and this is particularly apparent at the national level where the “home bias puzzle” (of greater investment in domestic, rather than foreign, stocks than optimal diversification would suggest) is well known. While increased availability of information through modern technology and communications might be thought to be a factor mitigating such an effect, it can be argued that it is optimal for investors to choose to focus their information gathering efforts in areas where they have a comparative advantage.<sup>2</sup> A consequence of such behavior is that while global financial market participants may focus their information gathering activities on global risk factors which affect large companies, local financial institutions may find it advantageous to focus on identifying profitable investment opportunities among local firms. Likewise, suppliers of funds to financial markets may base their choices partly on their knowledge of financial institution characteristics arising from personal contact with principals of those institutions. Similar comments can be made in the context of commercial property investment decisions where some commentators have suggested a bias in property portfolios of funds managers towards investments in the city in which they are based.

8. Being physically located in a large financial centre is one potential source of information advantage for financial market participants, which can flow through into decision-making which benefits the local economy. Contacts, networks, proximity of specialist skills, and sources of knowledge, both within the financial sector and with end-users of financial products are sources of such information advantages.
9. Historically, we have observed the tendency for large financial centres to emerge which dominate national and international financial systems. The agglomeration economies, externalities, and synergies referred to previously, work to explain this tendency. Even though electronic technology is reducing the importance of

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<sup>2</sup> See, Stijn Van Nieuwerburgh and Laura Veldkamp, “Information Immobility and the Home Bias Puzzle” New York University, Stern School of Business, March 13, 2007.

physical location for delivery of financial services, there is, and will still remain, a tendency for physical concentration, based on the generation of information advantages from being “in the flow”.

10. Exactly what that tendency towards physical concentration means for the number, size, and location of major financial centres globally and regionally is difficult to predict given the ongoing changes in technology and communications. But the information-based arguments articulated earlier about the economic benefits for the local economy of a strong local financial centre suggest that there is a case for local governments to examine whether there are net value adding actions they can take to promote its growth. In doing so, it is important to emphasize the need to concentrate upon the information advantages which may arise from agglomeration. Government actions which are low cost and which serve to build networks, clusters of specialist skills, and reputation for financial services expertise etc, may generate net benefits for the local economy.
11. But this is a very competitive area. Many cities and governments are attempting to identify such strategies to protect or develop global or regional financial centres. Such strategies sometimes involve financial or tax inducements to financial services firms to locate in those places. The social cost – benefit outcome of such strategies is unclear, partly because their effects may do more to change the evolutionary path of financial sector development than influence once-off location decisions. But given no persuasive theory of financial centre development to enable analysis of the effects, it is preferable to eschew such “direct inducement” based strategies in favor of those which identify particular niche areas of existing strengths or emerging opportunities where information expertise based approaches can be applied. These may be both within the financial sector or reflect particular aspects of the local economy with which the sector interacts.
12. To identify such areas, it is important to take notice of the major trends which are likely to shape the future evolution of financial markets and their role in the economy. Among such trends are the following
  - Electronic technology and communications – is continually changing financial services delivery mechanisms and information availability. It is

creating the possibility of markets for financial services which were not previously possible, for some financial services to be delivered electronically by remote institutions, and different configurations of the financial services supply chain. It is facilitating ever increasing globalization of the financial sector.

- Demography – the ageing of the population is altering the pattern of demand for particular financial services, as well as having macro-economic implications for savings and investment patterns
- Financial Knowledge – the continued progress of expert financial knowledge is leading to the creation of new financial products and techniques which involve better performance of the core economic functions of the financial system. At the same time, however, this is contributing to a knowledge deficiency in general community understanding of the characteristics of modern financial products, and in turn creating a need for more attention to consumer protection and specialist financial advice.
- Environmental Change – regardless of whether or not climate change is occurring, improved technology and knowledge are enabling the development and design of financial markets and products designed to enabling the trading, pricing and management of rights and risks associated with a variety of environmentally related items. Emissions, water, weather, energy are among these items. Regulatory responses to the problem of climate change are also influencing such developments.
- Regulation – financial regulation is an ongoing process of change in response to the evolution of the financial system and external events. It creates opportunities for new financial products and markets to emerge. Within this category, taxation changes drive much new financial sector activity and product development.

13. These forces are leading to a range of developments such as: growth of capital markets at the expense of traditional intermediation activities; an increased focus by banks and other institutions on wealth management; separation of origination and funding activities across a range of financing through the growth of

securitization and the growth of finance brokers in mortgage and other markets. Not unrelated to these developments is the growth of the funds management sector; and increased opportunities for investment in structured products in asset classes such as infrastructure, credit risk, private equity, and hedge funds, which, of course, need to be developed and designed by financial institutions. There has been an explosion in the range of sophisticated financial products aimed at retail consumers, such as warrants, capital guaranteed investments, and margin lending arrangements.

14. We are seeing the emergence of new financial markets including energy, water, and emissions trading, in addition to the ongoing development of new risk management products traded on futures exchanges or over the counter markets around the globe. Technology is also making possible the development of viable markets in other financial claims at relatively small scale - both of amounts on issue and transaction size. New (stock) market-based sources of finance for smaller enterprises and investment opportunities for retail investors (including SMSFs) may emerge.
15. There also appears to be increased activity in corporate finance activities involving financial institutions as advisors/consultants and in many cases principals. Changes in ownership and governance structures of business enterprises are occurring through a wave of mergers and acquisition, private equity activities, creation of trust structures for ownership of groups of (primarily) infrastructure companies, IPOs and venture capital activities. Governments are, with differing degrees of enthusiasm, embracing alternative methods of delivering public infrastructure and services, such as the use of PPP's.
16. What have all these developments got to do with the more general question of the shape and location of financial centres of the future and the potential role for government? In short, knowledge requirements. Finance is a dynamic, evolving industry, in which there is a high, and increasing, premium for specialist knowledge – including both technical expertise and a good data base of contacts. Increasingly, ability to access specialist knowledge is going to drive the location decisions of financial firms and the growth and development of financial centres. Cities which encourage the development of concentrations of financial knowledge

are those more likely to become important financial centres – with flow on benefits for the local economy.

17. This is reflected in various studies commissioned by major international financial centres seeking to identify the key factors which are important for encouraging financial services firms in choosing where to locate. Those studies identified access to sophisticated technology and labor and a “critical mass” of expertise as crucial. Competitive costs, a well trained labor force, good telecommunications, sensible regulators and tax policies were all relevant, but the “critical mass of expertise” dominated. Why? They noted that learning quickly about financial innovations was important, increased ease and lower costs of frequent exchange of information and ideas meant potentially better returns and lower risks, and that there was likely to be better access to the vast range of specialized services which sophisticated financial institutions require.
18. More importantly, the evidence points to the fundamental importance of a knowledge based explanation for the location decisions of financial firms. This suggests a strategy based around developing a renowned “knowledge hub” for any city wishing to develop as a financial centre. And in doing so, focusing on key areas where customers abound and agglomeration economies can be maximized also makes sense.
19. For Melbourne, this suggests one point of focus should be on further developing a reputation as a centre of excellence and knowledge for the funds management industry (with particular focus on pension fund management). Major suppliers of funds, in the form of Industry Superannuation Funds, are well represented. The expertise within the Victorian Funds Management Corporation, and now the Future Fund, will provide a strong knowledge base, complemented by the existing array of both large and small fund managers already located there. And, of course, the headquarters of two of the four major banks, which now dominate the wealth management business are also located there.
20. A second appropriate area of focus may be corporate finance, with particular focus upon the provision of financial services to new and emerging industries. The corporate, SME and start-up bio-tech and information based businesses are relatively strong in Melbourne and significant demanders of financial services.

The Melbourne based banks are, of course also strong in business and corporate lending, reflecting relationships and knowledge built up over many years dealing with a strong local business sector. Victoria's well developed experience with alternative methods of infrastructure provision and financing are also relevant in this regard.

21. A third area is that of new financial markets. As discussed earlier, information technology is increasingly making possible new methods and techniques for delivering financial services and for creation and trading of new and different types of financial claims, rights, or assets. While most of these markets and delivery mechanisms will be electronic in nature, geographical location of headquarters of their operators and major decision-makers is important, and can add greatly to the agglomeration economies of their host city. Melbourne has several fledgling financial exchanges (National/Bendigo and APX) with trading platforms in existence and which are actively examining new opportunities for market development.
22. What actions should a State Government take in attempting to influence location choice of financial services firms in these areas? The preceding discussion suggests that the correct approach is one which focuses upon fostering and developing a reputation as a place where financial expertise abounds, where specialist knowledge can be readily accessed and where strong networks of contacts can be accessed. And building such a reputation requires ensuring that those characteristics do exist and that they are well marketed to the global financial services sector.
23. In this regard, there are many quasi-public good activities which provide benefits to local financial sector participants, but which because they can be jointly consumed and are not excludable, will not be provided without some Government involvement. Marketing and branding, based on the merits of the city as a vibrant financial services sector, is one such area. Assisting the development of networks of contacts is another such. So also are measures to overcome information deficiencies which mean that the expertise already available is not adequately acted upon.

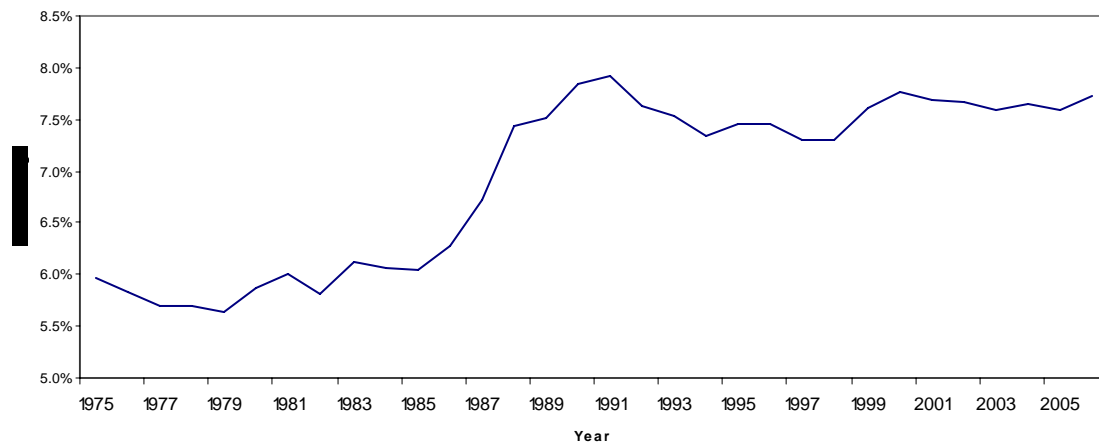
24. In this regard, one area where Melbourne “misses out” is in the location of finance industry associations, which are heavily concentrated in Sydney. As natural meeting points for industry leaders and producers of industry related research and policy advocacy, they can add significantly to the reputation of the host city as a place of knowledge accumulation – even in an electronic age. The personal contacts which develop between association staff and industry and academia in the host city are also important. Government encouragement of location in Melbourne of new finance sector associations, and articulation of the merits for some existing associations to consider relocating is perhaps warranted.
25. A specific action item stems from the coincidence of strong growth in self managed super funds and the absence of finance industry associations located in Melbourne. There appears to be no membership body for individuals who have (and are trustees of) self managed super funds. Such an association could provide information, educational and other development services for members of self managed super funds (including the financial literacy element referred to above), and is likely to receive some financial support from suppliers of services to those funds. State Government seed funding for such a body (ultimately funded by membership fees and industry sponsorship) to be headquartered in Melbourne could be considered.
26. There are other specific sectors where the Government might take actions to encourage establishment of locally based associations. One could be in the area of sustainable/environmental finance. The UNEP Finance Initiative Conference to be held in Melbourne later this year, provides an opportunity to develop support for such an initiative. Another area could be in encouraging international finance associations with local branches, but with no Australian secretariat, to establish such offices in Melbourne. Associations which might fall into this category include the CFA Society and PRMIA.
27. Another action area of potential merit is in measures aimed at enhancing general community financial literacy – given the increasing gap between financial product complexity and sophistication and consumer expertise and knowledge. The life-cycle wealth accumulation benefits of better household financial decision-making are well known, and may generate significant benefits to governments in terms of lowered demands on future social and community services. As well as targeted

programs at socio-economic disadvantaged groups, there is also merit in programs focused on increasing knowledge of such important life-cycle decisions as retirement accommodation choices and financing. There is a large, and generally poorly understood, range of options facing ageing individuals which have significant financial risk and cost issues, and also involve life-style considerations at a time of significant uncertainty regarding health and longevity.

28. One specific action item which could be considered in this respect arises from the potential risks and costs faced by surviving partners in self managed super funds where the household member who has taken responsibility for the management is the first to die or become unable to manage those affairs. Government assistance for provision of services for increasing financial literacy of otherwise “passive” members of self managed super funds which will enable them to take-over responsibility or transition easily to new management arrangements is worth consideration. It also fits within the suggested key target area of specialization of funds management.

FIGURE 1

**Finance and Insurance: Share of Gross Value Added  
AUSTRALIA**



Source: ABS – Australian National Accounts: National Income, Expenditure and Product – 5206.0 – Dec 2006

**TABLE 1: Employment in the Finance and Insurance Sector: Australia****EMPLOYED PERSONS ('000) in Finance and insurance Industry : Trend**

	Victoria				Australia		
	Males	Females	Persons	Vic % Australia	Persons	Total	% share of Finance and Insurance
Feb 2002	43.6	47.8	91.4	26.7%	342.9	9161.5	3.7%
Feb 2003	44.0	56.0	100.0	28.5%	350.3	9411.0	3.7%
Feb 2004	45.7	46.3	92.0	26.4%	348.3	9538.1	3.7%
Feb 2005	47.6	60.8	108.4	29.8%	363.3	9863.6	3.7%
Feb 2006	45.3	46.6	91.9	24.7%	371.4	10051.5	3.7%
Feb 2007	53.6	52.3	106.0	26.6%	399.0	10318.6	3.9%

Source: ABS - Australian Labour Market Statistics - 6105.0

**TABLE 2: Finance Sector Businesses: Employment Size Distribution**

	Businesses by Number of Employees						
	Non employing	1-4	5-19	20-49	50-99	100-199	200+
Number							
Finance and Insurance	94374	26130	6459	1170	417	252	336
Total	1154037	472265	225840	56281	17178	7814	5673
Finance and Insurance %	8.2%	5.5%	2.9%	2.1%	2.4%	3.2%	5.9%

*Source*

Australian Bureau of Statistics

8165.0 Jun 2003 to Jun 2006 Counts of Australian Businesses, including Entries and Exits  
 BUSINESSES BY INDUSTRY DIVISION AND SUBDIVISION, by Employment Size Ranges: June  
 2003–June 2006

**TABLE 3: Finance Sector Businesses: Annual Turnover Distribution**

	Zero to less than \$50k	\$50k to less than \$200k	\$200k to less than \$2m	more than \$2m
2005-06	28830	28626	50676	21015
All Industries	402891	781121	630745	124331
%	7.2%	3.7%	8.0%	16.9%

Source: ABS - 8165.0 Jun 2003 to Jun 2006 Counts of Australian Businesses, including Entries and Exits

**TABLE 4: Financial Sector size – Victoria and Australia (2006)**

	Victoria (June 2006)	Australia (June 2006)
FSI –Gross Value Add (\$b)	17.75	65.32
FSI as proportion of economy	8.70%	7.72%
Labour productivity (\$ Gross Value Add/employee)	\$178,751	\$173,308

Source: Australian Bureau of Statistics, 'Catalogue 6291.0.55.001 – Labour Force, Australia, Detailed – Electronic Delivery, Dec 2006', (2006); Australian Bureau of Statistics, 'Catalogue 5204.0, Australian System of National Accounts 2005-2006', (2006); Australian Bureau of Statistics, 'Catalogue 5220.0 – Australian national accounts: State Accounts, 2005-06