



# AUSTRALIA – A REGIONAL FINANCIAL CENTRE



The Government is committed to making Australia a more attractive regional financial centre and to building on our existing advantages to ensure Australia's full participation in the increasing global trade in financial services.

- Australia has a strong economy and a stable financial system.
- Australia's financial markets are sophisticated and its business conditions are cost-competitive.
- Major taxation reforms will complement further financial market developments.

The Government will implement a number of measures to further develop and promote our financial markets. In addition, the Government will consult with industry to analyse factors affecting the potential for financial sector growth and to consider possible further initiatives to develop Australia's competitive advantage as a financial centre.

## Australia's Advantages

Australian financial activities generate total annual revenues exceeding \$40 billion and employ around 320,000 people. Australia's advantages as a financial centre include:

- political stability and good economic fundamentals, including low inflation and sound macroeconomic policies;
- a stable financial system with unrestricted capital flows and a floating exchange rate trading in a deep and liquid market;
- synergies with commodity trading and resource development;
- a time zone which bridges operating hours in London and New York and is convenient for trading and managing funds in the Asia-Pacific region;
- favourable business conditions including:
  - a strong multi-lingual skills base which is relatively low cost compared with many other countries;
  - well developed infrastructure including an advanced telecommunications system;

- relatively low cost office space in central business districts;
- excellent support skills and systems in areas such as information technology, legal advice and accountancy;
- sound legal and regulatory arrangements; and
- relatively few restrictions on foreign investment and an open approach to foreign participation in local financial markets.

Despite these advantages, Australia is yet to fully develop its potential as a financial centre. Australia needs to:

- improve financial activity cost and efficiency relative to other countries;
- improve the depth and liquidity of some markets; and
- remove impediments to the provision of financial services to offshore customers.

### Participation in global trade

World-wide, the financial system has grown explosively over the past three decades. At the same time, new technologies have allowed an increasing proportion of financial services to be supplied across international borders.

Australia is already participating in the international trade in financial services. Exports of financial and insurance services reached \$1.3 billion in 1996-97. Over the six years to 1996-97 exports of financial services grew by more than 20 per cent. While Australia is a net importer of insurance services, insurance exports have reached \$820 million.

By increasing its role as a financial centre Australia can capitalise on opportunities for export growth.

### An established market

Australian financial markets have depth and liquidity and are the most sophisticated in the region. Further growth depends on their cost competitiveness, range and quality of the products, the liquidity of the markets, and the size of the pool of funds.

### *A snapshot of market developments*

The Australian dollar is the world's eighth most frequently traded currency, with over 60 per cent of trades occurring offshore.

The Australian stock market has grown strongly over the past ten years with domestic capitalisation reaching a record A\$444 billion on 30 June 1997, equivalent to about 87 per cent of GDP.

Liquidity, the ratio of turnover to market capitalisation, increased to 55 per cent in 1997 - a level which is comparable to that in London and New York.

The market ranks among the top dozen in the world in terms of average domestic capitalisation. It is the largest stock market for mineral resource companies with 28 per cent of the world capitalisation of these companies (compared with 19 per cent in the United States).

The range and sophistication of products traded in the Australian derivatives market is greater than in any other market in the region.

The Sydney Futures Exchange is the 15<sup>th</sup> largest futures exchange in the world and operates virtually around the clock. A comprehensive range of derivative products for hedging and trading activities is offered.

The over-the-counter (OTC) markets in Australia have almost three times the turnover of the exchanges and offer a wide range of products and services. Growth of over 50 per cent in 1997 was recorded in currency options and repurchase agreements. The OTC markets are open and highly internationalised with a significant proportion of the transactions dealt 'cross-border'.

The funds management industry is well-developed and currently has almost A\$400 billion under management - more than double that of ten years ago.

## Future directions

The Government has announced a financial system reform package which will establish a world-class regulatory system to support future market development.

The Government will also develop taxation arrangements which will be as non-distortionary as possible on product and institutional arrangements and which will accommodate the integration of Australian financial markets into global markets with minimal compliance and administrative costs.

Comprehensive tax reform provides the main means by which these taxation objectives can be met.

However, the Government has also decided to take some steps now to ensure more effective operation of offshore banking arrangements and to further support the development of the funds management and corporate debt markets. These tax measures are estimated to cost around \$22 million in a full year in revenue forgone.

## Developing Financial Markets

### *Corporate debt market - Interest Withholding Tax exemption*

In order to encourage the development of the domestic corporate debt market, the Interest Withholding Tax (IWT) exemptions provided under section 128F of the *Income Tax Assessment Act 1936* (ITAA) will be widened by removing, for eligible debentures issued by companies, the present requirements that they be issued outside Australia, and that the interest be paid outside Australia.

The wider exemption will apply to issues made after the date of introduction of the amending legislation, but will not apply to Commonwealth Government securities or securities issued by State and Territory central borrowing authorities. The current IWT treatment of sovereign issuers, which allows them to issue debt offshore free of IWT provided conditions such as the public offer test are met, will continue to apply.

This measure will remove a tax discrimination in favour of foreign financial markets over domestic

markets, and facilitate the deepening and greater liquidity of the Australian corporate debt market.

### *Foreign Investment Fund (FIF) rules - exemption for United States FIFs*

The FIF tax rules are to be relaxed to exempt FIF investments located in the United States (US). The exemption will encourage Australian funds managers to make their operations internationally competitive, by exposing them to competition from US funds and facilitating portfolio allocation to such funds.

The substantial similarity of relevant US tax rules to those in Australia will ensure that the exemption does not significantly weaken the FIF rules. The exemption will apply for notional accounting periods ending on or after the date of introduction of the amending legislation.

### *Other tax changes*


The application of the ITAA will be clarified to ensure that capital gains tax does not apply to capital gains distributed by a unit trust where such gains have a foreign source and are distributed to non-residents. If legislation is required then the change would take effect for disposals made after the date of introduction of the amending legislation.

An impediment, arising from the thin capitalisation "loan back" provisions, to foreign bank subsidiaries obtaining offshore funds free of IWT on behalf of a related foreign bank branch, will be removed by an amendment to the ITAA. This will be effective from the date of introduction of the amending legislation.

## A Competitive Offshore Banking Regime

Provision of financial services for transactions between offshore parties is a very competitive business as the funds involved are highly mobile. Therefore many countries provide low tax rates for the profits derived through engaging in such activities.

For several years, Australia has provided a special Offshore Banking Unit (OBU) taxation regime intended to facilitate such activity in Australia. The



regime exempts certain offshore parties from Australian tax and provides a 10 percent tax rate on the taxable income of OBUs.

The Government will make a number of changes to increase the attractiveness of the tax regime for OBUs.

### *Broadening the OBU regime*

Currently, only banks and authorised foreign exchange dealers can apply to establish an OBU and become eligible for the tax concessions. In order to facilitate greater non-bank competition for offshore business, eligibility is to be extended to funds managers and life insurance companies. Funds managers will be defined as being money market corporations subject to the *Financial Corporations Act 1974*. The new entities will be eligible to apply for approval to establish an OBU from the date the amending legislation is introduced into Parliament.

In addition, the range of eligible activities of OBUs will be extended to include:

- trading with any person in gold, and custodial services provided to non-resident “offshore persons”; and
- trading, hedging and other eligible contract activity in Australian dollars with an “offshore person”, including another OBU.

The income of offshore charities that are exempt in their home jurisdictions and whose investments are managed by an OBU will be exempt from tax.

### *Interest Withholding Tax changes*

An IWT exemption applies under the OBU regime to prevent tax being imposed on parties to offshore transactions. Uncertainties in the scope of the exemption will be addressed to ensure its comprehensive coverage.

An IWT exemption for interest paid on offshore borrowings under “conduit” arrangements will be allowed by extending the IWT exemption under section 128GB of the *ITAA*.

The penalties applying to OBUs for breaches relating to their IWT concession are excessive and create undue risk for OBU activities. Accordingly,

they will be reduced to bring them into line with penalties applying to breaches of the OBU income tax concession.

### *Capital gains tax changes*

An anomaly in the law currently can result in capital gains tax being imposed on non-residents disposing of a 10 per cent or greater interest in an OBU offshore investment trust. This has the effect of imposing tax on non-residents who obtain foreign source gains, rendering Australian trusts as unattractive vehicles for managing offshore investments. The anomaly will be removed, in cases where the “Australian asset percentage” of the trust is not more than 10 per cent, by reducing the capital gains tax to make it proportional to the share of the gain that relates only to any underlying Australian assets held by the trust.

### *Lowering administration costs*

Administration costs will be reduced for OBUs by removing the specific requirement that they maintain separate nostro accounts (accounts for overseas transactions) and allowing for alternative arrangements for meeting Australian Taxation Office audit requirements.

Further consultation on the OBU expense allocation rules will be undertaken with a view to introducing simpler rules.

### *Other technical tax changes*

To ensure that tax is only payable in respect of Australian source income, the interaction between the OBU offshore investment trust provisions (section 121EL of the *ITAA*) and trust provisions (sections 98(3) and 98(4) of the *ITAA*) will be clarified.

OBU income will be deemed to have a foreign source for foreign tax credit purposes where the income has been subject to foreign tax, and in these cases a deduction for foreign taxes paid will be denied.

The “thick capitalisation” provisions, which deem interest to be paid in respect of 90 per cent of

an OBU's "resident owner money", will not apply if arm's length interest is already paid in respect of 90 per cent or more of the resident owner money. Where the provisions do apply interest will be deemed only to the extent that interest is not actually paid.

These changes will apply from the date amending legislation is introduced into Parliament.

## Staying In Touch With Market Developments

International financial markets are changing rapidly and the Government wants to ensure that the policy framework continues to support the development of Australia as a financial centre.

To stay in touch with private sector views, the Treasurer will establish a task force of the Financial Sector Advisory Council (FSAC) to report on:

- developments in international financial markets;
- the effectiveness of measures proposed to date; and
- further options which could boost Australia's attractiveness as a financial centre.

Members of FSAC and the task force will be drawn from the private sector with its secretariat provided by the Treasury. The Council and its task force will be established in early 1998.

## Financial sector reforms

Australia is middle-ranking in most financial activity cost and efficiency measures relative to other countries. The Government is removing the unnecessary regulatory barriers to competition and efficient market operation through the financial system reforms following the Financial System Inquiry. Legislation to give effect to the reforms will be introduced in 1998.

Improving financial sector competition and efficiency will benefit the whole Australian economy as the international competitiveness of all industries relies on the cost effectiveness of the financial sector which provides essential services to the rest of the economy.

A competitive, efficient and sound financial system requires:

- the maintainance of overall system stability through sustainable fiscal and monetary policy and arrangements for minimising and effectively managing systemic risks;
- sound, orderly and transparent markets where transactions can be conducted with confidence, and risks can be assessed and managed; and
- cost effective, flexible and responsive government regulation which supports financial market innovation and development and promotes competition.

## A world-class regulatory framework

Streamlining the regulatory framework is a key part of the financial sector reforms. The goals and responsibilities of the financial system regulators will be clarified and better directed towards supporting the operation of markets. More cost-effective and competitively neutral regulation will be introduced that will be responsive to market developments flowing from technology or other factors.

The new regulatory structure will be based on three agencies with clear objectives:

- the Reserve Bank of Australia will continue to be responsible for monetary policy, financial system stability and enhanced regulation of the payments system;
- an Australian Prudential Regulation Authority will provide prudential regulation for deposit taking institutions, life and general insurance companies, and superannuation funds; and
- an Australian Corporations and Financial Services Commission will provide regulation for the integrity of market conduct, consumer protection and corporations.

## Promoting Best Practice

The Government will also introduce changes to reduce barriers to entry to financial services markets, promote improvements to financial system infrastructure and remove unnecessary restrictions on corporate form and structure.



### *Improving payments infrastructure*

The payments system is the infrastructure that enables resources to be traded and goods to be exchanged and a high quality and efficient system is essential for a financial centre.

The smooth functioning of the economy relies on confidence in the payments system.

The powers of the RBA to regulate clearing and settlement systems, to control risk in the financial system and to promote payments system efficiency, competition and stability will be strengthened. However, where industry-based arrangements adequately meet public policy principles, they will be able to continue to provide for the ongoing management and operation of the system.

Competition policy principles will be applied to the payments system. Access to clearing systems will be widened to include all institutions fulfilling objective criteria as determined by the RBA.

As part of the worldwide trend to strengthen arrangements for maintaining systemic stability, and to improve the international competitiveness of Australian institutions, legislative measures to support real time gross settlement (RTGS) arrangements are to be introduced in early 1998.

### *Reducing entry barriers*

Entry barriers will be reduced by:

- broadening access to the payments clearing and settlement systems, including by allowing non-banks with an appropriate business case and meeting prudential requirements to have access to exchange settlement accounts at the Reserve Bank.
- Enabling a wider range of entities to participate in the deposit taking market subject to maintaining high prudential standards. The Government will continue to support the general principle of separating ownership of regulated financial activities from commercial and industrial activities. However, restrictions will be relaxed where financial products can be logically bundled with a supply of non-financial goods and services.

### *Facilitating corporate structures*

Measures to facilitate commercially preferred corporate forms and structures will enhance competition and efficiency in financial markets.

In the financial sector, corporate structures based on non-operating holding companies can provide for greater transparency of group operations and are often preferred for a variety of commercial reasons.

The prohibition on non-operating holding company structures will be lifted, and adoption of these structures facilitated by legislation imposing essential prudential requirements.

The APRA will be given sufficient powers to regulate non-operating holding companies and financial conglomerates to the extent necessary to prevent material risks to the financial safety of licensed financial entities within the group.

Banking and deposit taking groups are currently prevented from holding more than one bank or deposit taking licence.

However, a change will be made so as to allow financial groups to hold more than one bank or deposit taking licence where prudential standards are not compromised and deposit holders and investors are treated equitably.

The blanket prohibition on mutual ownership of banks will be removed. Licence applicants, in this respect, will first need to satisfy tests of probity and financial standing, and demonstrate a capacity for ongoing compliance with capital requirements.

### *Improving international market access*

Efforts to improve international market access for Australian financial institutions continue to be made in the WTO negotiations on financial services, and through other fora such as the OECD negotiations for a Multilateral Agreement on Investment and APEC initiatives.

## Corporate law economic reform program

Financial sector reform is occurring in conjunction with a major programme of improvements to key areas of corporate law policy known as the Corporate Law Economic Reform Programme (CLERP). Reform of corporate law has an important role in the Government's drive to promote business and economic development.

Reforms being considered under the program recognise that the environment in which businesses operate is rapidly changing and becoming increasingly global. The regulatory framework is itself an important driver in facilitating business innovation and vitality. One of the main aims of CLERP is therefore to introduce world best practice in business regulation.

CLERP is focussed on six key areas of corporate regulation: accounting standards, fundraising, directors' duties, takeovers, electronic commerce, and financial markets and investment products.

### *Accounting standards*

Proposals on accounting standards are directed towards achieving greater harmonisation of Australian and international accounting standards. This would be achieved through Australia accelerating its move to adopt international standards, and improving institutional arrangements for standard setting, including the establishment of a Financial Reporting Council and a new standard setting body - the Australian Accounting Standards Committee.

These new arrangements will enhance stakeholder involvement and make the standard setting process more responsive to the needs of users and business. The reforms are aimed at promoting investor confidence in Australia's reporting framework and facilitating access to capital by Australian firms. This has the potential to reduce their cost of capital and increase the competitiveness of Australian businesses.

### *Fundraising*

The CLERP proposals also recognise the importance of firms being able to raise funds cost-effectively. Fundraising is an essential aspect of business activity and an improved environment for raising capital will lower transaction costs and lead to increased levels of investment and the creation of jobs.

In particular, the reforms under CLERP are aimed at streamlining company fundraising regulation to allow shorter, more useful prospectuses and more liberal rules for small fundraisings.

### *Directors' duties and corporate governance*

The proposed reforms seek to provide a more certain environment for directors and corporate governance and incentives for proper behaviour. The reforms include the introduction of a business judgement rule, which offers directors a safe harbour from personal liability in relation to honest, informed and rational business judgements.

At the same time a right of statutory derivative action will be created to enable shareholders or directors of a company to bring an action on the company's behalf, where the company is unwilling or unable to do so.

These proposals should ensure that directors duties do not impose an unjustifiable inhibition on business decision making as well as promoting investor confidence.

### *Takeover laws*

Australia's takeover laws will also be reformed to more closely align takeovers regulation with preferred commercial practices.

These reforms will facilitate a more efficient and contestable market for corporate control, whilst ensuring that shareholders are adequately protected.

CLERP invites discussion on whether a mandatory bid rule should be introduced, whereby an acquisition in excess of the statutory threshold would be permitted provided it is followed immediately by an announcement of a full takeover bid.

A specialist takeover panel is also proposed which is expected to play a primary role in takeover dispute resolution to improve efficiency and provide a commercial focus.

### *Electronic commerce including netting*

CLERP also proposes a number of reforms to Australia's business laws to facilitate electronic commerce: these will be announced shortly.

Electronic commerce can replace traditional face-to-face ways of doing business and transactions effected through the exchange of paper-based documents. The increasing internationalisation of markets and economies highlights the need for Australia to take advantage of developments in commercial technology. This will ensure the competitiveness and efficiency of Australia's markets in the global trading environment.

In addition, the Government will be announcing proposals to develop legislation to provide a more certain and robust legal framework for the operations of institutions in the financial system.

Under the current contract-based close-out and netting arrangements, there are legal uncertainties about whether those arrangements would be allowed to operate notwithstanding the insolvency of a party to the netting contract.

### *Regulation of financial products*

Financial innovation is increasingly challenging traditional product and institutional boundaries and investors face an ever-widening choice of products. However, financial markets and investment products are currently regulated differently depending on how the product is classified.

Under CLERP, the regulatory regime is being reviewed to ensure that there is consistent and comparable regulation of similar financial products to assist investors to make informed investment decisions. A consistent regulatory framework for the licensing of markets, financial advisers and dealers and product disclosure will be developed.

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