



1 February 2019

Budget Policy Division
Department of the Treasury
Langton Crescent
PARKES ACT 2600

Via email: prebudgetsubs@treasury.gov.au

Dear Treasury

2019-20 Pre-Budget Submission

The Australian Financial Markets Association (AFMA) represents the interests of well over 100 participants in Australia's wholesale banking and 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. Our members are the major providers of services to Australian businesses and retail investors who use the financial markets.

We are pleased to provide a submission to Treasury to assist in the formulation of the Government's 2019-20 Federal Budget.

1. Executive Summary

The proposals which form the basis of AFMA's 2019-20 Pre-Budget submission are:

- **Provide a cohesive development strategy for financial markets:** Australia's national interest is served by having strong competition in the financial system and a competitive tax and regulatory regime for internationally mobile financial services business, as this will generate higher income, employment and tax receipts in Australia. The Government needs to make a policy commitment to the enhancement of Australia's financial markets and Australia's attractiveness as a place to conduct financial services business. This will require the formulation of a cohesive strategy with clear objectives, timelines and a process that integrates policy initiatives relevant to tax, international trade, innovation and business investment, as well as implementation of outstanding recommendations of both the Johnson Report and the Financial System Inquiry (FSI);
- **Enhance the operational efficiency of the OBU regime:** Consistent with the desire to lift Australia's international competitiveness, the Government should

act to improve the scope and operational efficiency of the OBU regime, which does not compare well against competing schemes in centres such as Singapore. Moreover, the Government should firmly protect Australia's interest in remaining viable as a location for internationally mobile business, when making its response to concerns expressed by the OECD Forum on Harmful Tax Practices about the OBU regime.

- **Prioritise the Johnson reforms and conduct review of FSI tax observations:** The twin objectives of promoting competition within the financial system and improving Australia's competitiveness heighten the importance of implementing other measures that enhance Australia as a destination for foreign capital, such as those set out in the Johnson Report. These include:
 - The phase-down of interest withholding tax for financial institutions; and
 - The abolition of the LIBOR Cap.

The Government should request the Board of Tax to undertake a review of the taxation observations of the Financial System Inquiry.

- **Government to respond to Board of Tax Permanent Establishment Paper:** In April 2013, the Board of Taxation delivered to Government its report of its Review of Tax Arrangements Applying to Permanent Establishments. This report has some key observations and recommendations in terms of ensuring that Australia's taxation arrangements are aligned with key trading partners and financial centres. The Government has not responded to this report in the six years since its release and should do so in the 2019-20 Federal Budget;
- **Exempt withholding tax on payments made to/from CCPs:** The Government should urgently conclude its consideration of industry submissions on the withholding tax treatment of payments made to/from Central Counterparties (CCPs) to ensure that Australia's financial markets do not suffer an ongoing competitive disadvantage due to the tax system not properly reflecting the G-20 OTC derivative reforms that have been implemented; and
- **Central oversight of regulator funding models:** The Government should centralise the administration and co-ordination of the various funding models adopted for different regulators (ASIC, AUSTRAC, APRA, etc) to ensure consistency of approach, alignment of quantification models and to determine the collective funding burden on relevant entities. In addition, further consideration should be given to removing the Enforcement Special Account (ESA) from cost recovery arrangements.

2. Introductory Comments

AFMA's 2019-20 Pre-Budget Submission is made against the backdrop of a pending Federal Election that will occur in the first half of the 2019 calendar year. As such, the Federal Budget provides an opportunity for the Government to both articulate a comprehensive blueprint for the development of the Australian financial system, particularly the financial markets, and also confirm the commitment to reforms that are pivotal in enhancing the competitiveness of Australia's financial system. Such reforms should focus on initiatives that will enhance the sector, including the ability to attract mobile foreign capital to fund Australia's economy and to enhance Australia's financial services export capability.

As noted by the 2009 Johnson Report, a key pillar the competitiveness of Australia's financial sector is the Offshore Banking Unit (**OBU**) regime. The recent OECD Review into the OBU as a harmful tax practice, and the Government's commitment to amend the regime to address OECD concerns, runs the risk of taking away business from Australia that would otherwise be conducted here in order to draw on our hard earned non-tax advantages, like a highly skilled workforce. As it stands, competing financial centres like Singapore already impose a lower tax burden on this type of business.

More generally, to meet its economic and financial system development objectives, the Government will need to prioritise reforms of other frictions that currently stymie the flows of capital in and out of Australia, principally the phase-down of interest withholding tax for financial institutions.

In urging the Government to promote measures to enhance the productivity of the financial services sector, we note the recently issued Tax Transparency Data for the 2016-17 year, which highlighted that the banking and finance sector accounted for more than 34% of total corporate tax payable and, unlike all other industry sectors except the insurance and superannuation sector, increased its corporate tax contribution relative to the 2015-16 year. In addition, the banking and finance sector has a lower percentage of nil taxable entities than any other industry sector. Given the heavy reliance Australia's corporate tax base has on participants in the banking and finance sector, it is important for the Government to ensure that the sector remains internationally competitive, and that frictions in relation to the mobility of capital are minimised.

2.1 Articulation of strategy for financial system

Our primary recommendation for the Government in framing its 2019-20 Federal Budget is that it should articulate, and commit to, a comprehensive strategy for the future development of the financial system, its role in the Australian economy and its integration with the rest of the world, particularly the rapidly growing trade in financial services in the Asian region. While the Government has appropriately prioritised the conclusion and implementation of regional free trade agreements (FTAs), these have not been linked to domestic financial system development objectives in a way that would enable the financial sector to capitalise on the opportunities presented by these agreements.

It remains in Australia's economic interest for the Government to formulate and then champion at all political levels a strategy that will integrate the FSI's Final Report recommendations with the Government's policy agenda in related areas such as tax, international trade, innovation and business investment. This will require a stronger commitment of policy resources and political attention than has been previously forthcoming from successive governments and involves setting clear objectives, compact timelines and a process to advance reform. The decade long lag between the Johnson Report's recommendations and their actual implementation by government is symptomatic of this lack of political attention and the failure to integrate financial system development with broader policy objectives and priorities.

3. Taxation recommendations

3.1 Introductory Comments

During 2018, AFMA was the key industry contributor of information to Treasury and Government on the OECD Forum on Harmful Tax Practice (**the Forum**) review into the OBU regime. In our view, the assessment model applied by the Forum is deficient from a real-world perspective because it fails to consider the tax rate applicable to similar activities in competitor jurisdictions when coming to a view about the existence of harmful tax competition. AFMA is greatly concerned that the most likely manner in which the Government will amend the OBU regime by raising the applicable tax rate; the effect of which would be to neutralise the already limited competitiveness of our regime. This would result in a net loss of employment, income and tax to Australia.

As such, it is important for the Government to respond and commit to reforms that seek to rectify the competitiveness of Australia's tax system, as it applies to the financial sector. Many of these specific recommendations arise from the Johnson Report, while there is an opportunity for the Government to undertake a wholesale review of the taxation observations arising from the Financial System Inquiry, which provides a stocktake of pertinent issues and concerns.

3.2 Enhancing the Operational Efficiency of the OBU Regime

On the basis that the amendments to the OBU consequent to the review by the OECD Forum result in the regime being less competitive, such as through an increase to the tax rate applying to eligible-OB activities, then it is appropriate for the Government to consider the overall operation of the OBU regime and to implement initiatives that render the regime more user-friendly and, therefore, attractive.

AFMA has previously lodged a number of submissions regarding inefficiencies in the OBU regime, in advance of the most recent amendments to the regime in 2015. These submissions recommended the following:

- That the determination of which activities are eligible to be undertaken by an OBU be determined with reference to another legislative definition (such as a "financial arrangement" under Division 230 of the *Income Tax Assessment Act 1997*) as opposed to the current laundry list approach;
- Removal of the requirements around OB Money and the purity test; and
- Updating the regime to make custodial and settlement services and additional hedging activities eligible to be undertaken by an OBU.

Given the OBU legislation will require amendment to implement the changes to address the concerns expressed by the Forum, it is timely as part of that amendment process to consider additional legislative reforms to enhance the operation of the regime, and the Government should commit to doing so in the 2019-20 Federal Budget.

3.3 Remove interest withholding tax for financial institutions

AFMA continues to strenuously argue that the previously announced phase-down of interest withholding tax (IWT) for financial institutions should be taken up by the Government, given the economic benefits that would flow from this. A benefit from the application of fiscal discipline and a return to budget surplus, should be the capacity to address structural deficiencies in the tax system.

There is a considerable body of commentary that clearly articulates the erosive nature of interest withholding tax on the Australian economy and Australian businesses. Starting with the Johnson Report, where the AFCF expressed the view that “the application of interest withholding tax to offshore borrowings by Australian based banks is inconsistent with Australia’s need, as a capital importing country, to access a diversity of offshore sources of funding.” The AFCF went on to state that:

“the continuing 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.”

These comments were echoed and endorsed by the Henry Tax Review in 2010, which recommended that “financial institutions operating in Australia should generally not be subject to interest withholding tax on interest paid to non-residents.”

Further, and compellingly, the Final Report of the FSI, observed:

“(w)ithholding taxes generally increase the required rate of return for foreign investors, which reduces the relative attractiveness of Australia as an investment destination. Where foreign investors can pass on the cost to domestic recipients, this raises the cost of capital in Australia...reducing IWT would reduce funding distortions, provide a more diversified funding base and, more broadly, reduce impediments to cross-border capital flows.”

In essence, the FSI Panel agrees with previous observations made in the Johnson Report and the Henry Tax Review that, as a nation that relies on the importation of capital to ensure continued growth, it is incongruous that the government persists with a measure that significantly hinders the free movement of capital into Australia and causes Australian businesses to pay a higher rate for debt finance. This ultimately renders Australian businesses less competitive relative to their global peers.

AFMA urges the Government to acknowledge the recommendations of the Johnson Report and consider the effect of the phase-down of interest withholding tax for the wider economy. As such we call on the Government to commit to the implementation of the phase-down of interest withholding tax as per the Johnson recommendation, namely:

- on foreign-raised funding by Australian banks;
- to foreign banks by Australian branches; and
- on related party borrowings by financial institutions.

3.4 Abolish the LIBOR Cap

The Government should use the 2019-20 Federal Budget as an opportunity to finally announce the removal the “LIBOR Cap,” a statutory provision that operates to deny deductibility of intra-entity interest for an Australian branch of a foreign bank above the applicable LIBOR.

Our view continues to be that the LIBOR Cap unnecessarily inhibits the flow of capital into Australia through foreign bank branches and, therefore, increases pressure on the availability and cost of credit to Australian business. It is defective tax policy because it conflicts with internationally accepted transfer pricing norms that rely on arm’s length pricing/conditions. It also has serious technical flaws, most notably because LIBOR is not a representative funding rate for individual banks or for funding at a maturity greater than twelve months.

While AFMA’s view on the defective nature of the LIBOR Cap from a policy perspective has remained steadfast for some time, there are two recent practical developments that render the LIBOR Cap entirely inappropriate as a benchmark for determining deductibility of interest.

The first development was in 2013 when the British Bankers Association ceased to quote AUD LIBOR. This resulted in a situation where there was no applicable LIBOR in respect of AUD borrowings and consequently, in AFMA’s view, no cap on the deductibility of interest where the Australian branch borrowed in AUD. The industry took a responsible approach in responding to this legal conundrum and negotiated an Administrative Solution with the ATO that may be adopted by taxpayers to address AUD borrowings to which the LIBOR Cap previously applied. From a technical perspective, however, this can be no more than a temporary fix as there is now the untenable position where there exists a provision of the law which has no legal effect where the Australian foreign bank branch borrows in its own functional currency.

More recently, and importantly, it is apparent that LIBOR itself will not continue post 2021. In 2017, the UK Financial Conduct Authority indicated that it would not require panel banks to make submissions to support the calculation from LIBOR past 2021. This is widely recognised as being the “death-knell” for LIBOR, and will mean that there will be no benchmark available for LIBOR Cap purposes.

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. This recommendation was:

“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.”

This recommendation was made on the basis that:

“(a)s the financial crisis clearly demonstrated, in periods of stress in credit markets, there can be appreciable differences between the LIBOR rate and the rates that parent banks are able to offer their Australian branches on a commercial basis. While conditions in credit markets have eased significantly, Australia needs policies to ensure access to alternative funding sources at competitive rates should such tensions re-emerge. The Forum believes that any tax avoidance concerns from removing the LIBOR cap could be adequately dealt with by applying the usual transfer pricing guidelines in respect of interest paid to foreign banks by their Australian branches.”

At the Government’s request, AFMA 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. These estimates demonstrated that the cost of removal of the cap was immaterial (i.e. there is no material cost to revenue) and would deliver significant deregulation benefits, in addition to materially enhancing banking competition and the provision of product and service innovation by foreign bank branches.

Given the defective nature of the LIBOR Cap from a policy perspective, the impracticality associated with applying the cap for currencies for which no LIBOR is quoted, the likelihood that LIBOR itself will not be in existence in the near term and the revenue consequences associated with its removal, AFMA again calls on the Government to abolish the LIBOR Cap as a matter of urgency.

3.5 Exempt withholding tax on interest paid to CCPs

In February 2013, AFMA lodged a submission with Treasury seeking a withholding tax exemption for interest paid to central counterparties (CCPs).

As part of the G-20’s commitment to improving the transparency of OTC derivatives, systemically important OTC derivatives (such as AUD interest rate swaps) are required to be collateralised and cleared through an appropriately structured CCP. The concern expressed in the submission was that where the CCP was located outside of Australia, interest paid on the collateral could result in Australian interest withholding tax.

The submission sought an exemption for any withholding tax that would arise, on the basis that the cross-border interest flow arose solely due to regulatory reform and any withholding tax arising would adversely affect the Australian derivatives market, with the detrimental impacts vastly exceeding any government revenue.

The point was acknowledged by the Final Report of the Financial System Inquiry, which observed:

“Australia’s IWT regime also applies to derivative transactions. Under G20 commitments, certain standardised over-the-counter derivatives need to be collateralised and cleared through a regulated central counterparty. In Australia, outbound interest payments on collateralised positions may be subject to IWT (flows from Australian participants to offshore CCPs, or flows from Australian CCPs to offshore participants). This may increase costs for Australian participants and adversely affect liquidity in Australian derivatives markets.”

AFMA has received no response from the Government or Treasury with respect to this issue, which continues to be an ongoing impediment to the efficiency of the Australian derivatives market and AFMA urges the Government to consider the request made in the submission as part of the 2019-20 Federal Budget.

3.6 Government to Respond to Board of Taxation Permanent Establishment Paper

In 2012, the Government commissioned the Board of Taxation to conduct a review into the tax arrangements applying to permanent establishments. This was a key review, particularly for AFMA members, as the Board was asked to consider the advantages and disadvantages of Australia adopting the “functionally separate enterprise” approach to determining the profits attributable to a permanent establishment, as is adopted by the OECD Model Tax Convention, subsequent to changes in 2010. Our view is that aligning Australia’s approach to other key trading partners and OECD countries will enhance Australia’s standing as a financial centre. The Board also made a recommendation in this review for the abolition of the LIBOR Cap (refer above).

The failure to adopt of the functionally separate enterprise approach to determining the profits attributable to a permanent establishment is resulting in significantly detrimental taxation outcomes for AFMA members. The implementation of the anti-hybrid rules and the ATO stance on the non-deductibility of costs incurred to meet prudential regulatory requirements on liquidity are two current examples of where Australia’s approach is out of step with approaches taken in comparable jurisdictions. AFMA understands that the adoption of the functionally separate enterprise approach is strongly supported by the ATO.

Unfortunately, and notwithstanding the public release of the Board’s report in June 2015, there is yet to be any Government response to whether Australia will adopt the functionally separate enterprise approach and, if so, in which contexts. AFMA calls on the Government to formally respond to the Board’s report in the 2019-20 Federal Budget.

3.7 Board of Tax Review of FSI Taxation Observations

The terms of reference for the Government's Financial System Inquiry (FSI) prevented the making of recommendations into taxation matters. This was due to the Government, at the time of the release of the final FSI Report, continuing to commit to a comprehensive review of the taxation system through the Tax White Paper process. Accordingly, the FSI terms of reference allowed the FSI Panel to:

“examine the taxation of financial arrangements, products or institutions to the extent these impinge on the efficient and effective allocation of capital by the financial system, and provide observations that could inform the Tax White Paper.”

As noted above, the Government discontinued the Tax White Paper process in February 2016. As a result, the taxation observations made in the FSI Final Report have not been the subject of further government consideration/recommendation. In AFMA's view, had the FSI Panel known of the subsequent discontinuance of the Tax White Paper process, it may have made taxation recommendations, as opposed to observations, to the extent allowed by the terms of reference, with such recommendations being part of the Government's formal FSI response.

As can be seen from the specific issues referenced above, many of the taxation observations in the FSI Final Report are germane to AFMA and its members, and relate to matters set out below, particularly in relation to interest withholding tax, the LIBOR Cap and the application of interest withholding tax to interest paid to or from central counterparties. Further, the observations touch on more fundamental aspects of the Australian taxation system, such as the differential tax treatment of savings vehicles, which would benefit from further consideration and consultation. Accordingly, AFMA recommends that the Government, in the 2019-20 Federal Budget, commit to requesting that the Board of Taxation undertake a review of each taxation observation included in the FSI Final Report.

In addition, a Federal Budget immediately prior to a Federal Election would be a key opportunity for the Government to articulate its commitment to tax reform and to seek a mandate for a broad-based review of Australia's tax and transfer system, building on the submissions received from stakeholders in 2015 in response to the “Re:Think Tax Discussion Paper.”

4. Regulatory recommendation

4.1 Central Oversight for Regulator Funding Models

With the move to industry funding of ASIC from 1 July 2017, AFMA members now potentially contribute to industry funding of three regulators, namely ASIC, APRA and AUSTRAC. In addition, the Financial Institutions Supervisory Levy, which principally addresses APRA funding, also seeks to recover costs for the ATO's administration of the Superannuation Lost Member Register and the Unclaimed Superannuation Money framework and for the ACCC to administer the Financial Services Competition Unit.

These various funding models sit under different portfolios and adopt different metrics to determine the population of leviable entities and the amounts payable. Our concern is that there is no central oversight of each different funding model, and the administration thereof, such that the overall burden on entities is not understood. We therefore recommend that the funding models for each regulator are brought within the Treasury portfolio and that there is within Treasury a designated team responsible for the administration of all industry funding of financial regulator models.

4.2 ASIC Funding

AFMA believes that ASIC should be a strong and well-resourced regulator, and that it should be appropriately funded to carry out its regulatory activities including taking enforcement actions that punish wrongdoing and create a deterrence effect. AFMA's position on industry funding is that industry should pay its fair share of the costs of regulation, having regard to the mix of public and private benefits flowing from regulation.

However, the current treatment of the Enforcement Special Account (**ESA**) under the industry funding model provides unfair outcomes, conflicts with the principles that underpin the design of the model and is inconsistent with the approach taken to criminal cases. This problem can be rectified by removing the ESA from the cost recovery arrangements. This approach would alleviate the unreasonable financial burden otherwise placed on entities who have conducted their business appropriately and are not the subject of enforcement action by ASIC.

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Thank you for the opportunity to contribute to the Government's consideration of matters that should be addressed in the 2019-20 Federal Budget. We would be happy to discuss any of the matters that we have raised in this submission. Please contact me on (02) 9776 7996 or rcolquhoun@afma.com.au.

Yours sincerely,



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