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Inland Revenue
Te Tari Taake

POLICY ADVICE DIVISION

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: Tax minimum equity rules for foreign-owned banks

Date:	14 March 2011	**Priority:**	High
Security Level:		**Report No:**	T2011/425 PAD2011/58

Action sought

	Action Sought	Deadline
Minister of Finance	To be discussed at the Joint Ministers' meeting on Tuesday, 15th March 2011	Tuesday, 15th March 2011
Minister of Revenue	To be discussed at the Joint Ministers' meeting on Tuesday, 15th March 2011	Tuesday, 15th March 2011

Contact for telephone discussion (if required)

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14 March 2011

Minister of Finance
Minister of Revenue

Tax Policy Report: Tax minimum equity rules for foreign-owned banks equity rules for foreign-owned banks

Executive Summary

This report seeks decisions from Ministers on changes to the tax minimum equity rules for foreign-owned banks. In this report officials recommend that the minimum equity percentage for banks be raised from 4 to 6%. This increase reflects changes in the banking regulatory and commercial environment since the rules were introduced in 2005 and is consistent with the policy established at that time following extensive consultations with the banks. Moving beyond 6% is not recommended at this time as it would put at risk the constructive dialogue with the banks on policy and technical issues and could have an adverse impact on the banking sector's perceived risks from operations in New Zealand.

Background

The minimum equity rules were introduced in 2005 in response to a fall in the effective tax rates on the banks due to cross border structured financing and the potential for banks to reduce taxes paid in New Zealand through holding company structures. Experience had shown that the regulatory rules did not provide protection for the tax base, (which was not their purpose), and special tax rules were required.

The rules were designed to ensure that a foreign-owned bank group operating in New Zealand held a minimum percentage of tax equity in New Zealand. The definition of tax equity is similar to the definition of 'Tier 1' capital used by prudential regulators, in that the range of instruments in each is similar (common equity being the major component). However, there are some important technical differences such as the exclusion of hybrid instruments giving rise to interest deductions and fixed rate shares from tax equity, reflecting the differing goals of the tax and regulatory rules.

A variety of considerations were taken into account in setting the minimum percentage. Officials considered that a range of rates would be possible. In the end, the rate was fixed at 4%, which also equals the regulatory minimum. While the appropriate rate for tax purposes could in principle diverge from the regulatory rate depending upon market and commercial conditions, setting the rate equal to the regulatory rate has the advantage of providing a link to an external parameter, reducing the appearance of arbitrariness in its setting.

The general conditions in establishing the minimum equity percentage remain relevant today. However, the worldwide regulatory and commercial environment has changed considerably. The Basel Committee on Banking Supervision has recommended an increase in the Tier 1 capital ratio to 6%, amongst a package of changes known as 'Based III'. The Reserve Bank of New Zealand will be consulting with banks on this issue. The New Zealand Bankers Association has indicated to us that it expects the ratio will rise to 6%, and that this will occur some time between January 2013 and January 2015. Because of this, and the perception that banks need to hold more capital for commercial reasons following from the financial crisis, bank capital levels have risen by some 1 to 1.5 percentage points since 2005, and may rise higher.

Consultation with the Reserve Bank of New Zealand (RBNZ)

The RBNZ has been consulted during the development of this policy and concurs with the modelling undertaken by Inland Revenue which shows that an increase in the minimum tax equity percentage to 6% for the banks will have only a marginal impact on the cost of capital or cost of borrowing in New Zealand. The main reason for this result is that the increased New Zealand tax from shifting tax equity to New Zealand is significantly offset by decreased tax in Australia.

Consultation with New Zealand Bankers Association (NZBA)

In keeping with the established process in this area, consultations have been undertaken with the NZBA. This approach has been important in establishing an open and frank dialogue with the banking industry, which has benefits in maintaining a stable banking environment and protecting of the tax base.

The NZBA is expected to have extreme concerns with any increase in the minimum equity percentage above 6%. An increase in the minimum equity percentage to 6% in line with the increase in the regulatory minimum is likely to be less concerning from their perspective.

Transitional issues

Some banks have expressed concerns around timing of the changes to the minimum equity requirements for tax, given that they will need to put extra tax capital into their New Zealand balance sheets. This may involve converting some of their existing tax debt into tax capital. For some banks this debt is long term third party debt. Banks have also suggested that the tax changes should coincide with the changes under Basel III.

However, banks have already increased their capital due to commercial reasons and in anticipation of the Basel III changes. Accordingly, officials do not believe that the tax percentage needs to move in lock-step with the regulatory percentage. Officials recommend that the minimum equity changes are introduced for the quarter beginning 1 April 2012. This means that banks would need to have the extra tax capital in place by 30 June 2012. This allows banks to have some lead in time to organise the extra tax capital. It also allows for the legislation to be included in the next tax bill and for that legislation to go through the full Parliamentary process, including a Select Committee process.

Fiscal implications

A change to the 6% rate would, mean an extra $2 billion of tax capital across banks (noting some banks will have sufficient tax capital at the increased rate already). If banks were required to have this capital in place by 30 June 2012 this would raise approximately $8 million of additional tax revenue in 2011-12 and $31 million in each subsequent year. In officials' view, this provides banks with adequate time to adjust to this change. It is officials' preferred option.

If a change was legislated on budget night the increase in tax equity could apply from the quarter commencing 1 July 2011. This would require banks to bring in additional tax capital at short notice, and as noted above would be a concern to some banks particularly where they are planning to convert existing tax debt into capital and that debt is third party long term, debt. Under this option the revenue raised would be $31 million in 2011-12 and the same in each subsequent year.

Recommended action

We recommend that you:

(a) **Agree** to increase the tax minimum equity percentage for foreign-owned banks from 4% to 6%.

Agreed/Not agreed Agreed/Not agreed

(b) **Decide** whether:

(i) from 1 April 2012 (officials preferred option)

Agreed/Not agreed Agreed/Not agreed

(ii) from the quarter commencing 1 July 2011.

Agreed/Not agreed Agreed/Not agreed

(c) **Note** the revenue increase of implementation, with a corresponding impact on the operating balance:

(i) from 1 April 2012 (officials preferred option):

	$ millions increase / (decrease)				
Vote Revenue Minister of Revenue	2010/11	2011/12	2012/13	2013/14	2014/15
Crown Revenue and Receipts: Tax Revenue	-	8.000	31.000	31.000	31.000

Noted Noted

OR

(ii) from the quarter commencing 1 July 2011.

	$ millions increase / (decrease)				
Vote Revenue Minister of Revenue	2010/11	2011/12	2012/13	2013/14	2014/15
Crown Revenue and Receipts: Tax Revenue	-	31.000	31.000	31.000	31.000

Noted Noted

Peter Martin
for Secretary to the Treasury

Emma Grigg
Policy Manager
Inland Revenue

Hon Bill English
Minister of Finance

Hon Peter Dunne
Minister of Revenue

Purpose of Report

1. This report seeks decisions from Ministers to changes to the tax minimum equity rules for foreign-owned registered banks. This responds to a request by Ministers to consider these rules following changes to the general thin capitalisation rules made in Budget 2010. It also considers the implications of changes in the commercial and regulatory environment facing banks.

Background

2. A special form of thin capitalisation rule sets minimum equity requirements for foreign owned banks. The rule was introduced in 2005 and requires the New Zealand banking group to hold equity equal to at least 4% of its New Zealand assets (specifically, 4% of its risk weighted exposures (RWEs)). The rule prevents banks from using structures that allow excessive interest deductions against the New Zealand tax base. The level of 4%, which is the minimum level of 'Tier 1' capital for prudential regulatory purposes, was chosen after consideration of a number of factors outlined below.

Recent developments

3. Changes in the commercial and regulatory environments in which the banks are operating subsequent to the financial crisis of 2008 make it appropriate to consider whether the 4% minimum should be increased; and, if so, to what level.

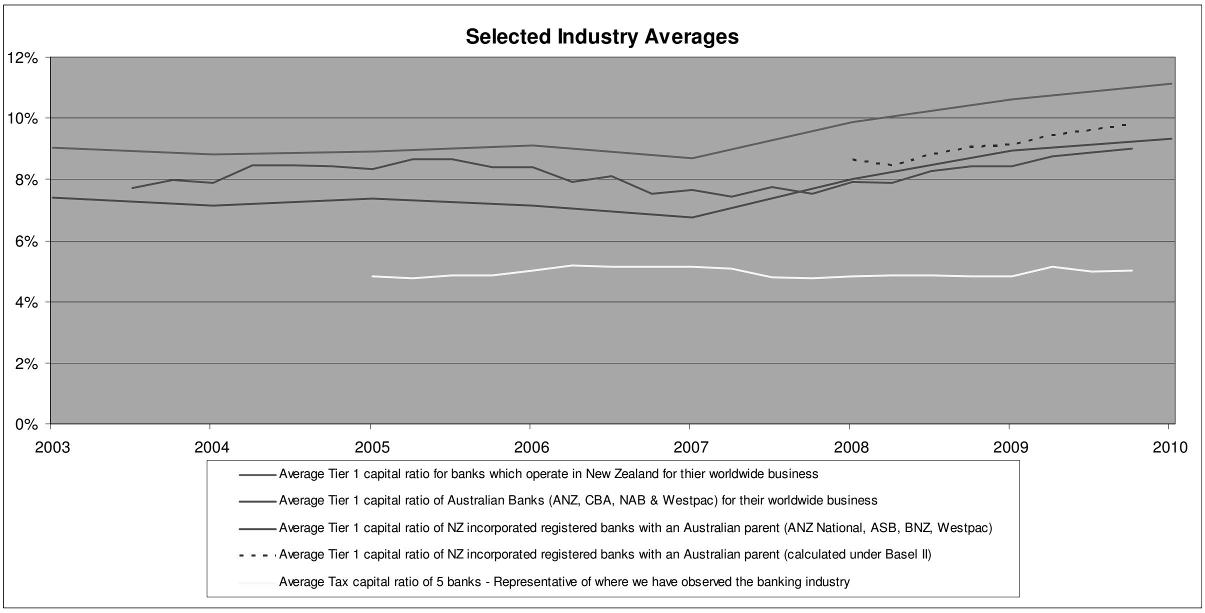
4. In particular, the banks currently maintain prudential capital levels that are higher than those held at the time that the minimum equity rules were introduced. This is due to several factors including market expectations of bank capital post financial crisis; the level required to retain strong credit ratings (which are important for securing funding etc); capital to enable expansion of lending or take new business opportunities; and a level of precautionary capital to ensure adequate buffers over the regulatory minimum in the event of unexpected losses.

5. Banks are also expecting significant changes to the regulatory environment, prompted again by the recent financial crisis.

6. Prudential regulations require banks to have a minimum amount of capital, to protect against insolvency in the event of bad loans or other unexpected events. This capital is split into 'tiers', with Tier 1 consisting of the capital that is closest in nature to ordinary share capital. Tier 1 capital is generally defined in the same way as equity for tax purposes, in that the instruments (such as common equity) that are included are similar. There are a number of important technical differences though, reflecting the different objectives of the tax and regulatory rules. These differences need to be taken into consideration when comparing tax and regulatory amounts of equity.

7. Prudential requirements are based on the ‘Basel’ frameworks, which are applied in many countries. The Basel Committee on Banking Regulation has recently recommended an increase in the regulatory minimum for the Tier 1 capital to 6%, as part of a number of changes proposed under the the Basel III framework. The Reserve Bank will be consulting with banks on this issue. The NZBA expects an increase from 4% to 6% will occur, and that this will happen some time between January 2013 and January 2015.

8. The effect of these developments is illustrated by the following graph. It shows that there have been steady increases in Tier 1 capital held by banks for commercial and regulatory purposes, while for tax purposes the equity ratio has remained close to the prescribed minimum of 4%.



9. As noted, part of the reason for the increase in Tier 1 capital is anticipation of new regulations, but even without those new regulations, our understanding is that there has been a fundamental reassessment by markets of the amount of capital that financial institutions must hold, and that this is not temporary.

10. The fact that the Tier 1 capital ratio of the banks is higher than the tax ratio may be explained by several factors, but the main one is the use of holding company structures in New Zealand. Holding companies are ignored for New Zealand regulatory purposes but are included in the tax calculation. This means that the tax capital ratio can end up being much lower than the regulatory capital ratio when banks take on additional debt at the holding company level, but place equity in the operating bank.

Consultations with banks and the New Zealand Bankers Association (NZBA)

11. The 2005 rules were introduced following an intensive series of consultations with the banking industry. The banks are a cornerstone of the financial system and the consultations were intended to ensure that the new rules did not place that industry at risk. Since that time, an open dialogue on developments relevant to the rules has provided stability both in government revenue collections and the banking sector, at least as far as the tax system is

concerned. Maintenance of this co-operation into the future has obvious advantages for both tax collections and economic policy.

12. In this spirit, further consultations have been undertaken with the banks on whether it is appropriate to increase the minimum equity percentage. The NZBA raised a number of issues including the impact on the cost of capital and the perceived stability of the New Zealand taxing environment as banks make long term financial commitments to this country.

13. Officials do not believe that the recommended increase in the percentage would unduly increase the cost of capital of banks. However, officials believe that maintaining confidence in the stability of the New Zealand taxing environment is important.

14. A key concern of the NZBA is that any increase in the minimum equity percentage is done on a principled basis. They would be concerned if it appeared to be a revenue grab, which would imply that the percentage could be increased any time that the government needed money. This perception would have ramifications for the financing structures they would use over the longer term, and therefore the cost of capital. Accordingly they have suggested that the tax requirement be linked explicitly with the regulatory requirement.

15. Officials do not believe that an explicit linkage would be appropriate. It would tie the government's hands both with respect to the timing of changes and in responding to relevant changes in the banking environment. Nevertheless, as outlined below, officials consider that lifting the tax ratio to 6%, consistent with likely changes in the regulatory ratio to implement Basel III is now appropriate. Considerations for choosing 6% are very similar to those which led us to choosing a 4% ratio initially.

Consultations with the Reserve Bank of New Zealand (RBNZ)

16. Officials have maintained close consultation with the RBNZ throughout this process.

17. RBNZ officials have emphasised their position that the regulatory regime in New Zealand is not designed to provide protection for the New Zealand tax base. The RBNZ applies its rules to the operating banks, not including the holding companies. Accordingly, the banks can hold adequate levels of regulatory capital at the level of the operating companies, while putting debt in the holding companies and thinly capitalising their New Zealand investments for tax purposes. This means that by themselves, the regulatory rules do not protect against excessive tax deductions being claimed.

18. This possibility was well recognised in 2005, so that the tax rules apply to the entire consolidated banking group, including the holding companies. Therefore the policy question raised by recent changes is not one of the structure of the minimum equity rules, but rather what should the minimum equity percentage be set at. This question is addressed below.

19. RBNZ officials have been consulted about the potential impact on the banking sector of raising the minimum tax equity percentage. As noted below, they concur with Inland Revenue modelling which shows that an increase in the percentage to 6% is likely to have only a minimal impact on banks' cost of capital or the cost of borrowing in New Zealand.

Considerations for changing the minimum equity percentage

20. The existing rules envisaged regular review – taking into account changes in regulatory and market practice to ensure a fair allocation of equity and debt to New Zealand. Ministers are asked to consider whether the minimum tax equity percentage for banks should be raised from its current level of 4%; and, if so, to what level.

21. The question of what percentage to use for the minimum equity calculation was addressed at the time that the rules were introduced. Those considerations remain relevant today. Officials originally thought to propose that banks' worldwide Tier 1 ratios be used to allocate equity to the New Zealand business for the purposes of a tax computation. However, there are technical complexities and comparability issues that arise under this approach. For example, there is uncertainty over whether hybrid debt/equity investments should be treated as equity or debt in the calculation of worldwide equity supporting banking operations. These issues also complicate a comparison of New Zealand and Australian equity ratios.

22. Other benchmarks could have been chosen. For example, some formula based on the economic capital held by the locally registered bank might have been used. A strong disadvantage of such an approach is that by explicitly linking tax to actual tax capital held, rather than some fixed benchmark, banks might have incentives to hold less capital than they otherwise would (over and above the regulatory minimum). That is, acting prudently would have a bigger tax cost. This could be destabilising, particularly in times of financial dysfunction.

23. As a consequence, a level of equity based on a prescribed percentage of risk-weighted exposures which applies to all banks was chosen as it avoided the complexities associated with the use of a worldwide ratio.

24. The setting of an appropriate rate requires analysis and judgement. In recommending an appropriate percentage in 2005, consideration was given to a number of factors. The appropriate starting point is worldwide Tier 1 capital ratios. At the time worldwide Tier 1 rates were, on average, 7% to 8% for the main banks. This was then discounted to take account of surplus capital held by the parent banks, non-bank business equity and the use of hybrid instruments (equity-like debt instruments). This took the rate to less than 6%.

25. However, other factors were also taken into account when exercising which lowered further the judgement as to the appropriate rate. These included the potential for disruption to the banking industry if further capital was required to support the New Zealand business, robustness over the business cycle and across different banks in different commercial situations, the fit with the broader Trans-Tasman relationship and the economic and revenue impacts.

26. At the time, the main focus was on preventing excessive interest deductions from cross border structured financing schemes, which prevented the loss of a large amount of revenue. In this regard it is noted that of the revenue raised – around $360 million, $334 million related to the cross border structured finance. The balance of $34 million was raised as a result of requiring a minimum of 4% tax capital in respect of the New Zealand risk weighted exposures.

27. It was also felt that the use of an external statutory amount would provide a benchmark that would avoid the perception of arbitrariness that could attach to a number that had no such

linkage. As such it reduced the potential uncertainty of the banks as to the future tax consequences of their long term financing decisions.

28. In the end, officials proposed that on balance a ratio of 4% was appropriate, the same as the regulatory minimum.

29. The 4% level also coincided with the rate under the Australian minimum equity rules for banks, although the different structures of the New Zealand and Australian banking industries imply that in general the New Zealand rate may need to be higher than the Australian rate (the holding company issue explained above is much less likely to be relevant in the Australian context, where the major banks are not foreign-controlled).

30. Officials consider that these considerations remain valid as a basis for setting the appropriate rate. However, as noted above, underlying market conditions have changed considerably since the rules were introduced.

31. For comparisons with the tax ratio, the relevant regulatory equity concept is Tier 1 capital held by the consolidated Australian banks. Tier 1 capital levels currently average over 8.5%, and have been growing over the last 24 months. Tier 1 capital levels for the New Zealand incorporated banks average over 9%. However some instruments that would not be included in equity for tax purposes are included in the regulatory capital, so these figures are not directly comparable to the minimum equity percentage. To the extent to which such instruments give rise to tax deductions, they are already excluded from equity for purposes of the minimum equity calculation in New Zealand. Accordingly the above figures would need to be adjusted downward for purposes of comparison. Overall the increase in capital has raised capital ratios by 1 to 1 ½ percentage points compared to their level in 2005.

32. Regulatory requirements are likely to change, following a process of consultation between the Reserve Bank and banking industry. As noted above, the minimum Tier 1 capital ratio is expected to increase from its current level of 4% to 6%, an increase of 2 percentage points. This increase has been anticipated and banks are already gearing up for it, holding more than the current regulatory minimum even though the financial crisis has eased.

33. The Basel III recommendations include a new concept, the capital cushion, which, when combined with the Tier 1 threshold, implies that common equity should be at least 7% of total assets. Common equity is the regulatory concept that most closely corresponds to capital for tax purposes. This raises the question of whether the tax percentage should be raised to 7%. However the 7% is more flexible, rather than a hard minimum as is the 6%. Banks that fall below 7% will face restrictions, such as on dividend payouts, rather than full regulatory sanctions. Accordingly there would be flexibility around the 7%.

Recommended approach

34. Based on these increases, applying the policy parameters underlying the 2005 decisions would imply an increase in the minimum equity percentage of between 1 and 2 percentage points. Given the advantages of basing the tax percentage on the regulatory percentage, officials recommend that the minimum equity percentage be raised from 4% to 6%.

35. In the light of current pressure on revenues, officials have also considered whether the minimum equity percentage should be raised more than the increase in the regulatory

minimum, say up to 7-8%. This option is not recommended because of the consideration outlined above (see paragraphs 20-33). In particular, it is not recommended because of the increased likelihood that banks' regulatory capital would be insufficient to meet the tax requirement at these higher levels.

36. The New Zealand Bankers Association (NZBA) provided a written submission which is attached as Appendix 1 to this report. They raise a number of arguments including an argument that the tax threshold could be lower than the regulatory threshold. They submit that under Basel III, the banks will be required to have 6 percent of Tier 1 capital but that 25% of this can be hybrid instruments on which interest deductions may be claimed. On these grounds they have suggested that a 4.5% tax ratio might be more appropriate. (On similar grounds they could have argued that a 3% tax ratio was appropriate under Basel II). We note that 4.5% would be a very low level of capital being allocated to New Zealand when Tier 1 capital ratios have been increasing throughout the world.

37. The NZBA is also concerned that if the tax threshold were set higher than the regulatory threshold, there would be a need for more external capital to be raised. They have indicated that the main non-transitional cost would be the cost of raising more common equity (which, as noted above, is more than the cost of raising other forms of Tier 1 capital). Their estimate of additional costs is $350-470 million per year with an 8% tax threshold and $150-200m with a 6% ratio.

38. We have some reservations about the NZBA analysis, but note that the cost of capital implications would be significantly more if it were to move to 8%. Our modelling suggests that an increase of the minimum equity percentage to 6% would not lead to a significant increase in banks' cost of capital or lead to a significant increase in borrowing costs for New Zealanders. This is primarily because the increased tax in New Zealand is significantly offset by decreased tax in Australia. The RBNZ has reviewed this modelling and concurs that an increase in the tax equity percentage to 6% is unlikely to have a significant impact on banks' cost of capital or cost of borrowing in New Zealand. Furthermore increasing the tax equity to 6% will not require banks to hold additional regulatory capital.

Transitional issues

39. Some banks have expressed concerns around timing of the changes to the minimum equity requirements for tax, given that they will need to put extra tax capital into their New Zealand balance sheets. This may involve converting some of their existing tax debt into tax capital. For some banks this debt is long term third party debt. Banks have also suggested that the tax changes should coincide with the changes under Basel III.

40. We have considered two possible options for introducing any change.

41. The first option, which is our preferred option, is to announce the change in the Budget but to introduce legislation as part of a tax bill planned for August 2011. Following the normal parliamentary process, the change would apply for the quarter beginning 1 April 2012, giving banks until 30 June 2012 to bring in any additional capital required.

42. The second option is introduction of the change on Budget night with the change applying from 1 July 2011. This would require banks to bring in additional capital at short

notice, with the above-mentioned risks of problems, but would raise more revenue in 2011-12 and the same in each subsequent year (again assuming a move to a 6% threshold).

Legislative implications

43. If the minimum equity threshold is changed, the change will need to be legislated in a bill (it cannot be done by regulation). Two bills that this could be included in are the August 2011 bill (our preferred option), with application from 1 April 2012, and the budget night bill, with application from 1 July 2011. If the legislation were included in the August 2011 bill this would allow for that legislation to go through the full Parliamentary process, including a Select Committee process. While the tax capital requirements would not correspond with the implementation of Basel III, we understand banks are already gearing up for these changes.

Fiscal implications

44. A change to the 6% rate would, mean an extra $2 billion of tax capital across banks (noting some banks will have sufficient tax capital at the increased rate already). If banks were required to have this capital in place by 30 June 2012 this would raise approximately $8 million of additional tax revenue in 2011-12 and $31 million in each subsequent year, as per the following table:

	$ millions increase / (decrease)				
Vote Revenue **Minister of Revenue**	2010/11	2011/12	2012/13	2013/14	2014/15
Crown Revenue and Receipts: Tax Revenue	-	8.000	31.000	31.000	31.000

45. If a change was legislated for on budget night the increase in tax equity could apply form the quarter commencing 1 July 2011. This would require banks to bring in additional capital at short notice, and as noted above would be a concern to some banks particularly where they are planning to convert existing tax debt into capital and that debt is third party long term, debt. Under this option the revenue raised would be $31 million in 2011-12 and the same in each subsequent year, as per the following table:

	$ millions increase / (decrease)				
Vote Revenue **Minister of Revenue**	2010/11	2011/12	2012/13	2013/14	2014/15
Crown Revenue and Receipts: Tax Revenue	-	31.000	31.000	31.000	31.000

46. Increasing the threshold to an alternative level such as 8% would bring in approximately $80 million of additional tax per 12-month period, rather than $31 million (though as noted above, the 6% figure is more likely to address concerns about arbitrariness and the practical problems involved with obtaining more tax capital).

Administration and compliance costs

47. These are not likely to be significant. Banks would be using regulatory concepts of capital which they currently use for the purposes of reporting to the regulator. The use of a prescribed rate for determining required equity will also assist in keeping administrative and compliance costs low. The administrative costs are also likely to be low, because the taxpayer group involved is small.