31st January 2018

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

Via email: prebudgetsubs@treasury.gov.au

Dear Treasury

2018-19 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 2018-19 Federal Budget.

1. Executive Summary

The proposals which form the basis of AFMA's 2018-19 Pre-Budget submission are:

- **Provide a cohesive development strategy for financial markets:** The Government needs to provide stronger 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**);

- **Impose a moratorium on significant new regulation for participants in Australia's financial services industry pending the conclusion of the Royal Commission:** Given the significant regulatory reform that has been imposed upon participants in the financial services industry and given the breadth of the Terms of Reference for the Royal Commission into misconduct in the banking,

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superannuation and financial services industry, it is appropriate that the Government not proceed with any new significant regulation until implementation of the current regulatory agenda, including initiatives already commenced, is complete and the recommendations from the Royal Commission have been handed down;

- **Government to reinvigorate the Tax Reform process:** In addition to continuing to legislate the Enterprise Tax Plan, it is appropriate for the Government to begin a process that builds on the work undertaken through the "Re:Think Tax Discussion Paper" process with a view to enhancing the efficiency and competitiveness of Australia's tax and transfer system, particularly as it relates to corporate tax. As part of this process, and to build on work already undertaken, the Government should commission the Board of Tax to undertake a formal review of the FSI's taxation observations;

- **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 and should do so in the 2018-19 Federal Budget;

- **Prioritise the Johnson reforms:** The Government should prioritise the implementation of the following outstanding Johnson Report recommendations:

    - The phase-down of interest withholding tax for financial institutions; and

    - The abolition of the LIBOR Cap;

- **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 derivatives 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.

2. Introductory Comments

AFMA's 2018-19 Pre-Budget Submission is drafted in a regulatory and political environment that is markedly different to previous years. The 2017-18 Federal Budget represented a significant shift in the way in which participants in Australia's banking industry are regulated, and the taxation arrangements that apply to a sub-set of banks, arising from the announcement of the Banking Executive Accountability Regime (**BEAR**) and the imposition of the Major Bank Levy on Australia's five largest domestic banks, respectively. These major policy announcements were followed by the formal establishment of the Royal Commission into misconduct in the banking, superannuation and financial services industry on 18 December 2017.

These developments should shape the Government's approach to framing the 2018-19 Federal Budget as it relates to participants in Australia's financial services industry, and particularly Approved Deposit-Taking Institutions. The implementation of the BEAR, on the basis that it is legislated substantially in its current form, will be a significant project for affected entities, which includes a large number of AFMA members. These entities have been the subject of an unprecedented regulatory reform agenda, both domestically and globally, since the Global Financial Crisis. Given that a Royal Commission is on foot, and that the Terms of Reference for the Commission empower the Commissioner to make any recommendation as considered appropriate, it is appropriate that the Government allow the process to run its course and not pre-empt, or potentially undermine, any of the recommendations that the Commission may make through the announcement of additional regulation.

The 2018-19 Federal Budget does, however, present the Government with an opportunity to focus on initiatives that will enhance the Australian financial services sector, including the ability to attract the mobile foreign capital to fund Australia's economy and to enhance Australia's financial service export capability. At the time that the 2018-19 Federal Budget is handed down, the Government will have reviewed at least the interim report of the Productivity Commission's review into Competition in the Australian Financial System, which has as part of its mandate to improve the productivity and international competitiveness of the system.

The macroeconomic data referred to below support the prioritisation of initiatives to enhance productivity of the financial services sector, given the current strength in the global economy with low volatility, and the subdued per-capita growth of the Australian economy, reflected in under-performance of Australian dollar denominated assets.

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 2015-16 year, which highlighted that the banking and finance sector accounted for more than 38% 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 2014-15 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 attractive and 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 2018-19 Federal Budget is that it articulates, and commits 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 incumbent on the federal 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 long lag between the 2009 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. Macroeconomic Policy Framework and Context

3.1 Macroeconomic support for strategic financial sector development

The world economy is enjoying considerable strength, with low volatility in the main economic aggregates of the world's main economies. This is reflected in asset prices, with strong gains in equity markets coupled with low levels of realised and implied equity market volatility.

This benign international macroeconomic backdrop represents a significant opportunity for the Commonwealth to press ahead with a clear strategic development program for the financial system and also consolidate its fiscal position and build resilience against future macroeconomic and financial shocks.

3.2 Domestic macroeconomic and financial environment

The Australian economy is growing close to its long-run potential growth rate, with real GDP rising 2.8% in the year-ended September 2017. On a per capita basis, real GDP rose a more modest 1.3% for the year-ended September 2017. This subdued growth in average living standards is reflected in the performance of Australian dollar-denominated asset markets. Australia's financial markets have generally underperformed offshore counterparts, with the exception of the bond market. Two-year swap spreads to the US have turned negative for the first time in 16 years, while the 10-year yield spread to the US has narrowed and may well test parity. This is symptomatic of the underperformance of the Australian versus the US economy.

3.3 Inflation outcomes and inflation expectations remain broadly consistent with the inflation target

Australia is fortunate to have a macroeconomic policy framework built around a floating exchange rate and an inflation-targeting central bank. This framework has important implications for how the Government should approach fiscal policy. In particular, fiscal policy should focus on tax and spending decisions that improve microeconomic incentives while balancing the budget over time. Fiscal policy should not be distracted by short-term demand management considerations, which are more appropriately the focus of the Reserve Bank in its conduct of monetary policy. Monetary policy is well suited to managing aggregate demand (nominal GDP) in a manner consistent with its medium-term inflation target.

The most relevant measure of the stance of monetary policy is actual and expected inflation outcomes. As of the September quarter 2017, the headline CPI is below the 2-3% target range at 1.8%, along with the RBA's statistical core measures. Inflation has been at or below the bottom end of the target range since the end of 2014. This indicates that monetary policy settings over the last few years have not been excessively stimulatory. Based on the RBA's November Statement on Monetary Policy, the RBA expects underlying inflation to remain below target until the end of 2018, and to remain at the bottom of the target range for all of 2019.

4. Taxation recommendations

4.1 Reinvigoration of tax reform process

In March 2015 the Federal Government released the "Re:Think Tax Discussion Paper," a broad reaching paper seeking submissions from stakeholders across the totality of Australia's tax and transfer system, with very few policy issues excluded from consideration. Many detailed submissions were provided to the Government (AFMA's included); however the Government did not progress with the production of a White Paper regarding potential policy reform. While the Government has, laudably, sought to put Australia on a glide-path to a 25% corporate tax rate for all companies, it is appropriate for the Government to consider other mechanisms to enhance the competitiveness of the tax system beyond merely reducing the company tax rate.

The importance of ensuring the international competitiveness of our corporate tax system was sharpened through the recent passage of the US Tax Reform Bill through the Senate and Congress. With a fall in the headline corporate tax rate from 35% to 21%, and also an increasingly attractive tax environment for the repatriation of offshore profits held by US companies, which historically have remained outside of the US, this reform will both reduce the stock of mobile capital available for investment and enhance the attractiveness of the US as a destination for such capital. Accordingly, it is incumbent on Australia to prioritise the taxation settings for its banking and finance sector given that participants in the sector are the vehicles through which Australia is able to attract the offshore capital on which it relies to fund the economy.

In this context, the Government should at least canvass other ways of enhancing the efficiency and competitiveness of our tax system, particularly in respect of corporate tax. It is timely that the Government recommit to undertaking a wholesale review into Australia's tax and transfer system.

4.2 Board of Tax Review of FSI Taxation Observations

Following on from the point above, the terms of reference for the 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.

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 2018-19 Federal Budget (if not earlier), commit to requesting that the Board of Taxation undertake a review of each taxation observation included in the FSI Final Report.

4.3 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 below).

The recently conducted consultation by Treasury into the implementation of the OECD Anti-Hybrid Rules, together with the pending release of the so-called "branch mismatch" rules, highlights practical issues associated with Australia's method of taxing permanent establishments being out of step with other jurisdictions.

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 2018-19 Federal Budget.

4.4 Remove interest withholding tax for financial institutions

AFMA continues to strenuously object to the decision made by the government to discontinue the previously announced phase-down of interest withholding tax (IWT) for financial institutions. This announcement was formally made by the government as part of the repeal of the Minerals Resource Rent Tax.

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.

The Government has publicly confirmed its commitment to the recommendations of the Johnson Report. The Coalition's "Our Plan for Real Action" document states that it would "give priority to the recommendations of the Johnson Report into Australia as a Financial Centre." The withholding tax recommendation is a core component of the Johnson Report package and the phase-down of interest withholding tax is accordingly consistent with the Coalition's key policy document.

AFMA is of the view that the Government has not prosecuted this key Johnson recommendation purely on the perception that the former Government was seeking

to fund any reduction in revenue from the proceeds of the Minerals Resource Rent Tax, which the current Government has abolished. 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.

4.5 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 the submission, nor to AFMA's 2015-16 Pre-Budget Submission in which the issue was again raised. This issue 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 2018-19 Federal Budget.

4.6 Abolish the LIBOR Cap

The Government should use the 2018-19 Federal Budget as an opportunity to 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.

The absurdity of the LIBOR Cap was exacerbated in 2013 when the British Bankers Association ceased to quote AUD LIBOR. This resulted in a situation whereby 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 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.

In addition, currencies in which LIBOR continues to be quoted, such as EUR and JPY, now exhibit negative interest rates, thereby creating issues with the application of the LIBOR Cap for such currencies. This again resulted in dialogue between AFMA and the ATO to confirm that a foreign bank branch would not derive assessable income on a payment made on a notional borrowing where the applicable LIBOR was a negative amount. The prevalence of negative interest rates highlights the impracticalities that may arise in applying the LIBOR cap and demonstrate the extent to which it is no longer fit for purpose.

The final nail in the LIBOR Cap coffin is the announcement by the Financial Conduct Authority in the United Kingdom that it will not use its influence or legal powers to persuade or compel panel banks to make LIBOR submissions after the end of 2021, which has generated considerable doubt about the future of LIBOR beyond that point.

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.”

During the 2014 calendar year, and 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 and the immaterial revenue consequences associated with its removal, AFMA again calls on the Government to abolish the LIBOR Cap as a matter of urgency. Abolition would give effect to another key recommendation of the Johnson Report,

mirrored by that of the Board of Tax. It would also be consistent with the Government's objective to foster innovation in the economy.

5. Regulatory recommendation

5.1 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 exist within Treasury a designated team responsible for the administration of all industry funding of regulator models.

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Thank you for the opportunity to contribute to the Government's consideration of matters that should be addressed in the 2018-19 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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