March 2014

Financial System Inquiry – NSW Government Submission

Introduction

The NSW Government welcomes the Financial System Inquiry (the Inquiry).

A well-functioning financial system is fundamental to the strength of the NSW and Australian economies. Sydney, as the pre-eminent financial centre in Australia is central to this.

The NSW Government notes that the financial system has broadly served Australians well. The World Economic Forum has consistently ranked Australia's financial system amongst the top five in the world, the World Bank noted that Australia's financial system is remarkably resilient, and the Global Financial Centres Index places Sydney amongst the world's most stable financial centres.[1] Renewal and review is essential for Australia to maintain and improve upon this performance in a rapidly evolving global and domestic environment. With 16 years since the Wallis Inquiry, the Inquiry is timely and necessary.

Due to the size of the financial sector in NSW and its connectedness with the broader economy, the NSW Government has a particular interest in ensuring a well-functioning financial system into the future. The NSW Government supports the Inquiry's remit to recommend policies that will allow for healthy growth and competition in the sector while also ensuring stability and consumer protection.

The remainder of this submission covers issues, including capital allocation, debt markets and financial products, that the NSW Government believes warrant consideration by the Inquiry Panel (the Panel).

[1] World Economic Forum, *The Financial Development Report 2012*, 2012. World Bank, *Global Financial Development Report 2013*, 2012. Z/Yen, *Global Financial Centres Index 14*, 2013.

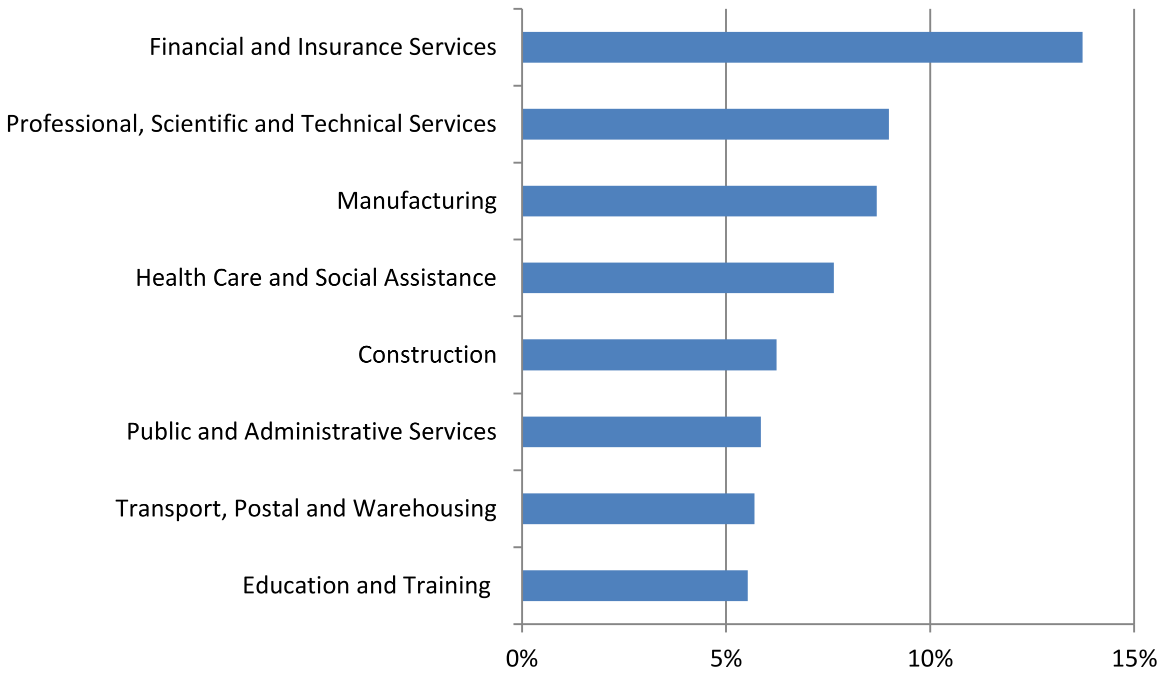
The importance of the financial services sector

The NSW Government notes the significance of Sydney as a financial centre as well as the importance of the financial services sector to the NSW and wider Australian economy due to its function, size and connectedness.

The financial and insurance services sector in NSW accounts for 44 per cent of the national industry, around 5 per cent of Australia's GDP, and 42 per cent of national employment in the sector. [2]

The financial services sector is the largest sector in the NSW economy and is likely to be an important source of future growth. In NSW, the sector accounted for 13.7 per cent of total industry gross value added in 2012-13 and employs over 175,000 people, or 5 per cent of the State's workforce. This compares to 9.8 per cent of total industry gross value added and 120,000 people employed in the sector in 1992-3.[3]

Chart 1: Top Eight Industry Sectors in NSW: Share of Total Industry Value Added



Source: NSW Treasury estimates and *Australian National Accounts: State Accounts*, ABS Cat No 5220.0
Notes: Top eight sectors by share of total NSW industry value added as at June 2013.

The financial services sector is deeply connected to all other sectors and plays a key role in facilitating growth across the economy through allocating capital and providing

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[2] NSW Trade and Investment, *Financial Services New South Wales*, 2013.

[3] NSW Treasury estimates and *Australian National Accounts: State Accounts*, ABS Cat No 5220.0.

financial services to businesses and households. The Australia Financial Centre Forum report (the Johnson Report) noted:[4]

> "The financial sector is at the core of the economic system, providing a range of services which are necessary for other domestic and trade related industries to function efficiently and enabling consumers to effectively manage their consumption-savings requirements over time. While economic growth tends to induce accompanying financial sector growth, empirical research demonstrates a well-established causal link from financial sector development to economic growth.
>
> In short, from a purely domestic focus, having a financial sector that meets the financing and investment needs for consumers, businesses and governments as efficiently and competitively as possible increases the nation's capacity to grow."

The NSW Government notes that the stability of the financial system is of particular importance to NSW due to its significant contribution to the NSW economy and the large number of people employed in the sector.

The NSW Government supports the Panel investigating the risk of shocks, both internally and externally, to the financial system and how to mitigate the likelihood and impact. This will require a detailed analysis of Australia's performance during the GFC.

A stable financial system which avoids accentuated booms and busts allows businesses in the sector and related sectors to plan and invest for the long-term. A stable financial sector avoids dramatically fluctuating employment levels, which are particularly problematic in a downturn, and fosters consumer confidence and trust in the system.

A financial system that works for consumers

Consumers heavily rely on financial products of varying sophistication at most stages of life. Therefore, the NSW Government encourages the Panel to investigate consumer and competition issues and notes that these issues are the responsibility of the Australian Government.

A well-functioning financial system will serve the interest of consumers through appropriately balancing stability, transparency, consumer protection, efficiency and competition.

For the various sectors of the financial system, the Panel could assess the level of competition, efficiency and innovation through understanding market concentration, barriers to entry and the ease of product switching.

Consumers should be able to make informed decisions when selecting financial products. It is worth investigating how easily consumers can access meaningful information to understand and compare financial products.

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[4] Australian Financial Centre Forum, *Australia as a Financial Centre*, 2009.

Sydney as a financial centre

Sydney is the pre-eminent financial centre in Australia and the region. Sydney's financial services sector is already a dynamic hub offering a wide range of sophisticated services.

Sydney's many positive attributes place it in a unique position. These include:[5]

- Sydney's location means its time zone bridges financial markets closing in the USA and opening in the UK.
- Sydney has strong long-standing links to fast growing Asian markets, including China and India.
- Sydney's large financial services workforce is highly educated and multilingual.
- Sydney offers an outstanding quality of life, which attracts some of the world's best financial talent.

The NSW Government encourages the Panel to explore the further development of Sydney as an internationally competitive financial centre. The Inquiry should ensure that Australia's financial system strengthens our ability to compete in the provision of high value finance and supporting services to global businesses and investors. This includes the provision of asset management, investment and project finance, and high value middle office and supporting services.

In developing its position the Panel should consider the outstanding recommendations of the Johnson Report.

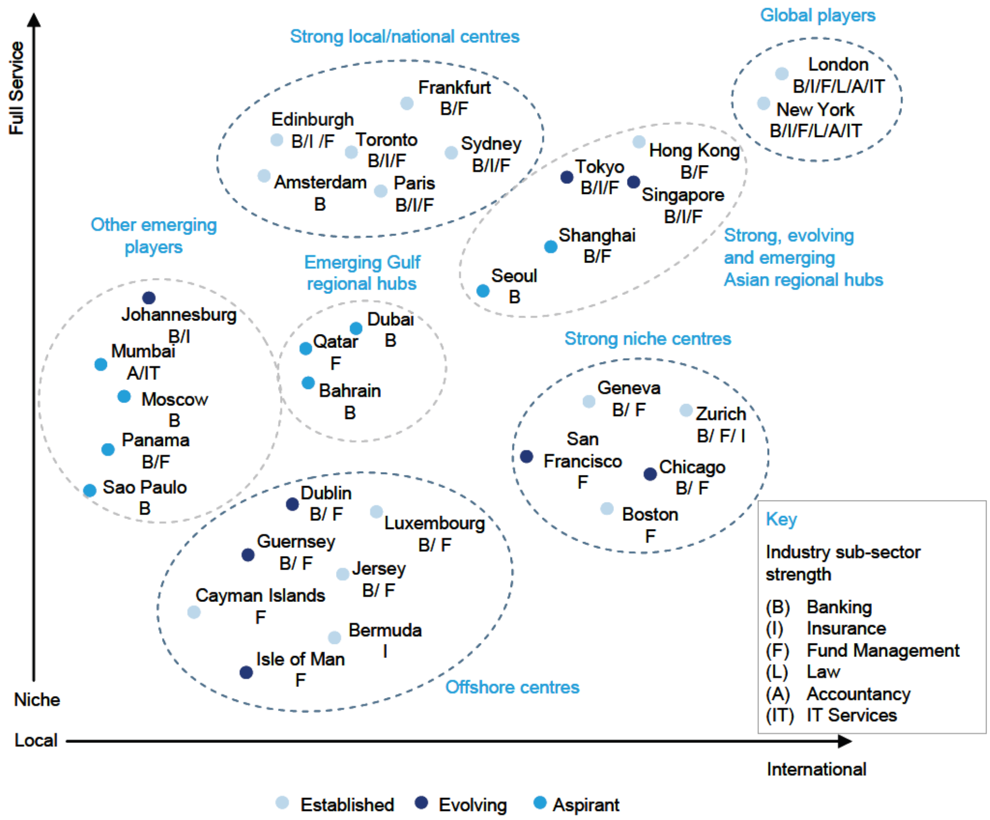
Internationalisation of the financial services sector

The Johnson Report noted that while Australia's financial sector offers a wide range of services, it is not highly internationalised. This is illustrated in Chart 2 which compares the differing focus of financial centres. Compared to other financial centres, such as the UK, Singapore and Hong Kong, Australia's financial service exports are a small proportion of the entire sector.[6]

[5] NSW Trade and Investment, *Financial Services New South Wales*, 2013.

[6] Australian Financial Centre Forum, *Australia as a Financial Centre*, 2009.

Chart 2: Categorisation of financial centres



Source: Oliver Wyman, Citi, reproduced by the Australian Financial Centre Forum, *Australia as a Financial Centre*, 2009.

Rapid economic growth in the Asia-Pacific region offers enormous opportunity for growth in offshore sourced funds under management in Australia. Furthermore, recent growth in export services such as education, tourism and legal services demonstrates the potential for significant increases in the export of Australian financial services.[7]

NSW and Australia has strong capability in asset management, with funds under management (FUM) in Australia currently estimated at $2.1 trillion and set to grow to $7.6 trillion by 2033. However the industry is largely domestically focused, with only $75 million FUM on behalf of foreign customers.[8]

While it is noted that the current Australian Government has moved to address uncertainty, including around Offshore Banking Units, more can be done. In particular, removing the tax uncertainty for foreign investors using Australian asset managers by establishing an internationally competitive investment manager regime should be a priority.

[7] Australian Financial Centre Forum, *Australia as a Financial Centre*, 2009.

[8] SGS Economics and Planning, *Australian Cities Accounts 2012-2013*, February 2014.
Deloitte Access Economics, *Positioning for prosperity? Catching the next wave,* October 2013

Deloitte Access Economics highlights three areas of exportable asset management activities that Australia is well placed to provide:[9]

- Managing funds for foreign investors.
- Advising other nations on developing wealth management sectors while exporting locally created financial instruments
- Expanding services into Asia to be preferred "banker to the region".

The Johnson Report, along with the NSW Professional Services Industry Action Plan Taskforce, identified the importance of Australia strengthening its competitiveness in high value services. The current cost structure of the industry however is increasingly seen as not being internationally competitive. While this is partially the result of a high Australian dollar and increasing capability and lower cost competition from both developed and emerging economies, it provides an impetus to consider whether there are local, structural issues, which are resulting in costs being higher than they otherwise should be.

The 2012 NSW Professional Services Industry Action Plan reported the results of KPMG's biennial *Competitive Alternatives* study which found Australia to be second only to Japan in the annual costs of running an international financial services business.[10] Total labour costs per employee were $105,000 in Australia versus $79,000 in the UK. Labour costs were found to be generally higher in Sydney than in Singapore (30-50 per cent higher for non-executive finance and accounting occupations) and Hong Kong, and were comparable or higher than London for most professional services occupations.

Given the importance of the sector as an input to the rest of the economy, the future competitiveness of Australian firms, and consequently household incomes, also hinges to some degree on minimising the cost of domestic financial service inputs.

To further support the internationalisation of the sector, the Panel may also want to investigate barriers, government imposed or otherwise, to foreign companies cross listing on Australian stock exchanges or establishing operations in Australia.

Why it is important for Australia that Sydney maintains its position as a regional financial centre

As activity becomes increasingly concentrated in key financial centres, enhancing the regional relevance of Sydney and Australia within the regional and global financial system will be critical not just for the industry but also for the Australian economy overall.

The ability to attract internationally contestable businesses improves local market depth and enhances competition, helping to drive local market innovation and skills

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[9] Deloitte Access Economics, *Positioning for prosperity? Catching the next wave*, October 2013.

[10] NSW Professional Services Taskforce, *NSW Professional Services Industry Action Plan*, 2012.

development and capabilities. Financial centres have an ability to provide access to state-of-the-art products and services, and the capacity to tailor these to local needs, to the benefit to businesses outside of the finance sector.

Failure to maintain Sydney as a regional financial services centre could see a gradual movement of functions and activities offshore. Over the longer term, with decisions affecting Australian operations increasingly made by foreign head offices, the ability to develop and sell quality financial services and products that meet local needs is also expected to be significantly reduced.

It could also see more skilled finance professionals leave Australia to work in larger financial centres. The concentration of financial services activities and its supporting services, with the presence of some of the world's leading companies, make Sydney the clear choice for expatriate and overseas talent relocating to Australia in this sector. If Sydney's position as a regional financial centre is eroded, it will be extremely difficult to continue to attract these high-skilled workers to Australia.

Capital allocation

The NSW Government supports the Panel thoroughly investigating the efficiency of capital allocation, as it is a cornerstone for a well-functioning financial system and economy.

Tax

The tax system, both at the state government and Australian Government level, influences the allocation of capital. The NSW Government supports the Panel examining the impact of taxes on the financial sector and the allocation of capital.

The NSW Government is currently taking steps to reform taxes including supporting lowering the GST threshold on imported goods and reviewing the NSW emergency services levy.

The NSW Government will consider relevant financial system tax recommendations made by the Panel and notes that tax issues will also be considered in the Australian Government's forthcoming white paper on tax reform.

Access to capital for business

The Panel should consider whether there are inappropriate barriers to the availability of capital to business, including new businesses, small to medium businesses (SMEs) and property developers.

In the residential development sector there are views that following the GFC developers have had difficulty in obtaining project finance.[11] This could be worthy of exploration.

For Australian small businesses, access to finance is the number one barrier to innovation and the third largest barrier to general business activity.[12] Approximately 10 per cent of all Australian small businesses have difficulties accessing finance. Given the importance of start-ups and small businesses to the overall economy, difficulties in accessing finance have the potential to significantly curtail economic growth, investment and employment nationwide.

Small businesses and start-ups have specific needs, requirements, issues and risk profiles compared to larger businesses.

The NSW Government supports further analysis of small business and start-up access to finance. In reviewing this, the Panel could consider the role that other sources of finance, such as equity and non-bank finance opportunities, have on the growth of early stage SMEs. The NSW Government also supports the Panel reviewing how the system performs on a sector by sector basis to determine whether there are market distortions or barriers existing in concentrated areas.

In particular, the NSW Small Business Commissioner supports increasing access to finance for small business and start-ups by investigating:

- Equity crowd funding as a complementary source of capital to traditional lenders.
- Greater regulatory certainty for peer-to-peer financing which currently lags behind similar initiatives in the USA and UK.
- Facilitation of investment by superannuation funds in venture capital and small business.
- Ways to reduce the scale of bank fees charged to small business operators, which can be ten times greater than fees charged to big business.

Infrastructure and superannuation

With infrastructure investment a significant enabler for productivity growth, the Panel could investigate barriers to private sector involvement in infrastructure, including investment by superannuation funds. Due to the long time-horizons faced by both infrastructure projects and superannuation funds, there is a potential synergy between superannuation and infrastructure.

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[11] The Australian Housing and Urban Research Institute, *The financing of residential development in Australia*, 2014.

[12] Deloitte Access Economics and Professor Marc Cowling for the NSW Business Chamber, *Small Business Access to Finance*, 2013

The NSW Treasurer and the Australian Treasurer will co-host a forum on superannuation and infrastructure in Sydney in mid-2014.[13] This will open a dialogue between the superannuation industry, government, and the infrastructure sector to deepen the understanding of barriers inhibiting greater investment in infrastructure projects.

The sound governance of the $1.62 trillion[14] in superannuation assets is essential. The NSW Government encourages the Panel to assess the adequacy of current superannuation governance arrangements noting previous reforms and reviews, including the discussion paper on governance and transparency released by the Australian Assistant Treasurer in late 2013.[15]

Debt market and government balance sheets

There are strong linkages between Australian Government, state government and corporate debt markets. This is evident in that the Australian Government's sovereign rating helps underpin positive sentiment towards the broader debt market.

Additionally, the Australian and state government balance sheets are closely linked, directly through the formal channel of debt guarantees (when in effect), as well as indirectly through fiscal payments under the federal financial framework.

It therefore makes sense to understand the aggregate national government balance sheet for budget and debt management purposes. The NSW Government is aiding a holistic view of government finances through assessing the long-term impact of policies on the fiscal gap and regularly reporting on the State's long-term fiscal outlook.[16]

Reflecting these linkages, in recent years the Australian Office of Financial Management and the NSW Treasury Corporation have worked alongside each other in marketing Australian debt instruments to investors. This has been an effective and productive partnership.

State governments are important sources of debt securities. The NSW Government alone had over $63 billion of debt issued as at 30 June 2013.[17] Banks' capital reserve requirements have boosted the attractiveness of our triple-A rated debt, at the same

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[13] Announced 13 March 2014, see http://www.nsw.gov.au/news/baird-and-hockey-host-superannuation-forum.

[14] The Australian Prudential Regulation Authority, *Annual Superannuation Bulletin 2013*, February 2014.

[15] Senator the Hon Arthur Sinodinos, *Better regulation and governance, enhanced transparency and improved competition in superannuation*, November 2013. The NSW Government also encourages the Panel to consider the findings of the 2009 Super System Review.

[16] NSW Government, Budget Paper No. 2, Chapter 1: Budget Overview, Context and Strategy, 2013.

[17] NSW Treasury Corporation, *Annual Review - 2013*, 2013.

time the number of issuers with a triple-A rating has shrunk. Without taking a view on whether current prudential arrangements are appropriate, the NSW Government notes that to some extent there appears to be a trade-off between market safety on one hand and secondary debt market liquidity on the other.

The NSW Government is committed to maintaining its triple-A credit rating. As part of this, the NSW Government is maintaining fiscal discipline and recycling the State's balance sheet through asset transactions such as the long-term lease of Port Botany and Port Kembla (see Attachment), and the ongoing sale of state-owned electricity generators. This allows the NSW Government to reinvest in new infrastructure without putting further pressure on its credit rating through additional borrowing. The NSW Government welcomes recent discussions, led by the Australian Government, on an initiative that could build on this model.

The Panel could investigate whether more could be done to support developing a deep and liquid debt market, including greater use of long-term debt. Both the NSW Treasury Corporation and the Australian Office of Financial Management have issued longer dated debt in recent years. Extending the maturity on government and semi-government debt may assist in the development of the long-term corporate debt market as it provides a benchmark for pricing.

In this regard, the NSW Government also welcomes the recent move by the Reserve Bank of Australia to publish corporate credit spreads.[18] This will further improve transparency in the corporate debt market.

Products

Government service delivery

The NSW Government is committed to improving the efficiency and quality of the services it delivers. As part of this the NSW Government has been exploring opportunities for service delivery through the not-for-profit and private sectors.

The NSW Government encourages the Panel to investigate any barriers arising in the financial sector to governments working with the not-for-profit and private sector to deliver services. The Panel could investigate whether financial service providers have adequate products to accommodate not-for-profit organisations entering into long-term contracts for government service provision.

One way the NSW Government is driving innovative service delivery in partnership with the private sector is through its trial of Social Benefit Bonds (SBBs). SBBs are a new financial instrument in which private investors provide up-front funding to service providers to deliver improved social outcomes. If these outcomes are delivered, there

[18] Reserve Bank of Australia, *New Measures of Australian Corporate Credit Spreads*, December 2013.

are cost savings to government that can be used to pay back the up-front funding as well as provide a return on that investment.

A recent evaluation found that the development phase of the SBBs was successful and demonstrated that this sort of financial instrument can be used in the Australian context.[19] The evaluation also found that the trial has heightened awareness and understanding of how SBBs can improve service delivery outcomes. Further evaluations of the pilot SBBs will be conducted throughout the life of the products and the NSW Government will work to learn from these evaluations and explore other applications.

Innovation

NSW Government industry consultations have raised concerns that there exists regulatory barriers that may be preventing the introduction of new financial products to the local market. Growing the size of the local market is an important aspect of maintaining Sydney and Australia's relevance as a financial centre, as is the industry's ability to innovate and introduce new products and services. Detailed analysis of these concerns by the Panel is supported.

Infrastructure financing

The NSW Government stands out as a jurisdiction employing innovative methods of financing significant infrastructure and drawing on the substantial financial expertise available in Sydney. An example of this is the innovative financing strategy for WestConnex where private sector capital will be raised against the tolls of the initial phases of the project once built and operating (see Attachment).

The NSW Government encourages the Panel to investigate impediments to the wider use of innovative infrastructure financing methods, drawing as needed on the current Productivity Commission Inquiry into public infrastructure. The Panel may also wish to consider any local barriers to the provision of infrastructure investment management in foreign jurisdictions.

Ageing population

The ageing Australian population has wide implications for governments and the financial system. By 2049-50 the number of working age people (between 15 and 64 years) to support each retiree is expected to fall, from 5 people in 2009-10, to 2.7 people. This compares with 7.5 working age people for each person aged over 65 years in 1970.[20]

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[19] KPMG, *Evaluation of the Joint Development Phase of the NSW Social Benefit Bonds Trial*, January 2014.

[20] The Treasury, *The 2010 Intergenerational Report*, 2010.

An ageing population means growing demand for particular financial products. The Panel could investigate barriers to the development, provision and take up of financial products that better support older citizens. Some of these products, such as superannuation funded annuities and reverse mortgages, could have an important role in assisting older citizens maintain financial independence and may reduce reliance on government services and budgets.

Financial advice

Quality financial advice allows individuals to better manage their finances and invest in products that are appropriate to them. Currently, the tax system favours ongoing financial advice over up-front advice. The Panel may want to investigate whether the tax deductibility of financial advice payments should be expanded to cover up-front advice, as well as ongoing advice.

Technology

Technology continues to rapidly change the financial system. The emergence of alternative digital currencies presents opportunities and risks to the financial system. The Panel could investigate digital currencies, what they mean for the financial system and identify what, if any, government action is required to mitigate any risks posed.

Further information and contacts

For further Information or clarification on issues raised in the submission, please contact the NSW Treasury’s Economic Policy Division on 02 9228 5893.

Attachment: Overview of the NSW asset recycling model

The NSW Government is committed to utilising the potential pool of funds available for infrastructure funds efficiently and effectively. One of the State's initiatives is the capital recycling program, which is implemented through the Restart NSW fund.

Capital recycling involves the State divesting or leasing assets that are not part of core public service delivery and for which transaction proceeds exceed retention value to the State. The proceeds from these asset transactions are then re-invested into new infrastructure initiatives.

These new assets can in turn be recycled when operational as is envisaged in the case of WestConnex.

Restart NSW

Restart NSW is the State's fund that sets aside funds to secure the delivery of major infrastructure projects and was established through the *Restart NSW Fund Act 2011*. Around $4.7 billion (as at June 2013) has been deposited into the fund.

Sources of capital for Restart NSW include windfall tax revenues in excess of Budget forecasts, proceeds from the issue of Waratah Bonds, as well as net proceeds from asset transactions:

- Port Botany and Port Kembla long term leases.
- Sydney Desalination Plant lease.

In turn, Restart NSW funds have been committed to projects including:

- WestConnex.
- M1-M2 Tunnel Unsolicited Proposal.
- Newcastle CBD revitalisation.
- Illawarra region priority projects.
- Pacific Highway upgrades.
- Princes Highway upgrades.
- Bridges for the Bush program.

WestConnex

The NSW Government has developed an innovative financing strategy for WestConnex which will minimise the impact on the State's balance sheet and provide the State the capacity to recycle its investment to new projects.

The NSW Government is structuring its initial investment in the WestConnex project as an equity investment rather than a capital grant. Under the strategy, private sector capital would be raised against the tolls of the initial phases of the project once built and traffic volume is known. In this way the Government can recycle the capital from its initial investment – being a fraction of the total project cost – to fund construction of the further sections of WestConnex over time.