



ASIC

Australian Securities & Investments Commission

REPORT 134

Enhancing capital flows into and out of Australia

July 2008

About this report

This report gives an update on the work the Australian Securities and Investments Commission (ASIC) has done, and proposes to do, to enhance capital flows into and out of Australia.

It also summarises findings from ASIC's external consultation on how to remove impediments to these capital flows.

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Document history

This paper was issued on 31 July 2008 and is based on the Corporations Act as at 31 July 2008.

Disclaimer

The proposals, explanations and examples in this report do not constitute legal advice. They are also at a preliminary stage only. ASIC or the Treasury's conclusions and views may change as a result of the comments we receive or as other circumstances change.

Copyright

Although this paper is copyright, publishers and other people may reproduce verbatim the words in this document in hard copy and/or in electronic format for sale or otherwise without asking for further permission from ASIC.

Contents

Executive summary	4
International capital flows: an ASIC priority	4
Benefits for business and investors.....	5
Current work to facilitate capital flows	5
Fact finding work.....	6
Future directions	6
Engaging with stakeholders.....	7
A Current work to facilitate capital flows	8
Mutual recognition with overseas jurisdictions	8
Review of the Australian Government's overall approach to recognition	10
ASIC guidance for foreign financial service businesses.....	11
Continuing engagement in international fora.....	11
B Results of fact finding	13
External consultation	13
Economic analysis of capital flows	14
Overseas regulation review	15
C Future directions	16
Key issues	16
What we hope to achieve	17
Appendix 1: Summary of external consultation	18
Background.....	18
Summary of findings.....	19
Impediments to capital flows.....	20
Australia as a financial centre.....	23
Foreign jurisdictions of relevance	25
What ASIC can do to facilitate capital flows	25
Recent developments in Australian taxation of international transactions	26
Appendix 2: Results of economic analysis of capital flows	28
Capital flows into Australia.....	28
Australian investment abroad	30
Sovereign wealth funds (SWFs)	31
Opportunities and threats	33
Key terms	34
Related information	35

Executive summary

Key points

Enhancing capital flows into and out of Australia is a key ASIC priority.

We have completed significant work on this priority in 2007/08. In 2008/09, we will:

- review our current work program in light of any Australian Government initiatives; and
- continue to work collaboratively with the Australian Government and other relevant agencies in complementary projects designed to promote Australia as an international financial centre.

International capital flows: an ASIC priority

- 1 Although Australians and their funds managers are increasingly investing in overseas markets to diversify, Australia is overall a substantial net importer of capital to expand the capital markets in Australia.
- 2 Against this background, the priorities for the 2007/08 financial year outlined by ASIC Chairman Mr Tony D'Aloisio to the Senate on 30 May 2007 included:

to improve what ASIC can do to facilitate inward and outward investment in Australia's capital markets. As an importer of capital and now with more of our investments going overseas, it is important to ensure there are only the necessary minimum roadblocks to investment flows, commensurate with adequate protection. This should facilitate both more liquid Australian markets and better access to offshore investment opportunities for Australia's investment pool, generating more competition, diversification and better overall returns for Australian investors.
- 3 This report summarises:
 - (a) our recognition work in the past financial year;
 - (b) fact finding we have done in the past year to inform our work going forward;
 - (c) how we plan to concentrate our resources for implementing this priority in the 2008/09 financial year.
- 4 We have also recently issued a joint consultation paper with Treasury: see Consultation Paper 98 *Cross border recognition: Facilitating access to overseas markets and financial services* (CP 98). While this report refers to CP 98, it does not seek to explore the same content or issues. The consultation period for feedback on CP 98 has now closed and ASIC and Treasury plan to make a statement about taking forward the results of that consultation.

Benefits for business and investors

- 5 Significant economic net benefits may arise from improving access between Australian markets and foreign markets and participants on those markets.
- 6 Open and efficient markets allow businesses to access capital as cheaply as possible and allocate it to businesses in the most efficient ways. This provides investors better returns on their capital for the risks involved.
- 7 Other things being equal, the larger the pool that investors can access, and the more capital available to businesses, the more liquid the market will be and the more efficiently returns will be allocated to investors and businesses. There will be more choice for investors and businesses and more competition, leading to a drive for further efficiencies.

Current work to facilitate capital flows

- 8 Some key recognition projects have commenced and/or come to fruition in the past year:
 - (a) We are in ongoing dialogue with the United States Securities and Exchange Commission (SEC) for the mutual recognition of exchanges and broker-dealer arrangements.
 - (b) We recently signed a declaration of mutual recognition with the Hong Kong Securities and Futures Commission (SFC) for the offer of managed investment schemes to retail investors in each other's jurisdictions.
 - (c) Together with Treasury, we have finalised a trans-Tasman mutual recognition scheme with New Zealand for disclosure documents for offers of securities or interests in managed investment schemes.
 - (d) Australia has been recognised as an approved destination for investments under China's Qualified Domestic Institutional Investor (QDII) scheme as administered by both the China Securities Regulatory Commission (CSRC) and the China Banking Regulatory Commission (CBRC).
 - (e) We are in discussion with the Monetary Authority of Singapore (MAS) to achieve recognition for the offer of managed investment schemes to retail clients in Singapore. ASIC has already recognised Singaporean schemes under ASIC Regulatory Guide 178 *Foreign collective investment schemes* (RG 178).
 - (f) As mentioned, we are reviewing with Treasury our overall approach to cross border recognition with the release of a joint consultation paper (see paragraphs 38 to 41).

- (g) ASIC continues to be significantly involved with the International Organization of Securities Commissions (IOSCO) to keep Australia at the forefront of recognition and cooperation discussions through our continued high standing in the forum (see paragraphs 43 to 50).
- (h) In the near future, ASIC will release a regulatory guide to help foreign businesses wishing to enter the Australian market (see paragraph 42).

9 Section A of this report summarises these projects.

Fact finding work

- 10 To provide an empirical basis for our decision making, we have done some significant fact finding work this year, including:
- (a) consultation with industry bodies and individual companies;
 - (b) technical legislative reviews to help us establish an indicative list of opportunities and impediments to inward and outward capital flows; and
 - (c) economic research to help identify key jurisdictions and inform us of current inflow and outflows against which to benchmark future achievements.
- 11 Section B and Appendixes 1 and 2 of this report summarise our findings.

Future directions

- 12 We will continue to work on finalising outstanding recognition projects in the coming year. In addition, based on our fact finding work, we will focus on the following three areas when targeting key jurisdictions:
- (a) maximising recognition arrangements (whether unilateral, bilateral or multilateral);
 - (b) maximising and enhancing our international cooperation arrangements; and
 - (c) working with other agencies to facilitate cross border financial services businesses (both into and out of Australia).
- 13 Section C of this report summarises these areas and related key issues.

Engaging with stakeholders

- 14 To ensure that our work has industry relevance, we are committed to working collaboratively with industry and professionals in implementing this priority. We invite your feedback on this report and our work in this area on an ongoing basis.
- 15 In our fact-finding work during the past year, we consulted with a wide range of industry representatives and interest groups including commercial banks, investment banks, fund managers, asset consultants, industry organisations and tax and legal firms and one government agency.
- 16 We have also maintained close and ongoing dialogue with industry representative bodies both for this project and more generally across a number of projects have emerged from the overall capital flows work.
- 17 We hope to continue this level of engagement with stakeholders going forward. This will include regular dialogue with industry bodies and special purpose dialogue with either industry bodies/representative groups or directly with industry participants or other interested stakeholder groups on an as-needs basis.

A Current work to facilitate capital flows

Key points

ASIC is currently working on projects with several key jurisdictions to facilitate capital flows both into and out of Australia.

These projects have included various forms of recognition agreements.

Treasury and ASIC are working to further enhance Australia's potential for recognition through the release of a joint consultation paper on 16 June 2008.

ASIC is separately soon releasing Regulatory Guide 121 *Doing financial services business in Australia* (RG 121), which will contain general guidance on whether a foreign participant may be required to hold an Australian financial services licence (AFSL).

Mutual recognition with overseas jurisdictions

United States Securities and Exchange Commission

- 18 In the US, the SEC announced in early 2008 that it would explore a limited agreement with one or more foreign regulatory counterparts that could provide a basis for the development of a more general approach to mutual recognition through rulemaking.
- 19 Prime Minister Kevin Rudd and Chairman Cox of the SEC announced in March 2008 the start of discussions that will lead to US and Australian securities exchanges and market participants being able to operate in each other's markets. ASIC and Treasury have been working to bring this important initiative to fruition.
- 20 The initiative has the potential to give Australian investors easier and cheaper access to a wider range of US securities through their Australian stockbrokers and to allow US broker-dealers to arrange trades by US retail investors in Australian listed stocks. Currently, such trades are confined to dual-listed Australian stocks.
- 21 This mutual recognition will bring benefits including increased liquidity in each market, lower transaction costs, a fostering of competition, and an increase in transaction efficiencies.
- 22 The proposal and subsequent agreement will be based on reciprocity.
- 23 It is not proposed at this time to extend recognition to unlisted foreign collective investment schemes nor would it include recognition of foreign prospectuses for fundraising purposes.

Hong Kong Securities and Futures Commission

- 24 ASIC signed a 'declaration of mutual recognition' with the Hong Kong SFC in July 2008 to facilitate the sale of retail managed funds to investors in each other's market.
- 25 The signing of the declaration means that Australian managed investment schemes (excluding hedge funds) are now able to seek authorisation in Hong Kong on the basis of streamlined authorisation and substantial deemed compliance with the Hong Kong regulatory regime for collective investments. This relief is based on substantive recognition of Australia's managed investments regime.
- 26 In return, Hong Kong collective investment schemes will get similar relief in the areas of product disclosure, prospectus, licensing and scheme registration when operating in Australia. The relief applies to funds where the SFC is the primary regulator of the fund (e.g. it does not apply to European funds recognised in Hong Kong).
- 27 This is the first time the SFC has entered into such an agreement with a foreign regulator. It will provide opportunities for Australian funds to directly access retail investors in Hong Kong and potentially access certain Chinese investment flows that are currently limited to Hong Kong funds.

New Zealand trans-Tasman recognition

- 28 A mutual recognition scheme for disclosure documents for offers of securities or interests in managed investment schemes was announced by Senator the Hon Nick Sherry and his NZ counterpart, Minister Dalziel, on 13 June 2008. This agreement will greatly reduce the cost of producing offer documents for both the Australian and New Zealand markets.
- 29 Under the mutual recognition scheme, entities from New Zealand can offer securities and interests in Australia on the basis of compliance with the NZ fundraising requirements. Australian entities can offer securities into New Zealand under the same terms. ASIC worked with Treasury in the design of this scheme and its regulations.
- 30 ASIC worked with the New Zealand Securities Commission (NZSC) to publish a joint guide on how the mutual recognition regime will operate in practice, *Regulatory Guide 190: Offering securities in New Zealand and Australia under mutual recognition*. It outlines how Australian issuers in New Zealand and vice versa are affected, and how ASIC and NZSC will work together. In addition, a protocol has been developed by ASIC and NZSC to address implementation of the regime. The New Zealand Companies Office (which has responsibility for registering company documents, including offer documents) is also a party to the protocol.

Qualified Domestic Institutional Investor Scheme (China)

- 31 The QDII scheme began in April 2006 as part of the Chinese Government's plan to liberalise China's capital markets and stimulate capital outflow. Targeted at Chinese individuals and institutional investors, this key financial program promotes and regulates the movement of Chinese financial investments offshore via approved Chinese intermediaries.
- 32 The CSRC confirmed in March 2008 that its existing memorandum of understanding with ASIC is sufficient for the purposes of recognising Australia as an investment destination under CSRC-issued QDII regulations.
- 33 The CBRC and ASIC accepted letters of exchange on 10 June 2008. This allows Australia to be recognised as an approved destination under the scheme as administered by the CBRC.
- 34 These arrangements mean that approved Chinese securities and banking institutions are eligible to invest in, on behalf of their clients, Australian listed companies and managed investment schemes registered by ASIC, as well as engage the services of Australian fund managers authorised by ASIC. This enables Australia to access some of the US \$42 billion that is currently administered under the QDII scheme.

Monetary Authority of Singapore

- 35 ASIC is in discussion with MAS on recognition by MAS for the sale of Australian managed investments to retail investors in Singapore.
- 36 This agreement would further expand the scope of funds that Australian retail investors could invest in to diversify portfolios. As with other recognition, the likely flow of capital between Australia and Singapore can only enhance the liquidity of the Australian market.
- 37 ASIC issued Class Order CO 07/753 *Singaporean collective investment schemes* under Regulatory Guide 178 *Foreign collective investment schemes* (RG 178) to provide certain relief to Singaporean managed investments schemes, authorised by MAS, entering the Australian market. The relief covers scheme registration requirements, AFSL requirements, and financial product disclosure requirements under the *Corporations Act 2001* (Corporations Act).

Review of the Australian Government's overall approach to recognition

- 38 On 16 June 2008, the Treasury and ASIC issued a joint consultation paper inviting comment on proposals for cross border recognition of financial markets, financial services and disclosure about investments: see

Consultation Paper 98 *Cross border recognition: Facilitating access to overseas markets and financial services* (CP 98) at www.asic.gov.au/CP.

- 39 The joint consultation paper contains proposals to:
- (a) refine ASIC's current framework of unilateral recognition as stated in ASIC Regulatory Guide 54 *Principles for cross border financial services regulation: Making the regulatory regime work in a cross border environment* (RG 54); and
 - (b) develop a mutual recognition framework for application in agreements between Australia and an overseas jurisdiction that ensures the integrity of financial markets and protects investors.
- 40 The comment period for this paper closed on 25 July 2008 and responses are currently being considered.
- 41 Treasury and ASIC will be releasing a statement outlining the next steps based on this consultation.

ASIC guidance for foreign financial service businesses

- 42 ASIC will shortly issue Regulatory Guide 121 *Doing financial services business in Australia* (RG 121). This guide will help foreign financial services providers understand Australia's financial services regime under the Corporations Act, including when the regime applies and what exemptions exist. This will help foreign businesses in their decision making about operating a financial services business in Australia.

Continuing engagement in international fora

- 43 ASIC continues to be held in high regard internationally for both our regulatory framework and our reputation as an effective regulator.
- 44 The International Organization for Securities Commissions (IOSCO) is recognised as the international standard setter for securities markets. IOSCO's wide membership regulates more than 90% of the world's securities markets and IOSCO is the world's most important international cooperative forum for securities regulatory agencies.
- 45 ASIC (through its predecessors) was a founding member of IOSCO. Since the early 80s, ASIC has held a number of prominent and influential positions across the various Committees of IOSCO, such as the Executive and Technical Committees and various Taskforces, in addition to membership of each of the five Standing Committees established under the Technical Committee.

- 46 ASIC was recently re-elected to the IOSCO Executive Committee, along with securities regulators from the US, UK, China, Japan, France, Germany and Italy. ASIC continues to be a member of the Technical Committee and once again was a founding member of this Committee.
- 47 The Executive Committee of IOSCO is the governing body where the strategic directions for IOSCO are set. The Technical Committee is made up of 15 agencies that regulate some of the world's larger, more developed and internationalised markets. Its objective is to review major regulatory issues related to international securities and futures transactions and to coordinate practical responses to these concerns.
- 48 The IOSCO Multilateral Memorandum of Understanding (MMOU) was initiated following the events of 11 September 2001, which underscored the importance of expanding cooperation among IOSCO members. The purpose of the MMOU is stated as:
- 'Desiring to provide one and other with the fullest mutual assistance possible to facilitate the performance of the functions with which they are entrusted within their respective jurisdictions to enforce or secure compliance with their laws and regulations...'*
- 49 ASIC was the second jurisdiction to apply to sign the MMOU and was in the first category of signatories. There are currently 48 IOSCO members that are full signatories to the MMOU with a further 15 applications pending. IOSCO aims to have all 109 members as signatories by 2010.
- 50 Through the networks and cooperation arrangements established at IOSCO and other fora such as the International Forum of Independent Audit Regulators, ASIC is well placed to discuss recognition and assistance with other jurisdictions.

B Results of fact finding

Key points

In October 2007 and April 2008, ASIC conducted two rounds of external consultation with financial market participants and industry bodies.

The Australian Government review of company taxation appears to have addressed a number of concerns raised by stakeholders in the initial consultation.

Stakeholders considered the US and Europe as the most important jurisdictions for capital flows with Asia being seen as having future potential.

There was support for the idea of Australia as a financial hub particularly in the area of funds management. This was seen as an Australian Government-led initiative with ASIC supporting where appropriate.

External consultation

- 51 ASIC has discussed impediments to international capital flows with 17 leading financial stakeholders, including commercial banks, investment banks, fund managers, asset consultants, finance industry organisations, tax and legal firms and one government agency.
- 52 As one would expect, there was a diversity of views and the views recounted should not be attributed to any individual or organisation. ASIC is grateful to the individuals and organisations consulted for sharing their perspectives on these important topics.
- 53 Stakeholders agreed on the key jurisdictions for current capital flows (i.e. the US and Europe) and made suggestions as to future sources of capital (centred in the Asian region).
- 54 There was also clear agreement among those consulted that the current Australian financial regulatory framework was among the most efficient in the world.
- 55 In both rounds of consultation, the stakeholders suggested that Australia should and could become a regional financial centre, particularly in view of expertise in the funds management industry in Australia. In the initial consultation, some consulted entities suggested that Australia should specialise in niche markets, such as hedge fund activity or resource stock trading and fundraising.
- 56 For more details on the findings of the external consultation, see Appendix 1 of this report.

Economic analysis of capital flows

- 57 The financial crisis that hit the world economy in the second half of 2007 has had a decisive impact on capital flows into and out of Australia. The sectors that suffered the strongest effects were banks and non-financial corporations, and there was considerable repatriation of capital across borders in the last two quarters of 2007.
- 58 Globalisation is intensifying. Increasingly capital investments are made across borders, giving rise to flows of capital and flows of income (interest and dividends) due on those investments. Among the categories of capital flows, the largest—and the most rapidly increasing—has been portfolio flows.
- 59 Over time there has been a decline in the participation of Australia's two main capital flows partners, the US and the UK with a strengthening of the capital flows from the rest of the world into Australia, suggesting that Australia is broadening its position as a global source and destination for capital flows.
- 60 Net flows of foreign investment into Australia grew at an average annual rate of approximately 16% during the period from 1992 through to 2007 (calendar years). However, net inflows have grown substantially in more recent years, from \$52.2 billion in 2001 to \$160.5 billion in 2006 (a growth of more than 200%, or over 20% per annum).
- 61 As a result of the global credit crisis, in the last quarter of 2007, banks registered a net outflow of foreign investment (a repatriation of \$9.3 billion), which followed an inflow of \$17.3 billion in the previous quarter. Private non-financial corporations saw a sharp decline in net inflows of investment from abroad in the last two quarters of 2007, down from \$17.9 billion in the September quarter to \$3.4 billion in the December quarter.
- 62 Since 1992, Australian investment abroad has also grown rapidly (around 14.7% per annum in average), increasing from \$7.3 billion in 1992 to \$107 billion in 2006.
- 63 The main destinations for net Australian investment abroad from 2001 and 2006 are the UK and US followed by Japan, New Zealand and Singapore, as individual countries. Cayman Islands also appears as an important destination for Australian investments.
- 64 Cross border investments and capital flows into and out of Australia are increasing. Portfolio flows out of Australia are increasing as more of the rising pool of superannuation savings is invested abroad. Portfolio flows into Australia are similarly increasing as foreign institutional savings are allocated to Australian assets and as Australian banks fund themselves with

capital sourced offshore. New sources continue to emerge, for example, the recent growth of sovereign wealth funds.

- 65 There are now few impediments to capital flows into or out of Australia. From an Australian perspective, the big issue was resolved in 1983 with the abolition of most capital controls at the time of the floating of the Australian dollar. Shifts in investor sentiment and in impediments affecting capital flows into and out of Australia will be reflected—with other influences—in moves in the exchange rate.
- 66 In view of the global credit crisis, which has resulted from problems of excess leverage originally in the US sub-prime mortgage market, a careful watch needs to be maintained on factors that might impede capital flows.
- 67 Greater detail is provided in Appendix 2 of this report.

Overseas regulation review

- 68 The technical research for our fact finding work in this area focused on securities and financial services regulation in the US, UK and Japan. In particular, we looked at identifying any areas where streamlining of recognition arrangements might be possible.
- 69 While some areas of actual or potential relief were identified in the selected legislative frameworks, in general, Australian offerors of financial products or services must comply fully with overseas regulatory requirements.
- 70 There is greater potential for recognition available in the area of financial reporting which is a result of Australia adopting International Financial Reporting Standards (IFRS).
- 71 Recognition of futures exchanges is another area where there is a greater level of acceptance. However there is little or no scope for recognition of prospectuses or capital raising documents.
- 72 Overall the jurisdictions reviewed do not have many existing frameworks to make any recognition arrangements. The European Union (EU) is, however, working towards recognition of third country auditors and there is potentially some recognition possible with the Commodities and Futures Trading Commission in the United States. Further, as discussed, in paragraphs 18 to 23, ASIC and Treasury are in mutual recognition discussions with the US SEC.

C Future directions

Key points

ASIC has identified three areas within our scope that would most contribute to increasing the ability for investment both into and out of Australia:

- maximising recognition arrangements (whether unilateral, bilateral or multilateral);
- maximising and enhancing international cooperation arrangements; and
- facilitating cross border financial services businesses (in and out of Australia).

We will focus on these areas when targeting key jurisdictions.

Key issues

- 73 We will continue to work on finalising existing projects, including our ongoing work with the SEC and MAS. We expect the results of the joint ASIC and Treasury consultation paper on cross border recognition to further shape our work on facilitating capital flows.
- 74 Table 1 summarises key issues and desired outcomes we have identified to help us design strategic directions and potential projects.

Table 1: Key issues in 2008/09

Problem to be addressed	Desired outcomes
Retaining the right balance between facilitating access to our markets and maintaining consumer protection and market integrity.	Jurisdictions are targeted for factors including liquidity and their own strong consumer protection and market integrity focus.
Encouraging greater liquidity and diversification of investments.	Increased investment into Australia (new areas/countries/markets) and increased export of Australian investment.
Reducing compliance costs for companies and investors stemming from competition, reductions in duplication and transaction efficiencies.	More cooperative arrangements with industry to ensure costs are being reduced and passed on to investors.
Improving international cooperation—quicker and more effective flows of information between regulators leading to an increased confidence in the Australian market.	Increased cooperation with overseas and domestic agencies—working together on foreign applications and transactions.

What we hope to achieve

75 Table 2 summarises where we plan to focus our attention in the coming year based on information gathered in our fact finding work.

Table 2: Key areas of focus in 2008/09

What we want to achieve	How we will do this
Actively maximise recognition of foreign markets/regimes.	<ul style="list-style-type: none"> • Continue to pursue recognition opportunities with key jurisdictions across a range of areas. Areas that will be considered include: product issuers, markets, mergers and acquisitions, auditor registration and collective investment schemes. • Work with Australian Government and other agencies to use a mix of multilateral, bilateral or unilateral recognition after determining what is best in the circumstances. • Complete the review of existing ASIC policy on cross border recognition (see the joint Treasury/ASIC consultation paper at paragraph 38).
Modernise and maximise international supervision and enforcement cooperation.	<ul style="list-style-type: none"> • Look at ways to improve on international supervision and enforcement cooperation relationships and capabilities (this could include potential law reform proposals to assist ASIC collect and share information with international regulators). • Build and develop enhanced cooperation with a range of jurisdictions where there are current significant capital flows and emerging flows (eg within Asia). • Consider with our regulatory counterparts how to deal with and monitor new technologies that are being used to facilitate cross border fraud. • Review our current Memorandums of Understanding (MOUs) and other recognition agreements with foreign regulators, enhance where necessary and develop an ASIC policy to make the best use of current and future MOU agreements. • Continue high-level technical assistance to foreign regulators as part of a long-term commitment to support quality cooperation arrangements between and among securities regulators going forward.
Make it easier to establish a financial services business in Australia and in foreign markets.	<ul style="list-style-type: none"> • Explore ways to work with other Australian agencies to promote contact points and provide assistance to foreign financial services business wishing to enter Australia. • Work with other Australian agencies to help foreign agencies to consider authorisation requests by Australian financial services businesses wishing to expand.

Appendix 1: Summary of external consultation

Key points

In October 2007 and April 2008, ASIC conducted two rounds of external consultation with financial market participants and industry bodies.

In general, Australia was seen to have an advanced and flexible regulatory regime compared to most overseas jurisdictions. While stakeholders saw no significant regulatory barriers for financial flows into and out of Australia in the wholesale sector, some hindrances were noted in the retail segment.

The US and Europe were seen as the most important jurisdictions for capital market interchange with Australia, with Asia having great future potential (as well as being a competitor).

The continuing hiatus in global debt markets was presumed by all to be a temporary interruption, albeit one with serious consequences and no early end in sight.

Recommendations for action included doing more to promote Australia as an international financial centre, having ASIC or another body act as a single point of entry for foreign firms seeking to do business in Australia, and increasing MOUs and/or recognition agreements between regulators in Australia and developed financial markets.

Note: The views presented in this appendix were not shared by all consulted, nor are they necessarily shared by ASIC.

Background

- 76 In October 2007 and April 2008, ASIC conducted two rounds of external consultation with financial market participants and industry bodies. Our objectives were to:
- (a) obtain first-hand information on financial capital flows into and out of Australia; and
 - (b) learn more from practitioners about facilitators of and barriers to cross border capital flows.
- 77 Overall, we consulted 17 leading financial stakeholders including commercial banks, investment banks, fund managers, asset consultants, industry organisations and tax and legal firms as well as one government agency.
- 78 In particular, we wanted to find out what ASIC could do (within our remit) to facilitate capital flows. Inbound and outbound flows have grown strongly over the past decades and are likely to be even more important in the future. They provide access to foreign savings, liquidity to local financial markets and diversification to domestic and foreign investors, assisting Australia's financial and economic growth.

79 The October 2007 round of consultation was an initial opportunity to learn about the issues that financial market participants and industry bodies consider most important in facilitating and promoting cross border flows. The April 2008 round of consultation reinforced and expanded on a number of topics. It also provided valuable new information and ideas in response to new developments since the first consultation (e.g. the prospect of some changes in tax regulations in Australia and the effect of the spread of the global liquidity crisis).

Summary of findings

80 Table 3 summarises the key findings of the external consultation. These topics are explored in more detail under specific headings in this appendix.

Table 3: Key findings of external consultation

Topic	Findings
Impediments to capital flows	<ul style="list-style-type: none"> • There were seen to be many types of impediments to capital flows into and out of Australia, involving market, regulatory and geographical factors. • Market factors often related to investor attitudes and strategies. • The regulatory barriers cited by the consulted entities mostly related to the local tax framework. The few non-tax-related regulatory barriers cited applied to retail services, in particular funds management. • Geographical factors related to the distance and the time difference between Australia and major financial centres in the US and Europe. • The continuing hiatus in global debt markets was presumed to be a temporary interruption, albeit one with serious consequences and no early end in sight.
Australia as a financial centre	<ul style="list-style-type: none"> • In general, Australia was seen to have an advanced and flexible regulatory regime compared to most overseas jurisdictions. The Australian framework was seen as one of the most capital flow friendly in the world. By comparison, the US and Japanese regimes were cited as comparatively more onerous. • From the domestic point of view, there were no significant regulatory barriers for financial flows into and out of Australia in the wholesale sector. Banks and large corporations, in particular, already have easy access to overseas markets. • Hindrances exist, however, in the retail segment. Specifically, there are barriers for foreign institutions seeking access to the Australian pool of retail funds and for domestic institutions to reach overseas retail markets. Most institutions consulted thought these barriers (e.g. licensing and disclosure requirements) serve useful purposes. Nevertheless, they identified the need for more openness across retail markets, provided this is achieved by sensible mutual agreements between Australia and carefully selected developed markets. • Despite its less onerous regulatory framework and relatively open borders, and its well developed domestic financial and funds management sector, Australia was seen to have made limited progress establishing itself as a major exporter of financial services. Nor was it seen as a leading clearing house for specific financial market niches. The reasons for this limited progress, according to the consulted entities, are the absence of a concerted effort to promote Australia as a financial centre and high tax rates compared to rival jurisdictions.

Topic	Findings
Foreign jurisdictions of relevance	<ul style="list-style-type: none"> • There was near unanimity in selecting the US and Europe as the most important jurisdictions for capital market interchange with Australia. Asia was seen as having great future potential, especially China and India. Singapore and Hong Kong were seen as very well established financial centres and as offering opportunities for Australian firms. However, these two jurisdictions were also seen as Australia's competitors, especially if Australia is to become a financial centre of some nature. • Japan is seen as a jurisdiction of somewhat lesser importance in terms of cross border portfolio flows with Australia (though not necessarily in direct investment). This was in part a consequence of the more onerous Japanese regulatory framework, with rules encumbering foreign portfolio investment. In addition, the Japanese retail investor was found by some to also maintain a 'home bias'.
What ASIC can do to facilitate cross border flows	<ul style="list-style-type: none"> • Most recommendations centred on the idea of promoting Australia as an international financial centre, at least in specific market niches such as structured credit, hedge funds or resource stocks. However, there was strong consensus that such an initiative had to be championed by the Australian Government itself and involve all relevant agencies. • There were also calls for ASIC or another nominated body to act as a single point of entry for foreign firms seeking to do business in Australia. One proposed measure was to issue publications to help overseas businesses set up operations in Australia. Another was to enhance the financial sector licensing regime in terms of speed and transparency. • Stakeholders also suggested an increase in the number of MOUs, or other recognition agreements, between regulators in Australia and developed financial markets. These agreements, however, should be carefully thought out and involve a strong element of reciprocity.

Impediments to capital flows

Market factors

- 81 Banks and large corporations generally can move financial capital across borders without substantial hurdles. This ease relates mostly to raising capital from wholesale sources. Managed funds, on the other hand, often face substantial regulatory barriers to access retail customers in most foreign jurisdictions. Some Australian fund managers bypass these hurdles by establishing funds in foreign jurisdictions of interest and duplicating structures and investment strategies. This is a costly and inefficient way to access overseas markets.
- 82 Compounding this, there appears to be weak demand from overseas retail investors for Australian assets. Australia was still a small component of global financial markets, and overseas investors do not see much scope to use Australian assets to diversify or hedge their positions in larger markets.

- 83 In some instances, the pool of local assets is not deep enough to warrant greater interest from investors. Domestic debt markets are a case in point. Low issuance over past years has resulted in a small and shallow market in Australian Government paper. In addition, the absence of inflation-linked bonds had also contributed to a small and dwindling market. Corporate and asset-backed debt issuance has grown in the past years to partially offset the decline in Government securities outstanding. But these markets were negatively affected by the higher cost of funding resulting from the global credit crisis, and have yet to fully recover.
- 84 The Australian dollar is also not seen as a currency to which most investors would like substantial exposure (especially Asian central banks and some sovereign wealth funds).
- 85 Australian retail investors display a high degree of ‘home-bias’—a weighting of local assets in Australian investors’ total portfolios in excess of Australian assets’ share in global market capitalisation.¹ That means that Australian investors tend to forego the potential benefits of diversification across global markets. Some of this ‘home bias’ can be explained by the currency in which investors’ liabilities are expressed and by access to local news and information as well as familiarity with domestic markets and economy. (Other causes of Australian investors’ home bias are discussed under ‘Regulatory factors’.)

Regulatory factors

- 86 Part of the local investor ‘home-bias’ also stems from Australia’s company tax imputation system. Local residents who pay tax benefit from imputation tax credits from companies paying Australian company tax, which makes them more likely to concentrate their holdings domestically. In addition, foreign investors feel comparatively disadvantaged by not having access to imputation credits. This, according to consulted entities, was a relative disincentive for overseas portfolio investment in Australia.
- 87 Another major barrier to capital flows up until the first half of 2008 was the withholding tax regime, which was seen as too onerous and complex. However, entities consulted in April 2008 appeared to be rather less concerned with taxation issues than those consulted in October 2007. Presumably, this reflects the perception that the Australian Government is already considering changing withholding tax arrangements and reviewing

¹ Australia’s home bias can be gauged by the disproportional size of Australian markets relative to Australian investors’ holdings of local assets. For instance, Australian equity markets represented only 2.1% of global market capitalisation in the first half of 2008 (according to the World Federation of Stock Exchanges). In total absence of home bias, portfolio theory suggests the optimal allocation of Australian residents’ equity investment funds to be 2.1% to local markets, as this proportion represents the relative importance of Australia in global markets. However, Australian households held virtually all their directly held equity assets (99.5% in the March 2008 quarter, according to the ABS Financial Accounts) in Australian stocks.

- the CFC and FIF frameworks.² At the time of the first consultation, stakeholders felt a stronger need to bring these issues to the fore.
- 88 State stamp duties were also cited as a comparative disadvantage faced by local property funds reducing their attractiveness to foreign investors. The duty incurred on the sale of real estate assets discourages property trusts from re-balancing portfolios and changing investment strategies. Reportedly, this resulted in Australian funds being relatively inflexible in comparison to some of their counterparts operating in other tax jurisdictions.
- 89 High personal tax rates were also cited as limiting Australia's potential to become a regional financial hub. These rates, according to consulted entities, deter the establishment of hedge funds in Australia. By their very own nature, hedge funds often raise funds and operate in a global scale. Their physical domicile is often less important than for conventional funds. Presumably, hedge fund managers would prefer to avoid Australia's comparatively high personal tax rates and set up their operations in competitor jurisdictions.
- 90 'Home bias' is also reinforced by local investors' uncertainty regarding dispute resolution and access to remedies overseas. (This barrier could be mitigated through MOUs, or other recognition agreements with foreign jurisdictions.)
- 91 Some consulted entities see the transportability of pension funds into Australia as cumbersome. Reportedly, it is difficult for foreign investors to transfer retirement balances into Australia without incurring significant administrative costs and tax liabilities. The problem is especially acute for those with UK pensions. This is a significant barrier for greater integration between the Australian superannuation industry and its foreign counterparts, and is also an impediment to bringing international business executives (with their retirement savings) to Australia.
- 92 Another factor potentially reducing the attractiveness of investing in Australia is the limitation that a consolidated group can only acquire up to 20% of a domestic company's stock without having to initiate a formal takeover process. This, according to consulted entities, discouraged large overseas funds from greater investment in local share markets. The so-called creep provision—allowing an additional 3% to be acquired per annum above the aforementioned limit without triggering takeover clauses—does little to mitigate this restriction. Some consulted entities suggested that the threshold should be lifted to 30%.

² On 19 May 2008, the Australian Board of Taxation released a paper *Review of the Foreign Source Income Anti-Tax-Deferral Regimes* (the issues paper) as the next step in its review of the foreign source income (FSI) anti-tax-deferral rules. The issues paper was in response to a request made by the Australian Government in October 2006 to review the controlled foreign company (CFC), foreign investment fund (FIF), transferor trust and deemed present entitlement regimes. The aim of the review was to enhance Australia's international competitiveness by reducing the complexity and costs associated with these regimes. So far, the review has produced amendments to the capital gains tax regime and a reduction of the withholding tax rate from 30% to 7.5% for managed funds. The issues paper proposes further enhancements. For more information about this review and the tax changes, see paragraphs 113-118 of this report.

Geographical factors

- 93 Some consulted entities suggested that the distance and the time difference between Australia and major financial centres in the US and Europe were hindrances to further integration and stronger capital flows. However, they also create advantages and opportunities and in any event have to be worked around.

Australia as a financial centre

- 94 In both rounds of consultations, stakeholders suggested that Australia should do more to become a regional financial centre. Some consulted entities suggested that Australia should specialise in niche markets, such as structured finance products, hedge fund activity or resource stock trading and capital raising.
- 95 There was a widespread view that Australia needed to harmonise its requirements with that of overseas jurisdictions to further integrate with the global financial system. This should happen both unilaterally (e.g. adjusting to the EU's Markets in Financial Instruments Directive (MiFID) standards) and through MOUs or other recognition agreements.

Promoting Australia as a financial centre

- 96 All consulted entities agreed that Australia could only establish itself as a financial centre if there was a concerted effort across all levels of government to iron out some regulatory issues and promote the country overseas. In October 2007, there were suggestions that ASIC should lead this effort. In contrast, the latest consultation made it clear that stakeholders see a strong need for sponsorship from the Australian Government.
- 97 The Australian licensing regime is internationally recognised as good regulatory practice. The possession of an AFSL is a 'selling point' that locally licensed hedge funds use to raise capital overseas. According to stakeholders, funds that are licensed and regulated in Australia are more likely to be seen as having sound internal checks and balances. Australia could use this perception in a more systematic manner to promote itself as a regional hub.
- 98 In addition, Australia is perceived as an attractive market for foreign fund managers due to the growing pool of superannuation funds. Australian financial markets are becoming more international, mainly as a result of the large volume of investment funds chasing too few local opportunities.
- 99 The domestic fund management industry is also seen as sophisticated by their international counterparts. However, the potential to export services and expertise to overseas markets has to date been frustrated mostly by tax burdens.

Harmonisation of regulatory regimes and bilateral agreements

- 100 There were suggestions from consulted entities that ASIC should promote the harmonisation of the local regulatory framework with Europe's MiFID, which may become a defacto global standard. This would lower product design and distribution costs for entities operating in both Europe and Australia.
- 101 Most consulted entities saw a strong case for an increase in the number of MOUs or other recognition agreements between regulators in Australia and in jurisdictions with developed financial markets. By clarifying issues surrounding oversight and conflict resolution, these agreements are likely to reduce 'home bias' from both sides and stimulate cross-investment.
- 102 However, several stakeholders commented that the MOUs, and/or recognition agreements Australia has signed with foreign jurisdictions to date have not been sufficiently reciprocal. The perception was that Australia had made concessions facilitating foreign access to Australian markets without obtaining the equivalent access for Australians to foreign markets.

Sovereign wealth funds (SWFs)

- 103 Given the large and growing size of funds under management, SWFs are believed to have affected pricing and flows into many global markets.³ However, the consulted stakeholders did not see the behaviour of these funds as being significantly different from large commercial investors.
- 104 There was an expectation among some stakeholders that SWFs were poised to invest more heavily in Australia. Middle Eastern SWFs did not restrict their investment to Sharia law-compliant investments, though Islamic finance is gaining prominence across the globe.

The credit crunch and the market turmoil

- 105 The second consultation took place after a period of increased market turmoil. The global credit crunch had significantly changed access to funds especially for those entities that operated in the structured credit market. Almost all consulted entities stated that cross border capital flows associated with debt financing had been negatively affected. In particular, structured credit funding had completely dried up.
- 106 Despite this, most entities agreed that the current scarcity of liquidity in structured credit markets was a temporary phenomenon, not a structural shift to a permanently different pattern of cross border capital and investment flows.

³ There is no precise gauge of the size of global sovereign wealth funds. However, some estimates suggest these funds may have held up to US\$4 trillion in assets in 2007. Growth in assets has been rapid; and projections suggest total assets under management could reach US\$12 trillion by 2015. For more information about these funds, see paragraphs 136 to 138 of this report.

Foreign jurisdictions of relevance

- 107 US and Europe are the most important jurisdictions for financial market interchange with Australia. Asia was seen as having great future potential, especially China and India. Singapore and Hong Kong were seen as very well established financial centres and as offering opportunities for Australian firms. However, these two jurisdictions were also seen as Australia's competitors in the global scenario, especially if Australia is to become a regional financial hub of some nature.
- 108 Despite its size and speed of growth, China is still regarded as a very difficult market to operate in. The reasons for this range from language barriers to multiple regional regulatory frameworks. Most consulted entities had plans to expand their operations in China (or to help their clients do so), albeit in the medium to long term. The short-term focus still appeared to be the vast business potential presented by the US, Europe, Hong Kong and Singapore.
- 109 Japan is seen as a jurisdiction of lesser importance in terms of portfolio financial flows with Australia. This was in part a consequence of the strict Japanese regulatory framework, which impedes foreign portfolio investment. In addition, the Japanese retail investor displays a preference or 'home bias' in their investment choices.
- 110 For the hedge fund industry, Japan is perceived as a difficult jurisdiction in which to raise capital, because of language barriers and the strict local securities laws. Hong Kong and Singapore are the jurisdictions most commonly used by local hedge funds when raising capital overseas.
- 111 Dublin is now becoming a noteworthy funds management hub, using funds from UK and European investors. Irish funds are designing and distributing tailor-made products for these particular investors.

What ASIC can do to facilitate capital flows

- 112 Table 4 summarises the main proposals from consulted entities about suggested steps ASIC could take to facilitate cross border capital flows.

Table 4: Suggested steps ASIC could take

Area	What ASIC could do
Act as a single point of reference	<ul style="list-style-type: none"> Act and promote itself as a single point of reference and consultation for overseas investors willing to do business in Australia. Set up a permanent facility foreign businesses and investors could contact for information and assistance before setting up operations in Australia. Produce simple publications targeted at overseas users explaining how to do business in Australia. One example was a regulatory guide or fact sheet on licensing for wholesale clients, which would be useful for foreign funds wanting to enter the Australian market.

Area	What ASIC could do
Promote Australia as a financial centre	<ul style="list-style-type: none"> Do what it can to promote closer cooperation across the four main Australian financial regulatory bodies—ASIC, APRA, ATO and RBA—with the view to promote Australia as a ‘niche’ financial centre. This inter-agency cooperation, however, would only be effective with a strong sponsorship of the Australian Government. ASIC should notify the Treasury about the need for this support.
Pursue bilateral agreements	<ul style="list-style-type: none"> Increase the number of MOUs or other recognition agreements with foreign jurisdictions with developed financial markets. Promote cross-investment via facilitating interchange in retail markets. Seek to incorporate a strong element of reciprocity in future MOUs or other recognition agreements. Engage in talks with the UK’s Financial Services Authority and German financial regulator Bafin to discuss ‘passporting’ relief for Australian funds managers seeking to access wholesale and retail funds in Europe and the UK. Seek recognition of Australian standards in the US to facilitate debt issuance, and seek to have the US’s rule 144A exemption extended to direct offerings from Australian entities.
Change local regulation and practices	<ul style="list-style-type: none"> Administer the financial services regime to maximise recognition of global compliance practices. For instance, ASIC could harmonise the local regulatory framework with Europe’s MiFID. Recognise (even if unilaterally) prospectuses from key jurisdictions. Improve transparency and communication on authorisation of AFSLs (i.e. better guidance as to what really matters for successful applications). Provide applicants with ex-ante assistance to facilitate the application process and to give continuous feedback on the progress of applications to allow for planning. Inform Treasury about the need for further review of prevailing tax regulations.
Foster international recognition and promote regulatory standards	<ul style="list-style-type: none"> Promote the merits of the Australian managed investment scheme (MIS) regime to regulators in Asian markets such as Singapore and Malaysia, where jurisdiction requires the separate trustee/manager model. The Australian approach has managed to mitigate conflict of interest and allow for more cost efficient MIS structures. Obtain recognition for Australian collective investment schemes in Hong Kong. Work to have Australia recognised under China’s QDII scheme. Promote principles-based regulation in Asia.

Recent developments in Australian taxation of international transactions

- 113 Recent changes in tax requirements are likely to affect cross border capital flows into and out of Australia.

2008 Budget announcement

- 114 In the 2008 Budget, the Australian Government announced that it plans to change the withholding tax regime for payments from managed investment

trusts to non-resident investors. The tax rate will be reduced from 30% to 7.5% over a three-year implementation period.⁴

115 Under this measure, the lower rate of taxation will be limited to residents of countries with which Australia has effective exchange of information. It will enhance the integrity of the new cross border arrangements and reflect Australia's commitment to combating international tax avoidance and evasion.

Review of tax arrangements

116 On 10 October 2006, the Australian Government asked the Board of Taxation to undertake a review of the anti-tax-deferral regimes—that is, the controlled foreign company (CFC), foreign investment fund (FIF), transferor trust and deemed present entitlement regimes.

117 The objectives of this review were to:

- (a) reduce the complexity and compliance costs associated with anti-tax-deferral regimes including whether the current regimes can be collapsed into a single one, and
- (b) examine whether the anti-tax-deferral regimes strike an appropriate balance between effectively countering tax deferral and unnecessarily inhibiting Australia from competing in the global economy.

118 Significant improvements from this review include reducing the exposure of Australian corporations to Australian tax on foreign dividends, foreign branch profits and foreign capital gains. All of the changes (including the amendments to the capital gains tax regime, the recently announced 7.5% withholding tax rate for managed funds and the introduction of the conduit foreign income rules) seek to make Australia a more attractive destination for investment funds.

⁴ Australian Government, *Statement 1—Budget Overview*, May 2008, page 1-32.

Appendix 2: Results of economic analysis of capital flows

Key points

The financial crisis that hit the world economy in the second half of 2007 has had a decisive impact on capital flows into and out of Australia. The sectors suffering the strongest effects were banks and non-financial corporations. Considerable repatriation of capital across borders in the last two quarters of 2007 was recorded.

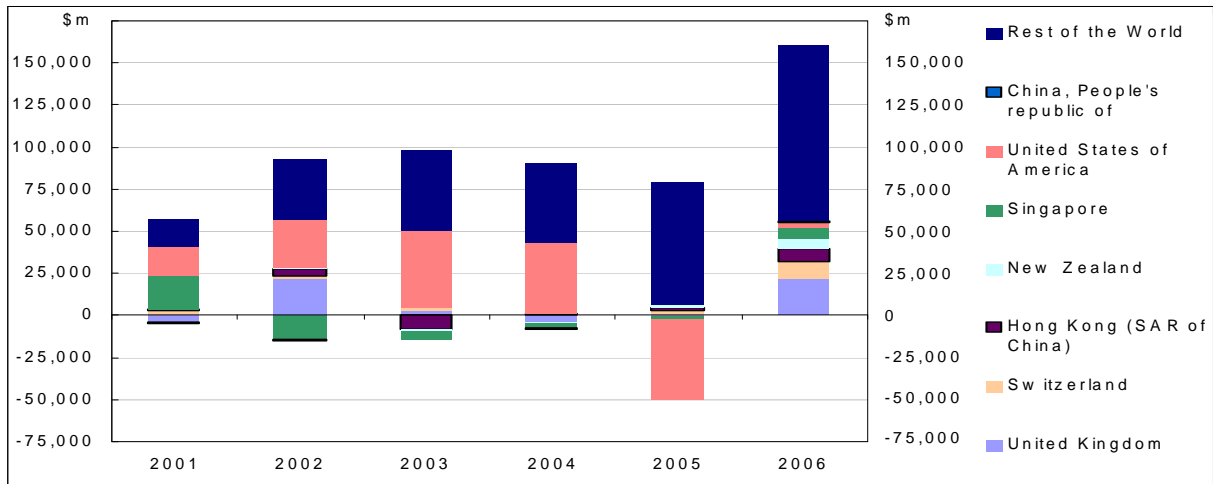
The latest Australian Bureau of Statistics (ABS) information on a country-by-country basis shows a decline in the participation of Australia's two main capital flows partners, the US and the UK, with a strengthening of capital flows from the rest of the world into Australia. This suggests that Australia is broadening its position as a global source and destination for capital flows.

Globalisation is intensifying. Increasingly, capital investments are made across borders, giving rise to flows of capital and flows of income (interest and dividends) due on those investments. Among the categories of capital flows, the largest—and the most rapidly increasing—has been portfolio flows.

Capital flows into Australia

- 119 Net flows of foreign investment into Australia grew at an average annual rate of approximately 16% during the period from 1992 through to 2007 (calendar years).
- 120 Net inflows have grown substantially in more recent years, from \$52.2 billion in 2001 to \$160.5 billion in 2006 (a growth of more than 200%, or over 20% per annum). However, the pace of growth has varied. In 2005, net inflows fell considerably (from net inflows of \$82.5 billion in 2004 down to net inflows of \$29.2 billion in 2005), largely as a result of the shift of domicile of News Corporation from Australia to the US. In 2006, net inflows picked up again, reaching \$160.5 billion for the calendar year, only to fall back again in 2007 to \$110.1 billion due to the effects of the global credit crisis in the second half of the year. In the first half of 2007, net inflows had totalled \$95.8 billion, but inflows fell to \$26.6 billion in the September quarter and turned to net outflows of \$12.3 billion in the December quarter.
- 121 Figure 1 depicts the foreign capital flows into Australia between 2001 and 2006 by country of origin. 2005 stands out as an anomaly as a result of the shift in domicile by News Corporation from Australia to the US.

Figure 1: Flows of foreign investment into Australia by country of origin – years ending 31 December (\$ millions)



Source: ABS Cat No 5352.0, International investment position, Australia: supplementary statistics, 2006, table 1.

122 As shown in Figure 1, the United States and the United Kingdom are the main sources of foreign investment flows into Australia, followed by New Zealand and some Asian countries, such as Hong Kong, China and Singapore. In 2006, however, net inflows from the US dropped considerably while inflows from the 'rest of the world' group rose substantially, suggesting that Australia has become a target for foreign investment on a worldwide basis. Data on net inflows by country for 2007 is not yet available, but we expect that the participation of the US will have remained subdued due to the global credit crisis.

123 Portfolio investment has increased its importance in terms of total net foreign investment inflows and, within portfolio investment, debt securities have been the most important, accounting for approximately 70% of net inflows in 2006 (\$111 billion), although falling back in 2007 to approximately 44% of total net foreign investment inflows to Australia (\$48.6 billion).

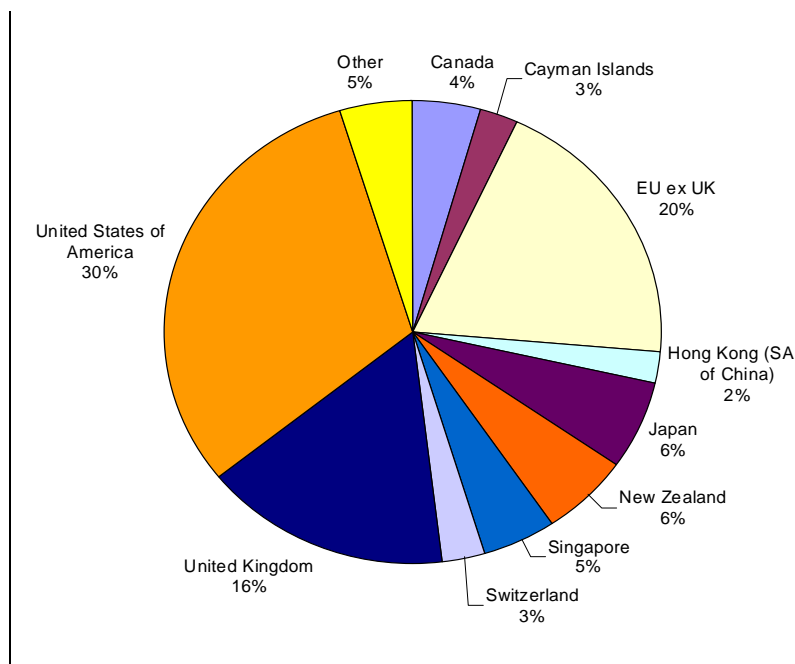
124 Banks, private non-financial corporations and financial intermediaries and auxiliaries have been the main recipients of net foreign investment inflows in Australia. They accounted, respectively, for 45%, 25% and 23% of the total \$165 billion of net inflows in 2006. The main instruments used by banks to attract foreign inflows were bonds (\$51.2 billion) and one name paper (\$30 billion) while private non-financial corporations used issuance of equity (\$29.1 billion) as well as bonds (\$7.7 billion).

125 As a result of the global credit crisis, in the last quarter of 2007, banks registered a net outflow of foreign investment (a repatriation of \$9.3 billion), which followed an inflow of \$17.3 billion in the previous quarter. Private non-financial corporations saw a sharp decline in net inflows of investment from abroad in the last two quarters of 2007, down from \$17.9 billion in the September quarter to \$3.4 billion in the December quarter.

Australian investment abroad

- 126 Since 1992, Australian investment abroad has also grown rapidly (around 14.7% per annum in average), increasing from \$7.3 billion in 1992 to \$107 billion in 2006. During periods of slower economic growth, for instance between 1997 and 2001, the growth in investment abroad was significantly stronger, running at an average growth per annum of 22.7%.
- 127 After 2001, net flows of Australian investment abroad have been more variable. Between 2001 and 2003, net outflows remained above \$38 billion per annum, but dropped to \$30 billion in 2004. In 2005, there was a net inflow due to Australian residents reducing their holdings of foreign assets of \$23.7 billion. Net outflows resumed in 2006, peaking at \$107 billion, but in 2007, the global credit crisis pushed down net outflows to around \$44.5 billion for the year.
- 128 2005 data on net flows of Australian investment abroad was distorted by the News Corporation shift in domicile. Net outflows resumed in 2006 but in 2007 the global credit crisis led to a reduction of Australian investment outflows during the third quarter of the year and to a repatriation of Australian investments abroad in the last quarter. In addition, the gross holdings of foreign reserve assets were reduced as banks closed out previous foreign currency swap agreements with the Reserve Bank of Australia (RBA).
- 129 Figure 2 shows the main destinations for net Australian investment abroad from 2001 and 2006. The UK and US are the most important single-country destinations followed by Japan, New Zealand and Singapore, as individual countries. Cayman Islands also appears to be an important destination for Australian investments.

Figure 2: Composition of Australian investment overseas—five years to 2006



Source: ABS Cat No 5352.0, International investment position, Australia, 2006.

- 130 Between 2001 and 2006, portfolio investment accounted for 35% of net flows of Australian investment abroad, direct investment 29%, financial derivatives 18%, other type of investments 11% and reserve assets 7%.
- 131 In 2005, there was a very strong repatriation of Australian direct investments abroad, probably linked with the shift of domicile of News Corporation to the US.
- 132 In the following two years, portfolio outflows rebounded, reaching \$58 billion in 2006 (approximately 50% of that was debt and 50% equity) and \$58 billion in 2007 (approximately two-thirds equity and one-third debt). This change in composition in portfolio investment flows reflects the effects of the credit crisis, which intensified during the last two quarters of 2007.
- 133 Looking closely at the last two quarters of 2007, the main sectors contributing to net Australian investment flows abroad were banks, private non-financial corporations, and pension funds and life insurance. Life insurance and pension funds were less severely affected by the global financial turmoil that occurred during that period and their net outflows remained at similar levels in both quarters.
- 134 On the other hand, both banks and private non-financial corporations were strongly affected by the credit crisis. In the September and December quarters, banks registered a net outflow of funds of \$8 billion and a net inflow (repatriation) of \$13 billion respectively. Currency and deposits, bonds and derivatives were the most affected instruments.
- 135 Private non-financial corporations also turned from net outflows of Australian investment abroad in the September quarter (\$16 billion) to a repatriation of Australian investments abroad in the subsequent quarter (\$3 billion). Equities were the main instrument affected.

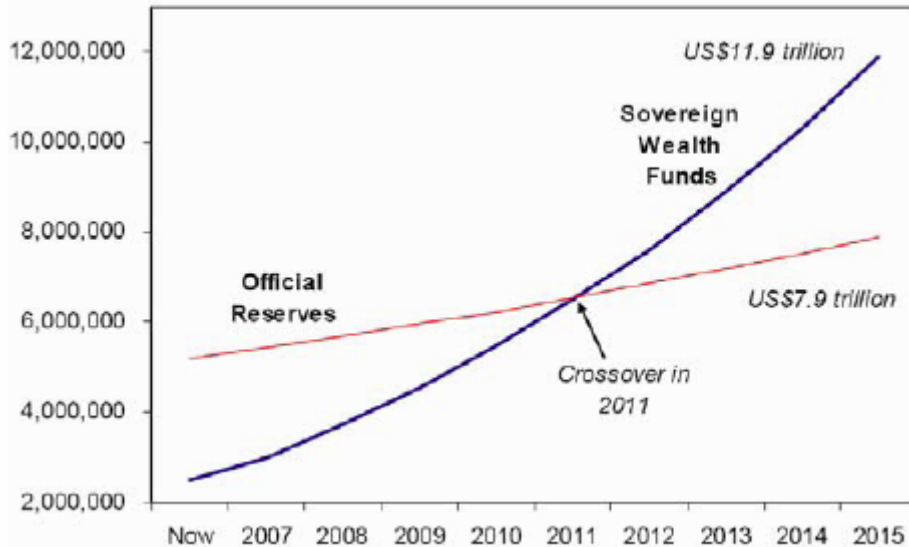
Sovereign wealth funds (SWFs)

- 136 The exact size of this sector is unknown, but estimates of total assets under management in sovereign wealth funds (SWFs) in 2007 vary from US\$2 trillion and US\$4 trillion for 2007.
- 137 The increasing importance of SWFs can be demonstrated by the growth of publicly recorded equity transactions. In 2007, there were US\$92 billion in publicly recorded transactions compared with just US\$3 billion in 2000. SWF publicly recorded equity transactions totalled US\$58 billion in the first quarter of 2008.⁵

⁵ Monitor Group, *Assessing the Risks—The Behaviours of Sovereign Wealth Funds in the Global Economy*, June 2008.

138 A recent study by Morgan Stanley estimated that the size of SWF assets could reach US\$12 trillion by 2015.⁶ This would exceed by far the estimated official reserves of US\$8 trillion: see Figure 3.

Figure 3: Projections for SWFs' assets under management



Source: Morgan Stanley

139 Table 5 lists the top 10 largest SWFs by assets under management. Most SWFs are building substantial foreign portfolios. Australia's Future Fund was ranked 11th in this study, with US\$50 billion assets under management.

Table 5: Top 10 largest SWFs

Country	Fund	AuM (US\$bn)	Start	Source
United Arab Emirates	Abu Dhabi Investment Authority (ADIA)	875	1976	Oil
Singapore	Government of Singapore Investment Corporation (GIC)	330	1981	Non-commodity
Norway	Government Pension Fund-Global (GPFGB)	322	1990	Oil
Saudi Arabia	Various funds	300	N/A	Oil
Kuwait	Kuwait Investment Authority (KIA)	250	1953	Oil
China	China Investment Company Ltd	200	2007	Non-commodity

⁶ IOSCO, *IOSCO Standing Committee No 5 on Investment Management—What role for IOSCO on Sovereign Wealth Funds?* 5 June 2008

Country	Fund	AuM (US\$bn)	Start	Source
Hong Kong	Hong Kong Monetary Authority Investment Portfolio	140	1998	Non-commodity
Russia	Stabilization Fund of the Russian Federation (SFRF)	127	2003	Oil
China	Central Hujin Investment Corp.	100	2003	Non-commodity
Singapore	Temasek Holdings	108	1974	Non-commodity

Source: IOSCO, *IOSCO Standing Committee No 5 on Investment Management—What role for IOSCO on Sovereign Wealth Funds?* 5 June 2008

Opportunities and threats

- 140 Cross border investments and capital flows into and out of Australia are increasing. Portfolio flows out of Australia are increasing as more of the rising pool of superannuation savings is invested abroad. Portfolio flows into Australia are similarly increasing as foreign institutional savings are allocated to Australian assets and as Australian banks fund themselves with capital sourced offshore. New sources continue to emerge, for example, with the recent growth of sovereign wealth funds.
- 141 There are now few impediments to capital flows into or out of Australia. From an Australian perspective, the big issue was resolved in 1983 with the abolition of most capital controls at the time of the floating of the Australian dollar. Shifts in investor sentiment and in impediments affecting capital flows into and out of Australia will be reflected—with other influences—in moves in the exchange rate. Australia continues to depend on net capital inflows to finance a substantial current account deficit reflecting an excess of fixed capital spending over domestic savings.
- 142 In view of the global credit crisis, which has resulted from problems of excess leverage originally in the US sub-prime mortgage market, a careful watch needs to be maintained on factors that might impede capital flows. Recently Iceland has faced capital flow problems that have threatened macroeconomic goals and other countries dependent on continued capital flows could expect to face international market scrutiny as global and/or local economic growth slows.

Key terms

Term	Meaning in this document
AFSL	Australian financial services licence
ASIC	Australian Securities and Investments Commission
CBRC	China Banking Regulatory Commission
CO 07/753 (for example)	An ASIC class order, in this example numbered 07/753
Corporations Act	<i>Corporations Act 2001</i> (Cth) in Australia including regulations made for the purposes of the Act
CP 98 (for example)	An ASIC consultation paper, in this example numbered 98
CSRC	China Securities Regulatory Commission
IFRS	International Financial Reporting Standards
IOSCO	International Organization of Securities Commissions
MAS	Monetary Authority of Singapore
MiFID	Markets in Financial Instruments Directive (MiFID) of the European Union
MIS	managed investment scheme
MMOU	IOSCO Multilateral Memorandum of Understanding
MOU	Memorandum of Understanding
NZSC	New Zealand Securities Commission
QDII scheme	Qualified Domestic Institutional Investor (QDII) scheme, which began in April 2006 as part of the Chinese government's plan to liberalise China's capital markets and stimulate capital outflow
RG 178 (for example)	An ASIC regulatory guide, in this example numbered 178
SEC	Securities Exchange Commission of the United States
SFC	Securities and Futures Commission of Hong Kong
SWF	sovereign wealth fund
Treasury	Australian Government Department of the Treasury

Related information

Headnotes

Capital flows, cross border regulation, financial services, overseas markets, international cooperation arrangements, regulatory barriers, unilateral recognition, mutual recognition, trans-Tasman recognition, economic analysis, external consultation, International Financial Reporting Standards (IFRS), sovereign wealth funds (SWFs)

Class orders

CO 07/753 *Singaporean collective investment schemes*

Regulatory guides

RG 54 *Principles for cross border financial services regulation: Making the regulatory regime work in a cross border environment*

RG 121 *Doing financial services business in Australia* (to be released)

RG 178 *Foreign collective investment schemes*

Legislation

Corporations Act 2001 (Cth)

Consultation papers and reports

CP 98 *Cross border recognition: Facilitating access to overseas markets and financial services*

Assessing the Risks—The Behaviours of Sovereign Wealth Funds in the Global Economy, Monitor Group, June 2008

Statement 1—Budget Overview, Australian Government, May 2008

Review of the Foreign Source Income Anti-Tax-Deferral Regimes, Australian Board of Taxation, May 2008

IOSCO Standing Committee No 5 on Investment Management—What role for IOSCO on Sovereign Wealth Funds? IOSCO, June 2008