13 June 2014

Wyatt Roy MP
Chair
Joint Standing Committee on Treaties
PO Box 6021
Parliament House
CANBERRA ACT 2608

BY EMAIL: jsct@aph.gov.au

Dear Mr Roy

KOREA AUSTRALIA FREE TRADE AGREEMENT

The Financial Services Council (FSC) welcomes the opportunity to make a submission to the Joint Standing Committee on Treaties (JSCT) to assist its review of the Korea Australia Free Trade Agreement (KAFTA).

The Financial Services Council represents Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks, trustee companies and public trustees. The Council has over 125 members who are responsible for investing more than $2.2 trillion on behalf of 11 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange and is the third largest pool of managed funds in the world.

The Financial Services Council promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

Should you wish to discuss this submission further please do not hesitate to contact me on (02) 9299 3022.

Yours sincerely,

James Bond
Chief Economist

Introduction

The FSC is a strong advocate of free trade. This includes advocating for multilateral, regional and bilateral free trade agreements. The FSC strongly supports KAFTA, which is a high quality agreement and provides opportunities for all Australian industries including financial services.

The FSC supports the reduction of barriers to trade for four reasons.

First as the investors of the $1.8 trillion in retirement savings for all Australians, and the largest sector of the Australian economy, the financial services industry advocates for policies which affect the economy in which we invest. Lower barriers to trade allows Australia to focus on the sectors in which we have a comparative advantage, trade with other nations and increase economic growth.

Second, Australia has the third largest pool of funds in the world at $2.3 trillion, and as a result has a funds management industry which is large, highly developed and highly skilled. This is a significant comparative advantage for Australia. At the same time, Australia is geographically close to rapidly growing demand for professional investment management in Asia.

Financial services in Asia are underdeveloped. While it has 60 per cent of the worlds' population, it has just 13 per cent of global funds under management. Asian markets are growing and increasingly lack the pension systems necessary to provide for retirement.

The combination of a comparative advantage in funds management and proximity to growing markets is a substantial opportunity to grow Australian financial services exports.

Third, lower barriers to trade allows Australian consumers of financial services access to a greater range of products. While Australia's market for financial services is already one of the most open and well regulated in the world, free trade agreements provide the opportunity to broaden the range of products available to Australian consumers.

Finally, free trade agreements, in particular bi-lateral FTAs, raise Australia's profile in the partner country. While lower technical barriers to trade are important, the signaling effect of a bilateral FTA is important as it raises Australia's profile in the partner country and provides further impetus for Australian firms to export.

Overall KAFTA delivers on all of these fronts. It is a high level agreement which improves on previous bilateral FTAs with other countries and builds in opportunity for further enhancements. This submission focuses on points two and four – that is the direct impacts on the financial services industry's capacity to export to Korea as a result of the agreement.

The FSC's main concerns with trade with Korea are less on technical matters covered by the FTA and relate more to practices by Korean Government agencies and the structure of Korean industry.

For the financial services industry to take full advantage of the agreement, Australia's domestic policy settings need to be changed. In particular the tax treatment of funds managed on behalf of foreigners needs to be reduced and streamlined to ensure Australia is competitive against other financial services hubs in the region. Without these changes the benefits of free trade agreements are limited.

The FSC is advocating for the remaining recommendations of the Johnson Review to be fully implemented to ensure Australia can take advantage of KAFTA and other free trade agreements.

Exports of Australian Financial Services

Despite having an end-to-end financial services industry with scale, sophistication and a record of innovation and delivery of quality outcomes to clients, the industry is neither a major source of export income nor is Australia recognised as a major financial centre with export capability.

Approximately just 3.4 per cent of total funds under collective management in Australia are sourced from offshore. This compares unfavourably with regional financial centres in our time zone such as in Singapore with 80 per cent and Hong Kong with 60 per cent sourced offshore.

The Asian region is expected to be a significant driver for growth of the global funds management industry in the future. This is due economic and demographic changes that are occurring in the region:

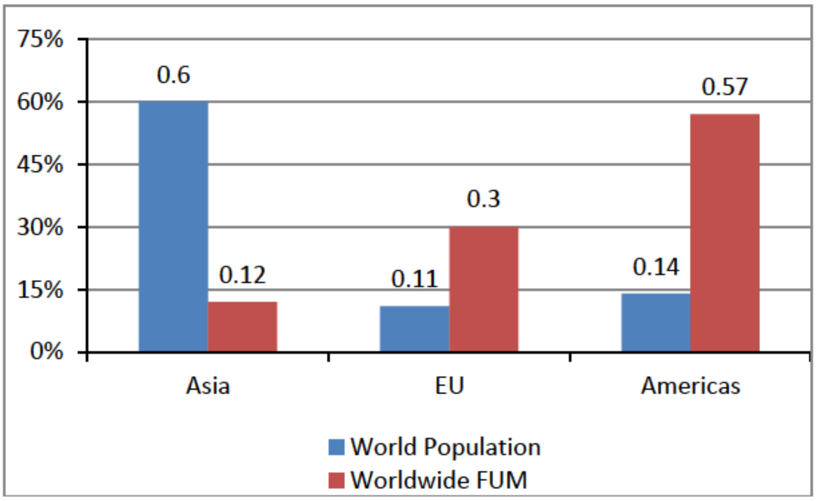
- Asia's middle class is growing quickly – this will drive demand for funds management as investors look for opportunities to invest and grow wealth;
- Asia's population is ageing rapidly – hence a need for pension and retirement savings products; and
- many countries in the region do not yet have compulsory superannuation contribution systems for workers– again driving a need for individual savings plans.

Funds under management (FUM) in the region is currently USD 3.410 trillion – this is only 12 per cent of world wide FUM, despite Asia's population sitting at 4.165 billion or 60 per cent of world's population.

By comparison, the US manages 57 per cent of worldwide FUM but only accounts for 14 per cent of the world's population. Thirty per cent of the world's FUM is managed out of Europe yet it accounts for only 11 per cent of world population (Chart 1).

As such, the Asia region provides a significant opportunity for Australian fund managers. Korea, through its sovereign wealth fund and government pension system provides a specific opportunity.

Chart 1 - Population and Funds under Management – Asia, Europe and the Americas



Benefits for Financial Services

Across the board range of measures the FSC seeks in bi-lateral FTAs, KAFTA legally meets these requirements. Table 1 provides a summary of the provisions in KAFTA that affect the financial services industry.

Table 1 Financial Services commitments in KAFTA

Commitment	KAFTA
Non discrimination against Australian providers	Yes. Accord foreign investment by financial institutions and investors, and some insurance and banking services, equal treatment to domestic investment and services. MFN. More favourable treatment subsequently given to a non-party, must be accorded to financial investment and services between parties of the FTA.
Market access (investment)	Yes. General prohibition on controls that limit access to the market by foreign financial institutions and investors (restrictions on the number, type or value of services and investment). Rights for offices and affiliates to perform certain functions in the foreign market (eg: data processing)
Market access (trade in services)	Yes. Certain insurance and banking services can be provided without the need to establish a commercial presence in the foreign market. Portfolio management services and investment advice for investment funds can be provided in the other party, subject to some limitations.
Supply of new services	Yes. Expressly permitted
Freedom of transfer of information	Yes. Data processing, payments and transfers for certain banking and insurance services. Korea to implement within 2 years.
Prohibition on senior management requirements	Yes. Exceptions for CEOs.
Access to payment and clearing systems	Yes. Non discriminatory access.

Temporary entry for professional service providers	Yes. Covers accounting and consultancy services, intra corporate transferees (ICTs), traders and investors. Australian accounting professionals may provide consultancy services through offices in Korea and over time work or invest in Korean practices.
Investor-State dispute settlement	Yes.
Review of commitments	Yes. Mandated review of commitments to build on market opening.

Areas for potential improvement

Korean Government Investment office

A significant factor holding back greater funds management exports to Korea is a lack of a deep market for AUD/ Won and a consequent lack of currency hedging services. While this clearly reflects a lack of demand for hedging services, action by the Korean Government has an impact on the depth of the market.

Korea has a large sovereign wealth fund, the Korean Investment Corporation and a large Government operated pension fund, the National Pension Service. Collectively, these two funds manage around $A400 billion. These funds will continue to grow with Korea's growing incomes and ageing population. For Australian fund managers this is a significant opportunity to provide funds management services. For Korea, the opportunity is to access Australian equities, bonds, infrastructure and other assets directly through Australian fund managers.

The lack of depth in currency hedging between the two countries reflects the low level of investment by these two funds in Australia. While the FSC would not expect the Korean Government to intervene to increase this investment, there appears to be a market failure in terms of information asymmetry which can be addressed.

The Korean Government has established investment offices in the United States and the UK. These offices act to reduce the gap in information available to Korean investors directly through the two government operated funds. There is no equivalent Korean investment office in Australia. Currently, EU and US fund managers have an advantage over Australian fund managers as a result.

The establishment of a similar office in Australia would have a substantial benefit in providing for direct relationships between the two Korean Government operated funds and Australian fund managers and in turn facilitate the development of deeper currency hedging services.

Korean Industry Structure

The structure of Korean industry can make opening new business relationships in Korea difficult. The Chaebol structure of large conglomerate businesses favours services provided by other subsidiary companies of the large Chaebol group. For Australian financial services companies already active in Korea, this has meant they have had no choice but to partner with companies that are part of a Chaebol group to compete for contracts.

This issue is not one that can be dealt with easily through a free trade agreement. While the free trade agreement formalises non-discrimination against Australian companies in a legal sense, opening access requires a change in business culture. While all businesses from outside Korea face similar hurdles, other countries have more established business relationships.

KAFTA raises the profile of Australia and Australian businesses in Korea and can assist in reducing the cultural bias to Korean companies and businesses with from other countries which have longer relationships with Korea.

Market access for Australian off-shore fund managers

The KAFTA formally allows access for Australian fund managers to provide services in Korea without having to establish there (ie: deliver on a cross border basis), but access is qualified.

It doesn't provide relief for Australian collective investment business entities intending to sell foreign collective investment securities within Korea from registration or qualification requirements (and likewise in Australia). Korea can continue to require registration/ authorisation of financial service suppliers under the FSCMA.[1] It doesn't grant a right to do business or solicit services in Korea (or Australia).

Each party can still regulate access, particularly at the retail level. Prudential regulation applies. The FSC welcomes these provisions as they ensures Australian consumer receives the protections of Australian prudential standards. Korean companies are required to meet Australian prudential standards and vice versa.

Ultimately, however, the FSC's goal through the FTA - or the Asia Region Funds Passport - is mutual recognition between Korea and Australian regulators similar to Australia's agreement with New Zealand.

A number of countries in the region are working together under the umbrella of APEC to develop the Asian Region Funds Passport – a set of regulations for funds management which would be common across all countries that agree join.

Once operational, the Passport would permit investment funds domiciled in one country to be sold directly to retail investors in participating jurisdictions and vice versa. At the APEC Summit in Bali in September last year four countries – South Korea, New Zealand, Singapore and Australia - agreed to develop a pilot of the Passport. Subsequently Thailand and the Philippines have also agreed to join development of the Passport.

There is a commitment in KAFTA to make administrative decisions, such as those on licensing applications, within a specified time period, which may ease registration requirements such as those imposed by Korean law for offshore funds.

Some members of the FSC have reported that licensing and regulatory approval processes have been long and difficult. These arrangements should be scrutinized in the review procedures built into the agreement to ensure they are as streamlined as possible and adhering to the principle of non-discrimination.

[1] *Financial Investment Services and Capital Markets Act 2009*

Table 2 – Possible enhancements to KAFTA

Access	Commitment	Limitations
Cross border services	Certain Australian financial services may be provided 'cross border' from Australia to Korea on a non discriminatory basis. Covers advisory, intermediation and auxiliary services relating to: asset management, such as cash or portfolio management, all forms of collective investment management, pension fund management, custodial, depository and trust services, investment and portfolio research and advice, advice on acquisitions and corporate restructuring and advice. Persons in Korea/Korean nationals abroad may purchase financial services from financial service suppliers in Australia	Korea can require registration/ authorisation of Australian financial service suppliers and financial instruments Prudential measures exempted Not permit Australian suppliers to do business or to solicit business in Korea Not apply to supply of financial services by an investment in Australia
Portfolio management	Financial institutions organised in Australia can provide investment advice and portfolio management services to a collective investment scheme located in Korea (and vice versa) Financial institution means 'any financial intermediary or other enterprise that is authorised to do business and regulated or supervised as a financial institutions under the law of the party in whose territory it is located." Collective investment schemes in Korea include those defined under the FSCMA.	Not apply to trust companies. Not cover custodial services, trustee services, and execution services that are not related to managing a collective investment scheme. Supply of investment advice or portfolio management services for Korean won-denominated assets can only be supplied to the extent Korea currently applies the supply of services. Korea can require registration/ authorisation of Australian financial service suppliers and financial instruments.
Transparency	Administrative decisions on applications for supply of services or investment to be made within 120 days and promptly notified.	N/A

Australia's Domestic Policy

Opening access for Australian financial services in Korea or any other market requires Australia's regulatory and tax system to be competitive to facilitate such exports. Without further domestic policy reforms, Australia will not be in a position to take full advantage of KAFTA.

The *'Australia as a Financial Centre: Building on our strengths'* report ("Johnson Report") handed down in January 2010 concluded that Australia has arguably the most efficient and competitive financial sector in the Asia-Pacific region and that there are significant opportunities to expand our exports to the region from a very low base. The Report stated:

> *"Australia has arguably the most sophisticated and advanced financial sector in the region. However, while Australia is a very open trading economy overall, our exports and imports of financial services as a percentage of GDP are, by international standards, low. The opportunities for leveraging off our financial services skills and*

expertise, in the region and beyond, are potentially enormous, and have been fully recognised by the Government."

The Johnson Report also found that in order to maximise this opportunity a series of ongoing policy changes were required:

"The recommendations are geared towards a wide range of opportunities for greater international engagement: Australian based fund managers managing more offshore sourced funds; foreign competitors setting up business in Australia or marketing their financial products in Australia; Australian banks doing more transactional business in the region; financial institutions having easier and cheaper access to offshore pools of savings to finance investment; or the Australian based treasury operations of a financial services company managing its offshore assets out of Australia."

While parts of the Johnson Report have been implemented and others are currently being implemented, many remain outstanding. At the same time competitor economies remain very focused on maintaining their position as leading financial centres in the region. We note the Government remains committed to continue working on implementing the Johnson Report's recommendations. We support the Government's policy to make Australia a more attractive base for financial services activity in the region. In particular, taxation-related incentives such as the development of an investment manager regime and reduction of withholding tax will increase inflows as well as support Australian investment managers in exporting their services through the Asia Region Funds Passport initiative.

The table below provides a summary of the reforms recommended by the Johnson Review and progress. A full explanation of the benefits of implementing these reforms can be found in the Chapter 5 of the FSC's submission to the Financial System Inquiry.

Table 2 Stocktake of Johnson Review Recommendations

Recommendation	**Status**
Road-testing of all significant financial services regulatory proposals to ensure necessity, effectiveness and to minimise compliance burden	Ignored
Periodic reviews of regulatory rules & framework to prevent against overregulation	Ignored
Removal of regulatory barriers to Islamic financial products	Ignored – unreleased Board of Taxation Report from 2011
Introduction of Investment Manager Exemption	Botched
Board of Taxation to review allowing a broader range of collective investment vehicles	Ignored – unreleased Board of Taxation Report from December 2011
Removal of state taxes and levies on insurance	Ignored
Removal of withholding tax for foreign raised funds and foreign banks	Botched Budget 2013wound back]
Support for offshore banking units	Botched [Budget 2013wound back]

Establishment of a Financial Centre Taskforce	Botched [established and recommendations consistently ignored]
Coordination between industry and government on skills shortages	Ignored
Government to more actively promote Australia as a financial services centre	Ignored [ex China trip, RMB]

Conclusion and recommendations

The FSC is very supportive of the Korea Australia Free Trade Agreement. It is a high quality agreement which has the potential to increase economic growth broadly and increase exports of Australia's largest industry, financial services.

The FSC makes three recommendations to enhance the agreement and ensure the provisions for financial services stay on track:

1. The FSC's expectation is that a licensed Australian fund manager must be permitted to access the Korean market through a mutual recognition arrangement. Although this may be achieved through the Asia Region Funds Passport, we believe it is essential that this bilateral FTA should result in true mutual recognition between the Australian and Korean regulators. We therefore recommend that a roadmap be developed to enlighten the industry on how market access (presumably through licensing mutual recognition) will be facilitated by the regulators.

2. Prior to the completion of mutual recognition arrangements, the FSC recommends the government use mechanisms in the Agreement to review the speed and ease of Australian companies complying with licensing and registration requirements in Korea.

3. The Australian Government should raise with the Korean Government the prospect of Korea establishing an investment office in Australia similar to those already established in the European Union and the United States. This would provide information to the financial services industry in Korea, facilitate a deeper relationship and allow for the development of currency hedging services between the two countries.

To ensure Australian financial services companies can take the greatest advantage of KAFTA, the FSC also recommends that the government complete implementation of the Johnson Review recommendations.