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## 4 Measures affecting the finance sector

The structure and performance of the Australian finance sector (box 4.1) has long been shaped by a variety of government policy measures. Previous editions of *Trade & Assistance Review* have reported on some budgetary measures pertaining to the finance sector. Most recently, the 2007-08 *Review* reported the finance measures announced in response to the global financial crisis and economic downturn.

This chapter brings together the various budgetary measures relating to the finance sector and reports on the implementation and usage of support measures introduced during the financial crisis. It also notes key prudential and other financial services regulation applying to the sector. The aim is to provide a more comprehensive and contemporary view of government policy measures affecting the sector.

Some of the policy measures listed (such as superannuation support) are not aimed at helping the financial institutions directly but, as a result of second-round impacts of broader economic and social policies, can have significant implications for the demand for financial products and differential effects within the sector itself.

*Inclusion of a policy measure in this chapter as affording assistance, or having assistance implications, does not mean it is unwarranted or inappropriate.* As noted in chapter one, industry assistance measures can deliver net community benefits, particularly where targeted at recognised market failures or at achieving recognised social or equity goals. The primary purpose of listing, and where possible quantifying, them is to highlight the measures that shape the finance sector and to draw attention to some of the budgetary and other costs that need to be considered when assessing the community-wide impacts of the policy measures. In this respect, it is important to ensure that the costs of concessions and other policies are at least commensurate with the benefits they are intended to deliver.

### Box 4.1 Overview of the Australian finance sector

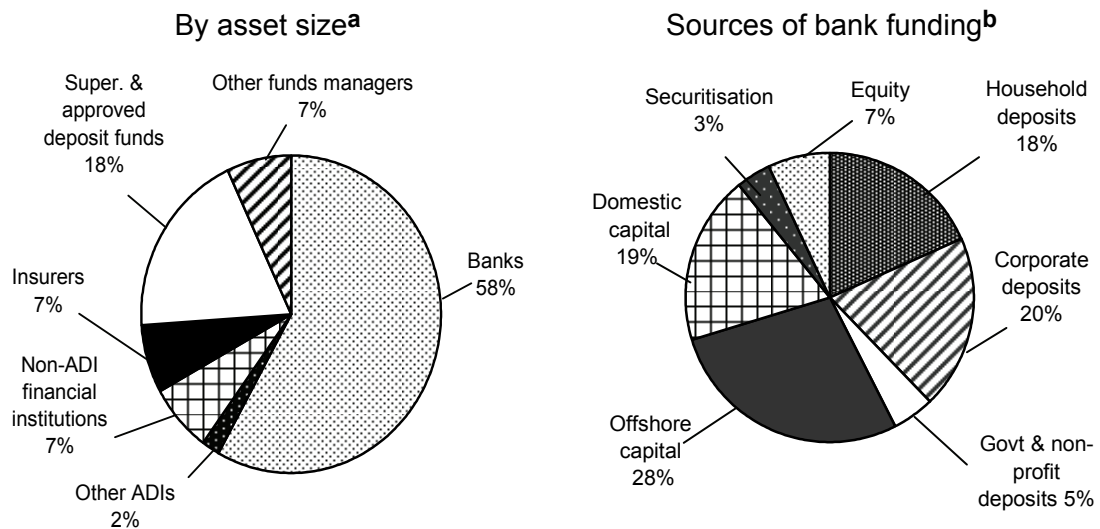
Australian financial institutions comprise authorised deposit taking institutions (ADIs) (including banks, credit unions and building societies), non-deposit taking institutions (including investment banks, finance companies and securitisers), and insurance and fund managers (such as life and general insurance funds, superannuation funds, cash management trusts and friendly societies). The sector is covered by *Finance and insurance* (Division K) in the Australian and New Zealand Standard Industrial Classification (ANZSIC).

The combined finance and insurance industries account for around 10 per cent of Australia’s GDP and employ about 418 500 persons (nearly 4 per cent of total employment) (ABS 2010).

Banks (excluding the Reserve Bank) accounted for around 60 per cent of the total assets of these industries, reflecting their relative size and central financial intermediation role in the Australian economy (box figure, left panel). Superannuation and approved deposit funds accounted for nearly 20 per cent of assets.

Nearly half of Australian bank funding comes from wholesale borrowings in domestic and offshore capital markets (right hand panel). In addition, banks source over 40 per cent of funds from deposits by households, businesses and government and other organisations. The share from deposits has risen about 5 percentage points since mid-2007 (Battelino 2009).

#### Composition of the finance sector and bank funding



<sup>a</sup> Estimated at December 2009. <sup>b</sup> Estimated at September 2009.

Source: RBA (2010b); Battelino (2009).

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## 4.1 Identifying measures affecting the finance sector

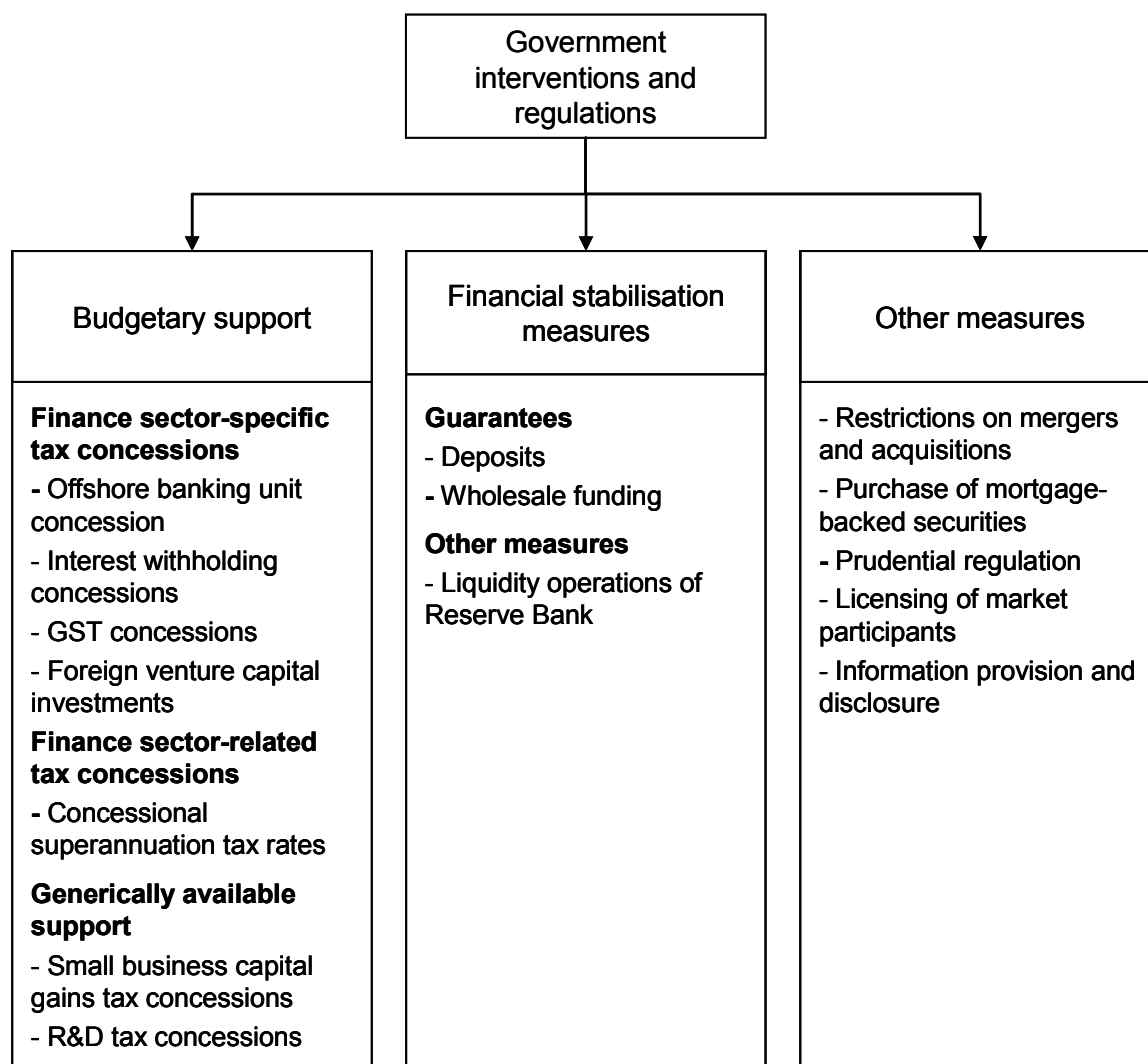
There is a wide range of government policies and regulations that affect financial intermediaries, and some have assistance implications (figure 4.1). Prior to the global financial crisis, budgetary measures affording assistance to the sector were largely in the form of tax concessions. Some of this support is specific to the finance sector (such as the offshore banking unit concession), while other budgetary measures are generally available across industries (such as small business tax concessions). In addition to concessions that accrue directly to financial institutions, the sector also benefits from finance-related concessions such as compulsory superannuation which, at a macro level, guarantees a flow of funds to eligible intermediaries.

In response to the financial crisis, the Australian Government implemented a guarantee on the deposits and wholesale debt funding of banks, and directly purchased residential mortgage backed securities. In addition, the Reserve Bank of Australia expanded its liquidity operations, with the intent of maintaining liquidity and stability in the financial system.

Regulations also strongly influence the shape of the finance sector. Much of the regulation is aimed at promoting financial stability and consumer protection. The Australian Prudential Regulatory Authority (APRA) is responsible for enforcing capital adequacy and other prudential requirements and the Australian Securities and Investments Commission (ASIC) enforces information disclosure, licensing and other conduct-of-business regulations. Other sectors of the economy similarly have sector-specific regulations. While such regulations are intended to yield community-wide benefits, they may also constrain the activities of business and raise compliance and administrative costs. The Australian Government also restricts mergers or acquisitions between the four major banks under the Four Pillars Policy to support competition in the domestic market.

The Commission has traditionally measured the level of assistance to industries by comparing a sector's returns with the returns that the sector would have received in the absence of the assistance. In measuring assistance, ideally, all government measures that selectively benefit financial institutions and activities they undertake, should be quantified.

Figure 4.1 Government arrangements affecting the finance sector



However, there are a number of difficulties in quantifying the assistance implications of many of the policy measures.

- *Determining the assistance implications of broader social and economic policies.* Many measures that have an impact on the finance sector are primarily intended to enhance social welfare, achieve stability in the sector or meet other economic management objectives, creating difficulties in attributing any benefit of a measure to a specific activity or industry. For example, mandating superannuation contributions and providing tax concessions for superannuation, while intended to influence saving behaviour and retirement incomes, benefits superannuation savings instruments and also results in preferment for the superannuation fund service providers over providers of other financial products.

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- *The contingent nature of some measures.* Guarantees of deposits and wholesale lending provide benefits to both parties to the transaction — depositors and lenders as well as eligible financial intermediaries. The value of assistance conferred depends on the probability that the guarantee would be called upon and other costs, being fully reflected in the guarantee fee. As a guarantee may not be called upon for a number of years after its issue, if at all, assessing the level of assistance conferred by a guarantee arrangement is problematic.
  - *Determining an assistance benchmark for tax concessions.* The standard approach for measuring tax expenditures is the ‘revenue forgone method’. The Treasury uses this in its estimates, and it is the Treasury estimates that the Commission has used in this chapter. Under the revenue forgone method, assistance is estimated as if normal tax rates applied to prevailing (ie assisted) levels of activity and income. The Treasury’s estimates, therefore, do not measure the additional activity that might be generated by the concession or the net impact of the measure on taxation revenue. For example, concessional tax rates intended to attract offshore banking activities may generate new activity that would not occur under normal taxation arrangements. The notional revenue foregone estimate does not measure the *net* impacts on financial institutions or costs to community of this concession.

These difficulties have meant that a number of long-standing policies (which provide at least some benefit to the finance sector, or to parts of it) are outside the scope of the Commission’s quantified assistance estimates (chapter 2). Nevertheless, Australian Government budgetary measures that directly benefit financial intermediaries and that are quantified are included in the Commission’s estimates. Section 4.2 of this chapter reports budgetary and other support measures that directly benefit the finance sector, as well as measures that incidentally benefit the sector. Section 4.3 reports on stabilisation and regulatory frameworks affecting the sector, including measures introduced in response to the financial crisis, while section 4.4 then assesses some of the implications of finance measures. This chapter does not report on measures assisting insurance activities in the broader ANZSIC division Finance and insurance.

## **4.2 Australian Government budgetary support**

Budgetary support provided directly to the finance sector is largely in the form of tax concessions (or tax expenditures). The Treasury reports on estimates of tax expenditures in its annual *Tax Expenditures Statement* (TES). As noted, the estimates are prepared in accordance with the revenue forgone method — the estimated difference between actual taxation receipts and what would have been

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received had non-concessionary tax rates applied at that level of activity, with all other things also remaining unchanged (box 4.2).

#### **Box 4.2 Estimating tax concessions**

Tax expenditures estimates are prepared using the *revenue forgone* method. Under this method, the concession is estimated as the difference between the level of tax receipts if non-concessional benchmark taxation arrangements applied and the revenue collected under the concessional arrangement. The estimated tax under the normal arrangement is known as the *benchmark*. Separate benchmarks are developed for the different components of the tax system, including superannuation.

The revenue forgone estimates are static in nature, that is, they do not estimate the potential impact of the concessions on the tax base or government revenues more broadly. Nor are the estimates a measure of what it would cost in budget outlays to deliver benefits equivalent to those provided by the tax concessions.

##### *Alternatives to the 'revenue forgone' method*

The two main alternatives to the revenue forgone method which take into account the potential impact of the method on the taxation base and budgetary costs are the *revenue gain* and *outlay equivalence* methods.

The revenue gain method assesses how much net revenue could increase if a particular concession was withdrawn. Meaningful estimation of this opportunity cost are difficult and requires estimates of the economy-wide behavioural effects associated with such a change.

The outlay equivalence method assesses how much direct expenditure would be needed to provide an equivalent benefit and requires determining a meaningful alternative measure of assistance, in the hands of the recipient. Such alternative estimates are beyond the scope of this study.

*Source:* Australian Government (2010a)

### **Finance-specific taxation concessions**

Specific finance sector tax concessions (other than those relating to superannuation and other concessions that indirectly affect the sector) are estimated at over \$330 million for 2008-09 (table 4.1).

**Table 4.1 Finance-specific tax concessions, 2005-06 to 2008-09**

| <i>Tax expenditure item (TES code)</i>   | <i>2005-06</i> | <i>2006-07</i> | <i>2007-08</i> | <i>2008-09</i> |
|--|----------------|----------------|----------------|----------------|
|  | \$m            | \$m            | \$m            | \$m            |
| <b>Quantified measures</b>   |                |                |                |                |
| <b>Business taxation</b>   |                |                |                |                |
| Exemption for certain payments made out of the National Guarantee Fund (B1)  | nil            | nil            | nil            | nil            |
| Concessional tax treatment of offshore banking units (B7)  | 90             | 160            | 320            | 305            |
| Unfranked dividends paid to foreign shareholders by Pooled Development Funds (B17)   | 0              | 1              | 2              | 3              |
| Capital gains tax concession for carried interests paid to venture capital managers (B53)  | 9              | 10             | 10             | 11             |
| Concessional treatment for Pooled Development Funds (B56 & B59) <sup>a</sup>   | 7              | 9              | 12             | 11             |
| Exemption for early stage venture capital limited partnerships (B58)   | nil            | nil            | nil            | 1              |
| <b>Total of quantified measures</b>  | <b>106</b>     | <b>180</b>     | <b>344</b>     | <b>331</b>     |
| <b>Non-quantified measures<sup>b</sup></b>   |                |                |                |                |
| <b>Business taxation (indicative range)<sup>c</sup></b>  |                |                |                |                |
| Interest withholding tax concession on interest payments by Australian branches to foreign banks (B15)   | 100-1 000      | 100-1 000      | 100-1 000      | 100-1 000      |
| Concessions resulting from the clarification of the debt or equity treatment of perpetual subordinated debt (issued by financial institutions) (B57) | 10-100         | 10-100         | 10-100         | 10-100         |
| Income tax exemptions for foreign superannuation funds (B63)   | 0-10           | 0-10           | 0-10           | 0-10           |
| Concessional tax treatment for foreign authorised deposit-taking institutions (B6)   | 10-100         | 10-100         | -              | -              |
| <b>Capital Gains Tax (indicative range)</b>  |                |                |                |                |
| Capital gains tax rollover relief for financial service providers on transition to the Financial Services Reform regime (E19) <sup>d</sup>           | 10-100         | 10-100         | 10-100         | 0 to -10       |
| Capital gains tax rollover relief for superannuation entities on transition to the new superannuation safety arrangements (E22)                      | 10-100         | 10-100         | 10-100         | 10-100         |

<sup>a</sup> Program closed to new registrations June 2007. <sup>b</sup> The Treasury's indicative range applies to the year the tax expenditure is considered to be the most significant. Other years may be smaller in value. <sup>c</sup> The value of four other concessions was estimated at approximately zero. The concessions are: Concessions resulting from the clarification of the debt or equity treatment of perpetual subordinated debt (issue by financial institutions) (B57); Tax exemption for small credit unions (B62); Capital gains tax relief for the demutualisation of friendly societies (B96); and International tax — a final withholding tax on certain distributions of Australian managed investment trusts to foreign residents (B97). <sup>d</sup> The indicative range value for 2005-06 to 2007-08 is taken from TES 2008 when the measure was positive. The 2008-09 value is taken from TES 2009 when it became negative (that is when it was a tax deferral).

Source: Australian Government (2010a).

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Of the measures that are quantified, the concessional tax treatment to offshore banking units (OBUs) afforded the largest level of support, amounting to over \$300 million in 2008-09. An OBU is a financial institution undertaking financial transactions for overseas institutions or residents. The intent of the concessional tax treatment of OBUs is to encourage what would otherwise be foreign denominated financial transactions between non-residents to be routed via an Australian bank or similar institution. Under the present OBU tax concession, income, other than capital gains, derived by an OBU is taxed at a concessional rate of 10 per cent. Also, interest paid by an OBU on qualifying offshore borrowings, and gold fees paid by an OBU on certain offshore gold borrowings, are exempt from withholding tax. The estimated taxation expenditures associated with the OBU tax concession doubled between 2006-07 and 2007-08. At August 2009, there were 132 gazetted OBUs, though less than 100 after excluding multiple licences from related entities, and many are not active (Johnson report 2009, p.58). Most of the active OBU licensees are investment banks, deposit-taking institutions or fund managers.

For the measures that are not quantified, the TES reports an indicative range within which the value of the concession is likely to fall. For example, the estimates indicate that the value of the withholding tax concessions on interest payments by Australian banks to foreign branches (TES item B15) could exceed \$100 million and may be as high as \$1 billion. Under this concession, withholding tax is only paid on half of the taxable amount of interest.

Four other measures were classified as potentially providing concessional treatment but the benefit conferred was estimated as approximately zero in recent years (see footnote d, table 4.1).

Over the last two years, the Australian Government has announced measures to promote Australia's financial services sector and remove obstacles to Australia becoming a financial services centre for the Asia Pacific region (box 4.3). These measures include a reduction in withholding tax on designated offshore distributions from Australian managed funds. This has been estimated to cost \$630 million, using the foregone tax revenue method, over the three-year period to 2011-12. The Government also accepted, either directly or in principle, most recommendations in the Report by the Australian Financial Centre Forum (the 'Johnson Report') (Australian Government 2009c).

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### Box 4.3 A financial services centre for the Asia Pacific area?

The Australian Government has announced a number of measures intended to promote Australia's financial services sector and remove remaining obstacles to Australia potentially becoming a financial services centre for the Asia Pacific, including:

- Cutting the withholding tax on certain foreign distributions from managed investment trusts from 30 per cent to a final rate of 7.5 per cent at an estimated cost to revenue of \$630 million over the three year period to 2011-12 (Australian Government 2008).
- Changing the attribution rules and providing deemed capital account treatment to eligible Managed Investment Trusts for gains and losses on disposal of certain assets (primarily shares, units and real property) to assist Australian managed funds and other businesses compete in export markets and to support higher employment in those activities (Bowen 2009b).
- Repealing and replacing the Foreign Investment Fund provisions with a narrowly-defined anti-avoidance rule and modernising the Controlled Foreign Company rules to reduce the complexity of attribution rules, the controlled foreign company rules, foreign investment fund rules, transferor trust rules and the deemed present entitlement rules. A consultation paper on the CFC rules was released in January 2010 (Sherry 2010).
- Transferring the supervision of financial markets from the ASX to ASIC, the corporate regulator, to provide a single unified supervisor for market participants, to establish international best practice in this area of financial supervision (Bowen 2009c)

In its response, in May 2010, to the Report of the Australian Financial Centre Forum (the 'Johnson' Report) the Australian Government accepted directly, or in-principle nearly all of the Forum's 19 recommendations including: the introduction of an Investment Manager Regime; the establishment of an online regulatory gateway; and the development of an Asia Region Funds Passport (Bowen and Sherry 2010). The Government will also phase down from 10 per cent to 5 per cent of the interest withholding tax (IWT) incurred by local subsidiaries and branches of financial institutions when they pay interest on borrowings from their overseas parents (Bowen, Swan and Sherry 2010).

In addition, the Treasury recently completed a review of the application of the GST to financial supplies. In response, the Government announced on 11 May 2010, changes intended to simplify the operation of the legislation and reduce compliance and administrative costs, consistent with the existing policy intent.

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## Finance-related taxation concessions

### *Superannuation tax concessions*

The principal taxation concessions with incidental benefits for the finance sector relate to superannuation. In Australia, compulsory superannuation arrangements apply as part of national retirement incomes policy. Under these arrangements, a designated proportion of earnings (between a floor and ceiling) is required to be contributed to complying superannuation funds, while withdrawal of funds is subject to age and other eligibility restrictions and is generally not permitted before retirement. Concessional taxation arrangements apply to those funds. In addition, government makes direct contributions on behalf of some (generally low income) wage earners and concessional arrangements apply to qualifying voluntary contributions through salary sacrifice and other arrangements.

The compulsory nature of the arrangements and the taxation concessions on voluntary contributions afford advantages to superannuation savings over other uses of funds (including own-account investment) and incidentally benefit superannuation saving vehicles and service providers.

In the TES estimates, the superannuation tax expenditures are based on the revenue forgone at the time the superannuation transactions occur (box 4.4). In 2008-09, TES estimates reported tax concessions relating to superannuation amounting to nearly \$25 billion (table 4.2). They do not represent revenue forgone and do not take into account long term consequences such as reduced pension costs. As indicated, these afforded benefits to complying superannuation vehicles over other fund management activities. It also increased the demand for superannuation services although the value of the taxation concession estimated in the TES is not a direct measure of assistance accruing to financial service providers.

Nearly 90 per cent of superannuation tax concessions in 2008-09 related to the combination of employer contributions to superannuation funds and the investment earnings of superannuation funds (TES items C5, C6). Employer contributions received by superannuation funds (up to certain limits) are taxed at 15 per cent; a lower tax rate than is applied to other marginal income accruing to most people. This concession was estimated to be over \$12.5 billion in 2008-09. In addition, the earnings of a superannuation fund are also taxed at 15 per cent, a discount on the tax rates that would normally apply under tax law to investment income in the hands of investors. This concession was estimated to be over \$10 billion in 2008-09.

#### Box 4.4 Establishing the superannuation tax benchmark

The Australian taxation superannuation benchmark, as established by The Treasury in the TES, uses an 'income' tax base that comprises:

- contributions as they would be taxed in the hands of the fund member when the contribution is made;
- earnings as they would be taxed in the hands of the investor when the earnings accrue; and
- benefits from superannuation which would be untaxed when the funds are drawn (Australian Government 2010a).

Some have argued for an alternative benchmark, particularly an 'expenditure' tax base. Under such a benchmark, contributions and earnings would be assumed to be 'untaxed' while the end benefits would be taxed — which would typically be at a lower rate. Under such an expenditure tax benchmark, the aggregate estimated concessions across time would be lower, as the expenditure benchmark itself is highly concessional. The Treasury has estimated that the current superannuation taxation arrangements are more concessional than the expenditure tax benchmark.

Table 4.2 **Estimated superannuation taxation concessions, 2005-06 to 2008-09**

| <i>Tax expenditure item (TES code)</i>                            | <i>2005-06</i> | <i>2006-07</i> | <i>2007-08</i> | <i>2008-09</i> |
|---|----------------|----------------|----------------|----------------|
|   | \$m            | \$m            | \$m            | \$m            |
| <b><i>Concessions to superannuation vehicles</i></b>              |                |                |                |                |
| CGT discount for funds (C4)                                       | 1 090          | 1 690          | 890            | 210            |
| Concessional taxation of employer contributions (C5)              | 9500           | 11 400         | 13 000         | 12 500         |
| Concessional taxation of superannuation entity earnings (C6)      | 12 150         | 16 050         | 14 450         | 10 000         |
| <b><i>Concessions to individuals (quantified)<sup>a</sup></i></b> | <b>565</b>     | <b>1 068</b>   | <b>2 310</b>   | <b>1 918</b>   |
| <b>Total<sup>b</sup></b>  | <b>23 305</b>  | <b>30 208</b>  | <b>30 650</b>  | <b>24 628</b>  |

<sup>a</sup> Sum of TES items: C7 (concessional taxation of unfunded superannuation), C8 (concessional taxation of certain personal contributions), C9 (measures for low income earners), C10 (spouse contribution offset), C13 (tax on funded lump sums relating to post-June 1983 service) and C14 (tax on funded lump sums relating to pre-July 1983 service). <sup>b</sup> In addition to the quantified items, three items — C11 (tax on excess concessional contributions), C12 (tax on excess non-concessional contributions) and C15 (tax on funded superannuation income streams) are not quantified. These latter three items are identified by Treasury as *negative* tax expenditures, with a combined indicative tax revenue gain ranging up to \$2 billion.

Source: Australian Government (2010a).

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In addition to these quantified concessions, a number of other superannuation measures are not quantified (footnote c, table 4.2). Rather than being concessional, these unquantified measures are considered to be ‘taxing’ (a negative tax expenditure) with a combined indicative range of \$200 million up to \$2 billion.

The review of Australia’s tax system (the ‘Henry review’) was asked to examine, amongst other things, superannuation issues including the taxation of savings, assets and investment, and the tax and transfer system for retirees (Swan 2008a). The report was delivered to the Treasurer in December 2009 and was released with the Government’s response in May (Swan and Rudd 2010).<sup>1</sup> A review of the governance efficiency, structure and operation of Australia’s superannuation system (the Cooper review) is to report to the Government by the end of June 2010 (Sherry 2009).

#### *Other finance-related taxation concessions*

The largest quantified GST concession is afforded through the GST input tax treatment of financial supplies (table 4.3). Where the normal GST rules apply, businesses charge GST on outputs but can claim input tax credits for the GST paid on inputs to make those supplies. In contrast to the approach normally applied, an input tax treatment is generally used for financial supplies in all countries that have a GST or VAT, because of the difficulty of determining taxable values for the relevant service flows — though a Treasury review is currently underway on this issue (see box 4.3).

- Where input taxing applies (as with financial services), no GST is charged on outputs, but tax credits cannot be claimed for inputs used in the provision of those services (item H2).
- There are however, some exceptions where partial credits are allowed for certain types of services used by financial service providers (item H3).
- There is also a *de minimus* rule that allows full input tax credits to be claimed if input tax credits claimed for financial supplies fall below certain thresholds (item H1, not quantified). The tax expenditure under this concession is estimated to range up to \$1 billion.

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<sup>1</sup> In the Budget, the Government announced: a government superannuation contribution tax rebate for low income earners; an increase in the concessional cap for those aged over 50 years with low superannuation balances; and an increase in the Superannuation Guarantee age limit from 70 to 75 years.

**Table 4.3 Finance-sector related GST and CGT concessions, 2005-06 to 2008-09**

| <i>Tax expenditure item (TES code)</i>   | <i>2005-06</i> | <i>2006-07</i> | <i>2007-08</i> | <i>2008-09</i> |
|--|----------------|----------------|----------------|----------------|
|  | \$m            | \$m            | \$m            | \$m            |
| <b>Quantified measures</b>   |                |                |                |                |
| <b>Goods and services tax</b>  |                |                |                |                |
| GST Financial supplies, GST free, and no input tax generally (H2)                    | 1 640          | 1 760          | 1 880          | 2 040          |
| GST Financial supplies, reduced input tax credit (H3)                                | 670            | 730            | 780            | 830            |
| <b>Capital gains taxation</b>  |                |                |                |                |
| Capital gains tax discount for investors in listed investment companies (E15)        | 25             | 25             | 40             | 35             |
| <b>Total of quantified measures</b>  | <b>2 335</b>   | <b>2 515</b>   | <b>2 700</b>   | <b>2 905</b>   |
| <b>Non-quantified measures</b>   |                |                |                |                |
| GST Financial supplies, input tax credits available below a threshold (H1)           | 100-1 000      | 100-1 000      | 100-1 000      | 100-1 000      |
| Capital gains tax exemption for certain foreign investments in venture capital (E32) | -              | -              | 10-100         | 10-100         |

Source: Australian Government (2010a).

A capital gains taxation exemption (not quantified) is also applied to the profits of certain non-resident investors in respect of their eligible venture capital investments (item E32). Treasury's indicative range for this tax expenditure was \$10 million up to \$100 million for 2008-09.

### **Finance business use of generally available budgetary support**

In addition to finance-specific and finance-related tax concessions, finance businesses are eligible to claim concessions and grants available generally to all business, including:

- capital gains taxation concessions for small businesses;
- a 25 per cent entrepreneur's tax offset for eligible small businesses; and
- R&D support.

An estimated \$262 million accrued to finance businesses (including insurance) in 2008-09 from these measures (table 4.4).

**Table 4.4 General budgetary support to the finance and insurance industries, 2005-06 to 2008-09**

| <i>Measure</i>   | <i>2005-06</i> | <i>2006-07</i> | <i>2007-08</i> | <i>2008-09</i> |
|--|----------------|----------------|----------------|----------------|
|  | \$m            | \$m            | \$m            | \$m            |
| <i>Capital Gains Tax (Small Businesses)</i>            |                |                |                |                |
| Rollover deferral (E20)                                | 8              | 13             | 17             | 26             |
| 50 percent reduction (E31)                             | 28             | 29             | 45             | 54             |
| Retirement exemption (C1)                              | 19             | 20             | 34             | 38             |
| Exemption for assets held more than 15 years (C20)     | 8              | 14             | 23             | 29             |
| <i>Business income</i>                                 |                |                |                |                |
| Entrepreneurs' 25 per cent tax offset (B52)            | nil            | 4              | 5              | 7              |
| <i>R&amp;D tax concessions and grants <sup>a</sup></i> | 72             | 76             | 99             | 108            |
| <b>Total</b>   | <b>135</b>     | <b>156</b>     | <b>223</b>     | <b>262</b>     |

<sup>a</sup> Comprising support from the following programs: R&D tax concession; Premium R&D tax concession; R&D tax offset for small companies; R&D Start; Preseed Fund; Innovation Investment Fund; COMET; and Commercial Ready.

Source: Commission estimates based on Australian Government (2010a) and ATO data .

### 4.3 Financial stabilisation and regulatory frameworks

As is the case for other industries, the structure and performance of the finance sector is influenced by regulatory and other government measures. The finance-related measures are intended to achieve stability, efficiency and competition in the sector, as well as broader economic and social goals. While intended to generate benefits, such regulatory and other measures potentially can add to the capital requirements and other costs of financial intermediaries. On-going measures influencing financial intermediaries include:

- prudential regulation administered by the Australian Prudential Regulatory Authority (APRA) which is aimed at promoting financial stability in Australia and protecting the interests of depositors, insurance policy holders and superannuation members, while allowing the continued development of viable, competitive and innovative industries in the financial services sector;

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- licensing and other regulation of financial services administered by the Australian Securities and Investments Commission (ASIC) which are intended to facilitate and improve the performance of the financial system and entities in it; and promote confident and informed participation by investors and consumers in the financial system;
  - provisions to protect depositors of ADIs under the *Banking Act 1959* including through control powers of APRA and the Financial Claims Scheme (in the case of insolvent ADIs);
  - financial stability actions of the Reserve Bank of Australia (RBA), such as possible provision of liquidity to the financial system (as a whole) through domestic market operations and, in special circumstances, direct lending to illiquid deposit taking institutions;
  - restrictions on entry and exit through regulation of the right to conduct banking business and restrictions on the acceptance of retail deposits by Australian branches of foreign banks; and
  - restrictions on mergers and takeovers among the four largest banks, under the four pillars policy.

In response to concerns about global liquidity and to buttress confidence in the stability of financial markets and competition in the Australian mortgage market in 2008, the Australian Government implemented the following finance-related measures:

- committed up to \$16 billion towards the purchase of Residential Mortgage Backed Securities;
- guaranteed deposits up to \$1 million in Australian deposit-taking institutions (ADIs) without charge under the Financial Claims Scheme;
- offered to guarantee deposits over \$1 million in ADIs and wholesale funding of ADIs, for a fee, under the Guarantee Scheme for Large Deposits and Wholesale funding (the Guarantee Scheme);
- made available the Guarantee Scheme, with some restrictions, to Australian branches of foreign owned banks;
- made available a temporary voluntary guarantee, for a fee, for designated state borrowings; and
- facilitated the establishment of a financing trust facility to provide temporary liquidity support for eligible car dealerships.

The government also established a guarantee scheme for car finance companies, but no payments have been made under the scheme.

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The details of the measures established during the financial crisis are outlined below.

### **Contribution to issues of Residential Mortgage-Backed Securities**

The tightening of credit markets early in the financial crisis restricted the ability of financial institutions to fund lending by selling asset-backed securities.<sup>2</sup> This contraction curtailed the lending operations of institutions which were more reliant on the sale of mortgage-backed securities as a funding source. There was an associated decline in the share of home lending accounted for by wholesale lenders (which largely raised funds through securitisation) from over 10 per cent, before the beginning of the crisis in mid-2007, to around 4 per cent by September 2008.

To support competition in Australia's mortgage markets, in September 2008, the Treasurer announced that the Australian Office of Financial Management (AOFM) would acquire Residential Mortgage Backed Securities (RMBS) from a wide range of Australian lenders in initial tranches totalling \$4 billion (Swan 2008b). In October 2008, the Prime Minister announced that an additional \$4 billion would be provided for the purchase of RMBS (Rudd 2008). At least \$4 billion of the \$8 billion was to be allocated to issuer/originators that are non-ADIs (AOFM 2008). By the end of 2009, the AOFM had contributed \$7.8 billion in 20 RMBS issues. Other investors contributed \$3.6 billion in these issues. The RMBS scheme has supported mortgage finance on over 62 000 residential properties. (AOFM 2009).

A further contribution of \$8 billion towards the acquisition of mortgage backed securities (plus the \$0.2 billion remaining from the initial program) was announced in October 2009 (Swan 2009d). The additional funding was an extension of the original (competition promoting) mandate with the additional objective of affording greater support to small businesses in the lending market. Proposals for the acquisition of securities are evaluated by AOFM in terms of the likely contribution they would make to maintaining competition in housing lending, and to small business lending (AOFM 2009).

Government support for the acquisition of RMBS enables securitizers to issue larger volumes than would have been the case in the absence of the government program.

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<sup>2</sup> A mortgage backed security (a particular type of asset-backed security) combines individual mortgages into a single, composite, security. The owner of the security is entitled to receive the repayments of interest and principal derived from the underlying mortgages.

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## **Guarantees of deposits and wholesale funding of ADIs**

Guarantees of deposits and wholesale funding held in qualifying Australian deposit taking institutions (including Australian subsidiaries of foreign banks, building societies and credit unions) were announced in October 2008. Under interim arrangements, all deposits and wholesale funding eligible for guarantee arrangements were guaranteed without charge. One hundred and eighty nine Australian ADIs were eligible for the wholesale funding guarantees.

Final arrangements were implemented from 28 November 2008 (Swan 2008c). Under these arrangements, guarantees are afforded to deposits of up to \$1 million without charge under the Financial Claims Scheme (FCS). The FCS, developed before the crisis, is a permanent feature of the Australian financial sector regulatory framework. When the government announced the \$1 million cap in October 2008 — higher than the threshold that was to be introduced for the permanent scheme — it committed to a review of arrangements after three years (that is, October 2011).

Separately, deposits over \$1 million and wholesale funding of eligible ADIs could be guaranteed for a fee, under the Guarantee of Large Deposits and Wholesale Funding (Guarantee Scheme) (box 4.5). The Guarantee Scheme was also made available, with some restrictions, to branches of foreign banks. The Guarantee Scheme was to remain in place until conditions ‘normalise’ (RBA and APRA 2009). Based on advice from the Council of Financial Regulators, the Government announced the withdrawal of the Guarantee Scheme from 31 March 2010 (Swan 2010a).

The guarantee arrangements were intended to protect depositors with ADIs, maintain the liquidity of key financial institutions during the crisis and contribute to the stabilisation of financial markets. Announced as a temporary measure, the guarantee selectively benefits institutions receiving liquidity support relative to others.

In terms of the benefits conferred by Australian arrangements on eligible ADIs, the Reserve Bank of Australia and APRA in a submission to the 2009 Inquiry by the Senate Economics Reference Committee into Bank Funding Guarantees, noted:

The Australian arrangements share many common features with those introduced in other countries although, on balance, the range of parameters are generally at the more supportive end of those internationally. (RBA and APRA 2009, p. 2)

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#### **Box 4.5 Large deposit and wholesale funding guarantee arrangements**

The wholesale funding guarantee was available to qualifying Australian deposit taking institutions (ADIs) for short-term liabilities such as bank bills, certificates of deposit, commercial paper and certain debentures with initial maturities of up to 15 months and to long-term liabilities such as bonds, notes and certain debentures with terms of maturity of 15 to 60 months. The guarantee applies for the full term of the relevant security even now after the scheme has closed to new issuances and can be applied to existing as well as new securities. The facility was restricted to senior unsecured debt instruments in major currencies, whether issued domestically or offshore.

##### *Restricted availability to foreign banks*

The Guarantee Scheme was also available with some restriction to branches of foreign owned banks. In particular, foreign bank branches in Australia could not use guaranteed liabilities to directly support the parent bank or group (of which they are part) outside Australia. The guarantee was also only available on the condition that the liabilities are not guaranteed by the home authorities and the branch provides additional information about the parent bank's prudential compliance.

##### *Guarantee fees*

The fee structure is based on the spreads likely to prevail in more normal conditions and provides the basis for a natural exit mechanism as financial conditions normalise. A fee of 70 basis points per annum applies to ADIs with credit ratings of AAA to AA-; 100 basis points for ratings of A+ to A- and 150 basis points for BBB+ and below and unrated institutions.

*Source:* (Swan 2008c)

#### *Guarantee of deposits up to \$1 million per customer per ADI*

It is estimated that by April 2009, the FCS covered over 16 million deposit accounts of up to \$1 million (over 99 per cent of depositors) holding around \$650 billion (70 per cent of ADI deposits) (The Treasury 2009).

One potential indicator of the impact of the guarantee during the crisis is provided by defensive measures taken by competing financial institutions not protected by the guarantee. In this regard, while there was a freeze on redemptions by at least 10 mortgage trusts before the introduction of the guarantee, many more followed. Overall, it has been estimated that around 80 mortgage trusts, with a combined total of over \$26 billion of funds under management, have applied withdrawal limitations (SERC 2009, The Treasury 2009). The Investment and Financial Services Association (IFSA) reported a 25-fold increase in redemption requests after the introduction of the guarantees (IFSA 2009). IFSA noted that investment funds tend

to receive larger deposits than do credit unions and building societies which were protected by the guarantee and suggested that investment funds would have been less affected if the guarantee had been capped at, say, \$100 000 rather than \$1 million.

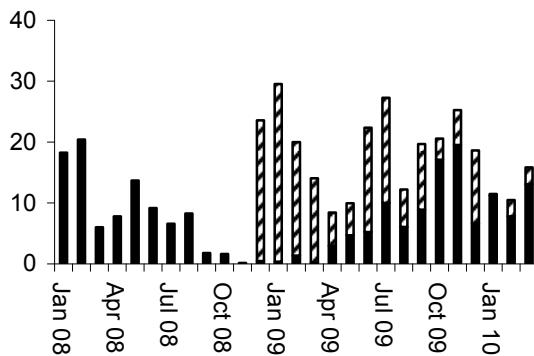
### *Large deposits and wholesale funding guarantee*

Following the introduction of the large deposit and wholesale funding guarantee in November 2008, there was a substantial increase in the level of wholesale funding raised by ADIs from domestic and foreign sources (figure 4.2, left hand panel). While nearly all funding from domestic and foreign sources was government guaranteed early in 2009, the use of the guarantee tapered off through that year, although the relative use of guaranteed and non-guaranteed borrowings varied from month to month.

**Figure 4.2 Trends in large deposit and wholesale funding of Australian deposit taking institutions**

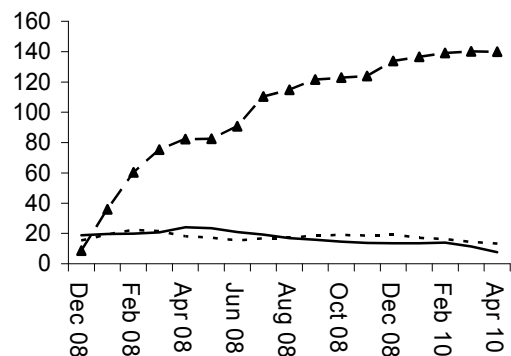
\$ billion

*Guaranteed and unguaranteed wholesale funding by month  
January 2008 to March 2010*



■ Unguaranteed    ▨ Guaranteed

*Cumulative take up of the large deposit and wholesale funding guarantee  
December 2008 to April 2010*



— Large deposits    ····· Short-term  
-▲- Long-term

Source: RBA (2010a); Australian Government (2010b).

The cumulative take-up of the guarantee on long-term wholesale funding has increased from less than \$10 billion at the commencement of the scheme to over \$120 billion in December 2009 (figure 4.2, right hand panel). The cumulative take up of the guarantee on large deposits and short-term funding has remained around \$20 billion for each category, or about 2 per cent of such deposits with ADIs. By

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February 2010, fees paid to the Government for use of the guarantee had totalled about \$1.1 billion, and are projected to amount to around \$5.5 billion over the full life of the guaranteed instruments (Swan 2010a).

### *Guarantee scheme for State and Territory borrowings*

Concern was expressed that the Wholesale Funding Guarantee Scheme could divert funds from Australian States and Territories. For example, the Tasmanian Treasury noted:

As soon as the [bank borrowing] guarantee was announced, it became difficult for the States to issue long-term debt as the market anticipated that the banks would issue large volumes of guaranteed debt. This was confirmed when the guarantee was implemented, which effectively crowded the States out of the market. (Tasmanian Department of Treasury and Finance, 2009, p.1)

In March 2009, the Australian Government introduced a guarantee scheme, on a voluntary basis, to designated state government borrowings (Swan 2009e). The guarantee is intended to increase the capacity of state and territory governments to fund infrastructure projects during the financial crisis. The guarantee was made available, for a fee, for existing and new issues denominated in Australian dollars.<sup>3</sup> In February 2010, the Australian Government announced that the State Guarantee would be closed to new issuance from 31 December 2010 (Swan 2010a). At February 2010, New South Wales and Queensland are the only jurisdictions to have employed the facility (Australian Government 2010c). The longer withdrawal period relative to the Guarantee of Large Deposits and Wholesale Funding is intended to enable states to establish liquidity in new unguaranteed bonds.

## **4.4 Implications of finance measures**

As demonstrated above, a range of measures provide support to the finance sector. This section considers some of the implications of the assistance that is aimed at developing the financial services industry, and the impact of the measures that have been introduced in response to the financial crisis.

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<sup>3</sup> The fee structure for AAA securities is 15 basis points for existing stock and 30 basis points for new issuance. For existing and new AA+ securities the fees are 20 and 35 points, respectively.

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## **The need to assess finance industry development measures**

Taxation concessions that provide commercial advantages to eligible finance businesses are intended to encourage additional activity in that sector, including relocation to Australia. However, such concessions:

- may reduce tax revenue from offshore banking activity compared to that which would occur if ‘normal’ corporate tax rates were to apply; and
- encourage the diversion of Australian labour and capital away from other activities (including other financial services).

Such policies also risk diverting business effort into seeking support and add to compliance and administrative costs.

The overall impact of the finance-specific concessions therefore depends on the economy-wide effects, including net tax effects, of the measures as opposed to the commercial advantages accruing to the particular businesses receiving support. Similarly, the broader economic effects of other policy measures to promote Australia as a finance centre would depend on their impact on sectoral innovation and productivity and the availability of Australian services that match those offered by overseas competitors.

On the other hand, the progressive deregulation of Australian and global financial markets over the past 30 years has subjected local financial institutions to greater competitive pressure. Increased competition has encouraged the domestic sector to lower costs and increase quality, not only to maintain its domestic business, but also to export its services. Further, government policies that enable consumers and business to access the most efficient financial service providers would lower costs and increase the productivity of other Australian businesses. (In this context, the Productivity Commission is undertaking a review of the regulatory burdens on business and consumer services, including financial intermediation services.)

## **A role for review of financial market regulation**

The Australian Government’s substantial support for the sector in response to the GFC has helped stabilise financial markets and underpin the performance of the wider economy. While the broad objective appears to have been largely met, the global financial crisis, and the associated temporary responses, are likely to have some enduring effects, giving rise to a number of policy issues.

First, a practical issue is how recent events will influence risk taking and moral hazard. The current round of targeted support is likely to have reinforced

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expectations that government support will be forthcoming during ‘financial emergencies’. However, uncertainty will remain about the level of support that may be provided (PC 2009e).

Second, the financial crisis and associated measures have affected the competitive landscape in the finance sector, both between ADIs and non-ADIs and within the ADI sub-sector. Some businesses have argued that the government assistance arrangements reinforced any ‘flight to quality’ — to deposit investments and large banks — that would be expected over a credit cycle. In the largest segment of the market (housing finance) large banks increased their market share mainly at the expense of foreign banks, and non-ADIs lost market share. While barriers to entry to financial intermediation generally appear low, any weakening of competition arising from the crisis and its aftermath risks dampening innovation and productivity growth.

Third, coordinated international action to strengthen financial market regulations is likely to change the operation of financial markets with flow-on effects to businesses and consumers. It is unlikely that Australia’s regulatory settings will remain unchanged — even allowing for the demonstrated resilience of Australia’s finance sector. In its *Annual Report 2008-09*, the Commission recognised that while some changes to financial regulations are likely to be warranted, there are risks that changes could unduly restrict competition, innovation and ultimately productivity of the sector and detract from the substantial gains derived from three decades of finance sector reform.

As with changes to markets and businesses more generally, any significant changes to prudential and other regulations in the finance sector should only be implemented following detailed examination of the likely costs and benefits. In preference to piecemeal regulatory changes, with their attendant risks and potential for unintended consequences, the Commission would see value in a wider public review of financial market regulation.