The Treasury

Budget 2011 Information Release

Release Document

June 2011

www.treasury.govt.nz/publications/informationreleases/budget/2011

Key to sections of the Official Information Act 1982 under which information has been withheld.

Certain information in this document has been withheld under one or more of the following sections of the Official Information Act, as applicable:

[1] 9(2)(a) - to protect the privacy of natural persons, including deceased people

[2] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials

[3] 9(2)(g)(i) - to maintain the effective conduct of public affairs through the free and frank expression of opinions

[4] 9(2)(b)(ii) - to protect the commercial position of the person who supplied the information or who is the subject of the information

[5] 9(2)(k) - to prevent the disclosure of official information for improper gain or improper advantage

[6] 9(2)(j) - to enable the Crown to negotiate without disadvantage or prejudice

[7] 6(a) - to prevent prejudice to the security or defence of New Zealand or the international relations of the government

[8] 9(2)(h) - to maintain legal professional privilege

[9] 6(c) - to prevent prejudice to the maintenance of the law, including the prevention, investigation, and detection of offences, and the right to a fair trial

[10] 9(2)(d) - to avoid prejudice to the substantial economic interests of New Zealand

[11] 9(2)(i) - to enable the Crown to carry out commercial activities without disadvantage or prejudice.

Where information has been withheld, a numbered reference to the applicable section of the Official Information Act has been made, as listed above. For example, an [8] appearing where information has been withheld in a release document refers to section 9(2)(h).

In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.

Office of the Minister of Finance
Office of the Minister of Revenue

Cabinet

Tax minimum equity rules for foreign-owned banks

Proposal

1. This paper proposes that Cabinet agree to increase the tax minimum equity percentage for foreign-owned banks from 4% to 6% from 1 April 2012.

Executive summary

2. The current tax minimum equity rules for foreign-owned banks were introduced in 2005 and require 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.

3. Recent changes in the commercial and regulatory environment facing banks make now an appropriate time to review the current tax minimum equity percentage, as there has 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%.

4. At our request, our officials have considered whether, in light of these recent changes in the commercial and regulatory environment facing banks, the tax minimum equity percentage should be increased.

5. Following analysis and consultation with the banking industry, we recommend that the tax minimum equity percentage for foreign-owned banks be increased from 4% to 6% from 1 April 2012.

6. This change would mean additional tax revenue of approximately $8 million in the 2011/12 fiscal year, and approximately $31 million in each subsequent fiscal year.

Background

7. 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 RWEs). The rule prevents banks from using structures that allow excessive interest deductions against the New Zealand tax base. The level of 4% was chosen after consideration of a number of factors outlined below.

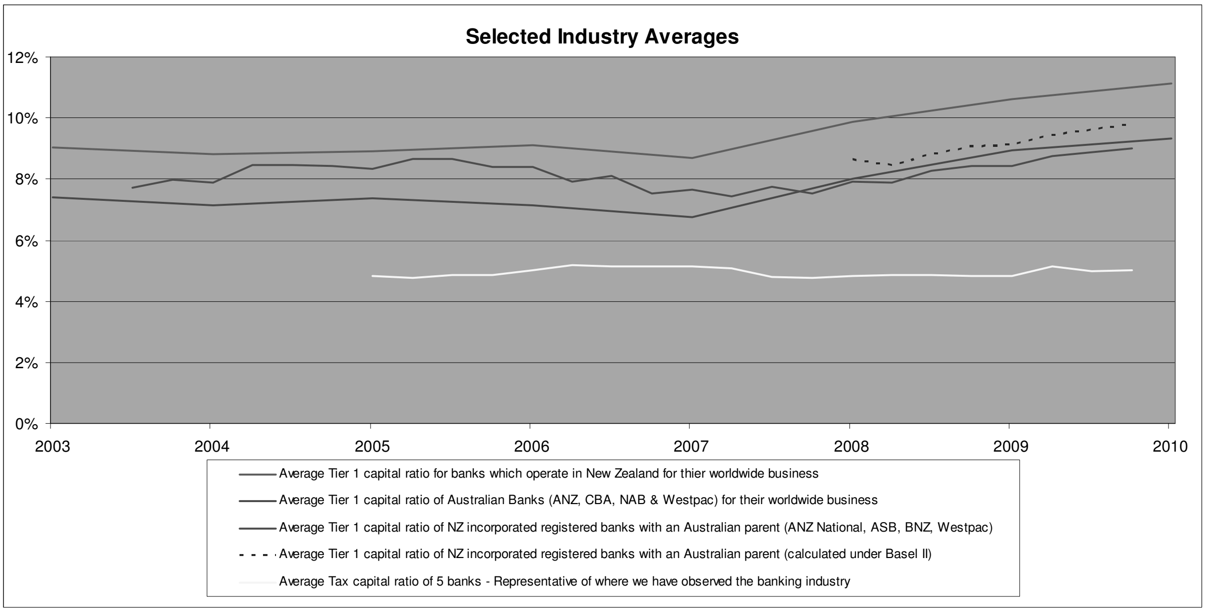
8. In late 2010, we requested that officials consider changes to the tax minimum equity rules for foreign-owned banks operating in New Zealand, with a view to announcing any changes that may result as part of Budget 2011. This request was made in light of changes to the general thin capitalisation rules made in Budget 2010, and changes in the commercial and regulatory environment facing banks.

9. New Zealand incorporated banks are also subject to prudential regulatory requirements which prescribe the minimum levels of capital they must hold, to protect against insolvency in the event of bad loans or other unexpected losses. This capital is split into "tiers", with Tier 1 capital consisting of the capital that is closest in nature to ordinary share capital. The minimum Tier 1 capital ratio is currently also 4% of RWEs. Tax equity and Tier 1 capital are generally defined in the same way, with similar instruments (such as common equity) being included in both. However, there are a number of important technical differences, reflecting the different objectives of the tax and regulatory rules, which must be borne in mind when comparing the tax and regulatory amounts of equity.

10. The prudential requirements are based on the "Basel" frameworks, which are applied in many countries. The Basel Committee on Banking Supervision has recently recommended an increase in the minimum Tier 1 capital ratio to 6%, as part of a number of changes proposed under the Basel III framework. The Reserve Bank of New Zealand (RBNZ) will be consulting with the banks regarding the implementation of Basel III in New Zealand. The New Zealand Bankers' Association (NZBA) expects an increase from 4% to 6% to occur, and that this will happen sometime between January 2013 and January 2015.

11. In recent times (post-financial crisis of 2008), the banks operating in New Zealand have been maintaining prudential capital levels that are higher than those held at the time that tax 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); capital to enable expansion of lending or take up new business opportunities; and a level of precautionary capital to ensure adequate buffers over the regulatory minimum in the event of unexpected losses.

12. The effect of these developments is illustrated in 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%.



13. The increase in average Tier 1 capital ratios is partly explained by the anticipation of higher prudential regulatory ratios, but officials understand that there has also been a fundamental reassessment by markets of the amount of capital that financial institutions must hold, and that this is not temporary.

14. The fact that the average Tier 1 capital ratio of the banks is higher than the average tax capital 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 for tax purposes. 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 (the prudentially regulated entity). This enables the holding company to take interest deductions on a portion of the "capital" and thereby pay less tax in New Zealand.

Comment

15. The existing rules envisaged regular review, taking into account changes in regulatory and market practice to ensure an appropriate allocation of equity and debt to New Zealand. Recent changes in market practice and the impending regulatory changes make now an appropriate time to review the current tax minimum equity percentage of 4%.

16. The question of what percentage to use for the minimum equity calculation was addressed at the time that the rules were introduced. The setting of an appropriate percentage requires analysis and judgement.

17. In setting the percentage in 2005, worldwide Tier 1 capital ratios were taken as a starting point. At the time, worldwide Tier 1 ratios 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%.

18. However, other factors were also taken into account, which further lowered the appropriate percentage. These factors 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; and the fit with the broader trans-Tasman relationship and the economic and revenue impacts.

19. It was also felt that the use of an external statutory benchmark would avoid the perception of arbitrariness that could attach to a percentage that had no such linkage. As such, it reduced the potential uncertainty for the banks as to the future tax consequences of their long-term financing decisions.

20. In the end, it was decided that on balance a ratio of 4% was appropriate, the same as the regulatory minimum.

21. The considerations taken into account in setting the percentage in 2005 remain relevant today. For comparisons with the tax minimum equity 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 tax 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 comparative purposes. Overall, the increase in capital has raised capital ratios by 1 to 1½ percentage points from 2005 levels.

22. The regulatory requirements are likely to change in the near future, following a process of consultation between the RBNZ and the banking industry. As noted above, the NZBA expects that the minimum Tier 1 capital ratio will be increased from its current level of 4% to 6%, an increase of 2 percentage points. This increase has been anticipated and banks are already preparing for it, holding more than the current regulatory minimum even though the financial crisis has eased.

23. 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, we consider that an increase in the tax minimum equity percentage from 4% to 6% would be appropriate.

24. An increase in the tax minimum equity percentage to 6% would mean that banks would have 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.

25. We consider that the new percentage should apply from 1 April 2012 (which would mean that banks would have until 30 June 2012 to bring in any additional capital required). This would give the banks a reasonable amount of time to bring in any additional capital required. This application date would also have the advantage of allowing for the legislation to go through the full Parliamentary process, including the Select Committee stage.

Consultation

26. The RBNZ has been consulted. RBNZ officials concur with tax policy officials' position that the regulatory regime in New Zealand is not designed to provide protection for

the New Zealand tax base. RBNZ officials were also consulted about the potential impact on the banking sector of raising the tax minimum equity percentage. RBNZ officials 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.

27. Consultation has been undertaken with the NZBA, and other individual banks. 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 New Zealand.

28. The NZBA's key concern was that any increase in the minimum equity percentage should be made on a principled basis, and not merely to raise revenue. If this is not the case, it would imply that the percentage could be increased any time that the Government needed money. This perception would have ramifications for the financing structures that banks would use over the longer term and, therefore, on the cost of capital. Accordingly, the NZBA suggested that the tax minimum equity requirement be linked explicitly with the minimum regulatory requirement.

29. Our 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. However, as outlined above, we consider that increasing the tax minimum equity percentage to 6%, consistent with likely changes in the regulatory ratio to implement Basel III, is now appropriate.

30. Another key concern expressed by banks was about the timing of the changes to the tax minimum equity requirements. They emphasised that it will take time for banks to put extra tax capital into their New Zealand balance sheets. This is because it may involve converting some of their existing tax debt (which for some banks is long-term third party debt) into tax capital.

Financial implications

31. A change in the tax minimum equity percentage for foreign-owned banks to 6% from 1 April 2012 (i.e. requiring the banks to have any additional capital required in place by 30 June 2012) would raise approximately $8 million of additional tax revenue in the 2011/12 fiscal year, and approximately $31 million in each subsequent fiscal 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

Human rights

32. There are no inconsistencies with the New Zealand Bill of Rights Act 1990 or the Human Rights Act 1993 arising from the current proposal.

Legislative implications

33. We recommend that the August 2011 tax bill be the legislative vehicle for the change to the tax minimum equity percentage. This would allow for the legislation to go through the full Parliamentary process, including the Select Committee stage.

Regulatory impact analysis

34. The Work Programme Manager, Policy Advice Division has reviewed the *Tax minimum equity rules for foreign-owned banks* Regulatory Impact Statement (RIS) and considers that the information and analysis summarised in it meets the quality assurance criteria of the of the Regulatory Impact Analysis framework.

35. The RIS contains all of the required information and provides an analysis of options for updating the tax minimum equity rules for foreign-owned banks, to reflect changes in the commercial and regulatory banking environment, and ensure that the appropriate amount of tax is paid in New Zealand.

36. The objectives are well defined and appropriately cover the problem definition. The RIS identifies a range of tax minimum equity percentages that could be chosen, the analysis has been fully developed with risks and issues considered and compliance costs factored in with the recommendation of a transitional approach.

37. There is clear evidence of efficient and effective consultation with all relevant stakeholders, key affected parties, government agencies and relevant experts; this included the release of a targeted issues paper on banking minimum equity in November 2010. The issues raised during consultation have been taken into consideration in recommending the preferred option.

38. The included agency disclosure statement identifies no significant constraints, caveats or uncertainties concerning the regulatory analysis.

39. We have considered the analysis and advice of officials, as summarised in the attached RIS and we are satisfied that, aside from the risks, uncertainties and caveats already noted in this Cabinet paper, the regulatory proposals recommended in this paper:

- are required in the public interest;
- will deliver the highest net benefits of the practical options available; and
- are consistent with our commitments in the Government statement "Better Regulation, Less Regulation."

Publicity

40. Following Cabinet's approval of the change to the tax minimum equity percentage for foreign-owned banks, we intend to publicly announce the change as part of the Budget 2011 package.

Recommendations

41. It is recommended that Cabinet:

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

2. **Agree** to an application date of 1 April 2012.

3. **Note** that agreeing to the recommendations above will result in an increase in revenue as per the following table, with a corresponding impact on the operating balance:

	$ 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

Hon Bill English
Minister of Finance

____ /____/____
Date

Hon Peter Dunne
Minister of Revenue

____/____/____
Date