SUBMISSION TO THE BOARD OF TAXATION CONSULTATION ON IMPLEMENTATION OF THE OECD ANTI-HYBRID RULES

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INTRODUCTION AND EXECUTIVE SUMMARY

ANZ welcomes the opportunity to provide a submission into the Board of Taxation's review of the "Implementation of the OECD Anti-Hybrid Rules". As an opening comment ANZ supports the work being undertaken by the G-20 and the OECD to address real concerns over base erosion and profit shifting. However, any measures implemented by Australia to address these concerns need to be co-ordinated at a multilateral level to ensure that Australian corporates are not placed at a competitive disadvantage.

In the context of anti-hybrid rules potentially to be adopted by Australia they should follow the broad principles.

i) be clear and simple;
ii) be certain in scope and effect;
iii) not lead to impractical or excessive compliance requirements or unintended consequences;
iv) implementation should be consistent with Australia's major trading partners to ensure no adverse tax consequences for Australia's competitiveness;
v) recognise the need for APRA regulated financial institutions including banks to issue hybrid capital in managing prudential requirements; and
vi) be sufficiently flexible to accommodate the frequent changes to the regulatory environment in which the banking industry operates.

This submission, limited to issues relating to regulatory capital requirements, is provided to the Board to assist with the examination of how best to implement anti-hybrid rules in Australia.

The rationale for this focus is that Regulatory Capital instruments are an essential component of the capitalisation of APRA regulated financial institutions, with access to all sources of liquidity increasing the resilience of the banking system.

The key issues and recommendations of the submission can be summarised as follows.

1. Alignment of tax characterisation with prudential characterisation – consistent with the Australian Bankers Association (ABA) submission to the Board of Taxation Review of the Debt Equity Rules of May 2014[1], ANZ is of the strong view that the Australian tax law should be amended to allow a tax deduction for distributions paid on Additional Tier 1 capital ("AT1"). It would increase the resilience of the banking system by diversifying funding and increasing liquidity.

2. Resolution of potential regulatory capital tax arbitrage – treating AT1 as debt for tax purposes would be consistent with international practice and hence provide more efficient integration with G20 rules adopted offshore and effectively remove an opportunity for tax arbitrage for widely distributed regulatory capital identified in the OECD paper in example 2.1. This would enable a carve-out from the anti-hybrid rules for regulatory instruments without enabling tax mismatches to be exploited. We note that this is the approach adopted by the UK which released its draft anti-hybrid legislation in December 2015.

[1] Australian Bankers Association (ABA) submission to the Board of Taxation Review of the Debt Equity Rules of May 2014, page 26. http://taxboard.gov.au/files/2015/07/ABA.pdf

3. Transitional arrangements should be applied to any impacted Regulatory Capital on issue at the implementation date of the anti-hybrid rules to avoid any material market disruption (for both the investor and the issuer) given the already significant refinancing of maturing AT1 capital that is required in the near/medium term.

4. The cost to revenue of changing the existing tax treatment of AT1 capital should not be significant given the increased amount of Core Equity Tier 1 ("CET1') capital Australian banks now hold (including as a result of regulatory changes summarised in Attachment 1) and neutral to other AT1 structuring arrangements. Changing the tax treatment of AT1 would benefit the national economy through greater system resilience and lower banking costs and risks.

5. The Board of Tax's Report on the Review of the Debt and Equity Tax Rules recommended that a regulation be made that the inclusion of APRA required features in a financing arrangement to satisfy the APRA characterisation as Tier 2 does not of itself prevent an obligation from being a non contingent obligation. In making that recommendation the Board noted that it was possible for the Government to amend a regulation in the event that the revenue impact of a particular change to Tier 2 capital is unacceptable to Government. ANZ recommends that the tax legislation be amended to provide that AT1 is debt for all purposes of the tax legislation. Similarly, if there were particular instruments or features that gave rise to particular concerns for the Government the legislation could allow for a regulation to be made that would remove the debt treatment from that instrument.

We note that when the United Kingdom (UK) introduced regulations allowing for debt treatment of AT1 and Tier-2 securities, the treatment did not extend to a regulatory capital security if there are arrangements where the main or one of the main purposes is to obtain a tax advantage in respect of that security[2].

[2] Regulatory Capital Securities Regulations 2013 Tax Information and Impact Notice. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/265979/RCS_Regulations_TIIN_complete.pdf

BOARD OF TAXATION – IMPLEMENTATION OF THE OECD ANTI-HYBRID RULES

This submission focuses on issues relating to regulatory capital requirements for Approved Deposit Taking Institutions ("ADI's") and other entities which are similarly regulated, and is provided to the Board to assist with the examination of how best to implement anti-hybrid rules in Australia.

The rationale for this focus is that Regulatory Capital instruments are an essential component of the capitalisation of financial institutions, with access to all sources of liquidity increasing the resilience of the banking system.

CET1 consists of "ordinary equity" and is the largest component of a financial institution's regulatory requirements. In addition to this, and for the context of this submission, Regulatory Capital includes AT1, Tier-2 Capital and Total Loss Absorbing Capital ("TLAC") issued by financial institutions that are subject to Australian Prudential Regulation Authority ("APRA") capital regulations. A full description of CET1 and Regulatory Capital developments is contained within Attachment 1.

In this context the questions specifically addressed by the submission are:

Q35. Whether hybrid arrangements that form part of a financial institution's regulatory capital should be carved out of Australia's anti-hybrid rules? Could (and should) any carve out be limited to regulatory capital issued to third parties?

Q36. Are there any other regulatory capital concerns that require special rules? For example, does Australia need specific rules to deal with regulatory capital issued to third parties but is then passed on to group members through back to back arrangements?

Q8. What is an appropriate transition period and transitional arrangements into the anti-hybrid rules?

Q9. Whether pre-existing structures and instruments issued prior to the start date of the anti-hybrid rules should be grandfathered? What are the integrity concerns for grandfathering?

In addressing the above questions we have focussed on the following key issues:

a. Alignment of tax characterisation with prudential characterisation;
b. Consistent with global tax treatment of AT1;
c. De-risk the Australian financial system;
d. Resolution of potential regulatory tax arbitrage;
e. Impact on the Australian tax base; and
f. Transitional arrangements and grandfathering.

<u>Alignment of tax characterisation with prudential characterisation</u>

Consistent with the Australian Bankers Association (ABA) submission to the Board of Taxation Review of the Debt Equity Rules of May 2014, ANZ is of the strong view that the Australian tax law should be amended to allow a tax deduction for distributions paid on AT1 capital. This would align the prudential classification of the instruments with the tax treatment.

Consistent with global tax treatment of AT1

The global precedent after the Global Financial Crisis ("GFC") and implementation of the Basel III regulations is to permit AT1 securities to be treated as debt for tax purposes. Since the GFC we have seen the majority of the G20 members and Australia's major trading partners move to either confirm or permit AT1 instruments to be tax deductible – the relevant G20 members include New Zealand, Singapore, Hong Kong, United Kingdom, France, Germany, Italy, Netherlands, Switzerland and Spain. The United States maintains tax equity treatment, however the US also has particular rules providing for concessional tax treatment for the investors.

De-risk the Australian financial system

In determining the required capital mix and the form and amount of ATI securities to be issued, ADIs are required to take into account a range of considerations including:

- prudential regulations, potentially of more than one jurisdiction;
- pricing;
- liquidity;
- diversification of investors and currency;
- business and legal constraints; and
- brand recognition and market appetite.

Prior to the GFC in 2007, ANZ had an AT1 Capital portfolio of ~$4.1bn (~1.75% of Risk Weighted Assets) which was split:

- Equally between offshore and domestic investors; and
- Weighted ~75% to domestic and international institutional investors (non-franked, tax deductible) and ~25% to domestic retail investors (franked securities, non-deductible).

By 2015, the post GFC market conditions and associated Basel III capital reforms had resulted in the AT1 portfolio of ~A$7.4bn still representing ~1.75% of RWA, but being ~95% issued in AUD to Australian retail investors as a franked security.

This experience is consistent with the other major Australian banks who also have significant Australian investor concentration.

These constraints to the ADIs' capital strategy over the last eight years 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; and
- Major banks dominating the Australian hybrid capital market with issuance tranches in the $1bn to $3bn range creating crowding issues for regional banks and corporate issuers.

Debt treatment for AT1 would permit Australian banks to access international capital markets across a range of currencies thereby:

- providing new regulatory capital funds to the Australian banking system and hence lowering costs; and

- reducing FX volatility in bank capital ratios due to a better alignment of the currency profile of the AT1 portfolio to the Risk Weighted Asset profile of the group.

Treating AT1 as "debt interests" would also result in the return of institutional fixed income investors to the Australian market. Institutional participation in Australian bank hybrids has been limited predominantly by fact that institutional fund managers' performance measurement is conducted on a pre-tax basis. This means they are unable to value the franking credits attached to securities. The existence of loss-absorbency features such as point of non-viability (PONV) and other Basel III features has not been seen as a contributing factor to low institutional participation, as institutional investors are participating in Tier-2 securities which have very similar features. Debt treatment of AT1 would have a significant positive influence on the liquidity seen in the primary and secondary markets, and significantly increase the ability of banks to access AT1 capital and therefore increase the resilience of the banking system.

Resolution of potential regulatory tax arbitrage

Treating AT1 as debt for tax purposes would remove any opportunity for tax arbitrage for widely distributed regulatory capital issued by Australian banks. The OECD report on *Neutralising the Effects of Hybrid Mismatch Arrangements* included an example which highlighted the tax mismatch created by an AT1 security issued by an offshore branch of an Australian bank to Australian investors (refer example 2.1 on page 279). This potential mismatch would be eliminated by Australia treating coupons payable on the security as being akin to interest (i.e. deductible, assessable, unfranked).

Additionally, it would resolve the existing complexity and uncertainty of the Australian taxation legislation dealing with offshore branch issuances of capital. This would allow Australian issuers to access both global and domestic markets without the need to obtain taxation rulings dealing with out of date and overly complex regulations. The complexity of the existing law makes the ruling process expensive and time consuming.

In December 2015 the UK released its draft legislation to address hybrid mismatch arrangements. The draft provisions include a carve-out for regulatory capital which satisfies the UK deductibility provisions. This ensures that the policy intent of ensuring tax certainty for issuers of regulatory capital remains. We note that the UK announcement indicates that the UK government will continue to consider its options for regulatory capital in conjunction with further work being done by the OECD on financial sector interest restriction rules. The area of focus is expected to be intra-group instruments which are used for tax planning purposes. The stated intention is not to impact regulatory driven arrangements[3]. The UK legislation also ensures that no gains or loss are recognised for tax purposes in relation to conversion, write-off or subsequent write up. We would recommend a similar approach be adopted for Australia.

Impact on Australian tax base

The cost to revenue of changing the existing tax treatment of AT1 capital should not be significant given the increased amount of CET1 capital Australian banks now hold (including as a result of regulatory changes summarised in Attachment 1).

[3] Explanatory Memorandum to Finance Bill 2016, Paragraph 232. HMRC 'Tackling aggressive tax planning: implementing the agreed G20-OECD approach for addressing hybrid mismatch arrangements. Summary of Responses. December 2015.' https://www.gov.uk/government/consultations/tackling-aggressive-tax-planning-implementing-the-agreed-g20-oecd-approach-for-addressing-hybrid-mismatch-arrangements

With global market conditions now returning to more normal conditions, ANZ may seek to refinance up to ~40% of its AT1 capital with offshore institutional investors to reduce these concentration and refinancing risks. Whilst some of this refinancing would be raised and used offshore by ANZ, some would be issued and used by ANZ in Australia, thereby resulting in an Australian taxation deduction being claimed. The claim on the Australian tax revenue base should be compared to other existing AT1 structuring alternatives and the tax profile that existed prior to the GFC with the AT1 portfolio in assessing cost.

Permitting AT1 to be tax deductible would align the tax treatment of AT1 securities to that adopted for Tier-2 securities. This would be consistent with the prudential treatment where post Basel III, AT1 and Tier-2 capital seen as "going concern" capital that is used to recapitalise the bank prior to it entering official administration.

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 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).

Avoiding market disruption is a key guiding factor as:

- Australian banks already face significant AT1 issuance programmes, with ~A$8bn of AT1 to be raised in 2016 to fund AT1 maturities and business requirements. Refinancing any non-compliant Regulatory Capital securities would either not be possible or at best cause market disruption to normal liquidity and pricing of new and existing securities;
- It would be consistent with APRA's methodology for phasing out of Basel II Regulatory Capital securities upon adoption of the Basel III regulations;
- Existing transactions have been issued with applicable taxation rulings and consultation with the respective tax authorities which should be honoured;
- Regulatory Capital securities issued by the Banks usually contain tax calls which would be triggered by any immediate application of the anti-hybrid mismatch proposals. Tax calls may result in penalties being applied to the issuer via compensation payments to investors, or to investors via forgone revenue. Either would result in economic costs being worn by the Australian issuer or the investor.

The development of new Regulatory Capital instruments, including documentation and approval by all relevant regulators (domestically and offshore) may take many months. An ability to issue under existing rules for up to 12 months, but also to allow issuers to elect into new debt treatment rules, will assist market stability by ensuring continued access to Regulatory Capital and avoid periods where no financial institutions are able to issue.

ATTACHMENT 1 – BANK CAPITAL AND REGULATORY DEVELOPMENTS

Basel III

The common framework for determining the appropriate level of bank regulatory capital is set by the Basel Committee under a framework that is commonly known as "Basel".

For calculation of minimum capital requirements under Pillar 1 ("Capital Requirements") of the Basel Accord, the ANZ Group has been accredited by APRA to use the Advanced Internal Ratings Based ("AIRB") methodology for credit risk weighted assets and Advanced Measurement Approach ("AMA") for the operational risk weighted asset equivalent.

On 1 January 2013, APRA's new Prudential Standards, implementing a capital reform package released by the Basel Committee ("Basel III") with the aim of strengthening the global capital and liquidity framework to improve the banking sector's ability to absorb shocks arising from financial and economic stress, came into effect.

Basel III also aims to increase the quality, quantity, consistency and transparency of banks' capital bases, whilst strengthening the risk coverage of the capital framework. APRA has fully adopted the majority of the Basel III capital reform package in Australia, although APRA is requiring ADIs to satisfy in full the minimum capital requirements from 1 January 2013 and the capital buffers from 1 January 2016. In particular, APRA's new Level 1 and Level 2 capital standards:

- increase the minimum level of capital, with new minimum capital ratio requirements for Common Equity Tier 1 Capital (4.5%), Tier 1 Capital (6.0%) and Total Capital (8.0%), although APRA may set higher targets for individual ADIs;
- increase the prescribed Common Equity Tier 1 capital buffers that ADIs are required to hold for stress scenarios and to dampen the impact of pro cyclical elements of the previous prudential regulations. These include a capital conservation buffer of 2.5%, a counter cyclical capital buffer of between 0.0% and 2.5% and a further 1.0% capital buffer resulting from APRA determining that ANZ is a domestic systematically important bank ("D-SIB"). Failure to maintain the full capital buffers will result in limitations on the amount of current year earnings that can be paid as discretionary bonuses to staff and coupons and capital returns to holders of Tier 1 Capital instruments (including the Notes);
- increase Common Equity Tier 1 capital deductions;
- increase the focus on Common Equity Tier 1 Capital and tighten the regulations for Additional Tier 1 Capital and Tier 2 Capital instruments, including that, at the time of 'non viability' of an ADI, these instruments will be either converted to Ordinary Shares or written off. Existing Tier 1 Capital and Tier 2 Capital instruments that do not have these requirements will be phased out between 2013 and 2022; and
- increase the capital requirements for traded market risk, credit risk and securitisation transactions.

Prudential Regulatory Changes

These standards may be supplemented by yet to be finalised proposals from the Basel Committee and APRA as to:

- supplementing the risk adjusted capital ratio requirements with the introduction of a minimum leverage ratio. In the draft requirements, APRA has maintained the Basel Committee calculation of the leverage ratio of Tier 1 Capital expressed as a percentage of ANZ's total exposure (on and off balance sheet assets). However, APRA has not committed to implementing a minimum leverage ratio requirement at this stage, pending the Basel Committee's intentions to further analyse and calibrate the requirements before introducing the leverage ratio as a Pillar 1 requirement in 2018. The current Basel Committee minimum requirement is 3%;
- introducing measures to address the impact of systematic risk and inter-connectedness risk; and
- resolution and recovery planning including the potential for this to include a minimum total loss absorption capital requirement where certain debt could be "bailed in" to recapitalise a stressed financial institution to avoid government support of that financial institution.

APRA recently provided industry wide clarification to the definition of the ADI level 2 group, where subsidiary intermediate holding companies are now considered part of the ADI level 2 group. The above clarification results in the phasing out, over time, of capital benefits arising from the debt issued by ANZ Wealth Australia Limited ("ANZWA").

In August 2014, APRA announced its planned framework for the supervision of conglomerates group (level 3) which includes updated level 3 capital adequacy standards. These standards will regulate a bancassurance group such as ANZ as a single economic entity with minimum capital requirements and additional monitoring on risk exposure levels. APRA has deferred a decision on the implementation date as well as the final form of the level 3 framework until the Government's response to the recommendations of the FSI have been considered by APRA. APRA has committed to a minimum transition period of 12 months for affected institutions to comply with the new requirements once an implementation date is established. Based upon current drafts of the level 3 standards covering capital adequacy, group governance, risk management and risk exposures, ANZ is not expecting any material impact on its operations.

Financial System Inquiry

The Federal Government announced on 20 November 2013 the appointment of Mr David Murray AO as head of an inquiry into Australia's financial system ("FSI" and "Inquiry"). On 20 December 2013, the Government announced the terms of reference for the Inquiry saying that "The Inquiry is charged with examining how the financial system could be positioned to best meet Australia's evolving needs and support Australia's economic growth". ANZ has been actively engaged in contributing to the Inquiry's deliberations and provided a number of submissions to the FSI.

The final FSI report was released on 7 December 2014 and contains a number of recommendations which focus on strengthening the economy by making the financial system more resilient. In particular, recommendations include (i) setting Australian bank capital ratios such that they are unquestionably strong by being in the top quartile of internationally active banks, (ii) increasing the risk weighting of mortgages and (iii) implementing a framework for minimum loss absorbing and recapitalisation capacity to allow effective resolution with limited risk to taxpayer funds.

The Federal Government has announced that it intends to consult with industry and consumers before making any decisions on the recommendations. The consultation will occur until 31 March 2015. ANZ expects that many of these recommendations will be implemented only after further consideration by, and consultation with, APRA and the RBA and after completion of the requisite legislative and regulatory processes.

It is therefore not possible to say with any certainty when and what particular recommendations ultimately will be implemented into law, regulation or policy, what timing and transition will apply or what the final capital impacts will be on the Group. However, implementation of these recommendations is likely to result in an increase in Common Equity Tier 1 Capital. The recommendations may also result in an increased requirement for other loss absorbing securities, which could take the form of Additional Tier 1 Capital, Tier 2 Capital or other forms of subordinated capital or senior debt which may be available to absorb loss. Any increase in other loss absorbing securities could have an adverse impact on the price or value of the Notes.

Regulatory Capital Classification

APRA currently classifies an ADI's regulatory capital into three tiers for its level 1 and level 2 supervisory purposes – referred to as Common Equity Tier 1 Capital, Additional Tier 1 Capital and Tier 2 Capital. Level 3 regulatory capital is only measured as to Common Equity Tier 1 Capital.

Common Equity Tier 1 Capital comprises the highest quality components of capital and includes paid up ordinary shares, certain reserves and retained earnings (excluding of subsidiaries that are not consolidated for level 2 capital adequacy purposes), together with minority interests, less Common Equity Tier 1 Capital Deductions such as intangible assets (including goodwill), investments in insurance subsidiaries and financial institutions, the excess of expected losses over eligible provisions, capitalised expenses and software, and net deferred tax assets. The ratio of Common Equity Tier 1 Capital to risk weighted assets is called the Common Equity Capital Ratio.

Additional Tier 1 Capital comprises high quality components of capital and consists of certain securities not classified as Common Equity Tier 1 Capital but with loss absorbing characteristics (such as ANZ's Capital Notes). Additional Tier 1 Capital together with Common Equity Tier 1 Capital constitutes Tier 1 Capital and the ratio of Tier 1 Capital to risk weighted assets is called the Tier 1 Capital Ratio.

Tier 2 Capital consists of subordinated instruments and, whilst a lesser form of capital than Tier 1 Capital, still has a capacity to absorb losses and contributes to the overall capital framework. Tier 2 Capital together with Tier 1 Capital constitutes Total Capital and the ratio of Total Capital to risk weighted assets is called the Total Capital Ratio.

To ensure that ADIs are adequately capitalised on both a standalone and group basis, APRA adopts a tiered approach to the measurement of an ADI's capital adequacy by assessing the ADI's financial strength at three levels:

- Level 1 – the ADI on a standalone basis (i.e. ANZ and a limited number of APRA approved subsidiaries). This is the ANZ Level 1 Group;
- Level 2 – the consolidated banking group (i.e. the consolidated financial group less certain subsidiaries and associates excluded under APRA's Prudential Standards, principally the insurance subsidiaries and ANZ's associated offshore financial institutions). This is the ANZ Level 2 Group; and
- Level 3 – the conglomerate group at its widest level. APRA is yet to set an implementation date.

Common Equity Capital Ratio

The Common Equity Capital Ratio of the ANZ Level 2 Group was 9.6% at 30 September 2015. The Common Equity Capital Ratio of the ANZ Level 1 Group was 9.6% at 30 September 2015. Volatility in the Common Equity Capital Ratio can be expected to arise in the future reflecting the buildup of current year earnings in normal conditions which increase the ratio and the subsequent payment of dividends (generally in July and December of each year) which decreases the ratio.

The differences between the Common Equity Capital Ratios for the ANZ Level 1 Group and ANZ Level 2 Group relate principally to the capital held within offshore banking subsidiaries. ANZ expects that those capital ratios will move in a similar way based on the application of ANZ's capital management strategy to its offshore banking subsidiaries (which includes a reliance on a repatriation of dividends by those subsidiaries subject to regulatory approval).

Subject to APRA finalising changes to its prudential standards (including any requirement to hold additional capital) arising from the recommendations contained in the final FSI report, ANZ will target an operating range for the Common Equity Capital Ratio around 9% range during normal conditions.