

MUTUAL RECOGNITION ARRANGEMENTS —

Australia and Asia

CARLA HOORWEG, Senior Policy Manager, Investment, Global Markets and Tax, Financial Services Council

This paper provides an overview of the various mechanisms by which cross-border financial services trade in investment management is being promoted in Asia, and Australia's engagement with these schemes. The paper examines the potential economic opportunities for Australia from increased trade in financial services, as well as specific mutual recognition and passporting schemes being developed within the Asian region. It also highlights key considerations for Australian investment managers looking to enter the Asian market through these schemes.

Australia's funds management capabilities

The financial services sector is a significant part of the Australian economy, contributing 9.3 per cent of the country's gross domestic product, second only to mining which contributes 9.4 per cent.¹ A key element of the sector is the management of investments for retail and wholesale investors and, as at 30 June 2015, the total funds under management in Australia topped \$2.6 trillion.² These funds are invested in managed investment schemes, which allow multiple investors to pool their money into a portfolio of assets managed by a professional manager.

Australia has developed a comparative advantage in investment management according to the report *Australia as a Financial Centre — Building on our Strengths (Johnson Report)* which was delivered to the government by the Australian Financial Centre Taskforce in 2009. The taskforce was charged with investigating whether changes to current policy settings could be made to improve Australia's competitiveness as an international financial services centre.

Despite this large pool of domestic savings, Australia is generally seen as punching below its weight when compared to London, Singapore and Hong Kong in relation to the proportion and value of investment management services provided to offshore clients.

The *Johnson Report* concluded that Australia has developed a significant skill base in investment management and also has 'one of the largest and most sophisticated funds management sectors globally'.³ This expertise has developed as a direct result of Australia's compulsory superannuation system which requires 9.5 per cent of employee wages to be contributed to a superannuation account. Currently the retirement savings system has over \$2 trillion in assets.⁴

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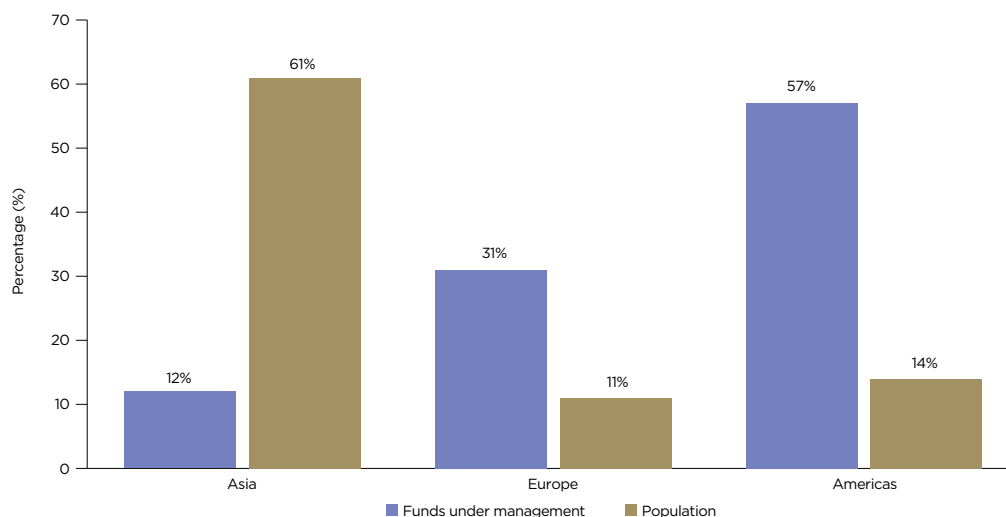
The opportunity

Improving Australia's competitiveness in this area could result in significant benefits to the economy over the medium term. In the case of funds management, money sourced from offshore clients and managed by Australian fund managers is considered to be an export for trade purposes, despite nothing tangible leaving Australian shores. The fees charged by Australian fund managers are then subject to corporate income tax in Australia.

Research by Deloitte Access Economics shows that fees generated from managing foreign fund flows contributed \$434 million in total value added to the Australian economy in 2012–13 and that a doubling of annual funds management export revenue could result in an increase in GDP of approximately \$330 million per annum by 2029–30.⁵ The proportion of funds sourced from overseas represents only 3.6 per cent of the total \$2.6 trillion invested in Australian managed investment schemes.⁶

At a regional level, the proportion of funds under management in Asia is low compared to the region's share of world population. As shown in Figure 1, Asia has only 12 per cent of global funds under management yet the region has over 60 per cent of the world's population. By contrast, the Americas have slightly below 60 per cent of global funds under management, despite having only 14 per cent of the world's population.

FIGURE 1: Regional share of global funds under management versus population⁷



Moreover, by 2030, Asia will represent 66 per cent of the global middle-class population and 59 per cent of middle-class consumption, compared to 28 per cent and 23 per cent, respectively, in 2009.⁸ There is clearly scope for a greater proportion of global funds to be both invested in and managed from Asia. Australia's existing expertise makes it well placed to capitalise on this future growth.

Government support

There is bipartisan government support for growing the amount of foreign-sourced funds managed in Australia. The *Johnson Report* was commissioned by the former Labor Government and many of the recommendations were accepted,⁹ however, there are key recommendations relating to increasing funds management exports which remain outstanding.

The Coalition Government appears to have a strong focus on increasing financial services exports.¹⁰ Free trade agreements were concluded in 2014 with Japan¹¹ and Korea¹² with both agreements containing strong financial services chapters,¹³ and on 20 December 2015 the China-Australia Free Trade Agreement came into force.¹⁴ The scene appears to be set for Australia to leverage its comparative advantage and manage more foreign sourced money from its Asian neighbours.

In a heavily regulated industry such as financial services, however, it is not merely enough to sign a trade agreement. Operating rules are complex, with industry participants required to have licences and approvals. Providers also need a translation of trade agreement rules and market access provisions to ensure they fully understand what they are permitted to do in a new market. Mutual recognition agreements form a key element of trade facilitation in financial services.

What is mutual recognition?

Mutual recognition of investment funds removes the need for an investment fund operator to obtain a licence from the regulator in a new market that it intends to access. It provides an avenue for understanding what activities are permitted in a new market, based on the operator's existing licencing arrangements in its current market.

A mutual recognition framework is facilitated by regulators from both jurisdictions reaching agreement on the acceptability of each other's regulatory structures and systems. Regulators then agree to allow operators to access their market without additional licencing requirements. Without a mutual recognition agreement fund operators would usually be required to set up a physical presence in the new jurisdiction and meet all relevant local licencing and capital requirements.

Conceptually mutual recognition is often described in terms of 'home' and 'host' jurisdictions. For example, in a mutual recognition agreement between Australia and China, the home regulator for Australian funds would be the Australian Securities and Investment Commission (ASIC) with the host regulator being China Securities Regulatory Commission (CSRC). The reverse would be the case for Chinese funds managers with CSRC being the home regulator and ASIC being the host.

Passporting

Mutual recognition usually refers to bilateral agreement between two countries, however, the concept of 'passporting' has recently become popular in the Asian region. Similar to mutual recognition, passporting schemes are designed to increase exports of investment funds between the participating economies.

Passporting operates under a slightly different model to mutual recognition, with participating regulators initially undertaking due diligence on each other's regulatory frameworks to ensure that they are each satisfied with the level of regulation in the other jurisdictions. Once agreement is reached, a common set of rules is agreed. This prevents the opportunity for regulatory arbitrage that might arise due to differences in levels of qualification or experience between each of the jurisdictions' 'home' rules.

The agreed rules for passporting arrangements cover the threshold licence requirements for fund operators and the allowable product features for a passportable fund. A 'passport' is issued by the home regulator on the understanding that all participating regulators agree to accept the operator with only very minimal approval in the host markets. The home regulator is responsible for licencing the provider and products comply both with the provider's home rules and the agreed passporting rules. Once passport approval is received from the home regulator, the provider is free to operate in the other participating jurisdiction with only a streamlined or minimal approval process required by each host regulator.

Australian examples of mutual recognition

New Zealand

Australia and New Zealand established mutual recognition of fund product offer documentation in 2008 under the 'Trans-Tasman mutual recognition scheme'.¹⁵ The aim of the scheme is

... to remove unnecessary regulatory barriers to trans-Tasman financial product offerings and reduce costs of capital raising in both Australia and New Zealand. At the same time the scheme maintains investor protection through appropriate disclosure and supervision of offerings.¹⁶

This arrangement has been largely facilitated by the regulatory similarities between Australia and New Zealand. It provides for a wide variety of products to be offered with only minimal entry and ongoing requirements in the host jurisdiction. While the regime has been successful,¹⁷ it is difficult to extrapolate from this example to mutual recognition agreements between Australia and other Asian jurisdictions, due to the regulatory similarities that exist between New Zealand and Australia, and existing close economic ties.

Hong Kong

Australia and Hong Kong established a mutual recognition agreement to overcome regulatory incompatibility issues in 2008.¹⁸ It is based on broad equivalence between the Australian and Hong Kong regulatory regimes.

Despite this agreement covering retail fund offerings, little cross-border activity appears to have occurred between Hong Kong and Australia through the arrangement.

It is unclear why this regime has not been successful. Hong Kong's positioning predominantly as a fund distribution centre into China may mean it is not an attractive retail market in and of itself for Australian fund manufacturers. Alternatively, the lack of a tax treaty with Hong Kong may mean that investors do not have sufficient certainty to be able to invest into Australian domiciled funds. There may be additional factors but this failure certainly warrants further investigation.

Regulatory equivalence

ASIC has established a general 'regulatory equivalence' program that allows foreign managers to apply for recognition of the licence they hold in their home jurisdiction.¹⁹ ASIC has also developed principles for cross-border financial services regulation which provide guidance for operators seeking to gain regulatory equivalence between their home jurisdiction and Australia's regulatory regime.²⁰

This approach is different from mutual recognition as it does not require involvement of the host regulator. If ASIC deems the manager's home regulations to have a requisite level of regulatory equivalence then it will recognise the home licence and allow the licensee to provide services to Australian wholesale investors, regardless of whether Australian operators have been granted reciprocal access to investors in that market.

Mutual recognition between China and Hong Kong

Arrangements for the mutual recognition of investment funds between China and Hong Kong commenced on 1 July 2015.²¹ Under the regime, a Hong Kong domiciled fund that is authorised by the Hong Kong Securities and Futures Commission (SFC) will be able to benefit from a streamlined approval program by the CSRC.²² While there is still a level of sign-off or authorisation required by the host jurisdiction, mutual recognition will remove the need for Hong Kong operators to establish a duplicate business in China. This regime is expected to have a significant impact on the take-up of investment fund products by Chinese investors due to their ability to access a wider range of fund products coming out of the well-established Hong Kong market.

The importance of the China and Hong Kong mutual recognition scheme should not be underestimated, despite the apparent absence of an immediate or direct benefit to Australia. China's track record with existing schemes (Qualified Foreign Institutional Investor, Renminbi-Qualified Foreign Institutional Investor and Renminbi convertibility) shows a genuine appetite to experiment and expand successful programs. If the China and Hong Kong mutual recognition plans are well received there is clear potential for other countries to seek to participate, or to have similar bilateral arrangements established.

Australia and China's relationship has been further strengthened through the recent China-Australia Free Trade Agreement (ChAFTA) agreement. As described earlier, this agreement provides a starting point for liberalisation of financial services trade between the two countries. Australia could be well placed if China begins to expand the Hong Kong mutual recognition agreement to other countries and regulators should begin discussions on this topic through the ChAFTA framework.

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Fund passporting in the Asia region

There are two passporting regimes currently being developed in the Asia region.

The passporting schemes have been modelled on the European Union's Undertaking for Collective Investment in Transferrable Securities (UCITS) directive that was first established in the EU in 1985.²³ UCITS offers a similar structure whereby funds licenced in one country can be marketed to investors in any other country in Europe.

Importantly, the rules for passporting under both regimes only extend to the production of investment funds (manufacture), they do not extend to distribution of these products. Depending on the host country requirements it may still be necessary for the operator to either become licenced to sell fund products in the host jurisdiction or to establish a commercial relationship with another entity that does. Further, under both regimes it is expected that a fund offered into a host jurisdiction will meet that host's relevant local consumer protection and product disclosure rules.

ASEAN Collective Investment Scheme passport

An ASEAN passport scheme was initiated between Singapore, Malaysia and Thailand and has been operational since the *Handbook for CIS Operators of ASEAN CISs* was published on 25 August 2014.²⁴ The *Standards of Qualifying ASEAN CIS* prescribes the standards for fund operators and product specifications for funds.²⁵ Only a small number of funds have been registered to date.

The ASEAN regime operates on the basis of a mutually agreed framework of rules applying to both the fund operator and the product. The rules are highly prescriptive and, in areas of regulation such as 'years of experience', they create a higher threshold level than that of participating jurisdictions.

Asia Region Funds Passport

There is also an Asia Region Funds Passport currently being developed by the APEC Finance Ministers that is expected to be implemented in early 2017.²⁶ Parties to this scheme are Australia, New Zealand, Japan, South Korea, the Philippines and Thailand. Singapore has been heavily involved in the scheme's development but is yet to sign on.

Like the ASEAN regime, the APEC passport will have an agreed set of rules to set a base level which is higher than that of individual jurisdictions. Draft APEC passport rules show the concept to be largely similar to the ASEAN regime in approach and level of prescription for fund operators.

For investors from participating jurisdictions the APEC passport would create relatively instant access to a wide range of investment products, resulting in more options to diversify investment exposure and greater competition to drive down investment management fees. Australian investors would likewise have access to more offshore investment options, which is essential for a growing pool of investment funds that has already outstripped its domestic stock market.

Research conducted by the APEC policy unit in relation to the APEC passport notes that increasing access to a broader range of investment funds could result in significant savings for investors in the Asian region.²⁷ For investors from participating jurisdictions the APEC passport would create relatively instant access to a wide range of investment products, resulting in more options to diversify investment exposure and greater competition to drive down investment management fees. Australian investors would likewise have access to more offshore investment options, which is essential for a growing pool of investment funds that has already outstripped its domestic stock market.²⁸

Although Australia cannot participate in the ASEAN scheme, it is interesting to note the potential crossover of both Singapore and Thailand in both passporting regimes. Questions clearly emerge regarding the long-term viability of two similar passporting regimes with similar participants, and the potential for schemes to merge over time. Until the APEC passport is operational it is not possible to speculate with any certainty about the coexistence of these schemes in the future. However, the increasing trend of passporting shows a strong desire in the region for greater access to a broader range of products and a higher level of integration.

Conclusions

A key question for fund operators entering into passporting or mutual recognition arrangements will be how to successfully distribute products into a new market. While part of the benefit from both these mechanisms will be alleviating the need for a fully licensed local presence, it remains to be seen whether products can be successfully marketed without a presence in the local market. The large banks' dominance of distribution channels in most jurisdictions means that careful planning is needed for distribution to be successful. Distribution agreements with providers on the ground in new markets will be critical in reaching customers.

Australia has a strong funds management capability and there is likely to be some resistance or concern from foreign asset managers at the prospect of experienced competitors being allowed access to their market. From a regulatory perspective this needs to be balanced against the needs of consumers and the flow-on benefits of greater competition. These include lower fees and a more diverse range of product offerings which would benefit consumers of fund products in the region.

The product features desired by foreign investors may be different from those currently on offer in the Australian market, and vice versa. Fund operators will need to understand the demands of investors both in terms of risk-reward trade off and other product features. The decision on whether to pay commissions also has the potential to influence product design and pricing. Remaining competitive on price, yet offering an attractive investment product, will be a key success factor.

The social and cultural issues arising from operating in foreign markets also cannot be overlooked and may potentially be more challenging than the construction of an effective mutual recognition or passporting agreement. A fundamental understanding of the potential pitfalls of litigation and the different approach to legislative interpretation adopted by foreign courts is critical.

Digital technology is an area where potential cost savings and increased efficiency could result. If mutual recognition and passporting arrangements within the region are to fully prosper they must be implemented so that advances in digital technology can be leveraged. Smartphone technology such as fingerprint identification has the potential to solve customer identification issues that are currently plaguing a wider use of technology in funds management. Consumer protection against fraud and online 'scams' must remain paramount, however, and achieving an appropriate balance between protection and facilitation could enable increased access to a wider range of products. This would benefit customers and assist in further increasing competition between providers.

There are risks but, on balance, mutual recognition and passporting represent a considerable opportunity for Australian fund managers and their peers within the region. The growing pool of funds under management in Australia will be attractive to foreign managers with the requisite expertise to compete. The growth projections for Asia's middle class represent an opportunity that every investment management market in the world will be trying to access.

Over time it is likely that opportunities for convergence among these schemes will emerge. China's track record with existing schemes suggests that if the mutual recognition agreement progresses well, it may not limit itself to an agreement with Hong Kong. Further, Japan has not yet entered a regime and remains a significant market with the potential to generate interest from other jurisdictions if it does choose to engage. The actions of these two key economies will be critical in determining the future structure of cross-border trade within the region.

To be successful and prosper Australian funds management businesses will need to have an excellent understanding of the regulatory structure and cultural environment in which they will be operating. The winners will be those businesses able to translate this understanding into effective and efficient business practices that provide investors access to attractive investment products.

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Notes

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