

Kim Hansen-Financial Systems Inquiry
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Please find attached the AusAsean submission to the Financial Systems Inquiry.

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SUBMISSION TO WALLIS INQUIRY

a. The Issue:

Australian banks being able to properly service medium size Australian companies seeking to do business in Asia and to compete in Asia with local financial services companies.

b. The Recommendation:

That Australian banks be allowed to be controlled by an offshore holding company with both local and Asian shareholders. The holding company would be the owner of Asian finance operations. This would enable a dividend flow of Asian profits direct to Asian investors without being subject to additional Australian taxes. All Australian banking operations to be held directly by an Australian domiciled company. Deeds to be entered into between the Australian regulatory authorities and the ultimate offshore holding company to charge all assets in favour of the Australian regulatory authorities exercisable upon an event of default in Australian or Asian operations.

Ultimate holding company to submit its Asian operations to the relevant Australian regulatory authorities for regular review and standard setting along with and on same basis as Australian operations.

c. The Background:

Enlarge the potential market for medium sized Australian banks.

1. Australian banks seeking growth need to either merge in Australia (mergers/takeovers) or seek to export their services to wider market.

The argument in Australia has centred largely on the competitive impact of mergers and takeovers between banks. On the one side of the argument are the perceived “predators” (as personified by The National Australia Bank) and the “prey” (all the rest).

Phrases such as “critical mass” and “substantial lessening of competition” are untestable opinions used by either side to defend their position on the need to grow which is enforced by the normal western-style capitalist economy.

In a closed environment such as has been created by legislation and regulations in Australia, a bank which wishes to grow must face the fact that the potential market is already well serviced. This leads to the natural inclination by banks to acquire the competition.

In any market an aggressive competitor will compete in a manner that delivers the best results.

If Australia is viewed as a closed system for banks, both in terms of entry from outside and also in terms of ability to expand outside, it will result in anti-competitive acquisitions.

If Australian banks are to view the Asian region as their natural market rather than Sydney/Melbourne/Brisbane, those regulatory structures which inhibit this progress should be removed. Most countries have viewed banks as a sovereign asset due to their undoubted importance to the payments and monetary system. The emergence of non-bank competitors has demonstrated that, as the pace of change quickens, these countries may be regulating an irrelevant industry if that industry becomes cocooned from the realities of an internationalising market place.

Asia has:

2. Asia is the most attractive of overseas markets as:

- (a) Competitors from advanced countries have achieved very little market penetration.

Low competition

There are few “global” banks that have penetrated Asia. Examples of these are Citibank, ABN-AMRO, (Chase-Chemical), and several Japanese banks. However, these banks have focussed on specific niches where they do not compete in loans to small to medium businesses or retail. This is the result of their inability to compete rather than their identification of the profits to be derived from that market.

- (b) Many of these local banks are unsophisticated relative to Australia.

Less sophisticated banks

Protected by barriers to entry, the local banks in Asia have unsophisticated products and systems. The earlier opening to competition of the Australian market has created a level of sophistication of banking products and systems of world class. This is demonstrated by the success of banks owned by the NAB in the U.K. and U.S.A.

An appropriate regulatory structure in Australia will allow Australian banks to enter the Asian market on a more than competitive basis with the result that Australian exports will grow, Australian businesses abroad will be better serviced and the pressure for uncompetitive acquisition in Australia will be lessened.

Large growth

- (c) Large growth market.

The Asian region already represents one of the three major global trading regions and is roughly equivalent in size (in terms of its share of the world’s GDP) to Western Europe or North America respectively. Double digit GDP growth, in a region which represents 60% of the world’s population, will be a continuing feature of Asian economies.

One of the major changes in the region, especially in South East Asia, is the shift from export dependence to consumerism. Increasing consumerism is expected to be the single major driving force behind Asia's future growth and the creation of new business opportunities.

In general the market for banking products should grow at least as quickly and sometimes more quickly. This means that a well-established bank in Asia can achieve organic growth to satisfy its business objectives.

The small to medium sized enterprise market

The importance of medium sized enterprises in contributing to export growth is central to the future economic performance of both Australian and Asian economies. Small to medium sized enterprises generate around 40% of Australia's private sector output and account for about half of private employment, while they make up 80% of all enterprises among the APEC 18-member countries and are responsible for between 32 and 84% of employment, between 30 and 60% of GDP and approximately 35% of APEC's exports.

Australia's fiscal environment inhibits direct Asian investment 3.

Asian countries have a fiscal regime that is closer to the Australia of the 1950's than today. In addition most countries do not apply tax at all to capital gains. For practical purposes this means that most investments focus on capital appreciation rather than income generation.

This is the reverse of the Australian economy where inflation is low and capital gains are taxed at the full corporate tax rate. In the Asian environment income streams on larger transactions are not conducive to paying fees demanded by Australian banks where income of all forms is taxed.

The reality is that in most local transactions in Asia, Australian banks cannot price competitively as the profits on those transactions are attributed with Australian tax rates on income as well as capital gains. In addition there are deals such as trade and large international transactions which are either beyond the capacity of the local Asian banks or not related to taxation and in these, Australia

can compete.

Australian banks have not penetrated Asia

4. Australian banks have not penetrated Asia to a large extent. They mainly deal with trade credit or infrastructure deals. Again this is only the majors, ANZ, Westpac etc.

Asian business is built on relationships

5. Asian business and investment is generated through relationships. Australian business, including banks, can either earn that relationship through performance over the longer-term or it can link to local parties with existing relationships.

One way to create such a link is to have substantial Asian investors in the bank. Our experience at AusAsean is that Asian investors will be reluctant to make an investment in a company which (a) cannot compete with their local banks and (b) repatriates the profits on local deals that they introduce to Australia to be taxed under Australian law.

d. Implications To Australia:

1. The Reserve Bank follows the argument of most central banks that it should, whenever possible, either directly supervise the operations of the constituent banks of its country or that they should be under the supervision of a monetary authority of which it approves.

This argument states that while a holding company may be acceptable (Colonial Mutual Life) to have an offshore holding company this reduces supervisory power to an unacceptable level.

It is hard to follow this argument. Prudential supervision in Australia today is already a function of cooperation with both other institutional supervisors within Australia and central banks overseas. It is not difficult to envisage legal agreements between banks and the RBA to clearly spell out powers and arrangements for default.

These agreements would reflect an end to the traditional British style method of supervision by the RBA approval of the senior staff of a bank and using influence and implied authority to gain carriage.

Australian tax base

2. Possible erosion of the Australian tax base is a risk that may result from the proposed change.

If Australian banks had already penetrated Asia and were deriving significant profits from the region it would be an issue. They are not.

The proposed changes will facilitate two-way trade and transactions that will increase the Australian-sourced revenue of the participating banks. This means that the implications are positive.

An Australian bank with an offshore holding company can, of course, carry out business in any country. To date the success of Australian banks has been in advanced economies. Overall, none of these countries has a local tax rate significantly lower than Australia. Countries in North America and Europe have comparable or higher overall tax rates. This growth in these areas has partly been brought about by the inability of Australian banks to compete in Asia.

3. The inability of Australian banks to establish a significant and competitive presence in Asia has meant that the service exports that they represent have been artificially constrained. As noted above, these financial service products are extremely sensitive to both the relationship provided by local shareholders and the local taxation and fiscal regime. The artificial constraints created by the attribution of Australian tax on all income earned offshore has and will continue to make them uncompetitive in this region.

Conclusion

The implementation of the recommendations in this submission would appear simple but would have potentially far reaching and beneficial effects on the Australian economy.

The ability to compete in new markets would allow even medium sized Australian banks to grow and increase their exports to the Asian region. This will not only increase the size of the market available but also increase the support available to Australian businesses as

they too expand into Asia.