Commonwealth Bank of Australia
Macquarie Group Limited
National Australia Bank Limited
Westpac Banking Corporation

20 January 2016

Ms Karen Payne
Board of Taxation
c/- The Treasury
Langton Crescent
PARKES ACT 2600

BY EMAIL: hybrids@taxboard.gov.au

Dear Ms Payne,

Re: Consultation Paper on implementation of the OECD's anti-hybrid rules

Thank you for the opportunity to comment on the Board of Taxation's Consultation Paper, *Implementation of the OECD Anti-hybrid Rules* ('**the Consultation Paper**'). This submission is made by Commonwealth Bank of Australia, Macquarie Group Limited, National Australia Bank Limited and Westpac Banking Corporation ('**the Parties**'). While the submission touches on a number of the questions posed in the Consultation Paper, we have chosen to focus principally on those issues that are particularly relevant for the Australian banking industry.

Executive Summary

This submission argues that, whatever form the Board's recommendations to the Government finally take:

1. A dedicated exception is needed, for the reasons set out below, for regulatory capital instruments involving Australian banking groups, their subsidiaries and branches [Questions 35-36 of the Consultation Paper].

2. If recommendation 1 is not accepted, any rule which might be enacted should be unequivocally prospective in its operation and apply only to instruments issued on a date *after* the relevant legislation has been enacted by Parliament. Only this transitional rule will provide the appropriate level of certainty about the status of instruments already on issue, avoid the difficulty and cost of potential refinancing for issuers and unintended impacts on investors and not challenge the market's capacity to meet the demand [Questions 6-10 of the Consultation Paper].

Focus of this submission. The proposals in the *OECD/G20 Base Erosion and Profit Shifting Project, Neutralising the Effects of Hybrid Mismatch Arrangements Action 2: 2015 Final Report* (October 2015) ('**Final Report**') deal with many different transactions and structures. The focus of this submission is on the issues arising for the Australian banking industry from the application of any proposed anti-hybrid rules to regulatory instruments held cross-border.

The submission focuses on:

- the three proposals directed to 'hybrid financial instruments,' being the recommended domestic rule, the dedicated anti-hybrid 'response' rule and the dedicated anti-hybrid 'defensive' rule [Chapter 1 of the Final Report; items 1 and 2 of the Table on page 7 of the Consultation Paper]; and

- the 'imported mismatch rule' [Chapter 8 of the Final Report; item 8 of the Table on page 7 of the Consultation Paper];

with particular reference to Additional Tier 1 instruments involving Australian banking groups.

Thus, we do not address the questions in the Consultation Paper or proposals in the Final Report which deal with transactions involving hybrid entities, reverse hybrid entities or dual resident entities. Nor do we examine the potential application of an anti-hybrid rule on other financial instruments included in the Final Report such as derivatives and 'hybrid transfers.'

While that is our main focus, the former Treasurer's letter to the Chair of the Board of 12 May 2015 commissioned the Board to:

> *... undertake consultation of introducing the G20/OECD's rules to neutralise hybrid mismatch arrangements. The Board is asked to examine how best to implement the new anti-hybrid rules in the Australian legal context.*

We take it from Questions 1-4 of the Consultation Paper that the Board is interested in considering the broader question as to whether the domestic rules recommended by the OECD are in fact appropriate for Australia, as well as the narrower question about how such rules might be framed. So, while the focus of this submission is quite specific, we do wish to note our views that the proposals in the Final Report:

- appear to us to be excessive, given the amount of Australian revenue at stake (or to be gained) both now and in the foreseeable future;

- will likely raise the cost of capital for all Australian businesses, both in the banking sector as well as through passing on additional cost to customers, to non-banking sectors of the economy including home buyers, small businesses and start-ups;

- involve a significant loss of sovereignty in tax matters to decisions made by the governments and tax administrators of other countries; decisions which could prove to be strategic or opportunistic and come at the expense of the Australian revenue base and/or Australian taxpayers;

- are unnecessary given Australia's decision to implement debt-equity rules in 2001 to counter the effects of instruments which implement abusive structures and produce unacceptable tax outcomes;

- are unnecessary given Australia's existing laws for countering the effects of instruments held cross-border which implement abusive structures and produce unacceptable tax outcomes;

- would be premature at this stage as they are not matched by measures adopted by other key jurisdictions such as the US, UK and Singapore;

- will prove difficult to administer and costly to comply with from the moment they are introduced because they are so dependent on matters which will change often, and are not within the reasonable knowledge and definitely not the control of either Australia's tax administrators or of resident taxpayers; and

- represent a less-than-optimal means for addressing problems.

Background to regulatory capital instruments. Australian banking groups are regulated by the Australian Prudential Regulation Authority (**'APRA'**) which adheres to the principles established by the Basel Committee on Banking Supervision.

APRA requires banking groups to hold a certain level of capital to protect depositors. In general, capital is permanent or long-dated funding with the ability to absorb losses in times of stress. The funding can be deployed in the banks' businesses because, in times of stress, banks are not required to repay the funding due to the application of the loss absorbency features.

APRA requires banks to hold capital in three forms: Common Equity Tier 1 Capital (**'CET1'**), Additional Tier 1 Capital (**'AT1'**, also called "hybrid Tier 1 Capital") and Tier 2 Capital. The subordination, risk-profile and loss absorbency features of CET1 are greater than those of AT1 and Tier 2 Capital. CET1 absorbs losses before AT1 and Tier 2 Capital. For these reasons, CET1 is more costly to raise than AT1, and similarly AT1 is more costly to raise than Tier 2. It is understood by regulators that each Tier becomes an increasingly expensive source of funding for the banking group to support – see Financial System Inquiry, *Final Report* (November 2014) p. 39, 47.

However, under the debt-equity rules of the Australian tax law, the loss absorbency features of AT1 cause AT1 instruments to be equity for tax purposes. Consequently, distributions paid on AT1 instruments are automatically frankable as a result of the interaction of regulatory requirements and the tax law.

All AT1 instruments are offered and priced at a market rate. Australian-resident investors value the franking credits attached to the distributions. Therefore, as a commercial matter, issuers pay the distributions as a combination of cash and the value of the franking credits. We stress that this is a commercial matter because, provided they receive the market rate in total, investors are broadly indifferent as to whether they receive cash or franking credits or a combination (for this reason, if franking credits are not attached, the cash component of the distribution increases). Investors are not involved in a scheme to obtain the franking credits. However, the ability to reduce the cash component of distribution has a real benefit to the issuer in terms of a reduced cost of funding and therefore reduced costs in lending to customers.

Finally, we note that, in discussions with the Board, the Parties have discussed a commonly-used security structure called the "deductible/frankable" structure. The structure is identical to the frankable AT1 instrument discussed in the preceding paragraphs. However, the instrument is issued by an Australian banking group through an offshore branch. The

primary reason for issuing through the offshore branch is the immediate ability to use the resulting funding in the offshore business.

As a consequence of using the funding in the offshore business, the funding maybe deductible for tax purposes in that offshore jurisdiction. As previously mentioned, investors usually allow the cash component of the distribution to be reduced as a result of the attached franking credits. Consistent with this, the deduction in the relevant offshore jurisdiction is only for this lower amount (ie, not for the value of the franking credits). Conversely, where no (or only some) franking credits are attached, and therefore the cash component of the distribution increases, this would have the effect of increasing the cost of funding to the offshore branch and therefore the relevant deduction which is less optimal for the foreign jurisdiction's tax base.

1. Carve out for regulatory capital instruments – Questions 35-36

It is our submission that a dedicated exception is needed for regulatory capital instruments involving Australian banking groups, their subsidiaries and branches [Questions 35-36 of the Consultation Paper].

The exception has to be expressed in these broad terms because it will need to cover situations where:

- the banking group (the Australian Parent, foreign subsidiary or offshore branch) is issuing an AT1 instrument as the means for **raising funds**, whether from within the group or externally; and

- where the AT1 instrument is being used as the means to **supply funds** for the group's onshore or offshore operations (to the Australian Parent, to an foreign subsidiary or offshore branch).

This exception is most critical for AT1 capital instruments where cross-border mismatches are more likely to occur due to the interaction of the banking regulator's requirements on the form of AT1 capital instruments and the application of Australia's debt equity rules, but it is possible that an exception may also be relevant and necessary for Tier 2 instruments as well. Indeed, the experience in Australia which led to the need to promulgate regulations 974-135D, 974-135E and 974-135F shows that even Tier 2 instruments can prove problematic under debt-equity tests.

Hence, our submission does not differentiate between AT1 and Tier 2 instruments, and is expressed to extend to all regulatory capital instruments, including those issued by a Non-Operating Holding Company ('**NOHC**') of a banking group. The Australian regulatory framework for banks now provides for groups which include a bank to be headed by a NOHC, which itself may issue regulatory capital instruments. As a result, it is important that any carve-out for regulatory capital instruments also include those issued by NOHCs of banking groups, as well as by banks themselves.

AT1 instruments are defined by APRA in *APS 111: Capital Adequacy: Measurement of Capital* (2014) as:

> *27. Additional Tier 1 Capital comprises high quality components of capital that satisfy the following essential characteristics:*

(a) *provide a permanent and unrestricted commitment of funds;*

(b) *are freely available to absorb losses;*

(c) *rank behind the claims of depositors and other more senior creditors in the event of winding up of the issuer; and*

(d) *provide for fully discretionary capital distributions.*

However, AT1 does not include CET1 (which typically comprises ordinary shares, retained earnings, current year earnings and certain other reserves). AT1 Capital instruments represent a permanent and unrestricted commitment of funds, which may be issued in the form of equity (for example, preferred shares) or in the form of debt (for example, subordinated, perpetual or converting debt). AT1 instruments will have both debt and equity-like features such as mandatory conversion to ordinary shares on the occurrence of a non-viability event.

As AT1 Capital instruments will not be conventional debt or equity in form, they can represent a hybrid financial instrument, depending on their treatment both in Australia and offshore, and thus potentially susceptible to challenge under an anti-hybrid rule of the kind being examined by the Board.

The exception being sought by the Parties needs to extend to:

(i) any proposal to change the current definitions and/or treatment of debt and equity and the returns on debt and equity interests in domestic law;
(ii) any proposed anti-hybrid 'response' rule; and
(iii) any proposed anti-hybrid 'defensive' rule.

1.1 Consistency with OECD Final Report

It is our submission that the proposed carve-out would be consistent with the recommendations of the Final Report.

First, we note that there was disagreement in the OECD during the BEPS project about whether the recommendations on Action Item 2 should extend to banking groups. In its December 2014 report, *Tackling aggressive tax planning: implementing the agreed G20-OECD approach for addressing hybrid mismatch arrangements*, UK Treasury referred to, 'the absence of G20-OECD consensus' leading to an agreement that, 'countries be allowed to provide on an individual basis how the hybrid mismatch rule should apply to hybrid regulatory capital' [paras 5.63 – 5.65].

The Final Report reflects that compromise position and permits countries to exclude intra-group regulatory capital instruments such as AT1 capital from the scope of any hybrid mismatch rules:

> *As indicated in the September 2014 report, countries remain free in their policy choices as to whether the hybrid mismatch rules should be applied to mismatches that arise under intra-group hybrid regulatory capital* [Final Report, page 11]

The Board should definitely recommend that the Government take this position. Adopting this carve out would immunise intra-group instruments from challenge by an anti-hybrid rule.

However, as will be seen below, this exception is not sufficient, given that the great bulk of the existing AT1 instruments involving Australian banking groups are currently issued to outside investors. Importantly, as publicly held securities, they should not be regarded as being within the ambit of Example 2.1 of the Final Report, which contemplates only "some" of the securities being held by unrelated investors. Hence it is our submission that an exception is needed for *all* regulatory capital instruments, whether held intra-group or by external investors and any related on-lending to subsidiaries or branches.

With respect to instruments held by external investors, and despite the impression given in the Consultation Paper, there has not been strong support for dedicated anti-hybrid rules of the kind recommended in the Final Report. The Consultation Paper says:

> *a number of countries (for example the UK, Japan and the Netherlands) have either already enacted, or have announced that they will enact, a similar rule to recommendation 2 in their domestic tax law* [Consultation Paper, para 4.13]

With respect, this is somewhat misleading. As was noted above, the OECD's Final Report recommends three rules:

> *specific improvements to domestic law, designed to achieve a better alignment between those laws and their intended tax policy outcomes (**specific recommendations**), and*
>
> *the introduction of linking rules that neutralise the mismatch in tax outcomes under a hybrid mismatch arrangement ... (**hybrid mismatch rules**)* [Final Report, para 4]

These countries are focussed on the domestic rule (the 'specific recommendations') to deny a participation exemption for dividends received from foreign subsidiaries where the payments were deducted or deductible to the payer. (The UK and The Netherlands, along with all other EU Member States, are obliged to enact the domestic rule in order to comply with the amendments made to the EU Parent Subsidiary Directive.) None of the countries have enacted the hybrid mismatch rules set out in the Final Report. Nor have these countries addressed payments made outside the group to external investors. The UK Government has also previously introduced legislation to ensure that AT1 and Tier 2 regulatory instruments are deductible for UK tax purposes.

Hence, by implementing the position recommended in this submission, Australia would be:

- acting consistently with the OECD compromise to exclude **intra-group** hybrid regulatory capital reflected in the Final Report; and
- would not be out of step with current international practice by excluding regulatory capital instruments held by **external investors**.

1.2 Commercial and regulatory aspects of AT1 instruments

Not only is such a carve-out consistent with our international commitments and current international practice, it is important to observe that, in the banking industry, AT1 instruments are issued (and in fact are required to be issued) for regulatory and commercial reasons that are not driven by tax considerations. Given the incremental cost of most AT1 instruments over normal bank funding, such instruments are typically only ever issued to meet relevant regulatory capital requirements.

We wish to stress this point because the tenor of the Final Report is that an anti-hybrid rule is needed to address deliberate, tax-motivated structures which are put in place to exploit divergent treatment:

> *The policy behind recommendation 1 is to prevent a taxpayer from entering into structured arrangements or arrangements with a related party that exploit differences in the tax treatment of a financial instrument to produce a D/NI outcome* [Final Report, para 18]
>
> *In general the rules are intended to improve the coherence of the international tax system and remove the incentive for taxpayers to exploit gaps in the international tax architecture* [Final Report, para 303]

This description is not applicable to AT1 instruments involving Australian banking groups. The terms of AT1 instruments are determined by APRA in great detail, with little room for issuers to modify. This means they are not instruments that can be deliberately manipulated to produce particular tax outcomes.

As mentioned above, APRA requires banks to hold a certain level of capital to protect depositors. One of the repercussions of the global financial crisis of 2008 and the Third Basel Accord has been increased focus on the amount and quality of capital. In Australia, APRA has been actively ensuring that Australian banking groups meet these enhanced capital adequacy requirements and in order to meet these heightened regulatory requirements several Australian banks have already increased their CET1, Tier 1 Capital, and Total Capital Ratios.

The recent experience of the Australian banking industry has demonstrated a strong market demand for products which are AT1 Capital. They offer higher returns than traditional debt-based products, due to the additional subordination and loss absorbing features. in addition, part of the attraction comes from the fact that these instruments can be easily traded on markets. A feature which makes these instruments appealing to some classes of institutions is that instruments which are debt-based may fall outside investment mandates which restrict investments in equity instruments.

From the issuer's perspective, AT1 Capital instruments have the advantage that they allow banking groups to raise additional capital which will meet the regulatory test of Tier 1 Capital but at a cost of funds that is substantially lower than the cost of servicing CET1 capital – see below. Consequently many recent and significant capital raisings have been undertaken by Australian banking groups in this form.

There are also other non-tax drivers for Australian banking groups to use AT1 instruments as the means of providing funds to offshore operations. The OECD's March 2014 document,

Public Discussion Draft – BEPS Action 2. Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws) alluded to two important trends in the regulation of the banking industry [para 160]:

- regulators are increasingly encouraging domestic banks to issue all regulatory capital out of the parent company and pass this capital down through the group to the relevant operating subsidiaries; and

- some regulators of foreign subsidiaries and branches are becoming reluctant to allow subsidiaries and branches to issue instruments directly to investors in local markets.

Both of these emerging trends, no doubt driven by views of sound banking policy, inevitably lead to the concentration of fund-raising on one (head) entity in a banking group, and the consequent need to supply funds cross-border, rather than having diversified equity funding with local operations sourcing regulatory capital locally. Banks will increasingly wish – or have – to raise funds in their home market using an AT1 instrument and then on-supply those funds to foreign operations using a similar instrument. The tax system should not interfere with issuing regulatory capital instruments or instruments that meet Total Loss Absorbing Capital Capacity ('**TLAC**') requirements at the parent level and passing this down within the group to local country subsidiaries or branches on similar terms, given that this is increasingly preferred by banking regulators.

The UK Treasury has expressed concern about the possibility of this aspect of the hybrids project challenging banking regulation more generally. In its March 2014 report, *Tackling aggressive tax planning in the global economy: UK priorities for the G20-OECD project for countering Base Erosion and Profit Shifting*, UK Treasury raised:

> ... *concern* [about] *the extent to which anti-mismatch rules might disincentivise regulated financial institutions from raising capital in more loss absorbing forms, an outcome which would be counter to regulatory objectives* [para 2.19]

There is clearly a danger that an ambitious anti-hybrid rule could discourage banking groups from having the most suitable capital structure; this would be an unfortunate outcome from a change to tax law.

So, while these instruments may appear complex, they take their form for the sound commercial and regulatory reasons just outlined, namely, the requirements of the banking regulator about the design of the instrument, the appetite of the market for these kinds of instruments, their attractiveness to issuers compared with Common Tier 1 Equity, the attitudes of banking regulators about where capital is raised, current regulatory preferences about how it is provided to local operations, and the desire to have capital with greater – not lower – ability to absorb losses. None of these explanations involves any tax considerations.

Given that the goal of APRA's regulatory rules is to protect depositors by ensuring a resilient banking system which can withstand financial shocks, measures which challenge the ability of banks to continue to issue these instruments have the potential to contradict regulatory settings with adverse impacts on the Australian banking industry and the broader Australian economy.

That is, a less competitive or weaker banking system will be less able to weather a financial shock which is at the core of APRA's objective to maintain financial stability.

1.3 Impact on the cost of capital

One of the main concerns of the Parties to this submission is the likelihood that any anti-hybrid rule enacted by Australia will increase the cost of raising regulatory capital. An ambitious anti-hybrid rule will make it more expensive for an Australian banking group to raise capital to lend to Australian customers and to finance to its offshore operations; to the overall detriment of the Australian economy at large, and not just the banking sector.

This can be seen in evidence given to the Courts in *Mills v Commissioner of Taxation* [2011] FCA 205, (***'Mills'***). The case involved a cross-border hybrid instrument issued by the Commonwealth Bank group primarily to Australian retail investors intended to fund the operations of the Bank's New Zealand subsidiaries. The instrument was classified as Tier 1 capital for regulatory purposes. Evidence on the public record and accepted by the Court showed that:

- if the funding was raised using the hybrid instrument, distributions on which were both deductible in New Zealand and frankable in Australia, the cost to CBA of servicing the instrument would be between 5.58% and 5.86% pa;

- if the funding was raised using the hybrid instrument, distributions on which were deductible but not frankable, the cost to the Bank of servicing the instrument would be 7.87% pa; and

- if the funding was raised by issuing ordinary shares, the cost to the Bank would be 14.20% pa.

See *Mills at* paras [63] – [65].

For the purposes of this submission we have undertaken some more recent estimates of the additional cost which a dedicated anti-hybrid instrument might entail. Although this exercise is admittedly speculative, our best judgment is an increase in financing costs of at least 100-150 basis points. Additional financing costs could even exceed 200 basis points depending on the jurisdiction into which the instrument is issued and the market conditions at the time. This range is consistent with the evidence given in the *Mills* case.

We have been asked to provide evidence about the value of AT1 instruments currently on issue. The Parties to this submission collectively currently have on issue the following AT1 hybrid capital instruments:

	Total (AUD bn)
AT1 instruments currently on issue to **external holders**:	26.21
of which, the value of deductible/*frankable* instruments is:	6.26

and of which, the value of deductible/*non-frankable* instruments is:	6.95
AT1 instruments currently on issue and **held internally:**	1.50
of which, the value of deductible/exempt instruments is:	1.00

Some of the AT1 securities were issued by the Parties with a foreign currency denomination. In such cases the table above includes the approximate current AUD equivalent of the foreign currency face values of such securities.

It is noted in relation to (foreign) deductible/non-frankable instruments that our previous comments equally apply on market pricing. That is, investors look at the total return, and to the extent that franking credits are not attached this would increase the cash component of distributions. This is reflected in the *Mills* evidence discussed above, where the cost of servicing these instruments was higher. It is also important to note that there can be limitations in issuing deductible/non-frankable instruments that are both commercial (e.g. offshore investor appetite) and tax related. Section 215-10 imposes restrictions on how these issuances may occur and how the funding may be utilised. There have been historic issues around the tax administration of this section that has meant that as of today only one bank has issued in this form since 2009.

These figures reveal several key points:

- the great bulk of the instruments on issue were issued by banks or their foreign branches to raise funds from external investors; only a relatively minor amount involves instruments held within the banking group. Given that a major focus of the Final Report is on payments flowing between 'related persons' or members of the same 'control group,' most of the instruments issued by Australian banking groups do not fall into the target groups;

- it is clear that the market for these instruments is mostly Australian resident entities (primarily, individuals and SMSFs) who value the franking credits attached to the instruments, where applicable. This is the explanation of the evidence in the *Mills* case (noted above) of strong demand for these instruments and this has been borne out by subsequent issues of AT1 instruments. Given that the other focus of the Final Report is on payments made under 'structured arrangements,' the instruments issued by Australian banks do not fall squarely into that group either. So far as the investors are concerned, the instrument is not 'designed to produce a hybrid mismatch.' The investor does not see any hybrid dimension to the instrument; it sees an instrument with a strong, stable, predictable, preferred (compared to ordinary dividends) and slightly elevated return (compared to senior or Tier 2 debt). How that occurs is not apparent to the holders; and

- because they are issued predominantly to external retail investors, the instruments are typically widely-held, and are often listed and traded. This could mean enormous compliance costs for a banking group – monitoring not just the identity and residence of holders, but also the ongoing treatment of each investor in its country of residence in order to determine the bank's own tax position. The cost will be large

because non-residents will often hold their instruments through custodians and nominees. Moreover, since it could be the bank's tax position that is put in jeopardy by an anti-hybrid rule rather than the investor's, investors are unlikely to come forward and update their records spontaneously. Experience shows some will even ignore repeated requests for information.

Ultimately, a higher cost of raising regulatory capital will mean that Australian banks will be less competitive internationally and will result in higher costs to borrowers, lower returns to shareholders or both.

1.4 Flow-on effects of a higher cost of capital

Another dimension to the effects of an anti-hybrid rule is its potential effect on the capacity to lend because of the balance sheet impacts. If the cost of AT1 capital became prohibitive, a bank would face a reduced capacity to lend and support the economy, by multiples of the amounts of AT1 capital.

Using the numbers above, there is currently about $26bn of AT1 capital raised from external sources and this (supplemented by other regulatory capital held by banks) likely supports hundreds of billions of loans to customers. Just how many hundreds of billions is difficult to calculate because of the identity of the borrower and therefore the various capital risk-weighting that may be applied, and the new rules requiring capital conservation and countercyclical reserves, but the multiple will be large. Based on current regulatory requirements, our calculations suggest that $1bn of AT1 capital, in conjunction with a required amount of CET1, would support at least $45bn of lending (for 100% risk-weighted assets), and maybe as much as $90bn of lending (for 50% risk-weighted assets). This implies that the current $26bn AT1 capital could be supporting over $2 trillion in loans, depending upon the risk-weighting of the loans.

Given that raising Tier 1 capital as CET1 is significantly more expensive than raising AT1 capital, and the very real difficulties banking groups have historically faced in raising AT1 Capital that the Australian law does not require to be franked, banks may need to replace AT1 capital with higher cost CET1, which would be difficult and expensive to refinance in a short period of time. Further, the shortfall cannot be made up by issuing Tier 2 instruments. The consequence is that banks may face a significantly reduced capacity to lend. Banks may, therefore, have to become more selective in their lending decisions, or be willing to suffer the incremental cost of raising additional regulatory capital.

As noted above, this is already a real challenge being faced by the sector as banks are increasingly being required to hold greater levels regulatory capital to support current lending, capital which at today's margins is also more expensive. Further increases to the cost of capital for Australian banks as a consequence of tax changes, that in fact serve to both diminish real economic activity and deplete foreign tax bases (through this higher cost), are not consistent with the underlying objectives behind the OECD's anti-hybrids work.

1.5 Ensuring consistency with Australia's international competitors

The Australian banking industry is one of the strongest performing sectors of the economy but there is a real risk that the ability of Australian banks to compete in international markets will be seriously jeopardised if an anti-hybrid measure is adopted and extends to

banking groups. The risk of damage to the banking sector will be increased if the Australian Government acts early or unilaterally or both.

The disagreement in the OECD about whether any recommendations should extend to hybrid regulatory capital has already been noted. Now that the focus has moved to implementation in domestic law, it is clear that the governments of other countries are treating the banking sector as a special case, requiring exceptions, at least temporarily and possibly permanently.

United Kingdom. For example, the UK has consistently taken the position that the UK banking industry is not to be adversely affected by the BEPS project. The Consultation Paper gives the impression that the UK is an enthusiastic and early adopter of anti-hybrid rules:

> *The UK is the only country that has announced publicly that it will implement OECD compliant anti-hybrid rules and indicated an intended start date, being on or after 1 January 2017* [Consultation Paper, para 2.7]

We think the position is better put as, *while the UK has announced publicly that it will implement OECD compliant anti-hybrid rules, the UK has also made clear it will **not** allow its banking industry to be disadvantaged by any anti-hybrid measure*. This is a consistent position adopted by the UK government and repeated every time the UK has examined the issue:

- For example, the report by the UK Treasury & UK HMRC, *Tackling aggressive tax planning in the global economy: UK priorities for the G20-OECD project for countering Base Erosion and Profit Shifting* (March 2014) recommended special caution in applying any anti-hybrid measures to the banking sector:

  > *The UK supports the current work around Action 2 to develop new international tax rules to prevent companies avoiding tax through the use of certain business structures or finance transactions, ensuring that these do not create an unfair advantage. However, the exercise needs to consider whether there could be special rules for intra-group hybrid regulatory capital instruments that are a direct consequence of regulatory requirements.*

- Again in Treasury & HMRC, *Tackling aggressive tax planning: implementing the agreed G20-OECD approach for addressing hybrid mismatch arrangements* (December 2014) ch 8, there is a clear statement that:

  > *There is a concern ... that the hybrid mismatch rule would have a negative impact on hybrid regulatory capital issued intra-group ...* [An anti-hybrid rule] *would trigger the mismatch rule and put the subsidiary (and possibly the wider group) at a tax disadvantage relative to banks for whom direct UK issuance is possible. This would create an uneven playing field between UK and some non-UK headquartered banks. It could also create tension between the tax and regulatory regimes, by providing incentives for groups to raise capital in a way that is sub-optimal from a financial stability standpoint. The government is keen to avoid this ...*

- The draft legislation released in the UK on 9 December 2105 proposes anti-hybrid measures to be enacted in 2016 and take effect from 1 January 2017, but these measures will exclude banks. See HMRC, *Tackling aggressive tax planning: implementing*

the agreed G20-OECD approach for addressing hybrid mismatch arrangements – Summary of Responses (December 2015):

> *The government wants to give further consideration to the hybrid rule's application to regulatory capital, taking into account the concerns raised by respondents and the ongoing considerations around interest restriction rules for the financial sector. The legislation therefore:*
>
> - *excludes from the hybrid rule any financial instruments that are regulatory capital securities for the purposes of the Taxation of Regulatory Capital Securities Regulations (SI 2009/3209 and any subsequent amendments to that instrument); and*
>
> - *references the existing power within under Section 221 FA 2012 that will allow the hybrid rule, or some modification of the rule, to be applied to regulatory capital securities at a later date if considered appropriate.*
>
> *The government will continue to consider which options provide the most appropriate solutions, in conjunction with the further work being undertaken by the OECD on financial sector interest restriction rules. It is the intention that the appropriate treatment of hybrid regulatory capital securities can be set out in regulations made at later date. Such regulations will enable the hybrid rules to focus on specific risks with regard to regulatory capital.*

The clear intention of these measures is to protect the competitiveness of the UK banks from the adverse impacts of an anti-hybrid rule.

United States. The UK position is not surprising given that the political situation in the United States for the foreseeable future militates against action to enact anti-hybrid rules. For example, in June 2015, Senate Finance Committee Chairman Orrin Hatch and House Ways & Means Committee Chairman Paul Ryan wrote to the Obama Administration and declared publicly that:

> *Regardless of what the Treasury Department agrees to as part of the BEPS project, Congress will craft the tax rules that it believes work best for U.S. companies and the U.S. economy... We expect that as we move forward on U.S. tax reform, U.S. tax policy will not be constrained by any concessions to other nations in the BEPS project to which Congress has not agreed... We ... have significant concerns about many of the provisions included in several other proposals of the BEPS project ...*

Although the US 'check-the-box' rules are at the heart of many of the examples in the Final Report, the clear import of the Hatch-Ryan letter suggests that the US Congress is not likely to change those rules just because they are the source of many of the cross-border mismatch outcomes.

Singapore. Based on the remarks to date of senior politicians (see below), it seems Singapore is also not proposing to pursue an ambitious anti-hybrid rule.

Given that anti-hybrid rules will drive up the cost of capital for Australian banking groups and as a consequence have flow on effects for the broader Australian economy, the implication for Australia of the situation in the US and UK is clear: the Australian Government should be

extremely reluctant to enact anti-hybrid rules which apply to the banking sector until after other countries have actually acted. Acting early and unilaterally will only disadvantage Australian banking groups vis-à-vis their US and UK competitors.

2. Grandfathering and transition [Questions 6-10]

This submission has argued that regulatory capital instruments involving Australian banking groups should be excluded from the scope of any anti-hybrid rules that might be enacted. If that submission is not accepted, it then becomes necessary to consider the transition to the new rules.

In our submission, any rule which might be enacted should be unequivocally prospective in its operation and apply only to instruments issued on a date *after* the relevant legislation has been enacted by Parliament. Only this transitional rule will provide the appropriate level of certainty about the status of instruments already on issue, avoid the incremental cost of leaving existing instruments on issue and avoid the difficulty and cost that would arise if the existing AT1 instruments were refinanced.

With regard to Questions 8 - 10, as was noted above, the Parties making this submission currently have about $26bn AT1 Capital instruments on issue. If an anti-hybrid rule was enacted and applied to even some of these instruments, it is very likely that greater funding costs would be incurred on these instruments or the instruments retired out of the proceeds of new fund-raising. The costs associated with refinancing that amount of regulatory capital would be very significant, especially if the Parties all had to go to market at more or less the same time.

With regard to Question 7, as was noted above, in our view there is real doubt whether the UK and US will enact dedicated anti-hybrid rules which extend to the banking sector. Furthermore, other significant banking centres in our region – Singapore and Hong Kong – have shown little interest in enacting any of the OECD recommendations. For example in speech in September 2015, Singapore's Senior Minister of State for Finance and Transport, Mrs Josephine Teo, said:

> *Singapore, like many countries, has been studying the BEPS recommendations... In our view, a global convergence towards higher taxes globally would be a poor outcome for the BEPS project, and a severe impediment to uplifting global growth prospects ...*
>
> *... we must recognise each country's sovereign right to determine its tax policies to attract investments, support entrepreneurship and promote growth. Countries compete on the attractiveness of our tax measures in the same way we compete in the quality of our human capital, infrastructure or administrative efficiency. There is a cost to developing a competitive advantage in any dimension, including tax measures. It is entirely up to each country to design its overall value proposition at a cost that it can afford...*

The Australian Government should not enact anti-hybrid rules which apply to the banking sector unless other jurisdictions with significant banking sectors (such as the UK, US, Singapore and Hong Kong) have also acted. Doing so will only damage one of the most stable, valuable and best-performing sectors of the Australian economy by putting

Australian banking groups at a competitive disadvantage. Strong banks are essential for maintaining financial stability and confidence in our financial system.

3. Franking credits should not be classified as "equivalent tax relief" [Question 15]

As mentioned above, distributions paid on AT1 instruments are frankable as a result of the interaction of APRA's requirements and the tax law (specifically the debt-equity rules). Neither the issuer nor Investors are involved in a scheme to obtain the franking credits.

The Board should exercise caution in classifying franking credits as "equivalent tax relief" for this reason.

Franking credits are important to the Australian economy and provide a key integrity measures to the Australian tax system. The key benefits to the Australian economy of having imputation/franking are:

- companies have an incentive to pay-out more profits as franked dividends, invest wisely and not accumulate excess cash;
- companies are discouraged from being excessively geared, funding their businesses with equity rather than debt and hence strengthening balance sheets ;
- the integrity of the tax system is improved as there is an incentive for Australian companies to pay Australian tax rather than avoid it; and
- it favours Australian investment in domestic companies, as offshore companies do not pay imputation credits.

If they are classified as tax relief, it could lead to unintended consequences for other parts of the Australian tax law as well as cause other jurisdictions to enforce the OECD proposals against Australian taxpayers in circumstances which should not otherwise attract their operation.

4. Deductions for ATI capital instruments

Finally, we would like to take the opportunity of this submission to repeat in this context the argument we have made elsewhere that distributions on AT1 capital instruments should be made deductible (and therefore un-frankable) as a matter of Australian domestic law, regardless of the characterisation of the instrument under Australia's domestic debt-equity rules. We hope the Board will take the opportunity of its report to the Government to endorse this position.

Making distributions on AT1 capital instruments deductible would align Australian tax law with the treatment offered by other countries such as the UK, France, Germany and recently Singapore. (It is perhaps not surprising that the Swiss banking house Julius Baer, announced in October 2015 that it would be issuing a new SGD-denominated AT1 instrument in the form of perpetual subordinated bonds to be listed on the Singapore Exchange out of its Singapore operations.) Allowing a similar deduction for distributions on AT1 instruments would make the tax environment for Australian banking groups closer to that facing many of their competitors, reduce the cost of raising capital in this form for Australian banking

groups and consequently their customers, reflect more accurately the market perception of these instruments.

* * * *

Please do not hesitate to contact any of the relevant bank representatives listed in the table below, should you wish to discuss the above matters, or if you require further information.

Commonwealth Bank of Australia	Chris Millett, chris.millett@cba.com.au	02 9118 1872
Macquarie Group Limited	Peter Radlovacki, Peter.Radlovacki@macquarie.com	02 8237 8435
National Australia Bank	Jeff Shaw, jeff_shaw@national.com.au	0414 279 764
Westpac Banking Corporation	Michael Barbour, mbarbour@westpac.com.au	02 8253 3348

Yours sincerely,

Chris Millett
General Manager, Group Taxation
Commonwealth Bank of Australia
02 9118 1872

Stuart Dyson
Group Financial Controller, Financial Management Group
Macquarie Group Limited
02 8232 8670

Mr Jeff Shaw
Head of Tax – Corporate Advisory
National Australia Bank Limited
0414 279 764

Michael Barbour
General Manager – Group Tax
The Westpac Group
02 8253 3348

groups and consequently their customers, reflect more accurately the market perception of these instruments.

* * * *

Please do not hesitate to contact any of the relevant bank representatives listed in the table below, should you wish to discuss the above matters, or if you require further information.

Commonwealth Bank of Australia	Chris Millett, chris.millett@cba.com.au	02 9118 1872
Macquarie Group Limited	Peter Radlovacki, Peter.Radlovacki@macquarie.com	02 8237 8435
National Australia Bank	Jeff Shaw, jeff_shaw@national.com.au	0414 279 764
Westpac Banking Corporation	Michael Barbour, mbarbour@westpac.com.au	02 8253 3348

Yours sincerely,

Chris Millett
General Manager, Group Taxation
Commonwealth Bank of Australia
02 9118 1872

Stuart Dyson
Group Financial Controller, Financial Management Group
Macquarie Group Limited
02 8232 8670

Mr Jeff Shaw
Head of Tax – Corporate Advisory
National Australia Bank Limited
0414 279 764

Michael Barbour
General Manager – Group Tax
The Westpac Group
02 8253 3348

groups and consequently their customers, reflect more accurately the market perception of these instruments.

* * * *

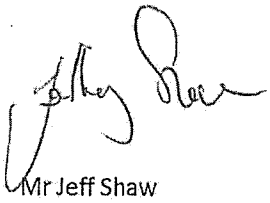
Please do not hesitate to contact any of the relevant bank representatives listed in the table below, should you wish to discuss the above matters, or if you require further information.

Commonwealth Bank of Australia	Chris Millett, chris.millett@cba.com.au	02 9118 1872
Macquarie Group Limited	Peter Radlovacki, Peter.Radlovacki@macquarie.com	02 8237 8435
National Australia Bank	Jeff Shaw, jeff_shaw@national.com.au	0414 279 764
Westpac Banking Corporation	Michael Barbour, mbarbour@westpac.com.au	02 8253 3348

Yours sincerely,

Chris Millett
General Manager, Group Taxation
Commonwealth Bank of Australia
02 9118 1872

Stuart Dyson
Group Financial Controller, Financial Management Group
Macquarie Group Limited
02 8232 8670



Mr Jeff Shaw
Head of Tax – Corporate Advisory
National Australia Bank Limited
0414 279 764

Michael Barbour
General Manager – Group Tax
The Westpac Group
02 8253 3348

groups and consequently their customers, reflect more accurately the market perception of these instruments.

* * * *

Please do not hesitate to contact any of the relevant bank representatives listed in the table below, should you wish to discuss the above matters, or if you require further information.

Commonwealth Bank of Australia	Chris Millett, chris.millett@cba.com.au	02 9118 1872
Macquarie Group Limited	Peter Radlovacki, Peter.Radlovacki@macquarie.com	02 8237 8435
National Australia Bank	Jeff Shaw, jeff_shaw@national.com.au	0414 279 764
Westpac Banking Corporation	Michael Barbour, mbarbour@westpac.com.au	02 8253 3348

Yours sincerely,

Chris Millett
General Manager, Group Taxation
Commonwealth Bank of Australia
02 9118 1872

Stuart Dyson
Group Financial Controller, Financial Management Group
Macquarie Group Limited
02 8232 8670

as delegate for:

Mr Jeff Shaw
Head of Tax – Corporate Advisory
National Australia Bank Limited
0414 279 764

Michael Barbour
General Manager – Group Tax
The Westpac Group
02 8253 3348