Australia in the Asian Century

Issues Paper Response

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1. Executive Summary

The Australian Financial Markets Association (AFMA) welcomes the Government’s initiative to explore the potential for Australians arising from the Asian Century. The development of Asia presents good opportunities for Australia, including our financial services industry. The high growth Asia continues to experience is producing large middle classes and an associated increase in demand for financial services. The Prime Minister has cited the potential for Australia to benefit from Asia’s economic development through financial services exports.

This is a significant but welcome challenge for firms participating in Australia’s financial markets, as the trend has been to conduct less traditional back office functions in Australia and a greater amount of trading activity in some markets is done from centres in the region. Cost advantages alone are not enough to attract business to Australia because other financial centres, like Singapore, offer significant tax benefits and seem more committed to maintain the conditions necessary for an internationally competitive financial sector.

The employment and income growth that should accrue to Australia from financial services in the Asian Century will only eventuate if we put in the necessary policy settings.

Australia has a demonstrated capacity to develop the kind of innovative policy that is required to support a deepening of financial services exports to Asia. However, we have not made this outcome a priority in the past and by falling short in our execution we have lost business to overseas locations. Thus, for example, we failed to capitalise fully on the relative strength of Australia during the Asian financial crisis. We will need to do better if Australia is to take full advantage of the opportunity for financial services that the Asian Century presents.

With this in mind, we suggest the Government should give an unequivocal policy commitment to developing our financial services exports. This would build confidence in firms considering Australia as the location servicing the growing Asian market. In addition, the Government should take steps to ensure its departments and agencies are given the necessary leadership and resources to implement this policy to full effect.

Some specific measures we suggest the Government should consider are:

- Implementation of the Johnson Report recommendations as a matter of priority;
- Improvements to the operation and governance of the tax system to provide greater certainty to business and avoid harmful retrospective taxation;
- Support for the international integration of Australia’s financial markets, subject to appropriate regulatory conditions; and
- Provide a coordinated, cohesive and disciplined policy to assess the basis for cost recovery for financial regulation and deal with implementation issues that it presents, like moral hazard and non-neutrality, which harm our international competitiveness.
2. About AFMA and our Asian Engagement

AFMA represents the interests of participants in Australia’s wholesale banking and financial markets. Our members include Australian and foreign banks, stockbrokers and investment banks, fund managers, energy traders and other market participants. Our core objective is to promote the development of efficient and competitive financial markets in Australia.

Key aspects of our work in this regard include:

- Engagement with government, policy departments and regulators in relation to law and regulation for financial markets, including energy and enviro-product markets;
- Management of the conventions, documentation and data services that ensure the efficient operation of Australia’s over-the-counter (OTC) markets and consistency with global standards; and
- Support high professional standards through industry guidance, training and officially recognised accreditation for individuals engaged in the financial markets.

AFMA brings an outward looking approach to these responsibilities. Much of our policy development work involves responding to international regulatory developments by bodies like IOSCO, the Bank for International Settlements and the Financial Action Task Force. We cooperate closely with our international peers in helping our industry to respond to these developments.

AFMA has established particularly strong links within the industry in the Asian region. We were a foundation member of the Asia Securities Forum (ASF) in 1995 and are a leading proponent of cooperation between industry bodies in the region. The purpose of ASF is to exchange views and information among the securities industry in the Asia-Pacific region and to contribute to the development of securities markets and economic growth in the region. AFMA hosted the 2009 annual meeting of the ASF in Sydney.

AFMA has signed a Memorandum of Understanding (MOU) with a number of industry bodies in the region including the Securities Association of China, the Chinese Taiwan Securities Association, the Japanese Securities Dealers Association and the Korea Financial Investment Association. The MOUs generally provides for exchange of information and cooperation between AFMA and our counterparts on matters of common interest including:

- laws and regulation in securities business and markets;
- planning, development and operation of securities trading practices; and
- accreditation and training for market professionals.

We have a good working relationship with the New Zealand Financial Markets Association and are developing ties with the National Association of Financial Market Intermediaries in China.

Against this backdrop, AFMA welcomes the Government’s Asian Century review process and we seek to understand what steps we might take to assist the success of this program.
3. Financial Services Opportunities in an Asian Context

The Asian Century presents great opportunities for the Australian financial services industry. The economic growth outlook for the region is promising; with projections by multilateral bodies like the OECD suggesting that Asia will continue to benefit from strong growth in relative global terms over the medium term. The ongoing development of China is a major contributory factor but other countries are expected to perform well too.

The high growth that many Asian countries continue to experience is producing large middle classes with an associated increase in demand for financial services. The Wolfensohn Center for Development at the Brookings Institution has projected that the Asia-Pacific middle class will grow from 0.5 billion to 3.2 billion people over the period to 2030, to represent 66% of the global middle class at that time.\(^1\) The Prime Minister has identified potential for Australia to benefit through a financial sector that “can become the investment brains of that same Asian middle class as they seek choice and security in retirement”.\(^2\)

A facet of increasing incomes in Asian countries is that it is likely their financial markets will deepen and grow faster than their GDP. This reflects the changing finance and risk management needs of business, driven by international trade (including intra-regional trade) amongst other things, and the greater demand for banking and wealth management services from individuals. It will also involve financial innovation to broaden the range of financial instruments and an opening of their financial markets to competition. This will require capacity building within financial institutions and markets, which can draw on experience gained in the mature, developed economies, like Australia.

The Australian financial system is highly developed in global terms, both in terms of products and services offered and the organisation of the entities that provide them. The scope for further Australian financial markets development driven by fast economic growth and growing sophistication in financial markets in Asia is significant. In doing so, we can build on our existing and developing capabilities.

For instance, Australia is leading the way in Asia by moving to implement a trading scheme for carbon emissions. The international dimension to the scheme will involve transactions between Australian companies (liable parties and others) with counterparts in Asia and elsewhere. We have the opportunity to build on the Government’s carbon policy initiative by ensuring we offer a competitive venue for conducting carbon transactions in the region.

The integration of the Asian and Australian markets is still in its infancy in some respects and the potential for growing these links to assist the national economy presents a commercial challenge for business and a policy challenge for the Government. The employment and income growth from financial services exports that this could reasonably be expected to

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\(^1\) “The emerging middle class in developing countries”, Homi Kharas, Wolfensohn Center for Development at the Brookings Institution, March 2010.

\(^2\) “Building a new Australian economy together”, Australia-Israel Chamber of Commerce lunch, 1 February 2012.
generate will only eventuate if the appropriate policy settings are put in place to enable firms in Australia to identify and leverage these opportunities.

4. Case Study – Opportunity Presented by the Offshore RMB Market

The official Chinese view is that the transition of Renminbi (RMB) to an international reserve currency meets the development needs of both China and the world, but it will be a relatively long process. In order to offset the impact of large capital inflows, the authorities have started to promote the use of RMB as an invoicing currency for international trade, starting with the bilateral trade with Hong Kong.

Currently, there are three different main markets for the RMB:

- Traditional onshore RMB (CNY) market in mainland China;
- Offshore RMB (CNH) market in Hong Kong;
- Dollar settled non-deliverable forward (NDF) market.

Each market operates in a separate jurisdiction. This splitting of onshore and offshore regulation creates different supply and demand conditions, which results in three separate, but related markets with differentiated market clearing exchange rates.

Hong Kong’s Role & Other Offshore Centres

Hong Kong has developed rapidly as the centre for CNH and has considerable advantages over other locations. Cross-border trade settlement can be cleared through both onshore correspondent banks and the local clearing bank, which is not possible elsewhere. Hong Kong is the only offshore jurisdiction that has a real-time local clearing system for RMB. CNH accounts can be held for any purpose, as opposed to being restricted only to trade-related flows, and there are no limitations on transfers between offshore accounts, thereby creating a CNH interbank market in Hong Kong.

Other financial centres are alive to the long-term opportunities presented by the offshore RMB market. Singapore is emerging as an active market place for CNH, with a number of banks announcing new RMB-denominated products in recent months, both for institutional and for retail customers. London also has an active interest; the UK Chancellor has declared his government’s intent to complement Hong Kong as a major offshore centre for the RMB. In January 2012, the Hong Kong Monetary Authority and HM Treasury announced a joint private-sector forum to promote cooperation between the two jurisdictions in developing the offshore RMB market.

Opportunity for Australia

From the Australian perspective the opportunity arising from RMB financing, both in CNH and CNY, for project financing is of particular interest. Given the importance of Australia as a
resource supplier to China and the growing investment stake that Chinese firms have here, there is a natural synergy in conducting transactions in RMB. From a market operations perspective the Australian dollar is a major traded currency with an increasing need to directly hedge risk against the RMB as well as the need to develop mechanisms for accepting collateral denominated in RMB.

Australia has the opportunity to grasp this nascent opportunity to operate within the network of developing offshore centres in cooperation with Hong Kong as the leading centre for RMB denominated settlement for Australian and Pacific trading activities and project financing.

There are three main conditions necessary for an offshore RMB centre:

- strong trade ties with China;
- a RMB swaps line with the People's Bank of China (PBOC); and
- the currency of the offshore centre being traded in China's domestic market.

Australia currently meets two of these prerequisites. The unmet third is the absence of a swap line. The non-deliverable status of offshore RMB means a central bank outside China needs a designated RMB swap line to enable it to intervene in the CNH market at times of stress. These are important for instilling confidence in China’s trade partners to use the CNY for settling their bilateral trade. Since late 2008, the PBOC has signed a total of 12 CNY currency agreements, called swap lines.

5. International Challenges Facing the Financial Markets Industry

Australia is under significant pressure in its effort to maintain, not to mind expand, the number of high quality financial markets jobs in Australia. It is evident from AFMA’s work with member firms through our market committees that some international banks have relocated staff or transferred trading functions to regional operations based in Hong Kong and Singapore. This process of consolidation is ongoing in some cases.

In relation to back office operations, AFMA’s 2011 Operations Survey Report provides a comprehensive picture of operations functions for financial markets performed in Australia, including the significant challenges facing the industry. In summary, the Report presents a declining trend in the percentage of traditional back office functions conducted in Australia:

- Back office functions are being taken or directed away from Australia;
- Offshoring of IT is common practice across the industry;
- Operations staff numbers have declined by 775, or 22%, compared to 2008; and
- Cost of operations and tax rates are important factors in offshoring.

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On a positive note, there was an increase in the percentage of organisations who undertake market risk, credit risk and operational risk functions in Australia. However, the overall trend is still likely to be negative, especially with some significant reconfigurations of global banks with operations in Australia.

The Asian Century presents an opportunity to recover ground and then build a presence in the Asian financial system that is commensurate with our skills base, our comparative advantage in sophisticated financial services and our economy.

6. Issues for the Australian Government to Address

Australia needs to improve its performance in assessing, adopting and implementing policy initiatives if we are to capture the full benefit of Asia’s expected growth through employment and income benefits for Australians from financial services industry exports.

Similar to the experience of the manufacturing, tourism and other industries, the international competitiveness of the Australian financial sector has been adversely impacted by the recent appreciation of Australian dollar. International banks and other firms have a choice about the jurisdiction in which they will base their trading and back-office operations. As outlined above, there is strong evidence of offshoring of operations in connection with transactions on Australian financial markets. However, the challenges in the financial sector are particularly significant. In contrast to many other sectors, equality of costs with other jurisdictions, or even lower costs, is not enough of itself to attract business to Australia, as financial centres like Singapore and Hong Kong offer significant taxation benefits to financial institutions and there is greater confidence in their ability to maintain a competitive position as a financial centre.

Because it is not feasible to match the low business taxation rates offered in these centres, it is essential that other factors within our control that impact Australia’s competitiveness as an international financial centre are managed in a highly effective way so our natural commercial capability to service Asia’s growing economies is not impeded. Traditionally, this is not something we have excelled at.

Australia has quite an innovative policy development history in the area of international financial services. However, our record in demonstrating a genuine commitment to the concept across all levels of government and in effectively implementing associated policy measures is mixed at best. For instance, the offshore banking unit regime (OBU) was revamped in 1992 and later extended in 1998 as part of the ‘Investing for Growth’ strategy but implementation of planned reforms was incomplete and subsequent contradictory policy actions reduced the competitiveness of the regime.\(^4\) It is hardly surprising that the OBU regime generates less income and employment for the economy than was originally anticipated.

\(^4\) For instance, the foreign income tax offset rules in Tax Laws Amendment (2007 Measures No. 4) Act 2007 were a setback to the competitiveness of the OBU regime. Another example is when the GST was introduced, the Government declined to make OBU transactions GST-free – the industry sought this treatment to reduce compliance costs; the tax impact would not be material.
More generally, the low priority sometimes given to measures to address identified problems in the application and the administration of rules affecting our standing as an international financial centre is a matter of ongoing concern.

For instance, by their nature, international financial centres need the regular, free movement of staff between jurisdictions to function effectively. However, a recently announced tax measure to significantly restrict living-away-from-home allowances available to expatriate workers will increase the cost of doing business in Australia. This measure will conflict with the objective of improving our competitiveness as a financial centre, unless the Government refines its proposal in a way that preserves the right for claims to be made in respect of legitimate expenses incurred by expatriate employees. Our purpose in raising this example is not to argue the case for change here, rather it is to simply illustrate how a government can give mixed signals about its policy priorities and in doing so be detrimental to efforts to promote Australia as a financial centre.5

The process for accepting an idea as being good policy can often take a long time to gestate and then delays in designing and legislating measures to implement this can further extend the time from idea to execution in a way that is unhelpful to our international competitiveness. For example, in the late 1990s, the Australian government announced withholding tax measures to promote foreign participation in our bond market but the Singaporean government had similar changes announced and effective before the law change was enacted in Australia. More recently, the Government announced interest withholding tax relief for financial institutions but with a delayed start date, which was further deferred to 2014-15 in November’s Mid-Year Economic and Fiscal Outlook. In situations like this, Australia makes the right policy decision but its execution of the reform reduces and delays the competitive benefits to the economy that flow from it.

More recently, the Johnson Report in 2009 recommended abolition of the LIBOR cap6, but this initiative has still not even progressed to the stage where Treasury can give advice to the Government, so a decision on this issue is left in policy limbo. The LIBOR cap penalises foreign bank branches and hinders banking competition and its effect is becoming more severe as the Basel III banking reforms are implemented. There is no sensible policy or administrative rationale for the LIBOR cap but the issue has been left unaddressed for almost a decade now.

Even major reforms can get delayed for an inordinate period of time. The taxation of financial arrangements (TOFA) regime, which helps our international competitiveness by broadly aligning our tax approach with international practice and lowering compliance costs, took over 15 years to get implemented. Moreover, the final rules are over engineered largely due to excessive concern about tax revenue protection and the new rules do not fully achieve their

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5 It is both interesting and relevant that the Irish government which is subject to a very stringent fiscal constraint last month took a different approach by offering a tax incentive to expatriates who can create employment – noting that these incentives are offered in other European countries. The following media report summarises the policy – http://www.irishtimes.com/newspaper/finance/2012/0209/1224311519210.html

6 Part IIIB of the Income Tax Assessment Act 1936 limits tax deductibility of interest paid by a foreign bank branch to its overseas parent for intrabank funding to the LIBOR rate.
objective. In our experience, too often good policy ideas do not translate into law with the speed and effect that is necessary to best serve the economy and we note that this concern is not limited to tax matters but also occurs in relation to financial services regulation. The overall effect works against our international competitiveness.

In contrast, proposals to further regulate the financial sector or to protect tax revenue are pushed through with relative speed, sometimes without proper cost benefit analysis. In addition, there does not seem to be a mechanism through which the Government can efficiently manage the cumulative impact of regulatory change over several fronts over a short period of time.

Australia’s current capability to make policy change to promote productivity and competitiveness does not align with the time frames required in business decision making. As an industry body we too often receive complaints about the time taken to implement change or for individual firms to receive a decision or an authorisation from a government body. We acknowledge that judgement on these matters must take account of the significance and complexity of policy matters and in some cases it would be harmful to the economy to embark on or accelerate a reform program because proper policy analysis can take time. However, in our experience, this is an area where on balance Australia needs to lift its performance if we are to take the opportunities presented by the expected growth of the Asian economies.

7. Suggested Actions for the Government to Consider

Over the past two decades, the industry has consistently emphasised the paramount importance of a genuine commitment by the Government to the objective of Australia as a financial centre, followed by action to create and maintain the conditions necessary to support a vibrant centre. This is necessary to give potential business entrants confidence that the Government is willing to engage with them and to deal with their issues efficiently and effectively. In practice, this means that the policy objective of supporting international financial services business is given due recognition in the formation and implementation of government policy. This is an area where the Asian Century consultation process may be of assistance to the Government, as measures to promote effective outcomes for the Asian initiative will also have application to the broader financial centre objective.

To give confidence to firms who might consider Australia as the location for their regional businesses:

- The Government should give an unambiguous commitment that it will give a high priority to measures necessary to sustain a competitive international financial sector;
- The Government should mandate the Minister for Financial Services to champion Australia as a financial centre both within government and externally;
- The Government and the Opposition parties should agree that the international competitiveness of the financial sector is in the national interest and work on a bipartisan basis to implement policy measures and to promote Australia internationally.
To ensure that its policy measures are fully effective and implemented:

- The Government should communicate its policy intentions, expectations and targets in clear terms to relevant departments and agencies, including Treasury and ATO;
- The Government should adopt a strategic focus on developing the capacity of its bureaucracy to support the design and implementation of its Asian Century objectives, particularly in respect of financial services;
- The Government should work with state governments, notably in NSW and Victoria, to develop policies that support the international competitiveness of the financial sector and to promote Australia on a coordinated basis;
- Many foreign jurisdictions have strong track records in developing and supporting their financial services industries - the Government should seek to systematically import international best practice to be used to the local industry’s advantage.

8. Specific Tax & Regulatory Measures

*Australia as a Financial Centre - Johnson Report*

Australia faces significant challenges in protecting its relevance as an international financial centre and in maintaining the level of associated financial services jobs. We are not in the same competitive tax league as Singapore or Hong Kong but we can take steps by making us more competitive in tax and other areas that would help to protect existing jobs in Australia and enable international banks to bring more business to Australia. This would help to provide the critical mass and diversity of business lines that is required to sustain financial services exports into the Asian region at the desired level.

The Johnson Report in 2009, *Australia as a Financial Centre – Building on Our Strengths*, has provided the Government with a good analysis of Australia’s strengths and weaknesses and our potential as an international financial centre. The report includes a range of recommendations relating to tax and regulatory matters that need to be addressed to achieve our national objective in this area. Progress in relation to several of the recommendations accepted by the Government is slow, so opportunities are being lost. The Government should implement these measures as a matter of priority.

*Managing the Tax System*

The growing number of instances where business representatives have expressed disquiet that law change is being applied retrospectively (eg in respect of transfer pricing), and sometimes without adequate consultation, is a significant concern from an Asian Century perspective. Companies seeking to build businesses in the Asian markets must accept and manage significant commercial and operational risks and they should not face another layer of risk through retrospective tax law change or through the administration of the tax system. A well-structured tax system that provides certainty to business is a pre-condition to Australia taking
best advantage of the Asian Century, so harmful retrospective tax change should be avoided at all costs unless it addresses a serious tax avoidance matter.

More generally, good governance of the tax system is necessary to support business activity and investment as it provides a more predictable and reliable tax environment for businesses, who must separately contend with a variety of economic and commercial risks. It is particularly pertinent at present to the maintenance of a high level of international confidence in our tax system. Good outcomes in this respect support Australia’s competitiveness as a place to invest in and from which to conduct international business. The Government should consider this aspect carefully as it finalises its planned enhancement to tax system governance.

In addition, the tax policy and legislative process regularly fails to deal with minor or technical deficiencies in the law in an efficient way. Collectively, these occurrences are a drag on economic growth and our international competitiveness. While there is an understandable focus on major reforms and revenue protection measures, the Government should provide the necessary resources to Treasury and the Office of Parliamentary Counsel to maintain all aspects of the tax law.

*Facilitating Cross Border Business Integration*

To take full advantage of the opportunities in the Asian Century, Australian financial services businesses may seek to increase exports from Australia, invest in Asian countries and businesses and in some cases combine their operations with Asian counterparts to deliver an integrated cross border business platform.

AFMA’s long standing position has been to support an internationally open financial system because it promotes better capital formation, innovation and competition. Australia’s financial markets currently benefit from a high level of international integration that is reflected in cross border capital flows, financial activity and the foreign ownership of financial institutions operating here. We support the international integration of Australia’s financial markets, especially with markets in the Asian region and in the major global centres.

The laws governing our financial system provide a sound legal and regulatory framework and the Australian regulators are well-placed to administer the law in a manner that will protect the stability, integrity, efficiency and competitiveness of our markets. Key financial market infrastructure facilities in Australia should continue to be subject to Australian regulatory oversight and business restructures should take account of the interest of their users and the national economy.

Within this framework, the cross-border combination of significant businesses could benefit our financial system and economy in terms of facilitating investment and capital flows between Australia and Asia, product innovation, market inter-operability and market efficiency. Australia should address issues raised by cross-border regulatory supervision through a global multilateral mutual recognition regime. The Australian economy has
benefited from an open approach in this regard through the development of our financial system and this approach will serve the economy well going forward.

Cost Recovery for Regulation

Cost recovery for financial regulation is being implemented in a way that is harmful to our international competitiveness and if the current trend continues it will more likely than not lead to more financial transactions being undertaken in offshore centres.

Cost recovery presents a significant ‘moral hazard’ for government because the incentive to have proportionate and efficient government regulation is diminished by the fact that the government itself does not have to pay for this regulation. Meanwhile, the business entities who must pay the levy have no control over the cost process. Whatever the design of cost recovery mechanisms, in practice they invariably lead to inequities in who pays, often lead to significant administration costs and can create inefficiencies in markets.

AFMA members are willing to pay their fair share of the costs of financial supervision, commensurate with the need to maintain fair and efficient markets for financial instruments and services and their existing financial contributions to government (including through tax). However, there are serious flaws in the current approach to cost recovery, including the unreasonable amounts that are being levied on some sections of the industry.

There has been a significant growth recently in government charges and levies on industry participants ostensibly to cover the cost of their regulation, which exacerbates the strain on the industry already implementing substantial, high cost regulatory reforms. In practice, some of these charges operate in a manner more akin to a tax on financial transactions. We are concerned both about the significant recent growth in cost recovery from the industry and the absence of rigour and discipline in the policy and practical basis upon which this is determined.

AFMA has advocated that where cost recovery measures are applied that they are subject to effective governance and accountability arrangements to ensure that administrative costs are reasonable, remain contained over time and have a neutral impact on financial markets. It should also take into account the public benefits, including higher government tax revenue that accrues from well-judged regulation.7

While entities in the financial sector are generally profitable, there is great diversity within the sector and individual entities may experience losses during dislocations like the global financial crisis or during more regular cyclical downturns. Cost recovery programmes, where they are implemented, should take account of the commercial conditions faced by the entities that are the collection point for regulation that in reality delivers a public benefit. This is not the case

7 For example, financial institutions’ compliance with anti-money laundering and counter-terrorism yields substantial public benefit in assisting the Government to combat crime and terrorism. In dollar terms, it yields $320m in tax revenue and other social cost recoveries.
in practice; cost recovery for ASIC’s equities market supervision, which is also not neutral in its competitive impact on the industry, is an example in this regard.\(^8\)

We believe that when government policy dictates cost recovery, the process for establishing and reviewing recoverable costs should fit within a coordinated policy framework that takes into account the economy-wide impact of multiple service charges, which are growing in number. This is not the case in practice, which is of concern to members and in some areas we have been told it will stymie business or lead to more business activities being done overseas.

9. **Concluding Comment**

While the opportunities for Australians presented by the Asian Century are promising and justify a policy response by the Government to enable us to maximise the potential benefits, implementation of effective policy measures in this area would be beneficial to our engagement with global markets in general. The developed economies, especially the US, will remain a major source of economic power, innovation and development and financial centres like London and New York will continue to be central to the world financial system. Asian growth presents a particularly exciting possibility for the Australian economy but this fits within the framework of a changing and more diverse global economy, all the elements of which are important to our future prospects. Thus, the comments and suggestions we make in this submission are relevant to the Government in terms of its broad economic policy, though the opportunities afforded by the Asian Century provide a notable incentive for change.

8 Moreover, it is relevant to note in this context that ASIC’s cost recovery charges are rising, while at the same time it is a net source of revenue to the Government (to the amount of $256 million in 2010–11).