Australian Banking Association

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Dear Mr Fischer

Tax Deductibility of Additional Tier 1 Capital in Australia

Thank you for meeting with the Australian Banking Association (**ABA**) on 16 July 2020 to discuss the tax deductibility of Additional Tier 1 capital ("**AT1**") in Australia. At that meeting, it was agreed that the ABA would provide Treasury with a submission on this topic.

Purpose

The purpose of this submission is to highlight the developments in the Australian market since 2017 and to continue to advocate for AT1 issued by APRA regulated financial institutions to be treated as debt for all purposes of the Tax Act, which was the preferred recommendation of the Board of Taxation Report. The key objectives sought being:

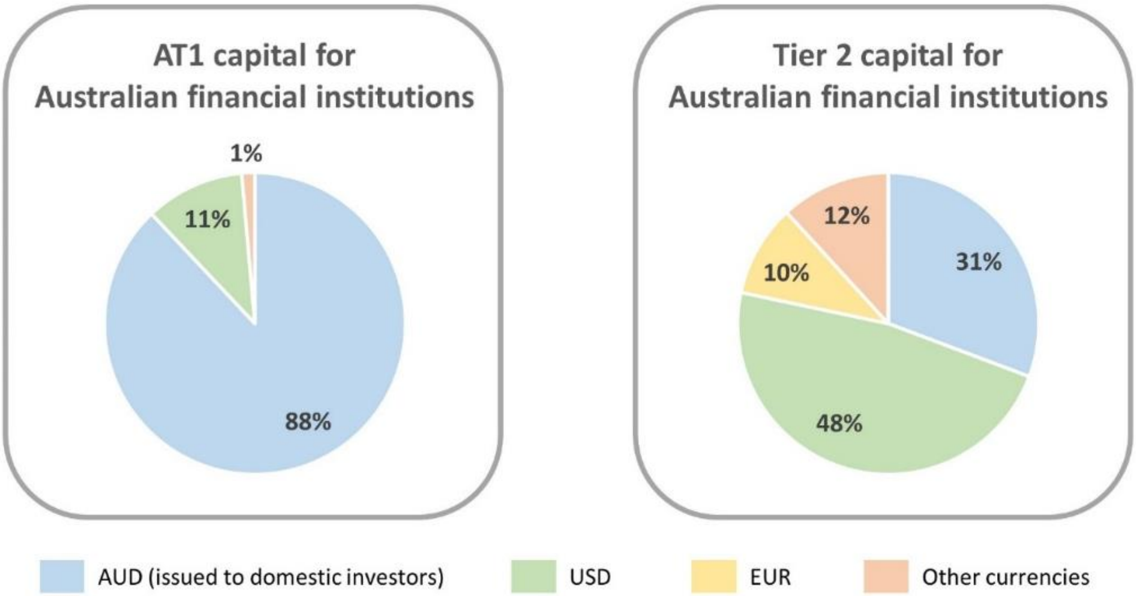
- Reduction in risk to the financial system and the Australian economy
- Simplification of tax laws and reduction in compliance costs
- Tax neutrality – no cost to the revenue
- Assisting small banks and other financial institutions to be on a level playing field with large banks (those with foreign branches)

Background

In May 2015, the Treasurer directed the Board of Taxation to report on the implementation of the Organisation for Economic Co-operation and Development (**OECD**) hybrid mismatch rules. In April 2016, the Treasurer issued the Board of Taxation with further terms of reference about regulatory capital. The Board of Taxation's report to the Treasurer ("Application of hybrid mismatch rules to regulatory capital") was released in December 2016.

The key recommendation from that report was to implement "Option B1" to treat AT1 as debt for tax purposes and make distributions tax deductible. However, the legislation announced in the 2016-17 budget has not resulted in achieving the outcomes recommended by the Board of Taxation, being to implement "Option B1".

The onset of the COVID-19 crisis and the disruption within the Australian economy highlight the importance of addressing the key factors considered by the Board of Taxation. Specifically, this includes addressing the continued concentration in distribution of capital instruments in the Australian ASX Listed market and the risks associated with this approach.



The above graph shows 88 per cent of the AT1 capital for Australian financial institutions is currently issued to domestic investors, with the majority of this being issued into the Australian Listed market, including to retail investors. The bias towards the domestic market is driven by coupons on AT1 securities generally being frankable, with Australian investors able to benefit from the franking, as opposed to offshore investors who do not value the franking or Australian fund managers who may not reflect franking within their benchmarking. AT1 issuance into the over-the-counter (**OTC**) wholesale-only market is much less common (than for Tier 2) due to limited AT1 demand from Australian and offshore wholesale investors.

If the tax treatment for AT1 securities was changed to Option B1 (as recommended by the Board of Taxation), this would likely see a larger amount of AT1 issued into the OTC wholesale-only market and it would also reduce the concentration of, and reliance on, Australian investors due to greater offshore AT1 issuance – as can be seen by the existing diversification of investors for Tier 2 securities. Tier 2 securities are currently treated as debt for Australian tax purposes.

Importance of this topic for the Australian economy and financial system

This is an important issue for the Australian economy and Australia's financial system. There are a number of considerations that we consider are important in making the financial system and Australian economy more resilient:

1. **Preference for less concentration of AT1 issued to the domestic listed market and greater participation from Australian funds managers and offshore investors**

There are currently in excess of $45 billion of AT1 securities on issue by Australian financial institutions. This capital is structured to adhere to APRA's requirements to support and bolster the capital positions of Australian financial institutions, including the ability to be written-off or converted to equity in the unlikely event of an idiosyncratic or systemic bank failure. The current concentration of AT1 issuance to domestic investors (including Australian retail investors) could exacerbate an Australian economic downturn, in the event of a systemic bank failure. It would be beneficial to the financial system to import more foreign capital and rely less on Australian investors to support a response to a crisis.

2. **Changing the tax treatment of AT1 would improve the access to capital of all financial institutions (particularly in stressed circumstances)**

The Australian economy benefits from, and relies on, Australian financial institutions having access to deep pools of capital at reasonable terms and within short timeframes. For example, when an economic downturn occurs (such as COVID-19), banks consider options for preserving strong regulatory capital ratios – as required by the regulator (APRA). If new capital is not available at reasonable terms, there is a risk that Australian banks may need to:

- Reduce their lending to Australian households and businesses; and/or
- Increase the cost of loans to Australian households and businesses

Both actions will have negative consequences for Australian households, Australian businesses, and the Australian economy.

However, these actions are less likely in a situation where Australian financial institutions continue to have access to deep pools of capital throughout an economic downturn.

Whilst specifics of future economic downturns, driven by COVID-19 or otherwise, are impossible to predict, it is clear that Australian financial institutions' rapid access to deep pools of capital would be materially improved if the Australian tax treatment for AT1 securities was changed to debt (as was recommended by the Board of Taxation).

3. **Changing the tax treatment of AT1 would assist smaller banks and other financial institutions to be on a level playing field with large banks which have foreign branches**

The existing Australian tax treatment for AT1 securities is particularly restrictive for smaller Australian banks and other regulated financial institutions, including regional banks, mutual banks, insurers and financial holding companies. Whilst large Australian banks (with foreign branches) have some limited capacity to satisfy s215-10 which enables unfranked AT1 securities to be issued via a foreign branch, this option is not possible for banks without foreign branches or other regulated financial institutions. As a result, these smaller Australian banks and other financial institutions have fewer options for sourcing AT1 capital than large Australian banks despite these institutions being subject to the same or substantially the same regulatory capital requirements. This places the smaller Australian banks and other financial institutions at a competitive disadvantage by limiting the pool of AT1 capital that can be sourced, as well as increasing the cost of AT1 capital.

Key factors analysed by the Board of Taxation

The Terms of Reference of the Board of Taxation review and the key factors that they were required to consider included:

a) Delivering on the objectives of eliminating double non-taxation

b) Ability to meet regulatory capital requirements
   - Diversity of funding sources
   - Minimising resolution risk
c) Fostering a level playing field
d) Economic implications and potential market disruption
   - Cost of funding
   - Risks for retail investors
e) Compliance and administrative costs for taxpayers
f) Interaction with Australia's existing domestic legislation

The Board of Taxation report considered these key factors and recommended treating AT1 as debt for tax purposes (together with a specific exemption from withholding tax for AT1 distributions under "Option B1"[1]), as the only solution that addressed all of these issues. That analysis continues to remain relevant in its current form, and so we have not sought to update that analysis within this submission. Our analysis of these key factors is contained in Attachment 1 for reference.

Additionally, we note the Board of Taxation recognised that "changing the tax treatment of AT1 from equity to debt should be broadly neutral from a cash perspective for both the regulated entities and domestic investors". Furthermore, diversification of AT1 funding sources to allow for more participation from foreign investors is likely to have a minimal tax impact due to:

- Sourcing more foreign capital for AT1 will free up domestic capital (which is currently invested in AT1) to invest in other areas of the Australian economy. This will generate income which will be taxed in Australia (as determined by the laws applying to that class of investment); and
- AT1 capital represents a very small portion of Australian banks' balance sheets – AT1 equates to approximately 1 per cent of banks' assets. Noting that a meaningful portion of AT1 capital will remain sourced from domestic investors, the quantum of AT1 capital that may end up being sourced from foreign investors is likely to be very small in the overall context of Australian banks' balance sheets.

Developments since 2017

There are significant risks in relying so heavily on a single market for distribution of capital instruments, particularly in uncertain economic times as is now the case with COVID-19. The concentration of Australian investors in AT1 securities exposes the Australian financial system to the significant risk of insufficient demand for financial institutions' capital instruments. We note the following issues that emerged since Board of Taxation review was released:

1. High levels of refinancing requirements

Issuance volumes of AT1 capital securities over recent years have been in the area of $4 billion per annum, with a significantly larger volume of securities reaching the first call dates in 2021 and 2022 (see chart below). Issuers will generally look to refinance the AT1 securities on their call date (subject to market conditions and regulatory approval), in most cases to utilise a roll-over offer to investors in the existing security.

Increased refinance volumes in the near term combined with the unknown effect of COVID-19 on investors' liquidity and the implementation of the Design and Distribution Obligations (more background on this is set out below), result in a significantly increased risk that the pool of domestic investors that

[1] To maintain neutrality between Australian and foreign investors.

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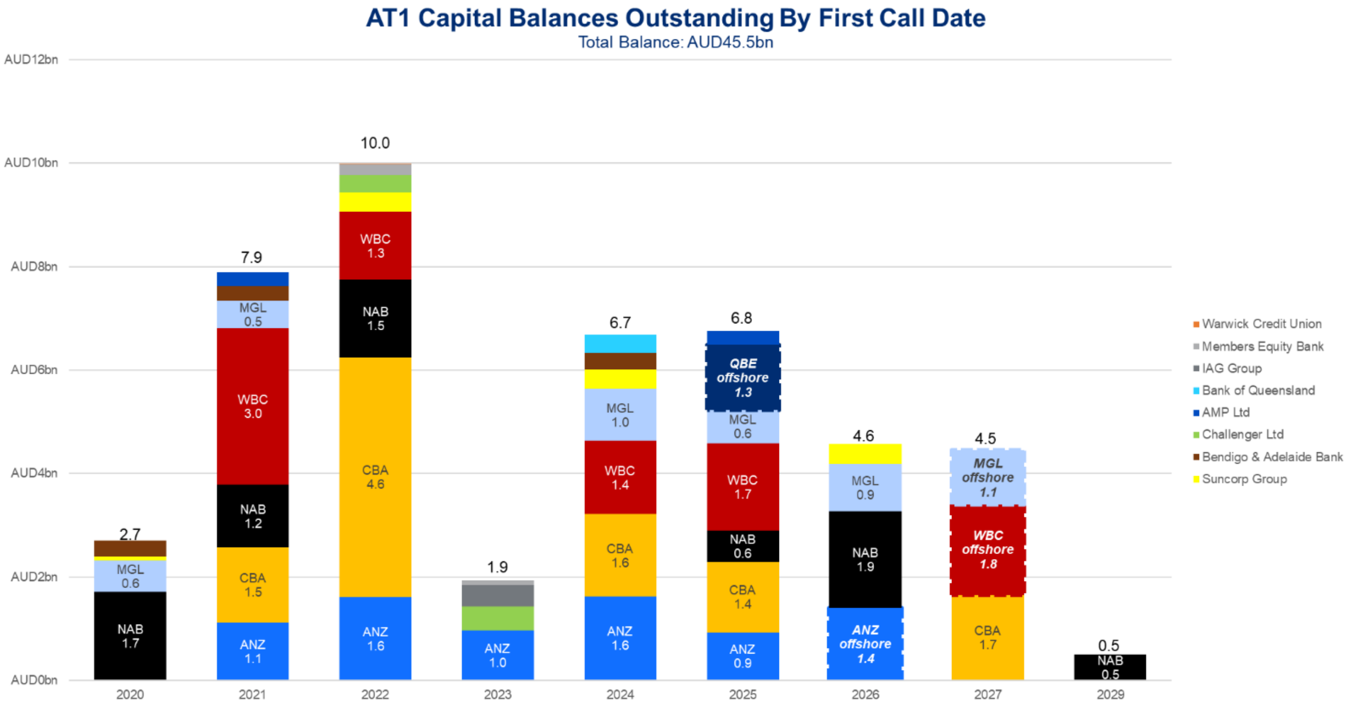
may be targeted for these instruments is insufficient to refinance AT1 securities approaching their call date.

Furthermore, this increased refinancing requirement arises at a time where the larger banks are also required to issue significant volumes of Tier 2 capital in order to meet APRA's recently introduced Loss Absorbing Capital requirements. The volume of issuance required places additional demand on capital markets and further increases potential financing risks.

Diversification of the available market for AT1 securities through greater participation of wholesale and institutional investors, and providing access to foreign investors' capital will significantly reduce this risk for regulated financial institutions issuing AT1 to satisfy capital adequacy requirements. Additionally, increased diversification will also assist in reducing the major banks "crowding out" smaller financial institutions within the domestic market.



Source: Bloomberg
Notes: (1) AT1 transitional credit amortisation of AUD1.2bn in respect of NAB Income Securities included in NAB 2021 call balance. (2) Challenger Capital Notes assumed to be repurchased in 2022 before their mandatory conversion date (Challenger Group Chairman's letter 30 March 2020).

2. High market volatility

Distribution of AT1 to the ASX Listed A$ market under current frameworks requires an extended offer period of circa 4-5 weeks to ensure that retail investors have sufficient time to fully consider the offer and make applications. Issuers are exposed to the risk of high market volatility through the offer period, which may result in the increased risk of investors failing to complete their purchase commitments. Recent examples include NAB and Macquarie Bank both attempting ASX Listed A$ transactions in early 2020 – with both of these transactions being cancelled after the completion of the bookbuild (i.e. after having announced pricing and volume) as a result of the extreme volatility caused by the onset of the COVID-19 crisis during the 3 to 4 week period after the completion of the bookbuild.

In contrast, institutional markets permit completion of AT1 transactions within a very short period, generally pricing within a single day, and settling within a week. Access to institutional markets will operate to reduce the market risks prevalent in ASX Listed transactions.

3. Design and distribution obligations

The design and distribution obligations include a distribution requirement for product issuers and their distributors to take reasonable steps to distribute to consumers in the target market. This entails a requirement for an assessment that the security is likely to be suitable for the investor's requirements. These requirements have been legislated with an effective date deferred to October 2021.

ASIC guidance as to the application of these requirements to the design and distribution of AT1 securities is still to occur. There is a risk that, in order to meet the suitability requirements, offer structures currently in use will need to change, potentially limiting the number and category of retail investors who may participate in new transactions. In particular, the ability to conduct rollover offers to existing security holders may be constrained, as the information available to the issuer as to the investor and the suitability of the replacement security may not satisfy the requirements of the legislation.

4. Canadian approach to investor concentration

The Canadian banking regulator (OSFI) has recently authorised the issue of a new form of security which addresses concentration risks on AT1 issuances.

Canada has a similar market environment to Australia, with the tax system providing for concessional tax treatment for domestic investors investing in preference shares resulting in a high concentration of domestic (including retail) investors in Canadian AT1 transactions. On 15 July 2020, OSFI released a Capital Ruling on a new AT1 structure, Limited Recourse Capital Notes "LRCN" which is a tax-deductible AT1. Immediately following the release, Royal Bank of Canada filed a prospectus supplement and investor presentation with SEDAR while marketing CAD-denominated AT1. The marketing exercise saw RBC price a CAD1.75 billion 4.500 per cent transaction. (See OSFI Capital Ruling https://www.osfi-bsif.gc.ca/eng/fi-if/app/default/Pages/lrcn.aspx). OSFI permits up to 50 per cent of a Canadian bank's AT1 to be distributed to institutional investors using this structure. This transaction is focused on distribution to Canadian institutional investors, but it is also expected to be utilised to access global institutional markets.

The key aspect of this transaction is not the structure (which is not readily suitable for APRA or Australian tax requirements), but that the banking and revenue authorities have cooperated to approve a mechanism to address the concentration in distribution of AT1 to Canadian retail investors by allowing Canadian banks to issue a new type security which is classified as 'debt' and is tax deductible.

5. Increased tax complexity

Implementation of anti-avoidance provisions addressing the OECD hybrid mismatch rules has resulted in legislation with increased complexity and unintended consequences (such as the deemed interest deduction in foreign branches) requiring further legislation to correct (Treasury Laws Amendment (2020 Measures No. 2)). Additionally, it has not sought to address any of the other factors considered important in the Terms of Reference.

Thank you again for the opportunity to provide this submission. The ABA would be happy to meet with Treasury to discuss it in more detail or to answer any questions you may have.

Yours sincerely

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Attachment 1 - Considerations for Addressing the Board of Taxation's Terms of Reference

Neutralisation of potential tax arbitrage

Treating AT1 as debt for tax purposes would:

- Remove any opportunity for tax arbitrage. The potential mismatch would be eliminated by Australia treating coupons payable on the security as being akin to interest (i.e. deductible, assessable, unfranked).
- Resolve the existing complexity and uncertainty of deductible AT1 issuances through offshore branches under Australian taxation legislation (through s215-10) and administrative practice. This would allow more Australian issuers to access both global and domestic markets without the need to obtain taxation rulings dealing with impractical and overly complex regulations. The complexity of the existing administrative practice makes the ruling process expensive and time consuming.

Fostering a level playing field within Australia and internationally

Treating AT1 as debt for tax purposes would:

- Level the playing field for Australian financial institutions' access to AT1 capital. Current tax laws only allow large Australian banks (those with foreign branches) to issue unfranked AT1 securities. As such, insurers, holding companies, regional banks and mutual banks are currently at a competitive disadvantage with respect to the pool of available AT1 capital that can be sourced, as well as the cost of sourcing this capital.
- Level the playing field for Australian banks with international banks. Australian banks' international competitiveness would be bolstered if the Australian tax treatment for AT1 was debt. If changed, the Australian tax treatment would be consistent with that of key trading partners including within the UK, Europe, Asia, and Canada is also moving in this direction (as set out earlier in this submission).

Investor concentration increases risk in the Australian financial system

Existing constraints to banks' capital strategies have resulted in:

- Significant investor and currency risk concentrations with investors who are also customers of the banks;
- No new international AT1 capital flowing into the Australian financial system;
- Major banks dominating the Australian hybrid capital market with issuance tranches in the $1 billion to $3 billion range, creating crowding issues for regional banks and corporate issuers.
- Tax deductible debt treatment for AT1 would permit Australian financial institutions to access international capital markets across a range of currencies thereby providing new regulatory capital funds to the Australian system and lowering costs; and
- Reducing FX volatility in bank capital ratios due to a better alignment of the currency profile of the AT1 portfolio to banks' capital requirements.

Australian market investor diversification

- Treating AT1 as debt for tax purposes would also encourage the return of institutional fixed income investors to the Australian market.
- Institutional participation in Australian bank hybrids has been limited predominantly by the fact that institutional fund managers' performance is measured on a pre-tax basis. This means they are unable to value the franking credits attached to securities.

- The treatment of AT1 as debt for tax purposes would have a significant positive influence on the liquidity seen in the primary and secondary markets, and significantly increase the ability of financial institutions to access AT1 capital and therefore increase the resilience of the financial system.
- Whilst recent wholesale unlisted transactions have been successfully completed, the number of issuances remains low and the pricing required a premium to the listed market for significantly lower volume.

Transitional arrangements and grandfathering

- The principle for determining the appropriate grandfathering period should be to limit market disruption, which would occur if there was a requirement for existing Regulatory Capital to be refinanced.
- Most AT1 instruments issued to external investors by Australian financial institutions take the form of a "mandatory convertible" security, with a specific date (generally 7-10 years from the initial issue date) where it is probable that the instrument will be redeemed or convert to ordinary shares.
- It is only in the case of extreme stress where conversion or redemption will not occur. Accordingly, no time limit needs to be, or should be imposed, with the instrument having a likely redemption or conversion date within 10 years. AT1 securities that have the conversion date amended may be considered as constituting a new issue.
- We recommend that all securities issued prior to implementation be grandfathered, with the potential for issuers to "elect in" to the new arrangements subject to market acceptance and practicality.

APRA considerations

Tax policy has had a significant impact upon the source of capital into the Australian financial system with significant implications for APRA. Removing some of the limitations will:

- Simplify AT1 issuance structures.
- Allow increased investor diversity (offshore and domestic institutional investors).
- Increase liquidity within the system.
- Reduce the impact on the Australian system for the resolution of a bank through the bail in of domestic investors (including retail investors).
- Facilitate a level playing field for all banks (assisting small banks and non-bank issuers without foreign branches to be on a level playing field with large banks with foreign branches).
- Reduce compliance risks associated with complex retail issuances or offshore issuances under s215-10.