



2 September 2014

Senator Alex Gallacher  
Chair  
Senate Foreign Affairs Defence and Trade References Committee  
PO Box 6100  
Parliament House  
CANBERRA ACT 2608

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Dear Senator

#### **KOREA AUSTRALIA FREE TRADE AGREEMENT**

The Financial Services Council (FSC) welcomes the opportunity to make a submission to the Senate Foreign Affairs Defence and Trade References Committee 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 \$2.3 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

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 \$1.9 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.

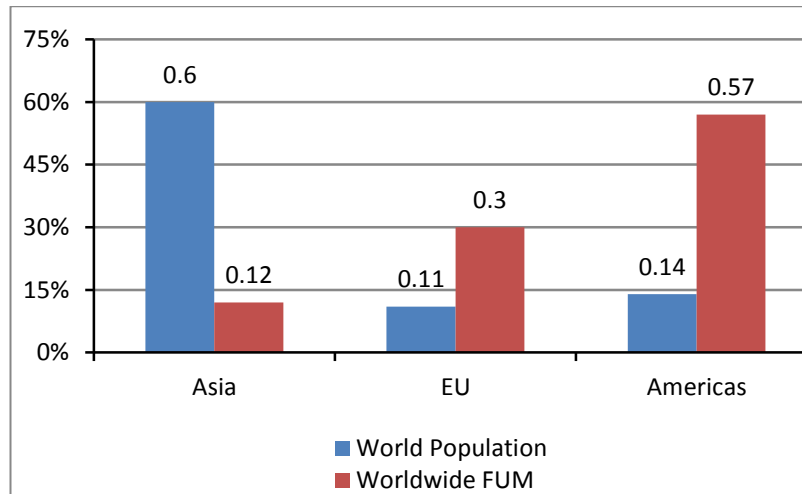
The Asian region is expected to be a significant driver for growth of the global funds management industry in the future. This is due economic and demographic changes that are occurring in the region:

- 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 of increasing Australia's financial services exports*

According to Deloitte<sup>1</sup>, increasing exports of funds management services would have notable flow-on effects to the economy, increasing GDP and jobs and adding to tax revenues. The increased supply of additional funds from abroad in effect would also lower the cost of capital in Australia.

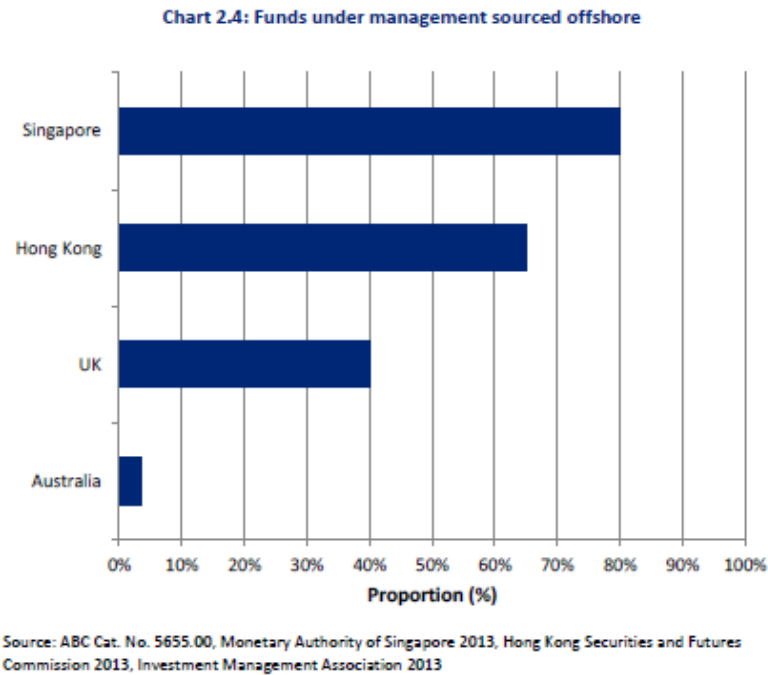
The size of the potential gains to key economic indicators (from Deloitte's modelling) indicates that there would be significant benefits to the Australian economy from increasing exports of fund management services.

There is significant scope for growth in exports of managed funds, from a very low base, given Australia's comparative advantage of a highly skilled workforce, proximity to Asia, and economies of scale due to our large superannuation system.

The report notes that looking at the broader measure of financial services; exports of financial services were \$1.6b in 2012. As a percentage of GDP this is 0.11% compared to 5.76% for Hong Kong and 5.58% for Singapore. This highlights the gains that could potentially be made in this area.

<sup>1</sup> Deloitte Access Economics 'The economic impact of increasing Australian funds management exports' May 2014

## Chart 2. Funds under management sourced offshore



The above chart shows the proportion of funds sourced offshore in Singapore, Hong Kong, the UK and Australia. This shows the very low export base from which Australia must grow in order to reap the benefits from increased financial services trade.

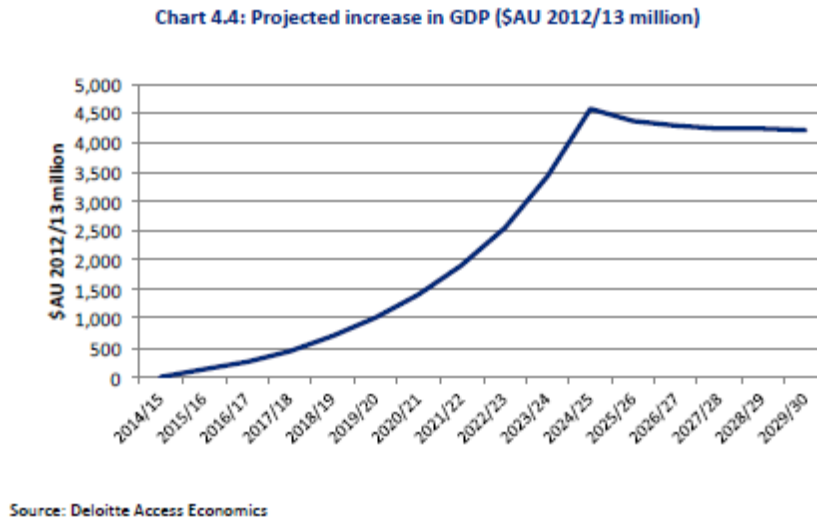
The report's analysis shows that the industry has a relatively high level of direct value added as a proportion of revenue. This indicates the majority of revenue in the sector goes either to wages or gross operating surplus in the fund management firms themselves and remains in Australia. Including other indirect economic contributions and flow-on effects to other sectors of the economy, 98% of industry revenue is converted to value added.

There are also positive tax implications and increased government revenue from increasing exports of managed funds which would also be the case for financial services in general.

Deloitte's modelling shows that a doubling in the value of funds management exports is estimated to lead to an increase in GDP of \$362m (as the peak in 2020-21). It was also estimated to lead to an increase of more than 1400 extra jobs in 2020-21.

If the level of funds management exports were to grow more rapidly such that they reached the levels of fund management exports in Hong Kong by 2023-24, it would lead to a \$4.2b increase in GDP above baseline levels in 2029-30 and 10,000 full-time jobs<sup>2</sup>.

<sup>2</sup> Deloitte Access Economics 'The economic impact of increasing Australian funds management exports' May 2014

**Chart 3: Projected increase in GDP (Australia)**

The above chart shows Australia's projected GDP increase if we were to increase the level of overseas funds under management to the projected level of Hong Kong. GDP would peak in 2024/25 at an increase of \$4.6 billion and then stabilise off at an increase of \$4.2b thereafter.

### Benefits of KAFTA for Financial Services

The potential benefits of increasing financial services exports for Australia are therefore significant. For this to be realised greater access to markets in Asia is one of several steps the government needs to take.

Like Australia's other agreements, KAFTA promotes open markets in that it makes services and investment more contestable between the parties, covers both services and investment activities and adopts an approach that supports market opening.

Across the broad 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
<b>Non discrimination against Australian providers</b>	<p>Yes. Accord foreign investment by financial institutions and investors, and some insurance and banking services, equal treatment to domestic investment and services.</p> <p>MFN. More favourable treatment subsequently given to a non-party, must be accorded to financial investment and services between parties of the FTA.</p>
<b>Market access (investment)</b>	<p>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).</p> <p>Rights for offices and affiliates to perform certain functions in the foreign market (eg: data processing)</p>

<b>Market access (trade in services)</b>	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.
<b>Supply of new services</b>	Yes. Expressly permitted
<b>Freedom of transfer of information</b>	Yes. Data processing, payments and transfers for certain banking and insurance services. Korea to implement within 2 years.
<b>Prohibition on senior management requirements</b>	Yes. Exceptions for CEOs.
<b>Access to payment and clearing systems</b>	Yes. Non discriminatory access.
<b>Temporary entry for professional service providers</b>	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.
<b>Investor-State dispute settlement</b>	Yes.
<b>Review of commitments</b>	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.<sup>3</sup> 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

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<sup>3</sup> *Financial Investment Services and Capital Markets Act 2009*



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.

*Table 2 – Possible enhancements to KAFTA*

Access	Commitment	Limitations
<b>Cross border services</b>	<p>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.</p> <p>Persons in Korea/Korean nationals abroad may purchase financial services from financial service suppliers in Australia</p>	<p>Korea can require registration/ authorisation of Australian financial service suppliers and financial instruments</p> <p>Prudential measures exempted</p> <p>Not permit Australian suppliers to do business or to solicit business in Korea</p> <p>Not apply to supply of financial services by an investment in Australia</p>
<b>Portfolio management</b>	<p>Financial institutions organised in Australia can provide investment advice and portfolio management services to a collective investment scheme located in Korea (and vice versa)</p> <p>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.'</p> <p>Collective investment schemes in Korea include those defined under the FSCMA.</p>	<p>Not apply to trust companies. Not cover custodial services, trustee services, and execution services that are not related to managing a collective investment scheme.</p> <p>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.</p> <p>Korea can require registration/ authorisation of Australian financial service suppliers and financial instruments.</p>
<b>Transparency</b>	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.

A full explanation of the benefits of implementing these reforms can be found in the Chapter 5 of the FSC’s submission to the first phase of the Financial System Inquiry.

#### *Australian coordination and promotion body*

Australia’s regulatory and international relations process is governed by several government bodies – Treasury (ARFP & international financial organisations), DFAT (International organisations & FTA negotiation), ASIC (mutual recognition & domestic regulation), Austrade (trade promotion), the RBA and APRA.

While these bodies attempt to coordinate as much as possible, it doesn’t always work efficiently in practice. There is no sole body responsible for coordinating Australia’s regulation in the financial sector and for promoting Australia as a financial sector globally. This lack of coordination has led to inadequate progress in trade of Australia’s financial services.

As an example, the recently negotiated mutual recognition arrangement for investment funds with Hong Kong has had no take-up from either country since it began in 2009. This is an

indictment on both jurisdictions for drafting a mutual recognition arrangement which neither jurisdiction has been able to put to use.

Australia urgently requires a coordination body to be established to progress international financial integration and promote Australia's financial services in the region. This will involve improving the regulatory process to better take account of global regulatory systems and changes.

The various coordination and promotion bodies in the region and beyond indicate Australia is lagging behind in this area. The low level of our financial services exports also reflects this.

A lack of coordination in international integration has meant a lack of progress. This body should be modelled on the ideas of the City of London and the Hong Kong Financial Services Development Council, and actively promote our economy as a financial centre. Australia's comparative advantage in this sector needs to be capitalised on, so we are not left behind.

*An Australian coordination body*

The Australian coordination body should progress international integration issues covering mutual recognition arrangements, financial services sections of FTA's, double tax treaties, the ARFP and coordination of government agencies. This government resource should be dedicated to focusing on international competitiveness issues with the authority to generate legislation quickly and effectively.

The body needs power in legislation to deal with tax and regulatory issues affecting the industry. The body should be government funded but have advisory representatives from industry.

More detail on this and other FSC proposals for a coordination body can found in Chapter 4 of the FSC's submission to the second phase of the Financial System Inquiry.

## **Conclusion and recommendations**

The FSC is very supportive of KAFTA. 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 five 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. 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. ASIC should take an active role in this process.
3. The Australia government should monitor licensing and regulatory processes and timeframes in Korea for Australian fund managers to ensure they become more transparent and timely.
4. 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.
5. The Government should establish the Australian Financial Services Agency through legislation. The Agency will progress international financial services competitiveness issues, coordinate the various government agencies, and review regulations taking into account international processes.