Submission to the Financial System Inquiry

"Policy Formulation in Evolving Financial Markets"

Executive Summary

Having an open, efficient, well regulated and competitive financial sector that meets the needs of households, business and government is in the interest of all Australians. Ensuring sensible policy settings are in place and then maintaining and adjusting them as required is crucial to achieving this objective.

Due in part to the continually evolving nature of financial markets, putting in place and updating appropriate financial market policy settings and avoiding policy mistakes require open and ongoing communication and feedback between the relevant policy makers and the market. Examples of policy "errors" and policy "gaps" suggest current institutional arrangements are not adequately meeting this need.

The most efficient and effective way of providing useful communication and feedback between the market and financial policy advisers would be to have a standing body that provides:

- policy relevant information to Treasury on market developments;
- advice to Treasury on likely market response and reaction to policy proposals under consideration;
- policy proposals on issues it considers critical to the efficient and effective operation of financial markets; and
- policy advice on an ad hoc basis at the request of Treasury.

The experiences of both the recently wound up Australian Financial Centre Task Force (AFCTF) and the still operative Financial Sector Advisory Council (FSAC) provide valuable information as to how best to structure such a body. In order to function effectively, the advisory body would require:

- a board made up of senior, respected financial market executives with considerable experience covering collectively commercial banking, investment banking, funds management and insurance;
- its own independent secretariat that has the experience, resources, focus and range of market contacts necessary for it to provide filtered and unbiased feedback, prepare detailed agenda papers for meetings and carry out liaison and follow-up work between meetings;
- a relationship of trust with the Treasury personnel with whom it interacts on a regular basis; access to other parts of Treasury as required; and where relevant access to other parts of the bureaucracy; and
- access through Treasury to the Minister responsible for the financial sector, to whom it would make 6 monthly reports.

(a) The Underlying Need

Efficient and competitive financial markets are by their very nature in a constant state of innovation and change. As a consequence, it is inherently difficult for policy makers to keep up with market developments.

From a policy perspective, this can have a number of adverse consequences. Firstly, it may lead to situations where policy advisers do not know with confidence what the market reaction and response will be to prospective policy changes, and hence whether the proposed changes are likely to achieve their underlying objectives. A recent example of this, albeit one that extends well beyond just the financial sector, was the announcement in the 2013 Budget of the intention to repeal a section of the Income Tax Assessment Act Section (section 25-90) which deals with deductibility of interest expenses for certain borrowed funds. This announcement was made with little if any market consultation. The extent of industry backlash led to reversal of the intention to repeal it. Another example - the adverse consequences of which also extended beyond financial services - was the 2009 changes to the tax treatment of employee share ownership schemes,

A second consequence can be that some existing policies relating to financial markets become outdated and ineffective in terms of meeting their underlying objectives. An example is the legislation relating to offshore banking units (OBU's). The 2009 Johnson Report on "Australia as a Financial Centre" set out clearly why the OBU legislation has become outmoded and as a consequence is not properly fulfilling its underlying purpose, but the legislation has still not been updated.

A third consequence can be that financial market developments both in Australia and overseas require new policies to deal with new issues that have arisen, and which existing policy settings do not deal with either at all or adequately. While periodic financial system inquiries such as the current one can help identify such gaps, the speed of change and innovation in financial markets and also of policy changes offshore can require policy adjustments that need to be put in place in between major inquiries. An example is the need for an effective investment manager regime (IMR) given the growing uncertainty concerning the tax treatment of cross-border financial transactions in Australia and the number of overseas countries with which Australia competes for business who now have an IMR in place. Another example is the need to remove interest withholding tax on offshore borrowings by financial institutions. These policy “gaps” are in the first case inhibiting Australia from exporting its widely acknowledged funds management skills and expertise; and in the second case raising the cost of offshore borrowings needed to fund Australian investment.

(b) The Constraints

While in principle it may be possible for policy advisers to keep on top of financial market developments and also have a good awareness of likely behavioural responses to policy changes, in practice this can prove extremely challenging, for a variety of reasons.

Firstly, advisers - often with good reason - do not always trust the quality of advice they are given by market participants, viewing it as self-serving and rent-seeking. Closely related, the experience of receiving biased and unhelpful market feedback can lead to an underlying distrust in the quality of *any* feedback or advice given by the private sector, and hence a reluctance to ask for it.

Secondly, there may be unwillingness on the part of some policy advisers to ask questions they need to ask, due to a fear it may be perceived as revealing an inadequate understanding of financial markets and how they work or of recent financial market changes and innovations.

Thirdly, where the underlying issue on which policy makers need information relates to a sensitive prospective policy change, they may be concerned that asking the relevant questions risks "leakage" of the proposal ahead of it being finalised and announced.

(c) Does the Financial Sector Advisory Council Meet These Needs?

The Financial Sector Advisory Council (FSAC) was established in 1998 as an independent, non-statutory advisory body, on the recommendation of the Wallis Financial System Inquiry. Its charter is to provide advice to Treasury and government on “policies that will maintain an efficient, competitive and dynamic financial sector, consistent with the objectives of fairness, financial stability and prudence”; and to “promote dialogue between the private sector and the Government in support of the development and growth of Australia’s financial sector.” It is made up of senior financial sector executives and meets four times each year. Secretariat support is provided by Treasury.

Discussions with some past and present members of FSAC suggest that it is having at best a marginal input into the development of sensible and up-to-date policy settings in the financial sector. Recent financial market policy “errors” and ongoing policy “gaps” also suggest this is the case. There are a number of reasons for this, but a critical one emphasised in our discussions is the lack of a dedicated secretariat which has widespread contacts throughout the financial sector, the time and resources to prepare detailed, independent background papers for FSAC meetings and the time and resources to do all the necessary follow-up work after meetings. Treasury staff providing Secretariat support would appear to have neither the time nor the breadth of financial sector contacts to adequately meet these objectives. This is no doubt largely a reflection of the work pressures that Treasury staff are under.

While FSAC could be restructured to meet the needs described earlier and overcome the constraints, this would require a number of changes, outlined below.

(d)The Proposed Solution

In order to meet the above needs and overcome the related constraints, we propose the formation of a new or reformatted standing advisory body to liaise between the financial sector and policy advisers. For such a body – which for convenience we will refer to as the Financial Sector Advisory Group (FSAG) - to provide useful, well-informed and comprehensive advice that is not based on vested interests, it would require a number of features set out below.

In making these suggestions, we have drawn heavily on the experiences - both positive and negative - of the Australian Financial Centre Task Force, along with feedback from past and present FSAC members. The Task Force was established in 2010 at the recommendation of the 2009 Johnson Report on “Australia as a Financial Centre” and was charged with “promoting Australia as a financial centre for the region and facilitating industry input into the design of a range of proposals…” The Task Force was officially wound up in November 2013 but in effect ceased to operate well before that date due to lack of funding.

Firstly, the FSAG would need to be made up of senior, respected financial market executives with considerable market experience covering all major parts of the financial sector - commercial banking, investment banking, funds management and insurance. Board members would be able to nominate a “second” to attend in their place if they are unavailable. Board positions would be subject to a three year rotation, with an extension possible at the discretion of the relevant Minister.

Secondly, through its Board and its secretariat the FSAG would need to have a wide array of contacts within the financial sector on which it can draw for information.

Thirdly, the Board and its secretariat would when relevant require access via its main Treasury contact point to other parts of Treasury - such as Revenue Group on tax policy issues - and when relevant to other parts of the bureaucracy.

Fourthly, the Board would also require access through Treasury to the relevant Minister responsible for financial services. It would report to the Minister every six months on progress with respect to its terms of reference. This would allow the Minister to respond to the work of the Group and set out the Government’s priorities for the Group’s ongoing work.

Fifthly, it would require adequate resourcing in the form of its own secretariat, which would act as the day-to-day conduit between the financial sector and Treasury, prepare detailed papers for meetings and be responsible for the necessary follow-up work arising out of the meetings of the FSAG. The existence of such a dedicated secretariat was of central importance to the efficient functioning of both the Australian Financial Centre Forum - the body which wrote the 2009 Johnson Report on “Australia as a Financial Centre”- and its successor, the Australian Financial Centre Task Force. By contrast, discussions with some past and present members of the Financial Sector Advisory Council suggest that this is a major constraint on FSAC’s effectiveness.

Sixthly, the Board and its secretariat would require the trust and respect of both the broad financial sector and key policy advisers. One of the problems which the Financial Forum and subsequent Task Force Secretariat faced was that, while it appeared to have the trust and respect of both the relevant Minister and Treasury Deputy Secretary, there was an underlying suspicion and hence lack of willingness to openly share information and ideas on the part of the main day-to-day Treasury contact person during most its period of operation, despite no “leakages” or breaches of trust during the whole period of either the Forum’s or the Task Force’s existence. This underlying reluctance to share information fed through to other, more junior Treasury staff with whom the Secretariat interacted.

Finally, from the point of view of both financial market contacts in general and members of the FSAG in particular, ongoing support for and involvement in the FSAG would require evidence over time that it was being listened to by advisers and government and that it was having some positive impact in terms of policy settings. If this were not the case, even the most public-spirited business executives will soon become unwilling to give up their time to work on such a body, and the body's network of contacts in the markets will also become unwilling to spend time providing feedback and information to it.

This was very much the experience of the Australian Financial Centre Task Force. While nearly all of the policy recommendations in the November 2009 Johnson Report on “Australia as a Financial Centre” were accepted in principle by the then Government, few of them have been fully and effectively implemented, to the considerable frustration of members of the Task Force, supporting organisations such as the Financial Services Council, the Australian Bankers Association and the Australian Financial Markets Association, and market contacts more generally.

The Appendix to this submission sets out where the recommendations of the Johnson Report have got to. Many of the recommendations in the report are of direct relevance to the Financial System Inquiry, including:

- the need to abolish withholding tax on offshore capital raisings by Australian banks and also remove the LIBOR cap on deductibility of interest paid on bank branch/parent funding, so as to ensure that as a nation we fund our offshore borrowing requirements as efficiently and cheaply as possible;

- the need to remove any unnecessary regulatory constraints to the development of a deeper and more diversified corporate bond market;

- the need to encourage greater private sector insurance and reduce demands on the public purse by removing all state taxes and levies on the insurance sector; and

- the need to ensure Australia benefits from the export of its financial services skills and experience by reducing tax uncertainty regarding the tax treatment of cross-border financial transactions, through the introduction of a broad-based and effective Investment Manager Regime.

The Role of the Australian Tax Office

As a final but critical observation flowing from the experiences of the Task Force, we would like to draw attention to what we see as a substantial obstacle to the establishment and updating of sensible and effective financial market policy settings - namely, the role the Australian Tax Office (ATO) plays in policy formulation. Our concerns can be best illustrated by reference to the Johnson Report recommendation regarding introduction of an Investment Manager Regime (IMR), but there are many other examples.

The ATO opposed introduction of an IMR from the beginning of the Forum's work on this issue. In our view, this opposition primarily reflected the fact that the ATO prefers the status quo of tax uncertainty, because it gives them the flexibility to tax a set of transactions if it looks like there may be significant revenue gains even if such transactions have not generally been taxed in the past.

During early discussions with the ATO about the need for an IMR, their response was that it was unnecessary since the type of cross-border transactions that the Forum was proposing it should cover would not be taxed by the ATO anyway. Once it looked like an IMR recommendation might be accepted, the ATO response changed to arguing that such a regime would be dangerous as it could encourage "round tripping" by Australian investors so as to avoid tax. No evidence at all was produced to justify this concern. Moreover, if the concern was genuine then the sensible policy response would have been early introduction of the draft Foreign Accumulation Fund legislation, which is designed specifically to deal with "round tripping".

Unfortunately, Treasury Revenue Group and the then Government responded to these unjustified ATO concerns by introducing a range of restrictions and conditions into the draft IMR legislation which, if not changed, will render the legislation largely ineffective.

The Tax Office has a responsibility to administer the tax system. But if sensible and effective tax policies - whether they relate to the financial sector or other sectors - are to be put in place, then close attention needs to be paid to the excessive influence the Tax Office has with respect to assessing the need for and design of tax legislation.

These concerns extend to the ATO's role in costing tax proposals. If the ATO is opposed to a proposed tax policy change, it can all too easily come up with an inflated cost estimate which may in turn influence the final estimate done by Treasury. When combined with the restriction on including in tax proposals likely revenue gains due to increased activity flowing from the proposed policy change, this ATO role can make it particularly difficult to get sensible policy changes through, especially in times of pressure on the Federal budget.

This submission reflects the author's personal experiences working with the Financial Centre Forum and the Financial Centre Task Force. It is provided on the basis that neither of the authors would wish to be involved in any future initiatives along the lines suggested.

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Attachment

"Australia as a Financial Centre"
Report by the Australian Financial Centre Forum
November 2009

Status of Recommendations as of April 2014

TAXATION

Investment Manager Regime ("IMR")

Treasury has released an exposure draft for the "third and final element of the IMR". There is widespread market concern that the draft is deficient in a number of key aspects. The definition of "widely held" excludes many important participants such as sovereign wealth funds and endowments. The requirement that investors be resident in jurisdictions with an Exchange of Information Agreement with Australia excludes Luxembourg domiciled UCITS Funds, which are dominant across continental Europe and much of Asia. Arguments to the effect that these measures are necessary to protect the integrity of the tax system ignore the fact that countries such as the UK and US - both of which are in substantially more difficult fiscal circumstances than Australia – have effective and wide-ranging IMR's in place and have seen no need to abolish or even amend their schemes.

Unless the draft is changed to overcome these weaknesses, very important market segments will not be included, tax uncertainty will continue to affect international growth prospects of fund managers in Australia and investors will be encouraged to select offshore locations and managers for international investment.

Offshore Banking Units ("CBU")

There has been no updating of the OBU legislation despite the problems with it identified in the Johnson Report. Financial institutions in Australia make limited use of the OBU legislation, reflecting, amongst other things a high degree of tax uncertainty.

Funds Management Vehicles

No action has been taken on introduction of a wider range of tax-flow through vehicles.

Withholding Tax Removal on Offshore Borrowings

Deferred for budgetary reasons in 2010. Was part of the then Opposition's list of fiscal savings prior to the last election. Assume rejected.

Removal of LIBOR Cap on Deductibility of Interest Paid on Bank Branch-Parent Funding

No action

Islamic Finance Products

The report of the Expert Group was completed more than two years ago and delivered to the responsible Minister. It included substantial work on removing tax and other impediments to the introduction of sharia compliant financial products. No action.

State taxes and levies on insurance

No action by Federal Government as this is a "State" matter

Monitoring progress on tax

Financial Task Force disbanded

REGULATION AND REGULATORY SUPERVISION

Avoiding unnecessary regulation

Accepted

Periodic reviews of regulatory rules and framework

Implemented – Financial System Inquiry

Asia Region Funds Passport

Partially implemented with APEC Pilot expected in 2015. Treasury and DFAT officials have carriage and have done an enormous amount of work on this initiative. There is an opinion that progress could be accelerated through high level intervention by the Treasurer to selected regional counterparts.

Regulatory online gateway

Implemented and operational

Increased competition on exchange traded markets

Implemented

Reduce regulatory requirements on corporate debt issuance

Legislations has been prepared but has not yet been submitted to Parliament. The draft legislation was prepared following widespread industry consultation, enjoys strong industry support, and there is optimism that the legislation will be effective.

Standardise non-prudential regulation of the insurance sector

No action by Federal Government as this is a "State" matter

Removal of regulatory barriers to Islamic finance

Not implemented: see above

PROMOTING AUSTRALIA AS A FINANCIAL CENTRE

Declaration of Intent

Implemented

Financial services missions

Partially implemented. There is some industry opinion that commitment and coordination is lacking.

ONGOING PARTNERSHIP BETWEEN GOVERNMENT AND INDUSTRY

Financial Centre Task Force

Task Force was disbanded mid-2013. Financial Services Advisory Council (recommendation of Wallis) generally regarded by industry and by some of its members as ineffectual.