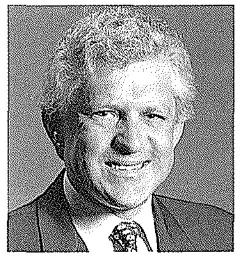
IWT – slamming the door on Asia?

There is an increasing belief throughout Australia that the country's economic and political future lies in the Asia-Pacific region. It is also accepted that other countries in the region are developing at a dramatic pace, posing aggressive competition. One area in which Australia has potential to become a regional leader is the financial services industry, in which we have sought to maintain an edge through the refining of markets, legislation and technology. However, writes ***John McMurtrie****, until remaining regulatory and tax obstacles are removed — particularly the interest withholding tax — our chances of becoming the preferred destination for international investors and financial institutions are slim.*



The distinction between banks and investment banks, merchant banks and securities houses is largely based on legal, historical and cultural differences in countries such as the United States, the United Kingdom and Japan. In Europe, for example, the universal banks of Germany, Switzerland and other countries have long been able to carry out the full range of financial services.

In Australia, the banks were highly regulated until the early 1980s. This saw the growth of merchant banks which took advantage of opportunities that not only mirrored the activities of their parents but in many cases took them into other areas where parents were subject to restriction in their home markets. Equity and debt securities underwriting were two examples of this.

Since the distinction between banks and non-banks is now less relevant, I will refer here to financial institutions operating in Australia which are predominantly foreign-owned and will call them international financial institutions.

I will be considering only international financial institutions whose predominant focus is on the wholesale markets and whose clients are likely to be the larger Australian public companies, subsidiaries of multinationals, governments, government-owned enterprises and Australian and offshore institutional fund managers.

Recognising the above factors and the composition of its membership, the former Australian Merchant Bankers Association (AMBA) changed its name on 1 January 1993 to the International Banks and Securities Association (IBSA). The 40 members of IBSA include entities active in all the wholesale markets, with at least 15 members engaged in stockbroking. A number of our members are licensed banks in Australia and nearly all are subsidiaries of major international banks, merchant banks or investment banks.

This article discusses four broad issues:

- the business opportunities and market niches available to international financial institutions;
- the choice between branch and subsidiary operations;
- how international are the Australian markets and whether we wish to

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play a role as a regional financial centre;

- the role of international financial institutions as providers and underwriters of debt and equity financing.

Opportunities and niches

International financial institutions operating in Australia are an important part of the financial system in various areas, such as:

- accounting for a significant share of the turnover of the Australian Stock Exchange;
- accounting for around 30 per cent of the volumes traded on the Sydney Futures Exchange;
- being important participants in the government and semi-government bond markets as underwriters and traders, accounting for an estimated 35 per cent and 50 per cent respectively;
- being important participants in foreign-exchange trading, derivatives trading, advisory activities, fund management, commodities trading and corporate lending.

In addition, international financial institution groups are a very important supporter of Australia in the offshore markets through underwriting and trading of Australian debt and equity securities and lending to Australian companies in their international operations.

The after-tax returns earned by international financial institutions in Australia have declined since the early-to-mid 1980s and for the past three years have averaged around 7 per cent for merchant banks and around minus 25 per cent for foreign banks, according to a KPMG Peat Marwick survey (Table 1). Generally better results seem to have been produced in 1992.

Branch or subsidiary?

Most international financial institutions prefer to operate as branches abroad, particularly if they are active lenders and traders where access to group capital is important.

It has been ten years since the opportunity first arose to allow banks to operate as branches in Australia. The Campbell Committee recommendations which were re-examined by the Martin Committee led to a decision taken in 1984 to invite applications for a "limited number" of banking licences. The banks were to be required to operate as subsidiaries, in part because of the emotional argument related to the need for local equity, and also in part because it was considered that locally incorporated subsidiaries, subject to the prudential supervision of the Reserve Bank, would be safer than branches.

Accordingly, the opportunity for the new banks to operate as branches was not taken at that time (note that BNP, BNZ and Bank of China all operated as branches before and after 1984).

In the event, the "limited number" turned out to be 16, although J.P. Morgan elected not to take up the invitation and has continued to operate as a merchant bank with a guarantee from its parent.

Many international banks were unsuccessful in their desire to become Australian banks; there were 43 applicants for the 16 licences. Those that missed out established themselves or continued to operate as merchant banks. More than 40 merchant banks now operate with a parent guarantee which effectively enables them to operate as branches.

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The federal government has foreshadowed that it intends to prevent merchant banks from calling themselves merchant banks in the future unless they obtain bank status. The logic in this decision is not clear, especially since, if retail depositor protection is an issue, merchant bank clients are predominantly wholesale.

The experience of the 15 new foreign banks, with few exceptions, suggests that many have paid their dues in Australia via large investments in systems, premises, personnel and, of course, in loan losses. It is necessary to point out that when the 15 foreign banks were established in 1985-86, significant additional costs were involved, relating to:

- the need to have a retail presence involving investment in systems and ground-floor premises;
- the need to observe prudential rules such as the prime assets requirement (PAR) and to lodge non-callable deposits (NCDs), equivalent to 1 per cent of liabilities, with the Reserve Bank of Australia;
- detailed reporting to the Reserve Bank.

The members of IBSA and the 15 foreign banks were pleased with the decision announced by the federal government in the One Nation statement in February 1992 to allow international banks to operate as branches in Australia.

Since One Nation, two things have happened to inch us closer to the reality of branch banking: legislation has been passed permitting branch operations; and the 5 per cent discount below 13-week Treasury notes on the rate of interest paid on NCDs is to disappear and "market" rates will be paid.

It is disappointing that brach banking has lagged behind OBUs in the implementation stakes. In principle, decisions on both issues were announced by the federal government at the same time in the One Nation statement. The branch banking taxation issues relate to:

- conversion from subsidiary to branch, including transfer of any tax loss and exemption from stamp duty on assets transferred;
- interest withholding tax;
- deductibility of borrowing costs.

Of the two *conversion* issues, indications are that the transfer of tax losses should not be an impediment to the establishment of branches. However, relevant federal legislation will probably not proceed on this until the Budget session of parliament. On the stamp duty side, various state governments are concerned about forgoing stamp duty, but the irony is that if they attempted to impose stamp duty on asset transfers, institutions would simply elect not to transfer the assets, so there would be no additional revenue for the government. Most state governments seem to have realised this and have indicated that they will not attempt to impose the duty.

The *interest withholding tax* argument is as follows:

IBSA and a grouping of the 15 foreign banks have submitted to the federal government that interest withholding tax (IWT) should not apply on borrowings from non-resident banks including sister branches.

The Treasury and the Australian Taxation Office point to an amount of \$A655 million being collected in IWT in 1991/92 and say that granting an exemption on branch borrowings from non-resident banks could lead to significant direct and indirect losses in IWT collections.

The IWT statistics produce some interesting and puzzling aspects:

■ Total collection have dropped over the past few years from more than \$1 billion annually, presumably as the result of lower interest rates, more widespread use of international bond and short-term paper programs which take advantage of the Section 128F exemption from IWT, and the lack of tax absorption capacity by international banks.

■ The major contributions by value of collections are financial institutions (20 per cent), public companies (40 per cent) and private companies (30 per cent). Financial institutions paid \$135.8 million in IWT in 1991/92.

■ Two-thirds of the amount collected comes from 120 remitters (or 0.4 per cent of a total of 32,418 remitters) of amounts of more than \$1 million each. Financial institutions represent only 2.9 per cent of remitters, yet they contribute 20 per cent of IWT collections.

■ Two-thirds of the remitters by number are private companies and "other". This surprises me; I would not have thought that these categories were significant offshore borrowers.

■ The statistics suggest there are almost 1,000 financial institutions making IWT remittances!

The IWT statistics are puzzling in the light of industry surveys showing that the major foreign financial institutions are paying IWT amounting only to tens of millions, rather than the \$136 million suggested.

It is hard to see where the private and public company borrowings are and even harder to see that they will be diverted through the banking system in order to take advantage of the IWT-exempt status of bank branches.

Turning to the *deductibility of borrowing costs*, the issue is that certain financial centres deny a deduction to branches for interest paid on a proportion of all borrowings on the ground that this is the notional capital of the branch. The federal government's advisers appear to be arguing for a level of notional capital to apply to bank branches which would add substantially to the costs of operations.

Despite these issues being unresolved, one Singapore-based bank, OUB, has proceeded down the path to becoming a branch for reasons related to Singapore's rules prohibiting its banks guaranteeing subsidiaries, and limiting subsidiaries in their lending to any one client to a small percentage of the subsidiary's capital. Other foreign banks are awaiting resolution of the tax issue.

> *Can Australia play a regional role? The unresolved issues relating to branch banking will be very important in determining this.*

Australia's regional role

How international are the Australian financial markets? Some indications are:

■ The Sydney Futures Exchange is the second-largest futures exchange in the region and the ninth-largest in the world. The Osaka Stock Exchange, ironically, is the largest futures exchange in the region only because of trade in the Nikkei Index. Comparable figures, excluding Osaka) in millions of trades annually are:

Australia	18
Tokyo	15
Singapore	10

The major difference is that 85 per cent of SFE volume is onshore and only 15 per cent offshore. Singapore and Tokyo trade 90 per cent and 75 per cent offshore respectively. Impediments to the growth of offshore trading at the SFE relate to the uncompetitive company tax rates and interest withholding tax.

■ The Australian Stock Exchange is the third-largest market by capitalisation in the region after Tokyo and Hong Kong. However, it ranks sixth by turnover after those two countries and Korea, Taiwan and Thailand.

At the Australian Stock Exchange, estimates suggest that around 17 per cent of purchases and a similar percentage of sales have a foreign counterparty. This statistic is confirmed by the estimate that, at the end of 1992, just under 20 per cent of the Australian Stock Exchange capitalisation was held by foreigners.

It is interesting to note that because of state stamp duty and other local costs, transactions equivalent to about 40 per cent of official Australian Stock Exchange volumes are estimated to occur offshore, although these estimates cannot be verified by the authorities,

■ The Australian Stock Exchange is clearly suffering in a regional sense because of stamp duties, tax rates and the effects of dividend imputation on foreign owners. Although it is becoming more competitive in certain back-office areas, the tightening of disclosure rules and the lack of international trading makes local listing less attractive to international firms.

The foreign exchange and bullion markets in Australia are international, particularly in the early-morning time-zone, although the volume of trading has declined in recent years relative to other regional centres. In short, the Australian markets are quite sizeable but not as international as others such as Singapore and Hong Kong.

Can Australia play a regional role? The unresolved issues relating to branch banking will be very important in determining this.

Singapore and Hong Kong provide IWT exemption on all non-resident borrowings (intra-bank and inter-bank) and also effectively provide the exemption for all non-resident borrowing, not only from banks. The federal government is arguing about IWT on intra-bank borrowings and does not appear prepared to concede the point on inter-bank borrowings. The major international financial centres (London, Singapore, Hong Kong) have all recognised the need to exempt non-resident bank borrowings from IWT. Other less important international jurisdictions, including Belgium, Germany and the Netherlands, have also provided these exemptions.

At a minimum, intra-bank borrowings must be exempted from IWT if merchant banks and foreign banks are even to consider converting to branch status. If Australia wishes to be competitive in the region, then the exemption must apply to borrowings from all non-resident banks. At present, Asian investors are reluctant to place deposits in Australia because of the taxing arrangements. Integration with Asia would be enhanced if those investors found no difference between deposits placed here or in Asia. Deposits placed in Australia would encourage greater familiarity, leading potentially to greater direct investments in Australia.

In relation to deductibility of borrowing costs, Singapore and Hong Kong do not apply notional capital to bank branches.

The federal government has been sending some conflicting signals in relation to the question of Australia as a regional financial centre. On the positive side, an important objective of the government in this term of office is for Australia to become closer to Asia in a commercial, financial and political sense. Accordingly, enabling Australia to compete effectively as a regional financial centre with Singapore and Hong Kong would seem to be an important part of this platform.

This means that any short-term revenue forgone from IWT (and it will be lower in 1992/93 than in the year before) must be balanced against long-term tax benefits which would occur if Australia played a regional role. It is surely no coincidence that the company tax rate, which is to fall to 33 per cent, is the same as that applying in Singapore.

The federal government's OBU decisions in 1992 on their own will go some of the way towards giving a better chance of playing a regional role. However, the employment effect of this move will be limited. A real regional role implies jobs and investment and taxes, and the prospects for these would be enhanced by appropriate decisions on IWT applying to bank branches.

Already Australia is becoming more competitive in costs (excluding taxes) compared with Singapore and Hong Kong, because of growth in wage and rent costs in Asia, particularly in Hong Kong.

Many Hong Kong traders have Australian passports following a cooperative and enlightened view taken by the federal government in 1985. Many Australians are already working in the region in financial institutions. There is an excellent chance to bring these Australians home, together with others with relevant skills in the different financial markets.

Providers of finance

There is no doubt that international financial institutions involved with Australia benefit from having a presence here. As the pressure on financial performance becomes greater, however, the cost of the presence will be more highly scrutinised than in the past.

> *Existing merchant banks will decide to convert to branches only if after-tax costs are outweighed by the benefits*

In relation to foreign debt, the fact is that the stock of debt needs to be refinanced at maturity of the bonds or at loan repayment date. The international financial institutions are the major conduit for this, through underwriting and distribution.

The largest suppliers are the Euromarkets, the European Community through bank lending and domestic banks, and Japan.

The desire of international financial institutions to continue to finance Australia's foreign debt will depend on the return, currency risk and political factors. However, an active and profitable local presence in Australia will increase their desire to be involved.

On the equity side, a similar argument can be mounted. Australian equity research capacity is almost a prerequisite for international financial institutions selling equity in the international markets.

Conclusions

Existing merchant banks will decide to convert to branches only if after-tax costs are outweighed by the benefits, with any decisions on IWT and notional capital being critical parts of the equation.

Australia is not as international as other financial centres in the region such as Singapore and Hong Kong, due to stamp duty, tax and other impediments. Australia could be a competitor with Singapore and Hong Kong if a long-term view is taken that is consistent with the desire of Australia to become better integrated with Asia.

The international financial institutions have been major participants in Australia and have been active supporters as Australian debt has blown out over the 1980s. They will continue to be important, given the refinancing of the $200 billion of foreign debt and the need for foreign equity to fund ongoing balance-of-payments deficits.

Australia has never been less relevant in the world. We are questioning our own historical links and our two major post-war allies are governed by baby-boomers with little knowledge of Australia. As far as South-East Asian economies are concerned, they are looking increasingly to the north for opportunities and even away from their own constituencies, for example within ASEAN. Therefore we have a real challenge in getting them to focus simultaneously on Australia.

The question to ask is: are we going to find out way in the sun or are we going to earn our way into Asia? The opportunities available in Asia are immense but let us not forget that our costs and tax structures are still uncompetitive with the bulk of the newly industrialising countries in the region.

At a time when Australia has three state banks potentially on the market, it is important that we have an overall financial regime that is attractive to investors including those from Asia.

Although the decision to make Australia competitive with Hong Kong and Singapore as financial centres will not solely achieve the aim of better integration with Asia, this, together with the promotion of regional headquarters (RHQs) and attacking our cost structure, certainly will. ■