September 5, 1996

Mr Greg Smith

Secretary

Financial System Inquiry

Treasury Building

Parkes Place

Parkes ACT 2600

Dear Mr Smith

ASCT SUBMISSION TO THE FINANCIAL SYSTEM INQUIRY

The ASCT welcomes the inquiry into Australia's financial system and the opportunity to make a submission.

It is imperative that the operations and needs of corporate treasuries are brought to the attention of decision makers and understood.

The ASCT is a national organisation which has over 1,200 individual members, over 600 corporates and the majority of the top 100 Australian companies are represented.

The enclosed submission represents the views of a diverse range of corporates who operate across a wide range of manufacturing, service and mining sectors operating domestically and internationally, all who strive for "world's best practice".

The ASCT sees the need for representatives from peak groups like the ASCT to be represented on governing bodies charged with the responsibility of considering the impact of decisions made by regulatory bodies on the end users of financial services.

Of importance to the ASCT is a consistent and harmonised system of regulation. To meet this objective the structure must be efficient, whether it be a "super regulator" or several major regulators.

To ensure an internationally competitive financial system, the ASCT requires a "level playing field" for each financial service be established, and that regulation be by service not by institution. Within such a framework, the need for certain types of regulation is not homogonous across all users. Consideration must be paid to the dynamics and the participants in the wholesale financial markets vis-a-vis the retail segment.

The only barriers to entry for all potential competitors should be prudential requirements. Such an environment would temper any potential side effects of market power and deliver benefits to consumers as outlined in the terms of reference.

Other countries like Singapore have gained an advantage over Australia as the headquarters for corporates and financial intermediaries in the Asia Pacific rim. The Inquiry has to recommend a financial system framework which gives Australia an international comparative advantage so community wants of more gainful employment are achieved.

The submission also outlines the need for a simple and efficient taxation system and the opposition to compliance and regulation which is of little value.

In the appendix are in-depth studies and submissions the ASCT has undertaken in relation to the costs of compliance of FID; the CASAC proposal for the regulation of the OTC Derivatives market and the effects of FID and Debits Tax on business.

Yours sincerely

Marilyn Forde

Executive Director

SUBMISSION FROM

AUSTRALIAN SOCIETY OF CORPORATE TREASURERS

TO THE FINANCIAL SYSTEM INQUIRY

Executive Summary and Introduction:

With the ever increasing global nature of business, the ASCT supports a financial system framework which must be forward looking and advantageous and not be burdensome. The ACST requires the committee to take action on the key considerations listed below so as to deliver to the corporate sector the aims of the inquiry , "a competitive and flexible financial system underpinning a stronger economic performance".

Key considerations:

1. Internationally Competitive Financial System:

Regulation must be carefully formulated, particularly in regard to attracting market participants, hence competition. No better example of this is the Companies and Securities Advisory Committee (CASAC) proposal to over regulate the already well functioning self regulated over the counter derivatives market.

In the approach to achieve a level playing field for financial services, regulation should be by a product or service, not by type of institution. Within such a framework, the need for some types of regulation is not homogonous across all users. Consideration must be paid to the dynamics and the participants in the wholesale financial markets vis-a-vis the retail segment.

To achieve an efficient financial system, a taxation and regulatory framework encouraging innovation, technology and "world's best practice" is essential.

To fulfil the desire for Australia to become the pivotal headquarters for corporates and financial intermediaries in the Asia Pacific rim, the resultant "super regulator" or one of several major regulatory bodies, should be charged with the responsibility of considering the impact of their decisions on the end users of financial services and, where possible, have representatives from peak groups including the ASCT on the governing bodies.

2. Compliance and law:

The need for an objective cost benefit analysis of the benefits to users, of current and proposed types of compliance for companies.

It is necessary that the "regulation industry" better understand the dynamics of today's and tomorrow's corporate structures, in-particular, the apparent non-understanding of the operations of the group treasury/in house finance company.

It is important for corporate groups operating in several major financial markets to ensure that Australian accounting and reporting requirements are not significantly different from those in operation in the world's other major financial centres.

3. Taxation:

The need for leadership in overhauling the current taxation system, in particular the abolition of FID and Debit tax, in light of the stifling effects these taxes have on the adoption of Electronic Funds Transfer technology and the enormous amount of economic loss and distortions imposed on the corporate sector.

Influence and action is required to abolish interest withholding tax. The tax is inequitable, illogical and places Australian corporations at a competitive disadvantage to overseas corporations, most of which do not bear similar loadings to their borrowing costs. It distorts the pricing of lending and gives domestic lenders a distinct pricing advantage vis-a-vis offshore lenders.

4.Long Term National Savings Policy:

Greater urgency is required to enact a more effective retirement income policy, so eliminating the margin Australian corporates pay over and above competitors from other countries for capital.

Background:

The Campbell Report: The ASCT view.

The ASCT has been partly satisfied with the benefits of better quality and choice of financial services that flowed from the promotion of competition recommended in the Campbell Report. However, the benefits have not been nearly enough. The regulatory framework still contained barriers to competition, which has developed a fragmented financial system.

The key initiatives of granting foreign banks an opportunity to operate in Australia without the requirement of local equity holdings; the floating of the Australian dollar; the withdrawal of many exchange controls, and dividend imputation were steps in the right direction.

However, the recommendation of a uniform duty on similar transactions so choice of financial arrangements would not be affected has failed badly. In fact, the opposite has occurred, with inconsistencies amongst the various States and Territories in regard to FID has lead to less business efficiency, higher compliance costs, economic and structural distortions and a stumbling block to the adoption of electronic banking technologies.

It is essential that the Inquiry recommends the changes necessary to make Australia's financial system internationally competitive and the unwinding of the uneconomic and distorting FID and Debit tax regime amongst other key considerations.

Specific Terms of Reference:

3(a) "best promote the most efficient and cost effective service for users, consistent with financial market stability, prudence, integrity and fairness" and 3(d) "establish a consistent regulatory framework for similar financial functions, products or services which are offered by differing types of institutions".

Current regulatory arrangements and regulatory proposals tend to overlook the dynamics of today's and tomorrow's corporate structure. This is especially prevalent when it comes to group corporate treasuries/ in house finance companies (IHFC) and the imposition of regulation and taxation law by the appropriate authorities.

It is imperative for corporate groups operating in several major financial markets that the Australian regulatory environment is not significantly different from that in operation in the world's other major financial centres.

Corporate treasuries provide the central point for the corporation's group treasury and risk management. In order to provide more effective risk and cash flow management, international best practice is for the corporate treasury function to be conducted through a special purpose company.

However this widespread structure of risk and cash flow management is often overlooked when regulations are being drafted. This is clearly evident in:

- the FID and Debit tax laws which penalise this type of group structure;
- the definitions used by CASAC on the regulation of the OTC derivatives market and the burden of extra disclosure and compliance of sensitive proprietary information of little interest;

When regulators set out regulations, they should allow for the fact that not all transactions are between a corporation and a financial institution. Many transactions are necessarily undertaken within a corporate group and should be permitted freely and allowed for in regulation.

Currently, corporations who have adopted international best practice for the corporate treasury find that for inter-group transactions it should not be a necessity that it be a requirement that one party to

all foreign exchange transactions must be “an authorised foreign exchange dealer”. It follows that the law needs to be modified to more readily facilitate inter-group foreign exchange transactions through an exemption for In House Finance Companies and Group Treasuries.

As mentioned above the ASCT has objections to the CASAC proposals for the regulation of the over the counter derivatives market. First, the proposals do not take into account the operations and sophistication of a corporate treasury and second, there is the misguided proposal to over regulate the over the counter options market. Appendix 1 contains the submission the ASCT presented to CASAC on regulation of the OTC derivatives market.

Main points of the ASCT submission are:

- **The definitions used are not broad enough. The definition needs to be expanded to make clear that a sophisticated end user can act as an intermediary within a corporate group and can elect to satisfy "safe harbour" conditions.**

- **It be inappropriate for any risk disclosure statement to be prepared in every instance before a transaction can be executed. Such compliance reflects CASAC's lack of understanding of the corporate and market maker dealing relationship.**

- **Further, it is inappropriate for any risk disclosure requirements to apply between members of a corporate group.**

Disclosure requirements for derivatives should be meaningful, that is, expressed as to how corporates assess and use derivatives, so long as commercial confidentiality is preserved, and the procedures are not too burdensome in establishing disclosure requirements around prudent management information requirements, and that the information disclosed is understandable, verifiable and comparable.

The law referring to netting of financial transactions needs to be clarified. The ASCT would like to see the objective of obtaining legal certainty for netting given the same priority as over the counter derivative transaction consumer protection.

The proposal by CASAC to impose regulation in the over the counter derivatives market is totally unnecessary.

The way the over the counter derivatives market operates currently fulfils the terms of reference of the Financial System Inquiry of

- **choice, quality and cost of service to end users**
- **most efficient and cost effective service for users, consistent with market stability, prudence, integrity and fairness**
- **exposed to international competition**

Any attempt to impose regulation without diligently having proper understanding of its effect can only lead to undermining the international competitiveness of the Australian financial system by distorting market mechanisms and imposing burdensome compliance and disclosure on Australian corporates which will place them at a disadvantage.

The advantage of the over the counter market has vis-a-vis the exchange traded market is the ability to better tailor risk management solutions, therefore, it is an extremely efficient mechanism of risk transfer. The philosophy of self regulation leads to more market participants increasing the depth and liquidity of the market and more competition. Over regulation has a twofold negative effect. Firstly, market makers will move offshore to conduct their business and, secondly, end users will transact offshore in a more liquid, deep and competitive market.

Regulating financial services by institution and not by products or services imposes costs on those institutions which are handicapped by the regulation and denies consumers the flow on benefits from better quality product at a better price from increased competition. The extra costs can either be absorbed by the institution or passed on to the end user. Alternatively an institution may create an artificial structure to comply with regulations again at a cost. Such an ad hoc regime of regulation has slowed down the pace of benefits to end users.

Corporations are not the only casualties of regulator oversight. It follows that major regulatory bodies whether it be a “super regulator” or one of several major regulatory bodies, should be charged with the responsibility of considering the impact of their decisions on the end users of

financial services and, where possible, have representatives from peak groups including the ASCT on the governing bodies.

The body or bodies resultant from the Financial System Inquiry must apply the test of "world's best practice" to regulation. Regulation should be consistent, forward looking, encouraging efficiency, stability and competition and not onerous in compliance.

4(d)"the policies for the taxation of financial arrangements, products or institutions."

The ASCT recommends the Commonwealth Government provide leadership on the importance of uniform tax laws. Corporates do accept their responsibility to pay taxes, but on the issues of uniformity, compliance costs and the economic and structural distortions associated with some taxes, the ASCT believes the Commonwealth Government should give priority to reviewing with the States, Territories, the ASCT and others financial taxation arrangements such as FID and Debit tax.

Although FID and BAD taxes are not Commonwealth taxes, the ASCT encourages the Inquiry's recommendation to the States and territories for the abolition of these taxes.

ASCT members have identified FID as a significant impediment to efficient business in Australia. In terms of human resources applied and cost is significant and disproportionate to the revenue collected by FID as compared with other taxes.

The ASCT has allocated significant resources analysing the costs of compliance and lack of uniformity in application across all States and Territories. Appendix 2 contains the ASCT's Reference Paper No#1 on FID which examines in detail the effects of FID on corporates and their treasuries.

The key recommendations of the ASCT Reference Paper No#1 on FID are:

1. **The preferred option is the abolition of FID. As a time lag will be required before Recommendation 1 is implemented, therefore the ASCT believes recommendations 2 - 11 are essential in the interim.**

2. **Current FID legislation penalises the adoption of Electronic Funds Transfer. The preferred option for reform is to allow the cap to apply to the total amount credited per day to an account.**

3. **Consistency with key definitions in the FID legislation, including the definitions of "receipt", financial institution", and "short term dealings".**

4. **Consistency in the operation of short term dealing accounts**

5. **Consistency of penalty provisions**

6. **Consistency in FID rulings issued by jurisdictions**

7. **Transfers between accounts held by the same person should be exempt from FID, at least where the accounts are located in the same jurisdiction.**

8. **An exemption from FID should be introduced in relation to transfers between group companies, at least where those companies are 100% commonly owned.**

9. **The issue of the application FID to "in house" finance companies should be formally resolved in all FID jurisdictions.**

10. An exemption from FID should be introduced to exempt the FID payable on foreign currency accounts, at least to the extent of exempting the FID payable on those accounts where amounts in foreign currency accounts are subsequently converted to Australian dollars, incurring FID again.

11. Charge FID at the point of destination and adopt a revenue sharing arrangement for those FID receipts.

Current FID obligations fail to understand the structure of group treasuries and their operations in their pursuit of efficient debt raising, risk and cash management. The globalisation of the Australian corporate scene is also overlooked. Unnecessary "artificial" structures are created to minimise FID liability, with the obvious example of not bringing foreign currency revenues onshore. In light of the above evidence, no other type of turnover tax should ever be introduced, however apparently insignificant.

The obstructive nature of FID is further underlined by many corporates baulking at adopting electronic payment systems.

The uneconomic and structural distortions imposed by FID will be further emphasised by the introduction of Real Time Gross Settlement (RTGS) by the RBA in late 1997. Under the current Deferred Net Settlement basis, corporates are able to bunch their deposits together once a day and "cap" their FID obligations.

Under RTGS, corporates will have to make several deposits to their working accounts during the day so payments can be processed, consequently, limiting the ability to use the FID cap for a day's deposits, inturn, increasing a companies' FID liability.

Alternatively the corporate could establish an intraday overdraft with their bank, but this service is likely to be accompanied by bank fees and charges, assuming the bank approves such a facility.

Withholding tax is an impost which places Australian corporations at a competitive disadvantage to overseas corporations, most of which do not bear similar loadings to their borrowings. This is clearly recognised by the Australian Taxation Office by the granting of some exemptions. The ATO

have made an attempt to "simplify" the requirements for granting exemptions, but have not gone far enough in its reforms.

Also the Campbell Inquiry concluded "That various features of the withholding tax in its present form are non-neutral and inequitable". The Campbell Report went on to say "Withholding tax is an undesirable levy insofar as the workings of the financial system are concerned. Indeed, if this were the only consideration it would recommend its removal".[1]

Current and proposed changes to legislation have failed to address the wider issue of inequality arising from the granting of exemptions.

First, smaller corporates are less likely to have access to global markets let alone direct access to the Euromarkets, therefore offshore borrowings are most likely to come from a bank or a syndicate of banks. However, this type of financing is liable for withholding tax even though it would pass at least one of the new "public offer" tests.

Second, there are offshore investors who would prefer to make a "loan" rather than invest in negotiable securities. The current and proposed interest withholding tax laws make this an uneconomic option for borrowers even though it would pass at least one of the "public" offer tests.

The current and proposed "public offer" test for the exemption of interest withholding tax only benefits the larger corporates. The exemptions should be widened to all types of offshore borrowing creating a level playing field amongst borrowers as well as offshore and domestic lenders/investors.

Widening the exemption as recommended above gives rise to the broader question: Should interest withholding tax be abolished? This is the preferred approach of the ASCT. As there could be a time lag for implementation of the abolition of withholding tax, the preferential treatment given to offshore borrowings by negotiable securities should be extended to all types of offshore borrowings.

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[1] Campbell Inquiry

The ASCT's recommendation better meets the objectives of the Treasurer's amendments to section 128F, "continue the efficient and cost effective access to overseas capital markets for Australian borrowers" and "more closely reflect the offshore fund raising activities of Australian companies".

The review of Taxation of Financial Arrangements was welcomed by the ASCT, however, along with other interested parties are wondering on the timing of the release of the recommendations.

The message for the committee is the major impact tax legislation can play in shaping market preferences and placing Australian corporations at a disadvantage to their international competitors. The committee should satisfy itself there is nothing proposed in the Inquiry which would further handicap Australian corporates.

3(b) "ensure that the financial system providers are well placed to develop technology, services and markets and that the financial system regulatory regime is adaptable to such innovation."

Corporates being a beneficiary of new financial system technology and services welcome a regulatory framework that promotes competition which leads to innovation and invention. Unfortunately such technology and innovation is either not persevered with or wasted due to regulation and taxation. For the small to the biggest corporate, no better example of this is the resistance by many to adopt electronic payment systems.

In 1995 the Australian Bankers Association and Coopers and Lybrand with the assistance of the ASCT undertook a study into the effects and future viability of FID and Debits Tax and the impact on banking technology. The study is contained in appendix 3.

The study found that much anecdotal evidence exists to suggest that FID and Debit Tax undermines Australia's ability to play a significant role in developing regional and global markets, undermining the attractiveness of new product technologies to businesses and individuals.

Key findings of the survey are:

- **FID and Debits tax are regressive: Small business on average pay up to 400% more FID and Debits Tax as a percentage of annual turnover than large business (turnovers > $2 billion a year).**

- **63% of businesses with annual turnovers in excess of $50 million cite FID as a major impediment to receiving electronic payments or state FID is such a significant impediment that they prefer to receive cheques.**

- **61% of businesses consider the FID and Debits Tax are major or decisive influences limiting Australia's ability to become a major regional financial centre.**

- **85% of businesses consider that financial transactions should not be taxed at all.**

The conclusion is simple: FID and Debits tax make the payments system inefficient and penalise the adoption of more efficient electronic banking technologies by business.

Currently the Bills of Exchange Act requires “paper” to be produced whenever Promissory Notes, Bank Bills and Negotiable Certificates of Deposit are drawn. In light of the developments of electronic clearing and the move by financial intermediaries towards dematerialisation, the requirement to produce actual paper is an anachronism. The ASCT recommends the Act be changed to allow either paper be produced or the security be electronically recorded. As in the case of CHESS, the client has the option of receiving a certificate or being electronically inscribed as the owner of the securities.

For a significant majority of securities which are governed by the Bills of Exchange Act the operational need to produce paper is unnecessary. To comply with the Act imposes unnecessary workload and associated costs on Austraclear and the member banks. The cost of compliance is inevitably passed onto customers. An example of this is the “Bank Bill Preparation” fee charged to corporates from their bank. The fee is charged so banks can recoup the cost of producing the Bank Bill paper, getting the Bank Bill signed and physically lodging the Bills with Austraclear as the central depositary for the securities, for no benefit other than to comply with the Act.

The ability to electronically record securities governed by the Bills of Exchange Act would do away with the “physical handling” of securities, which inturn would lower the cost of banking for corporates without jeopardising what the Act really is meant to achieve. Also, as the securities covered by the Act are bearer paper, electronically recording removes the security risk of holding the physical paper and allows easier recognition of ownership.

To ensure an efficient and competitive domestic financial system it is essential the market remain exposed to international markets and that there are little or no barriers to entry for foreign players, except for prudential requirements.

For banking services, the market should be thrown open to “non banks” to compete after complying with prudential regulatory requirements. The ability of organisations such as credit unions and cash management trusts to issue cheques, that is access to the payments system, has blurred the distinction.

To obtain a level playing field of competition for each financial service it is not practical to have regulation by institution, it has to be by product or service. Within such a regulatory framework it must be remembered that the needs and wants of different end users from regulation are not homogonous. Regulation that may be appropriate for the retail end user could be unnecessary and onerous for the sophisticate or wholesale participant. This distinction is important in achieving an internationally competitive wholesale banking industry.

Such a framework would guarantee competition and efficiency which would meet consumer's needs and demands of choice, quality, innovation and value.

A framework already exists. European banks are allowed to be universal banks (institutions that offer savings, life insurance, equity and general insurance products) and must comply for all their activities with the Basle rules.

Further consolidation of Australian suppliers of financial services is desirable. Benefits obtainable from mergers or acquisitions would include efficiency gains resulting from economies of scale, higher earnings for shareholders and lower margins and fees for consumers. The way to make sure the benefits to the community are passed on is not to look inwardly and prevent mergers and acquisitions occurring, but to mitigate any possible exercise of market power not in the community's interest, by international competition and integration of financial markets.

No constraints on the ability of domestic corporations to deal with offshore institutions and no restraints apart from transparent prudential regulatory requirements on the ability of offshore institutions to set up domestic operations and participate in all financial services markets should be encouraged.

A good example of the benefits from offshore participants and competition is electronic banking. Opening up banking to overseas providers leads to the transfer of technology to Australian consumers which otherwise may have taken longer if not at all. In the survey conducted by the ASCT and KPMG of electronic banking systems available to the corporate treasurer, 25% of market share of service providers for the top 500 corporates were foreign. The survey found intense competition in electronic banking from foreign providers was leading to a convergence of electronic banking products with more entrants offering most features.

The advancement in technology now makes it feasible for bilateral "netting" of payments and the development of private payment systems to occur, bypassing the current bank payments monopoly. A better regulatory approach would be to open up the current payment system to any participant that can meet the prudential requirements. Under the current regulatory framework, such a scenario would be almost unworkable, further emphasising regulation by service as the most workable regulatory framework.

As mentioned before, some of the current and possible regulatory framework, plus FID and Debit taxes work against the attractiveness of offshore institutions setting up domestic operations.

For accountability, regulations should be cost effective and paid for on a user pays system.

Of importance to the ASCT is a consistent and harmonised system of regulation. To meet this objective the structure must be efficient, whether it be a "super regulator" or several major regulators. The test being the creation of a competitive and efficient financial system, not an ad hoc, inward looking anachronistic system of institutional jurisdictions.

4 (b) "long term national savings policies"

The low level of domestic savings and the consequential higher margins Australian corporates have to pay over their American, Japanese, New Zealand, European and Canadian competitors places Australian corporates at a distinct disadvantage when raising capital, therefore, hindering growth, international competitiveness and the creation of wealth.

For corporates unable to access the Euromarkets, the low level of domestic savings puts them at a disadvantage not only with international competition, but domestic corporates who can achieve lower borrowing costs by borrowing offshore.

Growth of the local capital markets has been slowed by the low level of savings and if this continues to be too small relative to investment requirements, business investors will be forced to continue to look to offshore markets for long term finance needs. It is therefore important that Australia has a greater proportion of long term household savings being created and directed towards investment that will expand the country's production capacity at a cost which can produce goods and service capable of competing in the world's markets.

Long term savings in recent times has been towards superannuation retirement income policy. If this is to continue to be the main source of long term savings then regulation should be consistent with a retirement income policy. If domestic savings are to be encouraged, whether through superannuation or other forms of savings, then it requires stability and certainty in the law and

regulations governing those savings. Hence, the need for accountable regulation based on product which provides a level playing field in respect to those regulations.

Appendices:

- Appendix 1: ASCT submission to CASAC on Regulation of the OTC Derivatives Market
- Appendix 2: ASCT Reference Paper No#1 on FID
- Appendix 3: Australian Bankers Association and Coopers and Lybrand "Effects of FID and Debits Tax on business", ASCT Technical Supplement, July 1996

The ASCT would be happy to meet with members of the committee to discuss or explain any of the issues or comments in greater depth if the committee so desires.

For enquiries, please contact Ian Crofts, Technical Manager (03) 9629 5099