Board of Taxation Secretariat
C/- The Treasury
Langton Crescent
PARKES ACT 2600

Via email: hybrids@taxboard.gov.au

19 January 2016

Dear Sir

Insurance Australia Group (IAG) welcomes the opportunity to make a submission in relation the Board of Taxation's review on the Australian implementation considerations arising from the recommendations included in Action Item 2 of the Base Erosion and Profit Shifting (BEPS) Action Plan developed by the Organisation for Economic Cooperation and Development (OECD).

IAG would be happy to discuss the submission and to assist in any way we can. If you wish to discuss this matter or make further inquiries please contact the undersigned on 03 96018249.

Yours faithfully

Craig Hespe
Head of Group Taxation

Who is Insurance Australia Group?

Insurance Australia Group Limited (IAG) is the parent company of a general insurance group with controlled operations in Australia, New Zealand, Thailand and Vietnam (collectively the Group), employing more than 15,000 people. Its businesses underwrite over $11 billion of premium per annum, selling insurance under many leading brands including NRMA Insurance, CGU, SGIO, SGIC, Swann, WFI and Lumley Insurance (Australia); NZI, State, AMI and Lumley Insurance (New Zealand); Safety and NZI (Thailand); and AAA Assurance (Vietnam). IAG also has interests in general insurance joint ventures in Malaysia, India and China.

IAG and the Group are regulated by the Australian Prudential Regulation Authority (APRA). APRA's Prudential Standards pertaining to General Insurance are highly correlated with APRA's Prudential Standards pertaining to authorised deposit-taking institutions (ADIs), particularly in relation to capital baseapital. As such, IAG's submission as a group of general insurance companies will likely highly correlate with similar ADI submissions.

Executive Summary

This submission advocates that:

1. Franking credits should not be considered to be 'equivalent tax relief (Q15 of the Consultation Paper).

2. Regulatory capital instruments issued by Australian regulated entities, their subsidiaries and branches [Questions 35-36 of the Consultation Paper] particularly where those instruments are listed on a relevant stock exchange should be treated as an exception.

3. Any rule which might be enacted should be prospective applying only to instruments issued at a date *after* the relevant legislation has been enacted by Parliament so as to retain the status of instruments already on issue and avoid the cost of forced refinancing [Questions 6-10 of the Consultation Paper].

1. Franking credits should not be considered equivalent tax relief – Questions 15

Recommendation 2.1 as set out in Chapter 2 of 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**') seeks to deny the payee a dividend exemption or equivalent tax relief to the extent that the payment is deductible to the payer. Equivalent tax relief includes domestic tax credits.

The analysis of Example 2.1 encourages countries to limit the availability of tax relief on dividends to prevent such relief being claimed when the profits out of which the distribution is made have not borne underlying tax. Relevantly, the analysis refers to the situation where the profits out of which the payment is made were not subject to tax in Australia due to the branch profits exemption.

However, for the imputation credit to have become available, previously undistributed profits of the payer must have borne tax in Australia. Imputation credits are an exhausting asset that cannot be distributed more than once.

Moreover, in the case of the instrument issued by IAG similar to that in Example 2.1, the majority of the holders would be classified as retail investors, a proportion of whom would be required to pay tax when their marginal rate of tax exceeds the corporate tax rate.

It is difficult in these circumstances to identify a material detriment to the Australian Revenue. This is supported by figures released by the Parliamentary Budget Office that estimates the cost of all hybrid arrangements at $50 million per annum that no doubt also reflects the strength of Australia's existing rules that apply to hybrids including section 177EA.

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

Regulatory capital instruments issued by Australian regulated entities, their subsidiaries and branches [Questions 35-36 of the Consultation Paper] particularly where those instruments are listed on a relevant stock exchange should be treated as an exception.

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

- the regulated insurer or non-operating holding company 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 likely to occur often, but it is possible that an exception may also be relevant and necessary for Tier 2 instruments as well. Hence, our submission does not differentiate between AT1 and Tier 2 instruments, and is expressed to extend to all regulatory capital instruments.

AT1 instruments are defined by APRA in *GPS 112: Capital Adequacy: Measurement of Capital* (dated January 2013) as:

> *25. 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.*

(Note: this definition aligns with APRA APS111 Cl. 25 applicable to ADIs)

However, AT1 does not include Common Equity Tier 1 Capital (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, deferred 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.

IAG would suggest an exception should 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.

We believe this proposed carve-out is consistent with international practice and we note that, contrary to several references in the Final Report, IAG's AT1 instruments are issued for legitimate commercial reasons and are not driven by tax considerations.

One of the repercussions of the global financial crisis of 2008 and the Third Basel Accord has been the requirement by national financial regulators for banks and in the case of Australia other financial services providers such as general insurers to increase the quality of their regulatory capital available to absorb losses. In Australia, APRA's Life and General Insurance Capital (LAGIC) initiative has incorporated much of the latest Basel capital initiatives implemented in the global banking sector. IAG has been compliant and worn the impost of these heightened regulatory requirements since their introduction in 2013.

APRA's Prudential Standards demonstrate APRA's acceptance of AT1 instruments as an alternate source of high quality capital and the ratings agencies recognition of these instrument's debt like qualities support the reduced cost relative to traditional equity.

For IAG, in addition to the cost effective nature, AT1 instruments offer significant capital diversification benefits and offer easy liquidity to investors. The documented lifespan of the instruments also provides periodic opportunities for IAG to recalibrate the capital mix to better align with, for example, new or amended APRA rules or a change in corporate strategy.

There are also non-tax drivers for Australian banks 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

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

Such trends may in time similarly apply to general insurance groups, and together with other practical constraints lead to the concentration of fund-raising on one (head) entity in IAG's general insurance group and the consequent need to supply funds cross-border, rather than having diversified funding with local operations funded locally. Banks and general insurers will increasingly wish – or have – to raise funds in their home market using an AT1 instrument and then on-supply those funds to foreign markets using a similar instrument. The tax system should not interfere with issuing regulatory capital 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.

3. Grandfathering and transition – Questions 6-10

If our submissions set out above are not accepted, it is necessary to comment upon transition.

In our submission, any rule which might be enacted should be prospective applying only to instruments issued at a date *after* the relevant legislation has been enacted by Parliament so as to retain the status of instruments already on issue and avoid the cost of forced refinancing.

The costs associated with refinancing regulatory capital would be significant, especially if a general insurer was competing with banks going to market at more or less the same time – which will inevitably lead to a likely shortage of funding and increase in cost.

IAG, through its wholly owned subsidiary IAG Finance (New Zealand) Limited, currently has reset exchangeable securities on issue and listed on the ASX with a face value of $550 million that are next due to be reset on 16 December 2019. These instruments may be impacted if any measures are not made prospectively.

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