AFMA

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Budget Policy Division
Department of the Treasury
Langton Crescent
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Via email: prebudgetsubs@treasury.gov.au

Dear Treasury

2022/23 Pre-Budget Submission

The Australian Financial Markets Association (AFMA) represents the interests of over 120 participants in Australia's financial markets. Our members include Australian and foreign-owned banks, securities companies, treasury corporations, traders across a wide range of markets and industry service providers. They are the major providers of wholesale banking and financial market services to Australian businesses and investors.

We are pleased to provide a submission to Treasury to assist in the formulation of the Government's 2022/23 Federal Budget.

1. Context for Submission

At the outset it is noted, at the time of writing, that the 2022/23 Federal Budget is to be handed down on 29 March 2022 in advance of the 2022 Federal Election. In this context, the Federal Budget represents an opportunity for policy commitments to be made by the Government prior to the commencement of the caretaker period.

AFMA's perspective in terms of policy priorities continues to be the advancement of policies that attract the undertaking of mobile financial centre business from Australia. The specific recommendations that are included in the attachment to this submission all represent opportunities to enhance the competitiveness of Australia's financial sector and build on initiatives that have been supported by successive governments on a bipartisan basis.

2. Australia's Financial Sector Competitiveness

Financial services can contribute to increased economic growth on a sustained basis through two primary means:

1. Providing high quality, innovative and cost-effective financial intermediation and risk management services to Australian businesses, governments and consumers; and
2. Operating as an international financial centre, by providing services to overseas clients and generating employment, income and tax revenue in Australia.

The COVID-19 pandemic has been a catalyst for many financial system participants to consider where to conduct mobile financial centre activities. This represents a significant opportunity for Australia to capitalise on its relative strengths, such as adherence to the rule of law, political and economic stability (at a time where such stability is not as apparent in competing regional financial centres), quality of life and access to talent to enhance the proportion of mobile financial busines that is conducted in Australia.

However, considerable barriers to conducting business from Australia have caused our relative attractiveness as a financial centre to fall in recent times. Based on the latest report of the Global Financial Centres Index from September 2021, a ranking of the competitiveness of financial centres, Sydney ranks 25th and Melbourne 29th, with seven Asian financial centres ranked above them, including five in the top ten. Such rankings may be compared to 2017 when Sydney's ranking as a financial centre was 8th globally.

The relatively modest rankings of Sydney and Melbourne as financial centres exist notwithstanding laudable efforts in recent times to address frictions that reduce the attractiveness of Australia as a location to conduct mobile financial centre business, such as the 2020 Report by the Australian Finance & Technology Centre Advisory Group into Australia as a Finance and Technology Centre and the three reports of the Senate Select Committee on Australia as a Financial and Technology Centre.

In order to rectify the perception of Australia as being relatively uncompetitive as a financial centre, it is important that outstanding recommendations of the recently commissioned reports are committed to by Government and legislated in a timely way and, in some cases, urgently. AFMA maintains that the Government should establish a Financial Centre Taskforce comprised of industry and official sector representatives who have the experience and authority to confirm and prioritise the components of a financial centre development plan. This would ensure that there is a central, appropriately resourced body with holistic oversight of the various proposals and initiatives aimed at enhancing the standing of Australia's financial centres.

Specific Recommendations

In addition to the establishment of the Financial Centre Taskforce and the formulation of the development plan, the Government should commit to a number of specific measures in the 2022-23 Budget to arrest the decline in Australia's attractiveness as a financial centre. These include:

- Commitment to legislating the "Global Markets Incentive" (**GMI**) in the 2022 calendar year, as recommended by the Final Report of the Senate Committee on Australia as a Technology and Financial Centre;
- Commitment to the abolition of non-resident interest withholding tax on borrowings by financial institutions, as recommended by the Senate Committee on Australia as a Technology and Financial Centre;
- Immediate abolition of the 'LIBOR-cap' on deductible interest expense for cross-border intra-branch funding given the cessation of LIBOR in 2021;

- Commitment to the recommendations of the House Standing Committee on Tax and Revenue's Inquiry on the Development of the Australian Corporate Bond Market; and
- Adjustment of financial regulator cost recovery models to be fairer, more consistent, administratively efficient and reflective of the public benefit from regulation at least to some degree.

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Thank you for the opportunity to contribute to the Government's consideration of matters that should be addressed in the 2022-23 Federal Budget. We would be happy to discuss any of the matters that we have raised in this submission.

Yours sincerely,

Rob Colquhoun
Director, Policy

ATTACHMENT

A1 - Legislating the Global Markets Incentive

Recommendation:

The Government should confirm in the 2022-23 Federal Budget that it will legislate the Global Markets Incentive (GMI) regime well before the end of the 2022 year, as the replacement to the Offshore Banking Unit (OBU) regime. If this is not feasible due to intervening priorities arising from the COVID-19 pandemic, we recommend that the OBU regime be extended for a further 12 months to allow for sufficient time for the GMI regime to be legislated in a manner that achieves its principles.

Background

The OBU regime was repealed in 2021, consequent to a review undertaken by the OECD Forum on Harmful Tax Practices and subsequent EU securitisation regulation that had the potential to undermine European institutional investment into Australian securitisation vehicles. Pursuant to the legislation repealing the regime, a two-year transition was allowed, whereby the concessional tax rate currently available to OBUs would cease to apply from the end of the 2023 income year (varying for each OBU depending on year-end for tax purposes), with the interest withholding tax exemption to cease to apply from 31 December 2023. The loss of the OBU concessional tax rate may occur for certain OBUs as early as 31 December 2022.

The two aspects of the OBU regime which caused the OECD Forum to raise concerns were the concessional 10% tax rate, which potentially resulted in the "low or no tax" criterion being satisfied, and the requirement that an OBU only undertake a transaction with an "offshore person," which potentially resulted in the "ring-fence" criterion being satisfied.

In the intervening period since the legislation to repeal the OBU regime was passed, the OECD announced, as part of its work on addressing challenges arising from the digital economy, consensus on a minimum rate of tax of 15% to apply to multinational enterprise on a jurisdiction by jurisdiction basis. This is important as it sets a consensus as to what rate of tax should not be considered to be "low or no tax" and accordingly be acceptable from an OECD perspective.

Principles

The principles that, in AFMA's view, should shape the regime that is legislated to replace the OBU regime are as follows:

- That the regime is sufficiently competitive to retain existing business in Australia and attract mobile financial centre business to Australia based on the considerable non-tax factors that Australia offers to such business;
- That the regime would withstand scrutiny from the OECD Forum on Harmful Tax Practices on the basis that the gateway criteria for a regime being classified as harmful would not be satisfied;
- That the range of activities to be eligible in the regime are agnostic to financial innovation and remain contemporaneous;
- That the aspects of the OBU regime which render the regime difficult to administer and inefficient are not replicated unless there is a demonstrable need; and
- That the revenue implications for Government are largely consistent with the OBU regime.

The Global Markets Incentive

Noting the repeal of the OBU regime, the Senate Committee on Australia as a Technology and Financial Centre included in its terms of reference specific consideration of replacement regimes. AFMA's submission to the Senate Committee set out a proposal for the GMI, which was designed to address the OECD's concerns while still being sufficiently competitive to attract and retain mobile financial centre activity in Australia. The elements of the GMI regime, as provided to the Senate Committee, are as follows:

- A tax rate of 15% to apply to eligible GMI activities;
- The existing interest withholding tax exemption that applies to the OBU regime to apply equally to the GMI;
- GMI activities to be determined with reference to the existing suite of eligible OB-activities;
- GMI activities able to be conducted with any eligible counterparty (both domestic and international), with a prohibition against transactions with individuals or small business entities;
- Given that the focus of the GMI regime is to allow Australia to compete in relation to transactions that would otherwise be conducted with international competitors, a prohibition against GMI activities being denominated in AUD.

The Senate Committee, in its Final Report, made the following recommendation:

> The committee recommends that the Australian Government establish a Global Markets Incentive to replace the Offshore Banking Unit regime by the end of 2022.

Refining the Global Markets Incentive

Eligible Activities

Noting the time parameters to legislate the GMI prior to the cessation of the OBU regime, it is AFMA's recommendation that in determining the activities that are eligible to be conducted within a GMI regime, such activities should be determined adopting an approach similar to that adopted under the current OBU regime, that is, eligibility is determined with reference to the activities specifically defined in the enabling legislation. This will ensure that existing business conducted in Australia may be retained and the revenue implications arising for Government from the GMI regime may be determined with more specificity than if an alternate approach was adopted.

In terms of determining the activities eligible for the GMI regime, AFMA's view is that the activities that are currently eligible to be conducted in the OBU should be eligible on the basis that they remain activities that the Government should incentivise in order to enhance Australia's attractiveness as a financial centre. Additionally, we would support safeguards being implemented that ensure that the GMI is delivering on its stated policy objectives.

Our view is that the GMI should further allow for transactions with respect to digital assets to be eligible. Noting the recommendations of the Final Report of the Senate Committee on Australia as a Technology and Financial Centre in relation to digital assets, it is presently unclear whether transactions in relation to digital assets would be eligible for inclusion under the current rules for OBU eligibility as such assets are not clearly categorised as a security, an eligible commodity or a currency. Confirming eligibility for transactions in relation to digital assets to be included in the GMI will support the broader recommendations of the Senate Committee in relation to digital assets.

Finally, to the extent that the method of determining GMI eligibility is a list of articulated eligible activities, as is the approach for OBU eligibility, we would support the updating/refinement of the list to occur through a regulation-making power as opposed to through legislative amendment. There is support for this approach from the Johnson Report into Australia as a Financial Centre, which stated that:

> "(t)he Forum's preferred option is for much of the detail in this Division to be replaced with Regulations. Regulations would contain an updated list of eligible OBU activities, developed with advice from Treasury and the ATO, and following consultation from industry. These Regulations would be updated periodically on advice from the proposed Financial Centre Task Force, which would also make periodic recommendations on any other changes to the OBU regime necessary to ensure that it remained internationally competitive."

GMI Restrictions

To address the concerns of the OECD with respect to the OBU regime being "ring-fenced" but also to limit the scope of the GMI to those activities where there is a global market, it is proposed that the GMI is limited to transactions with or services provided to counterparties that are not individuals or small business entities. This will ensure that the GMI regime only applies to financial market participants of sufficient scale. The other proposed restriction from a GMI perspective is a prohibition against GMI activities being denominated in AUD, again to ensure that the GMI is limited to those transactions/services in relation to which there is a global market.

One aspect of this approach that will need to be confirmed is that, in respect of trading activities, where a transaction is effected on a securities exchange, the counterparty will be taken to be the clearer of the transaction and there is no requirement for the GMI entity to "look-through" to determine the nature of the party on the other side of the transaction.

Modification of Current OBU Features

The repeal of the OBU regime and the exactment of the GMI regime represents an opportunity to remove the existing inefficiencies in the manner in which the current regime operates and create a regime that is more operationally attractive, particularly for new entrants looking to move business and staff to Australia. A summary of suggested improvements to the OBU regime that should be reflected in the GMI is set out below:

- The current OBU rules require that, in order for an activity to be eligible to be conducted in the OBU, it is necessary to be funded by "OB-money," broadly an OBU's paid-up capital, retained earnings and money received through conducting eligible-OB activities. To the extent that an OBU uses more than 10% of non-OB money then the concession is lost for the OBU for the entire year of income (the so-called "purity test"). These requirements were introduced in 1992 when the OBU was limited to pure banking activities and became increasingly out-of-step as the scope of eligible activities increased over time. The GMI should have no such restrictions and rather allow a GMI entity to source funds to conduct activities from any source and in any currency, with a requirement that the cost of funds be at arm's length in a related party context. The ability to source funds in any currency will have the added benefit of increasing hedging activities which the GMI regime will incentivise being conducted from Australia;

- Under the current definition of a "trading activity," it is necessary that in order to be an eligible activity in respect of an equity interest, the OBU cannot hold a more than 10% participation interest in another entity. In practice this is an operationally burdensome requirement to monitor and the policy intent underpinning the requirement would be better served to allow for "trading" to apply without restriction in respect of instruments publicly listed and quoted on a recognised securities exchange, with the 10% participation exemption applying only to unlisted instruments;
- Currently, in order for an activity to be an eligible-OB activity, it is necessary that the "thing is done" in Australia. This drafting is problematic to apply in practice, has few comparisons in the tax legislation either in Australia or globally and is becoming increasingly anachronistic as markets evolve, such as where increased automation of functions creates difficulties in identifying the "thing" that is being "done". A preferred approach to eligibility would be to align to the OECD concept of "Key Entrepreneurial Risk Taking" (e.g. per OECD PE Profit Attribution Report) and to allocate the profits to the OBU and other parts of the enterprise based on where the KERT functions are performed. This would also satisfy the requirements of BEPS Action 5 regarding substantial activities.

Concluding Comments

AFMA and its members are committed to assisting the Government ensure the taxation settings that apply to mobile financial centre business are competitive and allow Australia to leverage its considerable non-tax features to attract and retain this business in Australia. The repeal of the OBU regime represents a threat to Australia's competitiveness if a replacement regime is not legislated in a timely manner. As such, the Government should announce in the Budget that it will give effect to the recommendation of the Senate Committee on Australia as a Technology and Financial Centre and legislate the GMI regime in the 2022 calendar year.

A2 - Implement Interest Withholding Tax Reform

Recommendation

The Government should announce the abolition of interest withholding tax on offshore funding by financial institutions, as recommended by the Johnson and Henry Tax Review reports, acknowledged in the Financial System Inquiry report and recommended by the recent Senate Committee on Australia as a Technology and Financial Centre.

This reform would remove a tax barrier to cross-border finance, reduce pressure on the cost of finance in the economy and assist competition. It would be a timely reform as the direct Budget cost of the reform has largely been eliminated by:

- Historically low interest rates; and
- The increased number of Australia's Double Tax Agreements that provide an interest withholding tax exemption for financial institutions.

Support

A key driver of enhancing the attractiveness of Australia as a place to do business, particularly with respect to financial services business, is removing frictions that inhibit the free-flow of capital both in and out of Australia. One such friction is the imposition of interest withholding tax on interest paid by Australian entities (including branches) to offshore lenders and the related tax compliance costs. The removal of interest withholding tax for financial institutions was a key recommendation of the 2009 Johnson Report into Australia as a Financial Centre, and had apparent bipartisan support, but the reform has not been implemented.

The objective of the Johnson Report's recommendation was, broadly, to ensure that Australia has access to a broad range of offshore savings pools to finance domestic investment needs and improve Australia's competitiveness as a financial centre as, for example, it would facilitate bank regional treasury functions. The Report noted that Australia's interest withholding tax regime is inconsistent with the approach taken in other financial centres, as it had the effects of both raising the cost of capital for Australian business (through requiring the payer to "gross-up" for the amount withheld) and also increasing complexity, given the exemptions that exist for payments made to unrelated financial institutions in many Double Tax Agreements and also under Section 128F. It noted that:

> "the continued application of interest withholding tax on financial institutions' borrowing offshore sits uneasily with the Government's desire to develop Australia as a leading financial centre and is putting Australia at a competitive disadvantage with respect to overseas financial centres, which increasingly do not charge interest withholding tax on such transactions."

This comment has been echoed by:

- **Senate Standing Committee on Economics 2011 Report into Competition within the Australian Banking Sector:** "The Committee recommends that interest withholding tax be abolished as budgetary circumstances permit to increase the ability of foreign banks to compete in the Australian market."
- **Henry Tax Review: "**Financial institutions operating in Australia should generally not be subject to Australian interest withholding tax on interest paid to non-residents."
- **Financial System Inquiry:** "For financial institutions, different funding mechanisms are subject to different rates of IWT. Reducing IWT (for the relevant funding mechanisms) would reduce funding distortions, provide a more diversified funding base and, more broadly, reduce impediments to cross-border capital flows."

- **The Senate Committee on Australia as a Technology and Financial Centre:** "In order to access a diversity of offshore sources of funding and ensure Australia's competitiveness, the committee believes it is time to act on the recommendation of the 2009 Australia as a Financial Centre – Building on Our Strengths report (the Johnson Report) to remove withholding taxes: on interest paid on foreign-raised funding by Australian banks; on interest paid to foreign banks by their Australian branches; and on financial institutions' related party borrowing."

AFMA notes that given globally low (and potentially negative) interest rates at present and the increasing number of Double Tax Agreements that offer an exemption from interest withholding tax for interest paid to unrelated financial institutions, the revenue cost of reform in this area is immaterial. In this regard, it is important to note that Australia is currently negotiating/renegotiating Double Tax Treaties with Luxembourg, India, Iceland, Slovenia, Greece and Portugal, and has committed to Treaties with a further three jurisdictions in the 2022 year, which will further narrow the revenue cost of phasing out interest withholding tax for financial institutions.

The existence of the withholding tax obligation, coupled with the compliance burden associated with determining the circumstances in which interest withholding tax applies, the applicability of any exemptions and the appropriate rate at which to withhold are significant disincentives to establishing regional headquarters in Australia.

As such, AFMA recommends that the Government announce in the 2022-23 Federal Budget a commitment to the Johnson Report recommendation as it applies to interest withholding tax, namely:

- Remove withholding tax on interest paid on foreign raised funding by Australian banks, including offshore deposits and deposits in Australia by non-residents;
- Remove withholding tax on interest paid to foreign banks by their Australian branches; and
- Remove withholding tax on financial institutions' related party borrowing.

A3 - Abolition of the LIBOR Cap

Recommendation

The Government should announce the immediate abolition of the LIBOR Cap in the 2020/21 Budget. This would encourage foreign banks to conduct more business in Australia and help provide the critical mass and diversity of business that would help sustain financial services exports. The cessation of LIBOR at the end of 2021 for most currencies/tenors renders the LIBOR Cap as untenable.

Support

The LIBOR Cap is a uniquely Australian restriction that limits the tax deductibility of interest expense on internal funding by foreign bank branches. It harms competition, increases intermediation costs and amplifies a perception that Australia is an exceptional and complex tax jurisdiction. Abolition of the LIBOR Cap was considered a 'low hanging fruit' in the 2009 Johnson Report but it remains an outstanding flaw in the Australian taxation system.

The Government asked the Board of Taxation to review the appropriateness of the LIBOR Cap as part of its review into the Tax Arrangements Applying to Permanent Establishments. The Board of Taxation made only one recommendation in its report to the Government, namely:

> "subject to confirmation that the removal of the LIBOR Cap would result in no material cost to revenue, the cap should be removed. That would assist in fostering competition in the domestic market."

In providing context to the recommendation, the Report stated:

> "The Board agrees that the LIBOR Cap has the potential to reduce bank competition. Put another way, it is hard to see how a cap on the amount of deductions that can be claimed in respect of intra-entity debt can assist in promoting banking competition by foreign banks with their domestic counterparts that do not face the restriction. The LIBOR Cap has the effect of potentially increasing the funding costs for foreign bank branches and hinders their ability to compete in the business loan market. Moreover, new entrants into the Australian banking market are likely to be disproportionately affected by the LIBOR Cap because they are relatively more reliant on head office funding to which the cap applies."

Such comments are consistent with those included in the Johnson Report, which made the recommendation to "remove the LIBOR Cap on deductibility of interest paid on branch-parent funding."

At the Government's request, AFMA has previously provided both the Government and Treasury with revenue estimates of the cost of the removal of the LIBOR Cap, based on survey responses from its members. The cost of removing of the cap was immaterial to tax revenue and removal would deliver significant deregulation benefits, in addition to enhancing banking competition and the provision of product and service innovation by foreign bank branches. AFMA's view is that Australia's transfer pricing requirements in Division 815 of the ITAA 1997 are sufficiently robust to ensure that the interest deductions claimed by foreign bank branches on internal funding are at arm's length.

A4 – Recommendations of the Corporate Bond Inquiry

Recommendation

The Government should commit to and prioritise key recommendations of the House Standing Committee on Tax and Revenue's Inquiry into the Development of the Australian Corporate Bond Market. In particular, the Government should focus on:

- Reviewing the licensing regime for credit rating agencies with a view to minimising access barriers for small and medium enterprises;
- Streamlining disclosure requirements for the issuance of corporate bonds with enhanced reliance on the continuous disclosure regime for listed issuers;
- Amendment to regulations to ensure that the existence of an early redemption feature does not prevent an instrument from being classified as a simple corporate bond; and
- Investigation of the tax system to assess the impact of tax settings on demand for corporate bonds relative to other asset classes.

Support

In 2020, the House Standing Committee on Tax and Revenue undertook an inquiry into the development of the Australian bond market. The Committee noted that the Australian retail bond market was small compared to other jurisdictions and that Australian issuers make greater use of offshore bond markets.

AFMA's submission to the Inquiry noted that to enhance the depth and liquidity of the retail corporate bond market, it is first necessary to remove any constraints for issuers to issue corporate bonds and then, to the extent possible, and while balancing investor protection concerns, enhance alignment between products available to retail and wholesale investors.

The Final Report of the Committee was issued in October 2021 and contains a number of practical recommendations that would support both of these aspects and should be pursued. AFMA is not aware of the Government formally responding to the recommendations of the Inquiry and our view is that the Government should use the 2022/23 Federal Budget to provide its response, if not before.

A5 - Regulation Cost Recovery

Recommendation

The Government should:

- Allocate government funds to cover a part of the cost of running ASIC, AUSTRAC and APRA to reflect the public benefit from this regulation, which would reduce moral hazard and allocate cost recovery charges in a more proportionate and fair manner;
- Remove the Enforcement Special Account from ASIC's industry funding model, as a means to give equitable outcomes that are more consistent with the model's principles; and
- Centralise the administration of the funding models for ASIC, AUSTRAC and APRA to improve consistency, efficiency and fairness of the cost burden on regulated entities.

Support

Regulated entities are levied to cover the operating costs of ASIC, APRA and AUSTRAC (whose 'industry contribution' levy is outside the Government's Cost Recovery Guidelines but is clearly cost recovery). The levies operate like a tax and are economically inefficient. They have increased markedly in recent years and can be especially burdensome for new entrants and firms operating on tight margins, making Australia less competitive as a business location.

In 2021-22, the industry levies for APRA and AUSTRAC are expected to be \$221m and \$93m respectively. The ASIC industry funding model is expected to be \$265 million, charged to both financial and non-financial businesses. This represents a direct cost burden of over \$579m on Australian business. The Major Bank Levy, budgeted at \$1,610m, is in addition to this.

Moral hazard is a significant problem in the design of cost recovery arrangements. The structures for these arrangements present little incentive for government to keep costs low or efficient, as these costs are passed onto the invoiced entities. Moreover, governments have paid little attention to the cumulative burden of *ad hoc* increases in cost recovery levies and also have failed to recognise that the primary beneficiary of regulation is the public, whose interests can in effect only be reflected in a government contribution to regulator funding.

Cost recovery for ASIC's Enforcement Special Account (ESA) is unfair, as it charges the cost of an enforcement action against a particular person to all of the regulated entities in the relevant segment of the industry. Moreover, industry should not be charged for the recovery of enforcement costs where ASIC is unsuccessful in an action, or when where ASIC already receives monies from entities involved in an enforcement action to cover the cost of its related investigation and action.

More generally, the mapping of regulator costs to the regulated community is imperfect and creates distortions and inequity, particularly where the cost burden is poorly calibrated to regulatory risk.[1] The funding models for ASIC, AUSTRAC and APRA sit under different portfolios and adopt unique metrics to determine the population of leviable entities and the amounts payable. There is no central oversight of the different funding models, nor is a consistent rationale or set of principles applied. Moreover, each is administered differently, such that the overall burden on entities is not transparent.

[1] For example, only 620 out of 14,000 reporting entities contribute to the AUSTRAC levy, while AUSTRAC regulation gives rise essentially to a public benefit; such as through crime detection and prevention, and higher tax receipts.