5th February 2016

Budget Policy Division
Department of the Treasury
Langton Crescent
PARKES ACT 2600

Via email: prebudgetsubs@treasury.gov.au

Dear Treasury

2016-17 Pre-Budget Submission

The Australian Financial Markets Association (AFMA) represents the interests of well over 100 participants in Australia's wholesale banking and financial markets. Our members include Australian and foreign-owned banks, securities companies, treasury corporations, traders across a wide range of markets and industry service providers. Our members are the major providers of services to Australian businesses and retail investors who use the financial markets.

We are pleased to provide a submission to Treasury to assist in the formulation of the Government's 2016-17 Federal Budget.

1. Executive Summary

The proposals which form the basis of AFMA's 2016-17 Pre-Budget submission are:

- **Provide a cohesive development strategy for financial markets:** The Government needs to provide stronger commitment to the enhancement of Australia's financial markets and Australia's attractiveness as a financial centre. This will require the formulation of a cohesive strategy integrating policy initiatives relevant to tax, international trade, innovation and business investment, as well as implementation of outstanding recommendations of both the Johnson Report and the Financial System Inquiry (**FSI**);

- **Prioritise the Johnson reforms:** In particular, the Government should prioritise the implementation of the following outstanding Johnson Report recommendations:

    - The phase-down of interest withholding tax for financial institutions; and

    - The abolition of the LIBOR Cap.

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- **Exempt withholding tax on payments made to/from CCPs:** The Government should urgently conclude its consideration of industry submissions on the withholding tax treatment of payments made to/from Central Counterparties (**CCPs**) to ensure that Australia's derivatives markets are not undermined by the implementation of the G-20 OTC derivative reforms;

- **Improve the international competitiveness of the OBU regime:** The Government should announce a further review of the Offshore Banking Unit (**OBU**) regime, building on the momentum of the Johnson Report and the 2015 legislative amendments to the regime;

- **Review interest deductibility rules:** The Government should announce a review of the rules around interest deductibility on capital protected products so as to eliminate a structural disincentive for investment on a protected basis;

- **Ensure cost recovery accords with government guidelines:** The Government should ensure that all cost recovery arrangements are subject to the Government's own Cost Recovery Guidelines; and

- **Retain a mixed funding model for ASIC:** The Government should retain a mixed funding model for ASIC and should not proceed with the industry funding model outlined in Treasury's 2015 consultation paper. The Government should enter into long-term funding agreements with ASIC to provide certainty and predictability in resourcing.

2. Introductory Comments

This submission follows our engagement with both the Financial System Inquiry (FSI) and the Government's Tax Discussion Paper processes. AFMA's participation sought to highlight the important roles of the financial system and financial markets in supporting the Australian economy and as important pillars of economic growth and the Government's fiscal strategy.

In our view, the FSI's recommendations were largely a housekeeping exercise and not a complete agenda or strategy for future financial system development. The FSI's Final Report does not provide a comprehensive strategy for guiding the future development of the financial system, its role in the Australian economy and its integration with the rest of the world, particularly the rapidly growing trade in financial services in the Asian region. While the government has appropriately prioritised the conclusion and implementation of regional free trade agreements (FTAs), these have not been linked to domestic financial system development objectives in a way that would enable the financial sector to capitalise on the opportunities presented by these agreements.

It remains incumbent on the federal government to formulate and then champion at all political levels a strategy that will integrate the FSI's Final Report recommendations with

the government's policy agenda in related areas such as tax, international trade, innovation and business investment. This will require a stronger commitment of policy resources and political attention than has been previously forthcoming from successive governments. The long lag between the 2009 Johnson Report's recommendations and their actual implementation by government is symptomatic of this lack of political attention and the failure to integrate financial system development with broader policy objectives and priorities.

Further, as noted below, some key recommendations from the Johnson Report remain unimplemented, reflecting both a lack of cohesive and holistic strategy with respect to the recommendations in the report. This undermines confidence about the extent to which the Government is committed to enhancing Australia's capability as a financial centre. Like the FSI, the Johnson Report is also only a partial agenda for progressing the development of Australia's financial system. While important, the government should not view the implementation of the outstanding Johnson Report recommendations as completing the process of financial system development. The Johnson Report recommendations should be seen as a necessary but not sufficient condition for progressing Australia's positioning as an international financial centre.

Accordingly, the broad theme of AFMA's 2016-17 Pre-Budget Submission is to highlight measures and integrated policy approaches that will strengthen the attractiveness of Australia's financial markets, both regionally and globally, as a financial centre. Specific recommendations include implementation of those outstanding recommendations contained in both the Johnson Report and the Final Report of the FSI, including taxation matters that were rightly referred to in the Final Report of the FSI but for which detailed consideration was beyond the Inquiry's Terms of Reference. However, we stress that mere implementation of outstanding recommendations is insufficient to properly ensure the optimisation of Australia's financial services capability, particularly in the absence of a clear strategy for future development of the sector.

3. Macroeconomic Policy Framework and Context

Australia is fortunate to have a macroeconomic policy framework built around a floating exchange rate and an inflation-targeting central bank. This framework has important implications for how the government should approach fiscal policy. In particular, fiscal policy should focus on tax and spending decisions that improve microeconomic incentives while balancing the budget over time. Fiscal policy should not be distracted by short-term demand management considerations, which are more appropriately the focus of the Reserve Bank in its conduct of monetary policy. Recent inflation outcomes, reviewed below, suggest scope for monetary policy to do more to support aggregate demand.

3.1 Role of the exchange rate

The floating exchange rate absorbs much of the macroeconomic impact of external shocks to the Australian economy, such as the current slowdown in the Chinese and world economy. Australia's derivatives markets enable the foreign exchange risk associated with non-Australian dollar denominated foreign liabilities to be swapped back into Australian dollars. The Australian economy has repeatedly demonstrated

its resilience to exchange rate volatility. The Australian dollar – US dollar exchange rate is currently below its post-float average around 0.7600.

3.2 Role of monetary policy

The Reserve Bank's monetary policy is primarily responsible for managing fluctuations in aggregate demand, that is, the level and growth rate of nominal spending or GDP. The Reserve Bank has recently indicated its willingness to further reduce its cash rate if needed to ensure that inflation remains consistent with its medium-term 2-3% target.

The current level of the official cash rate at 2% and its proximity to the so-called zero bound on nominal interest rates is not a constraint on the ability of the Reserve Bank to further ease monetary policy if necessary to maintain inflation outcomes consistent with the target range.

The Reserve Bank has access to other policy instruments that can be used to implement monetary policy even if the official cash rate were to fall to zero. The Reserve Bank can expand its balance sheet through outright purchases of government bonds and other securities to maintain the effectiveness of monetary policy with a bounded cash rate. So long as the medium-term inflation target is not compromised, there is no in-principle limit to the Reserve Bank's ability to use these alternative operating instruments, should that be necessary.

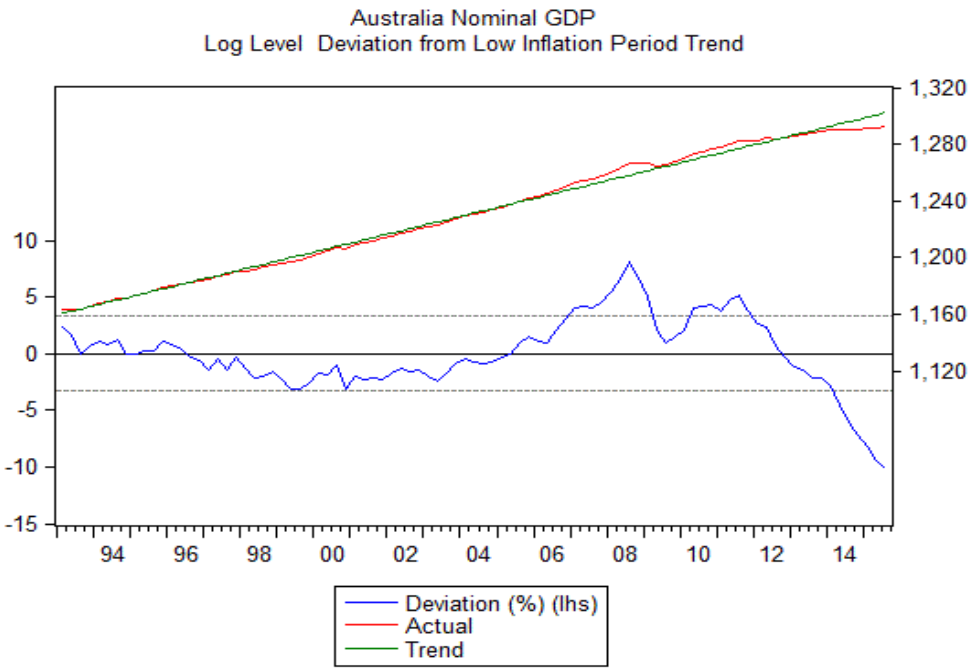
3.3 Inflation outcomes and inflation expectations remain broadly consistent with the inflation target

The most relevant measure of the stance of monetary policy is actual and expected inflation outcomes. As of the December quarter 2015, the headline CPI is below the 2-3% target range at 1.7%, while the RBA's statistical core measures are at the bottom of the target range at around 2%. This indicates that monetary policy settings over the last 12-18 months have been broadly consistent with the inflation target. Long-term inflation expectations implied by inflation-linked Commonwealth government have recently been at or below the bottom end of the target range.

Figure 1

As of the third quarter 2015, the nominal GDP remains around 10% below the level implied by its post-1993, low inflation period trend. This reflects some of the weakest nominal GDP growth rates since the 1961 credit squeeze. While partly attributable to the decline in the terms of trade, the below trend level of nominal GDP also implies scope for monetary policy to do more to stabilise nominal spending (Figure 2).

Figure 2



Source: AFMA estimates

3.4 The role of fiscal policy

One of the main advantages of a macroeconomic policy framework based on a floating exchange rate and an inflation targeting central bank is that its allows the government to focus on the role of spending and tax decisions in conditioning incentives to work, save and invest and the need to balance the budget over time, without having to be concerned with their short-run implications for the economic cycle. Monetary policy and the exchange rate offset the macroeconomic implications of the change in the budget balance as a share of GDP from one year to the next. The Government does not need to condition fiscal policy on the short-term macroeconomic outlook.

Expansionary fiscal policy can be counter-productive given a floating exchange rate and inflation targeting central bank. The foreign capital inflows needed to fund an expansionary fiscal policy put upward pressure on the exchange rate and reduce the contribution net exports make to overall economic growth. Even if a discretionary

fiscal expansion is not fully crowded-out by changes in the exchange rate and net exports, monetary policy can be expected to offset any residual effect of fiscal policy on aggregate demand for a given inflation target.

Conditioning fiscal policy on the short-term macroeconomic outlook can compromise the government's pursuit of long-term fiscal consolidation objectives that must be met to maintain Australia's sovereign credit rating and to support long-run economic growth. A failure to balance the budget over time can be costly in terms of the burden of public debt interest and the need to increase future taxes in the absence of offsetting expenditure restraint. The cost of public sector borrowing is not just the interest rate on outstanding government debt, but the efficiency cost of future tax increases needed to repay the debt. Expectations for the future path for net debt can undermine economic confidence even if current levels of Commonwealth debt remain relatively low by international standards.

The budget deficit for 2015-16 forecast in the Mid-Year Economic and Fiscal Outlook is larger as a share of GDP than it was in 2012-13. The long-term deterioration in the federal government's fiscal position reflects a failure to adhere to a rules-based framework for fiscal policy to guide spending and tax decisions. Fiscal policy has been distracted by the pursuit of short-run macroeconomic stabilisation objectives that are inconsistent with the institutional design of Australia's macroeconomic policy framework noted above.

3.5 The need for fiscal policy rules

Fiscal rules are a useful way of disciplining fiscal decision-making and encourage a more systematic approach to the budget. The National Commission of Audit[1] recommended three fiscal rules and suggested the Parliamentary Budget Office report progress against the fiscal rules following the annual release of the Final Budget Outcome:

- Achieve a surplus of 1 per cent of GDP by 2023-24;
- Substantially reduce net debt over the next decade;
- Ensure taxation receipts remain below 24 per cent of GDP.

[1] National Commission of Audit, *Towards Responsible Government*, October 2013

Treasury Secretary John Fraser has also recently suggested that federal spending be limited to 25% of GDP as a 'useful marker' for fiscal policy.[2] This would imply that tax plus non-tax revenue should also be capped at 25% of GDP to maintain a balanced budget over time. While recent governments have articulated various fiscal policy commitments as part of the fiscal strategy statements mandated by the Charter of Budget Honesty, these commitments have been too readily abandoned. For example, the Government's most recent Mid-Year Economic and Fiscal Outlook abandoned the previously articulated timetable for a return to budget surplus. Both Australian and international experience with fiscal rules suggests they can be helpful in improving fiscal outcomes, but require a much stronger level of commitment by government than has been seen in recent years.

4. Taxation recommendations

4.1 Alignment of regulatory and taxation outcomes

A fundamental pillar to ensuring that government reforms are undertaken to promote the efficiency and competitiveness of Australia's financial markets is to consider regulatory or other changes in a holistic manner through the adoption of a "whole of regulation" mantra. That is, to the extent that changes are required to the taxation system to ensure consistency with regulatory reforms, these be implemented consistently and not only where there is a perception that the amendments will be revenue accretive for the Government. The request for a specific interest withholding tax exemption for interest paid to or from Central Counterparties, as set out in more detail below, is an example of where the Government should adopt a holistic approach to the consequences of regulatory intervention.

4.2 Remove interest withholding tax for financial institutions

AFMA continues to strenuously object to the decision made by the government to discontinue the previously announced phase-down of interest withholding tax (IWT) for financial institutions. This announcement was formally made by the government as part of the repeal of the Minerals Resource Rent Tax.

[2] John Fraser, 'The Australian Budget: Some Context,' Speech to the Sydney Institute, 28 January 2016 http://www.treasury.gov.au/PublicationsAndMedia/Speeches/2016/The-Australian-Budget

There is a considerable body of commentary that clearly articulates the erosive nature of interest withholding tax on the Australian economy and Australian businesses. Starting with the Johnson Report, where the AFCF expressed the view that "the application of interest withholding tax to offshore borrowings by Australian based banks is inconsistent with Australia's need, as a capital importing country, to access a diversity of offshore sources of funding." The AFCF went on to state that:

> "the continuing application of interest withholding tax on financial institutions' borrowing offshore sits uneasily with the Government's desire to develop Australia as a leading financial centre and is putting Australia at a competitive disadvantage with respect to overseas financial centres."

These comments were echoed and endorsed by the Henry Tax Review in 2010, which recommended that "financial institutions operating in Australia should generally not be subject to interest withholding tax on interest paid to non-residents."

Further, and compellingly, the Final Report of the FSI, which did not have specific taxation recommendations within the ambit of the Inquiry's Terms of Reference, noted:

> "(w)ithholding taxes generally increase the required rate of return for foreign investors, which reduces the relative attractiveness of Australia as an investment destination. Where foreign investors can pass on the cost to domestic recipients, this raises the cost of capital in Australia…reducing IWT would reduce funding distortions, provide a more diversified funding base and, more broadly, reduce impediments to cross-border capital flows."

In essence, the FSI Panel agrees with previous observations made in the Johnson Report and the Henry Tax Review that, as a nation that relies on the importation of capital to ensure continued growth, it is incongruous that the government persists with a measure that significantly hinders the free movement of capital into Australia and causes Australian businesses to pay a higher rate for debt finance. This ultimately renders Australian businesses less competitive relative to their global peers.

The government has publicly confirmed its commitment to the recommendations of the Johnson Report. The Coalition's "Our Plan for Real Action" document states that it would "give priority to the recommendations of the Johnson Report into Australia as a Financial Centre." The withholding tax recommendation is a core component of the Johnson Report package and the phase-down of interest withholding tax is accordingly consistent with the Coalition's key policy document.

AFMA is of the view that the government has not prosecuted this key Johnson recommendation purely on the perception that the former government was seeking to fund any reduction in revenue from the proceeds of the Minerals Resource Rent Tax, which the current government has abolished. AFMA urges the government to

acknowledge the recommendations of the Johnson Report and consider the effect of the phase-down of interest withholding tax for the wider economy. As such we call on the government to commit to the implementation of the phase-down of interest withholding tax as per the Johnson recommendation, namely:

- on foreign-raised funding by Australian banks;
- to foreign banks by Australian branches; and
- on related party borrowings by financial institutions.

4.3 Exempt withholding tax on interest paid to CCPs

In February 2013, AFMA, the Australian Bankers' Association and the Financial Services Council lodged a submission with Treasury seeking a withholding tax exemption for interest paid to central counterparties (CCPs).

As part of the G-20's commitment to improving the transparency of OTC derivatives, systemically important OTC derivatives (such as AUD interest rate swaps) are required to be collateralised and cleared through an appropriately structured CCP. The concern expressed in the submission was that where the CCP was located outside of Australia, interest paid on the collateral could result in Australian interest withholding tax.

The submission sought an exemption for any withholding tax that would arise, on the basis that the cross-border interest flow arose solely due to regulatory reform and any withholding tax arising would adversely affect the Australian derivatives market, with the detrimental impacts vastly exceeding any government revenue.

The point was acknowledged by the Final Report of the Financial System Inquiry, which observed:

> "Australia's IWT regime also applies to derivative transactions. Under G20 commitments, certain standardised over-the-counter derivatives need to be collateralised and cleared through a regulated central counterparty. In Australia, outbound interest payments on collateralised positions may be subject to IWT (flows from Australian participants to offshore CCPs, or flows from Australian CCPs to offshore participants). This may increase costs for Australian participants and adversely affect liquidity in Australian derivatives markets."

AFMA has received no response from the government or Treasury with respect to the submission, nor to AFMA's 2015-16 Pre-Budget Submission in which the issue was again raised. This issue continues to be an ongoing threat to the Australian derivatives market and AFMA urges the government to consider the request made in the submission as part of the 2016-17 Federal Budget.

4.4 Abolish the LIBOR Cap

The government should use the 2016/17 Budget as an opportunity to announce the removal the "LIBOR Cap," a statutory provision that operates to deny deductibility of intra-entity interest for an Australian branch of a foreign bank above the applicable LIBOR.

Our view continues to be that the LIBOR Cap unnecessarily inhibits the flow of capital into Australia through foreign bank branches and, therefore, increases pressure on the availability and cost of credit to Australian business. It is defective tax policy because it conflicts with internationally accepted transfer pricing norms that rely on arm's length pricing/conditions. It also has serious technical flaws, most notably because LIBOR is not a representative funding rate for individual banks or for funding at a maturity greater than twelve months.

The absurdity of the LIBOR Cap was exacerbated in 2013 when the British Bankers Association ceased to quote AUD LIBOR. This resulted in a situation whereby there was no applicable LIBOR in respect of AUD borrowings and consequently, in AFMA's view, no cap on the deductibility of interest where the Australian branch borrowed in AUD. This has necessitated agreement between the ATO and AFMA, as an industry body, of an Administrative Solution that may be adopted by taxpayers to address AUD borrowings to which the LIBOR Cap previously applied. From a technical perspective, however, there is now the untenable position where there exists a provision of the law which has no legal effect where the Australian foreign bank branch borrows in its own functional currency.

The Government asked the Board of Taxation to review the appropriateness of the LIBOR Cap as part of its review into the Tax Arrangements Applying to Permanent Establishments. The Board of Taxation made only one recommendation in its report to the Government. This recommendation was:

> "subject to confirmation that the removal of the LIBOR Cap would result in no material cost to revenue, the cap should be removed. That would assist in fostering competition in the domestic market."

In providing context to the recommendation, the Report stated:

> "The Board agrees that the LIBOR Cap has the potential to reduce bank competition. Put another way, it is hard to see how a cap on the amount of deductions that can be claimed in respect of intra-entity debt can assist in promoting banking competition by foreign banks with their domestic counterparts that do not face the restriction. The LIBOR Cap has the effect of potentially increasing the funding costs for foreign bank branches and hinders their ability to compete in the business loan market. Moreover, new entrants into the Australian banking market are likely to be disproportionately affected by the LIBOR Cap because they are relatively more reliant on head office funding to which the cap applies."

Such comments are consistent with those included in the Johnson Report, which made the recommendation to:

> "remove the LIBOR Cap on deductibility of interest paid on branch-parent funding."

This recommendation was made on the basis that:

> "(a)s the financial crisis clearly demonstrated, in periods of stress in credit markets, there can be appreciable differences between the LIBOR rate and the rates that parent banks are able to offer their Australian branches on a commercial basis. While conditions in credit markets have eased significantly, Australia needs policies to ensure access to alternative funding sources at competitive rates should such tensions re-emerge. The Forum believes that any tax avoidance concerns from removing the LIBOR cap could be adequately dealt with by applying the usual transfer pricing guidelines in respect of interest paid to foreign banks by their Australian branches."

During the 2014 calendar year, and at the government's request, AFMA provided both the government and Treasury with revenue estimates of the cost of the removal of the LIBOR cap, based on survey responses from its members. These estimates demonstrated that the cost of removal of the cap was immaterial (i.e. there is no material cost to revenue) and would deliver significant deregulation benefits, in addition to materially enhancing banking competition and the provision of product and service innovation by foreign bank branches.

Given the defective nature of the LIBOR Cap from a policy perspective, the impracticality associated with applying the cap for currencies for which no LIBOR is quoted and the immaterial revenue consequences associated with its removal, AFMA again calls on the Government to abolish the LIBOR Cap as a matter of urgency. Abolition would give effect to another key recommendation of the Johnson Report, mirrored by that of the Board of Tax. It would also be consistent with the Government's objective to foster innovation in the economy.

4.5 Improve the international competitiveness of the OBU regime

In 2015, legislation giving effect to amendments to the Offshore Banking Unit (OBU) regime was passed through Parliament.

On balance, the amendments contained in the legislation were positive and provided a useful first step in ensuring the OBU regime continues to be contemporaneous in light of financial and product innovation and competitive with similar regimes in the region aimed at attracting mobile financial sector activity. However, the amendments did little more than give effect to some (but not all) of the OBU recommendations of the Johnson Report. Given the Johnson Report was delivered to Government in 2009, many of the recommendations may have been superseded and hence merely giving effect to these recommendations does not guarantee that the OBU regime is fulfilling its policy objectives.

Of particular concern is the apparent lack of rigour around ensuring that the OBU regime is updated in a timely and efficient manner where required. AFMA is concerned that given the current focus on investment on fintech, Australia may be left in the invidious position of being unable to retain successful financial services innovation due to the OBU regime, which would support the provision of financial services to non-residents from Australia.

Given the government's stated focus on innovation, we believe it is appropriate for the merits and potential improvements to the OBU regime to be reviewed to maintain the momentum started by the 2015 legislative amendments. We believe that the Board of Taxation would be well placed to conduct such a review and recommend that the review be announced in the 2016-17 Federal Budget, together with timing of both delivery of the Board's report and the government's commitment to respond to the recommendations contained therein.

4.6 Review of capital protected borrowing rules

Capital protected products include protected equity loans and instalment warrants. They are an efficient investment tool for retail investors, including many retirees, to manage their financial risk and grow their wealth in a prudent way by investing in the Australian economy.

Schedule 2 of the *Tax Laws Amendment (2010 Measures No. 5) Act 2011* (TLAB5) reduced the benchmark rate for the tax deductibility on interest on capital protected borrowings to the indicator home loan rate plus 100 basis points. AFMA advised the Senate Economics Legislation Committee in its inquiry into the related Bill that this level is not a fair reflection of the borrowing costs for investors and it would continue to stymie the market's ability to meet their needs in a cost effective way. Subsequent evidence confirms that our concerns were valid and investors have lost access to cost effective capital protection at the very time that market volatility places a premium on such protection.

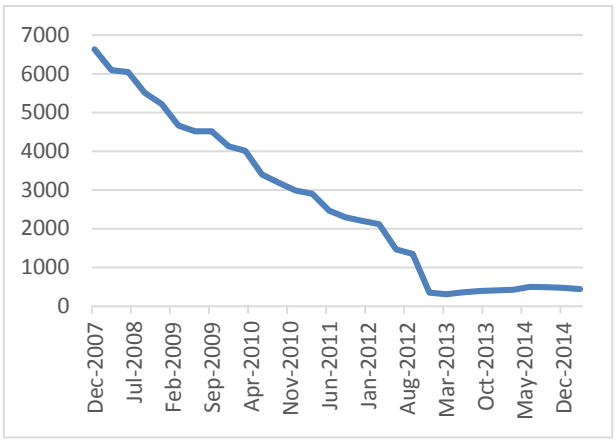
Table 1, set out below, highlights the inefficiencies associated with the reduction of the benchmark rate as set out in TLAB5, namely:

Volume - A continuous decline in market size since the Government announced a greatly reduced benchmark rate in the May 2008 Budget, with total capital protected borrowing amounts in December 2013 exhibiting a reduction of approximately 80% from the peak (December 2007); and

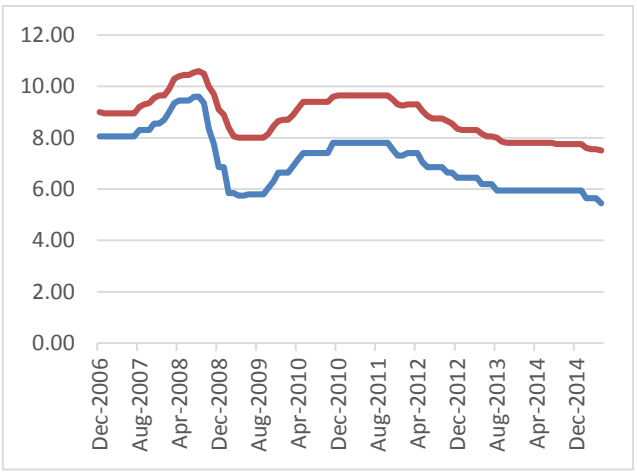
Price - The non-deductibility penalty has increased, as illustrated by the increase in the spread between the margin lending rate and the home loan rate between 2007 (average spread of 85-90bps) and 2015 (spread of approximately 195-210 bps).

Table 1

Capital Protected Borrowing ($mn)



Interest Rates (Margin Lending v Home Loan)



Source: Reserve Bank of Australia Tables F5 and B10

In terms of what is an appropriate rate, AFMA agrees with the view provided to the Senate Committee by Treasury, namely that the objective of the benchmark rate is to strike a balance between not inhibiting use of capital protected borrowings and not stimulating the product by affording them an overly generous tax treatment. Clearly, as evidenced by Table 1 above, this balance has not been struck by the current rate.

The current, restrictive rate is entirely inconsistent with the Government's deregulation agenda and adds a layer of complexity and red tape to investors seeking to protect their investment. Anecdotal evidence from our members suggest that investors are having to spend time and money in completing their tax returns in order to make adjustments for amounts frequently less than a few hundred dollars and that this is a disincentive to obtain protection. Changing the rate to one which only affects those investors seeking to claim a deduction that may be perceived as "over-generous" will ensure that the vast majority of investors are not burdened by the compliance costs associated with applying the capital protected borrowing rules.

This was a point agreed with by the Coalition Senators in their Dissenting Report to the Report by the Senate Economics Committee review of TLAB 5, which stated:

> "More persuasive is the establishment of a benchmark rate at the midpoint between the indicator rates for standard variable rate housing loans and personal unsecured variable rate loans, as recommended by the Australian Financial Markets Association. This is an attempt to set a level that equates the cost of the component required for capital protection equivalent to the cost of acquiring separate protection. Given this was the original goal of the legislation in establishing a threshold, it would seem to the Coalition to be the more sensible approach."

AFMA is seeking a solution that would provide a stable and workable solution that protects tax revenue, enable investors to go about their business in a prudent manner and reduce the likelihood of inadvertent impacts on business. The position presented by the Coalition provides a good basis to formulate a benchmark rate that is economically more effective, fairer to investors and appropriately protects the tax revenue base.

We reiterate that the government should acknowledge the problem and look to make amendments in the 2016-17 Budget. Under the current rules, investors face higher compliance costs, additional taxation on their investments and a tax bias towards riskier investments, which given current market volatility, is counter-intuitive from a policy perspective. AFMA is seeking a stable and workable solution that protects tax revenue, enables investors to go about their business in a prudent manner and reduces the likelihood of inadvertent impacts on business.

5. Regulator funding

5.1 Proposed industry funding model for ASIC

AFMA notes the Government's intention to make a decision in relation to the future funding model for ASIC after it has received the report from the ASIC Capability Review. AFMA believes that industry funding should not be used as a budget repair mechanism; rather, it should only be adopted if it can be shown to improve the efficiency and quality of regulation, taking account of its impact on industry participants and users.

AFMA submits that the proposed industry funding model, as outlined in Treasury's 2015 consultation paper, is incompatible with the government's broader policy objectives and tax reform priorities. In particular:

- The proposed industry funding model will amount to a significant impost on the financial services industry and the corporate sector of around $1 billion every four years;
- This is effectively a tax increase, which goes against the government's tax reform agenda and its recognition that the corporate tax and regulatory burdens are already too high;
- The burden will fall particularly heavily on new entrants into the financial services industry, who may have limited capacity to pass on the burden of the industry funding model to consumers. This will adversely affect competition and innovation in financial services and is at odds with the Prime Minister's stated policy objectives in relation to promoting new fintech business;
- Feedback from AFMA members in the financial markets infrastructure (FMI) and brokerage spaces indicates that the proposed levies will amount in some cases to as much as 20-50% of current net profit; and

- The additional cost burden will reduce Australia's competitiveness as a regional and international financial centre. Potential consequences include the exit of marginally profitable financial services businesses from Australia and an opportunity cost in terms of inward foreign investment opportunities lost.

AFMA submits that the government should retain a mixed funding model. The Government should retain significant 'skin in the game' by continuing to fund ASIC's general regulatory functions, particularly where these functions benefit the community as a whole in their capacities as consumers, investors and borrowers. The proposed industry funding model would lead to a weakening of the incentive for government to maintain effective scrutiny and oversight of ASIC's costs and effectiveness and work against the objective of more efficient regulation.

Financial service should provide a proportionate amount of ASIC's funding by paying user fees for demand driven services. This contribution would be on top of the general tax burden on financial services firms and the corporate sector.

AFMA supports the Financial System Inquiry's recommendation that the government enter into long-term funding agreements with ASIC to provide the regulator with greater certainty and predictability in its resourcing.

5.2 Adherence to cost recovery guidelines - AUSTRAC

More broadly, AFMA continues to advocate that any cost recovery measures (however badged) imposed by the government adhere to the government's own *Cost Recovery Guidelines*. This is particularly relevant in relation to the AUSTRAC "industry contribution," as announced in the 2014-15 Federal Budget, but equally applicable to other regulator funding arrangements.

The 2014/15 Federal Budget saw the government announce the removal of the AUSTRAC cost recovery process and replacement with a new industry contribution model. Under the model, the proportion of AUSTRAC's total expenses recovered from industry will increase from 53% (the cost of AUSTRAC's regulatory arm) in 2013-14 to 100% by 2017-18. Essentially, the model sees the government recover the costs of AUSTRAC's Financial Intelligence Unit - the primary beneficiaries of which are government border protection, enforcement and revenue agencies - from industry.

AFMA remains particularly concerned that the government abandoned its own *Cost Recovery Guidelines* by making this announcement. This was evidenced by its document "AUSTRAC industry contribution - outcome and feedback of stakeholder consultations" which stated that:

> "The new charge on industry as announced in the 2014-15 Budget is not subject to the Government's cost recovery guidelines or the requirements for a

regulatory impact statement because it is neither a cost recovery nor a regulatory arrangement."

AFMA does not understand the rationale for implementing a model which is clearly one of cost recovery but is not subject to the *Cost Recovery Guidelines*, merely through re-badging the model as one of "industry contribution." The practical impact on industry is that substantial amounts of money are required to be paid by regulated entities every year, but without the rigour, transparency or governance of the process that applies under the Cost Recovery Guidelines. Given that the Cost Recovery Guidelines provide that recovery should only occur, where efficient, in relation to the "provision of government goods and services (including regulation)," and that "costs that are not directly related or integral to the provision of products or services" should not be recovered, then it is clear that the recovery of the costs of AUSTRAC's Financial Intelligence Unit would be in contravention with the Cost Recovery Guidelines.

Accordingly we again request that, in the 2016-17 Federal Budget, the Government ensures that the industry contribution arrangements (such as those that apply to AUSTRAC) are made subject to the Government's own Cost Recovery Guidelines and that, as a consequence, the costs of AUSTRAC's Financial Intelligence Unit are outside the industry contribution arrangements.

* * * * *

Thank you for the opportunity to contribute to the Government's consideration of matters that should be addressed in the 2016/17 Federal Budget. We would be happy to discuss any of the matters that we have raised in this submission. Please contact me on 02 9776 7996 or rcolquhoun@afma.com.au .

Yours sincerely,

Rob Colquhoun
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