The Treasury

Budget 2023 Tax Initiatives Information Release

July 2023

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[33] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials

[34] 9(2)(g)(i) - to maintain the effective conduct of public affairs through the free and frank expression of opinions

[35] 9(2)(g)(ii) - to maintain the effective conduct of public affairs through protecting ministers, members of government organisations, officers and employees from improper pressure or harassment;

[36] 9(2)(h) - to maintain legal professional privilege

[38] 9(2)(j) - to enable the Crown to negotiate without disadvantage or prejudice

[39] 9(2)(k) - to prevent the disclosure of official information for improper gain or improper advantage

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POLICY AND REGULATORY STEWARDSHIP

TE TAI ŌHANGA
THE TREASURY

Joint Report: Potential tax system responses to supernormal profits within the New Zealand banking sector

Date:	10 March 2023	Report No:	T2023/282 IR2023/084
		File Number:	4764224:1

Action sought

	Action sought	Deadline
Minister of Finance (Hon Grant Robertson)	**Agree** to the recommendations	16 March 2023
Minister of Revenue (Hon David Parker)	**Agree** to the recommendations	16 March 2023

Contact for telephone discussion (if required)

Name	Position	Telephone		1st Contact
Paul Fulton – Inland Revenue	Principal Policy Advisor, Policy and Regulatory Stewardship	[39]	N/A (mob)	
Dan Doughty – The Treasury	Analyst, Tax Strategy		N/A (mob)	✓
Stephen Bond – The Treasury	Manager, Tax Strategy		N/A (mob)	

Minister's Office actions (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report	

Enclosure: No

Treasury Report: Potential tax system responses to supernormal profits within the New Zealand banking sector

Executive Summary

Purpose

1. You requested advice on a retrospective levy on large banks making persistently elevated profits. You are also considering this measure as a means of addressing significant one-off costs associated with Cyclone Gabrielle. This report outlines a levy option that could be used to respond to potential supernormal profits within the banking sector, the impacts of that option, and seeks final policy decisions on the levy option.

There is inconclusive evidence of supernormal profits within the banking sector

2. As previously reported, the four large New Zealand banks have persistently (i.e., beyond just the 2021 and 2022 years) elevated levels of profitability relative to the smaller New Zealand banks and overseas comparators, in part due to the relatively low costs of the large New Zealand banks [T2023-053 refers].

3. It is possible that structural or uncompetitive issues exist that are allowing excess profits to persist (referred to as ongoing supernormal profits in this report). It may also be the case that these banks are benefiting from advantages derived by their foreign ownership and economies of scale.

4. Ultimately, the evidence of supernormal profits within the New Zealand banking sector is inconclusive. Where that evidence exists, the strongest indicators point to supernormal profits being earned by the four largest banks. However, there are numerous possible explanations for why profits are elevated for these banks; many of which would be consistent with normal competitive behaviour which would not normally attract unique tax treatment.

5. Definitively establishing any uncompetitive behaviour would require significantly more robust analysis than has been possible within the time constraints of preparing this report. In the absence of that analysis, we cannot confidently conclude that there are supernormal profits, but acknowledge that it is possible that further analysis of the market could conclude supernormal profits are being earned.

A temporary nominal profit levy could respond to any supernormal profits

6. One option to respond to supernormal profits is a one-off profit levy, which could be imposed on the net profits of the banks in the target years. The levy would have a similar effect to a retrospective increase in the corporate tax rate for the affected banks, with the payment of the levy due in a future period.

7. Following your previous feedback, we have proposed a design for a temporary retrospective levy on the net profit in 2021 and 2022 years, applied to banks with a net profit of more than $1 billion. We are recommending that threshold solely on the basis that it would ensure the levy applies only to those banks where there is evidence of supernormal profits. Those banks have earned higher returns over an extended period compared to the rest of the industry, with this relative strength persisting in recent years.

8. Noting the profit growth in the 2021 and 2022 years, and the inconclusive evidence on whether supernormal profits are being earned, if you want to progress with this option, we recommend that any levy be limited to these years only.

A levy would raise revenue that could support your distributional objectives

9. The proposed levy will raise substantial revenue in a way that could support your wider distributional objectives, including but not limited to the costs of Cyclone Gabrielle. The amount raised by the levy will depend on the final configuration of various factors, but we have included indicative configurations that would raise between $230 to $700 million. The revenue would likely be recognised in the 2023 fiscal year. However, the timing of the revenue may change depending on the final design of the initiative and legislation, and the timing of both Cabinet decisions and the introduction of the final legislation.

But a levy would have significant unintended consequences

10. Notwithstanding the fact that there may be underlying uncompetitive behaviour that could be addressed through a levy, we are concerned that this levy would have significant unintended consequences. If it is the case that banks are operating in a relatively competitive manner, then our concerns intensify. The possible unintended consequences include:

    a. While the incidence a one off retrospective levy is most likely to fall on shareholders, there is a risk that at least a proportion of a levy could be passed on to consumers over time whether in the form of lower lending, higher interest rates, or other charges. The extent or timing of that pass-through is unclear, and depends on the trust that banks have that the levy is genuinely one-off, or may be repeated in future years.

    b. The favourable position of New Zealand as an investment destination is due in part to the relatively high confidence in our principled approach to the development of tax policy. Applying a retrospective levy without having sufficient evidence for taking this approach risks being viewed as arbitrary; damaging confidence in future investment decisions.

    c. Banks may view the levy as overly punitive in the context of lending activity during the pandemic period. If the perception is that the returns earned by participating in the Government's funding for lending programme will be subject to future levies, banks may be reticent to participate in future schemes in the future.

    d. Imposing a temporary levy imposes costs on previous uncompetitive behaviour, but may not disincentivise future behaviour. If there is underlying uncompetitive behaviour, the proposed levy may not prevent this in future years. Additionally, without imposing future focused proposals we are concerned that a levy will be seen as license to act in an uncompetitive way; potentially exacerbating any pre-existing issues.

11. These consequences could negatively impact New Zealand's financial capital by imposing higher costs on businesses and residential borrowers, or reducing investment incentives for banks.

We do not recommend that a retrospective levy be imposed

12. We do not believe that there is sufficient evidence to definitively conclude that banks are earning supernormal profits. In addition, we note significant unintended consequences for imposing a one-off levy on supernormal profits, especially if those profits do not exist.

13. Even to the extent that banks are earning supernormal profits, we cannot determine with any confidence what proportion of total profits are comprised of supernormal

profits. As a result, we consider it highly likely that the levy will capture some proportion of normal profits – and potentially exclusively normal profits if it is the case that the banks are not earning supernormal profits.

14. Therefore, without the ability to target the levy more carefully, we are concerned that there may be a large number of unintended consequences. The severity of those consequences is then dependent on how close our estimates of supernormal profitability are to reality.

15. On balance, and with regard to the evidence currently available, we do not believe that the desired revenue raised through the proposed levy outweighs the risks outlined above. As a result, we do not recommend that the levy be introduced.

We recommend you consider a market study before progressing a levy

16. As noted previously, we recommend that you consider a market study into competition in the banking sector if you believe that there may be supernormal profitability in the banking sector. This would allow officials to consider responses with a better understanding of how to design an effectively levy that would also raise future revenue. This, in turn, would minimise exposure to unintended consequences.

17. If you wish to impose a levy, we recommend that the study be commissioned as well. This would still allow officials to consider future options, and mitigate (to some extent) the consequences identified with imposing a levy as discussed above.

[34]

Administration impacts

19. There are a number of second-order administrative considerations that arise as a result of the unique nature of the levy. We have outlined the specific considerations for Ministers in this report, but do not expect that any prevent the implementation of the levy. However, there may be additional consequences from the implication of certain design choices, such as deductibility and imputation credits.

Next steps

20. If you wish to proceed with the proposed levy option, we will draft a Cabinet Paper based on your preferred design options.

Recommended Action

We recommend that you:

EITHER

Agree not to progress a supernormal profit levy on banks (**officials' recommendation**).

Agree / disagree *Agree / disagree*

OR

Agree to impose a supernormal profit levy on banks for the 2021 and 2022 income years.

Agree / disagree *Agree / disagree*

Agree to impose the levy on banks that have reported a net profit before tax figure in excess of $1 billion in each of the 2021 and 2022 income years (as a proxy for banks more likely to be earning supernormal profits).

Agree / disagree *Agree / disagree*

Agree that the levy will be imposed on the net profit of the banks for the relevant years at the rate of (please circle to indicate preference):

a. 1.4%
b. 2.8%
c. 4.2%
d. A separate rate as selected by Ministers, at:

Note the following financial impact estimates over the forecast period for the above rates (if one is selected):

a. 1.4% - $230 million
b. 2.8% - $470 million
c. 4.2% - $700 million

Noted *Noted*

Note an estimated one-off implementation cost of approximately $3 million, with an estimated ongoing operating cost of $1.65 million over the forecast period (2022/23 to 2026/26) for associated depreciation and capital charge costs (regardless of rate).

Noted *Noted*

Note that Inland Revenue, with the Treasury, will report back to you in mid-March on the overall financial, resource and capacity impact of all proposed Budget 2023 tax initiatives, including the potential for Inland Revenue to partially self-fund the capital and/or operating impacts of these initiatives.

Noted *Noted*

Agree that the following administrative features be designed into the levy (please indicate where you disagree with specific design feature with an "X" in the opposing column):

Particular feature	**Yes**	**No**
Levy is exempt from GST	✓	
Non-deductible for income tax purposes	✓	
Not factored for provisional tax payments	✓	
Does not give rise to imputation credits	✓	
Levied on the New Zealand banking group	✓	

Agree that the cabinet paper includes a delegated authority for the Minister of Revenue to make decisions on further technical administrative elements for the levy that do not have fiscal impacts.

Agree / disagree *Agree / disagree*

Direct officials to prepare a cabinet paper on the proposed design of the supernormal profit levy on banks.

Directed / not directed *Directed / not directed*

Stephen Bond
Manager, Tax Strategy

Paul Fulton
Principal Policy Advisor, Inland Revenue

Hon Grant Robertson
Minister of Finance

Hon David Parker
Minister of Revenue

_____/_____/_______ _____/_____/_______

Treasury Report: Project Cricket

Purpose of Report

1. You requested advice on a retrospective levy on banks to raise revenue in a way that supports your distributional objectives, while minimising negative impacts. Specifically, you are considering levy options as part of a broader response to the costs involved with Cyclone Gabrielle.

2. While we have advised that current evidence on supernormal profits is inconclusive, the four large New Zealand banks have persistently elevated levels of profitability relative to the smaller New Zealand banks and overseas comparators, in part due to the relatively low costs of the large New Zealand banks [T2023-053 refers].

3. It is possible that an enduring structural issue, such as weak competition between the large banks, may be allowing excess profits to persist. This could suggest that the four largest banks are making supernormal profits, and that the elevated profits in the 2021 and 2022 years could be the target of the retrospective levy.

4. If you wish to direct us to begin detailed design work on the proposed levy, we will prepare a draft Cabinet paper to that effect.

Supernormal profits within the banking sector

The current regulatory and taxation environment of banks

5. As businesses, banks operating in New Zealand (regardless of where their ultimate parent is based) are subject to the standard corporate tax rate of 28%. In the 2021 income year, the four largest New Zealand banks reported a tax expense of $2.2b which would be equivalent to 10.7% of all income tax paid by New Zealand businesses ($20.4 billion).

6. Similar to many industries, banks are also subject to various bespoke tax rules that alter their ultimate tax liability. These rules have previously been implemented to limit risks to revenue integrity arising from the unique business operated by banks (for example, the specific rules that apply for thin capitalisation ratios for banks).

7. Banks are also subject to both prudential and conduct regulation. As part of its prudential regulation role, the Reserve Bank has recently increased the capital buffers of banks. Registered banks need to have capital of at least 16% of risk-weighted assets by 2028, with the four largest banks required to have a higher 18% ratio. The Deposit Takers Bill will also establish a new legislative framework for prudential regulation and introduce a Depositor Compensation Scheme.

8. The four largest banks are subject to this heightened ratio as they hold 85% of the assets held by banks in New Zealand. As a result, the failure of any of these four banks would likely cause significant disruption to the New Zealand economy, and threaten our broader financial stability.

There is preliminary evidence of supernormal profits amongst the four largest banks

9. This section summarises prior advice on banks' supernormal profits [T2023-053 refers].

10. The four largest New Zealand banks have had persistently elevated levels of profitability compared to the rest of the banking sector, measured by return on equity

and assets. In addition, evidence suggests that the large New Zealand banks are also relatively more profitable than key international comparators. Reserve Bank analysis for the period 2016-2022 found the large New Zealand banks' return on common equity was generally the second highest of the comparator group, after Canada (table 1):

Table 1: Return on equity (CET1) for large banks in peer countries (F)[1]

Country (number of banks)	Return on Equity	= (Total income	- Total expenses)	X Leverage multiplier
	$\frac{Net\ income}{CET1}$	$\frac{Income}{Exposure}$	$\frac{Expenses + Tax}{Exposure}$	$\frac{Exposure}{CET1}$
	%	%	%	times
New Zealand (big 4)	**18.4**	**2.26**	**1.27**	**18.5**
New Zealand (small 5)	**8.8**	**2.71**	**2.04**	**14.3**
Canada (4)	20.3	2.60	1.83	26.3
Australia major (4)	16.7	2.25	1.47	21.6
Sweden (4)	15.6	1.72	1.02	22.6
Singapore (3)	14.5	2.24	1.25	14.7
Norway (3)	13.7	2.01	1.06	14.4
Austria (3)	13.3	2.72	1.91	16.5
Australia minor (3)	12.2	2.29	1.66	19.5
Netherlands (4)	11.2	1.74	1.29	25.1
Denmark (4)	10.2	1.31	0.87	23.5
Switzerland (4)	9.7	2.67	2.30	24.9
Finland (1)	9.5	3.30	2.17	8.4
Ireland (4)	9.2	2.69	1.96	13.3
Peer average (41)	**12.9**	**2.27**	**1.55**	**19.2**

11. The high return on equity of the four largest banks is a historic trend, and is not limited to the 2021 and 2022 income years [T023/053 refers]. Therefore, while we cannot conclude that the large banks have derived supernormal profits in the recent past, it may be the case that supernormal profits have existed for some time.

12. Additionally, when comparing the assets of the four largest banks to smaller banks with similar return on equity, the smaller comparative banks have a higher prevalence of high-risk products (such as reverse mortgage products). It is therefore unclear why the largest banks are able to achieve similar profitability with comparatively low risk.

13. Notably, and as illustrated in table 1, the Reserve Bank also found the large New Zealand banks' revenues (net interest income and other income) are close to peer country averages when measured against the size of their balance sheets, while expenses (operating expenses and credit impairment expenses) are lower than peer country averages. By comparison, the small New Zealand banks operate with higher cost structures than the large New Zealand banks, leading to the lowest return on equity in the peer group.

[1] Source: Banks' financial statements for the 2018 financial year, RBNZ calculations. See Response to Official Information Request NZ Banks' return on equity (rbnz.govt.nz). Note: country averages are weighted by exposure amount; peer average is the unweighted mean of countries.

Elevated profits could be due to uncompetitive behaviour or competitive advantages…

14. It is possible that elevated profits arise from an implicit guarantee against failure. As failure of a major bank would have significant consequences, the market may expect that these large banks are likely to benefit from Government bailout in that event. Any such perceived implicit guarantee would be reflected in a lower cost of funding for the major banks, enabling them to earn larger profits than their peers.

15. A study from 2015 estimated that the implicit guarantee may be equivalent to a 3-8 basis point subsidy on banks total operating costs. However, officials do not have access to more contemporary or definitive data to conclude on this point. Therefore, the impact that this guarantee may have is difficult to quantify.

16. Moreover, any implicit guarantee has likely fallen as a result of strengthened capital requirements, the pending introduction of an explicit Depositor Compensation Scheme, and forthcoming strengthening of the crisis management framework in the Deposit Takers Bill. Officials expect that this component would continue to shrink in future years, to the extent that it is present.[2]

17. A lack of sufficient competition within the sector is another possible explanation of elevated profits. It is unclear why competition between the large New Zealand banks has not eroded the relatively high profitability of its four largest entities, particularly given the existence of a Government-owned bank which has achieved reasonable scale and has similar product offerings for mortgages and deposits. Typically, a market with these indicators would suggest uncompetitive behaviour, but previous high-level reviews conducted by The Treasury have not identified any clear evidence of this behaviour.

18. In recent months, banks have experienced growth in their net interest margins from the second half of 2021, and that recent half-year reporting suggests that this will continue in the 2023 year. Data shows that this is driven by customers having significant amounts in transactional accounts earning low interest. The rates earned on these products in particular appear to be lagging behind increases in lending rates, and rates on longer term deposit savings products. We estimate that elevated margins explain about 20 percent of the growth in profits between 2019 and 2022.[3]

19. Owing to limited opportunity for consultation, officials cannot conclude on the causes for this misalignment, but note that the elevated margins could reflect delays in customers responding to the increased gap between transactional accounts and term deposit rates that is resulting from increases in the Official Cash Rate. If this is the case, margins should normalise in coming months.

20. We note that increases in net interest margins are not limited to the four largest banks. Nearly every bank operating in New Zealand is currently experiencing elevated margins, or experienced (to some extent) heightened margins within the 2021 and 2022 years. If supernormal profits are attributable to structural issues in the deposits market, those profits would not be limited to the four largest banks.

…but elevated profits could also be explained by other factors.

21. Contrary to the discussion above, we believe that heightened profitability of the four largest banks could also be explained by other factors:

[2] Moreover, any implicit guarantee is likely to be at least as strong for Kiwibank as the big-4, yet Kiwibank has earned substantially lower returns over time.

[3] This estimate is based on estimating counter-factual profits in year to September 2022 that would have resulted if the major banks had margins that were in line with the per-institution average margin over the 2018-2022 period, and comparing the reduction in profits to the overall increase in profits over these years.

a The largest banks' profits are not a result of uncompetitive behaviour and are actually a fair return on an elevated risk premium. Credit reporting agencies note these large banks enjoy a 2-3 notch uplift to their credit ratings from expectations of financial support from their parent banks. The parent banks may therefore require a higher return on their New Zealand operations to compensate for higher risk. However, this seems unlikely given that credit impairments have been low in New Zealand for many decades.

b Being subsidiaries of larger foreign groups, the large banks may be deriving economies-of-scale benefits that their domestic competitors do not enjoy. This in turn may be driving down costs relative to other market participants, increasing their relative profitability. Reserve Bank data appear to support this, as reporting suggests that the four largest banks have relatively low operational expenses when compared to their domestic competitors and international peers.

The evidence of supernormal profits is inconclusive

22. The evidence currently available is insufficient to conclude on the cause of large banks' elevated profitability. It may be that banks are operating in uncompetitive ways, or that certain banks enjoy (and have enjoyed for a long time) certain competitive advantages. It may also be the case that there are uncompetitive elements to the market that have existed for a long period, and are as-yet unidentified.

23. Ultimately, to the extent that there is uncompetitive behaviour it is poorly understood, and an intensive targeted study would be required given the inherent complexities of the banking sector and its various submarkets. Absent that study, the evidence does not currently support a conclusion that supernormal profits exist in the banking sector. Equally however, we cannot definitively say that these supernormal profits do not exist.

24. In the absence of compelling evidence of supernormal profitability in the banking sector, the analysis performed below is on a best-estimate basis. While officials acknowledge that supernormal profits may exist, we view the risks associated with levying normal profits as significantly greater than the potential benefits of levying supernormal profits. On that weighting, we do not recommend the levy below.

25. As noted previously, we recommend that Ministers consider a market study into competition in the banking sector if you believe that there may be supernormal profitability in the banking sector. This would allow officials to consider responses with a better understanding of how to design an effectively levy that would also raise future revenue. This, in turn, would minimise exposure to unintended consequences.

Tax option for supernormal profits in the banking sector

You requested advice on levying banks' supernormal profits

26. You have requested advice on a levy on banks' supernormal profits. Supernormal profits are profits generated above the level that would generally be anticipated for a business in a competitive market. A levy on supernormal profits therefore requires separating the taxable profit of a taxpayer into two portions:

    a normal returns that are anticipated in a competitive market; and

    b supernormal profits exceeding what should be possible in a competitive market.

27. The levy is then applied to the second portion. You have indicated that you want to target banks making large supernormal profits for a sustained period.

28. Per the analysis presented above, if there are banks that are earning supernormal profits in New Zealand, the best evidence (which is still inconclusive) is that supernormal profits are concentrated in the four largest banks. Therefore, to meet Ministers' objective, we would recommend a levy that is limited to the following banks:

    ANZ Bank New Zealand Limited

    Westpac New Zealand Limited

    ASB Bank Limited

    Bank of New Zealand Limited

29. As noted above, the four largest banks are unique in their consistently high return on equity, while taking on proportionally fewer high-risk assets to achieve those returns. For that reason, a threshold based on return on equity does not properly limit the levy to these banks, as it would likely capture much smaller banks with high returns on much smaller asset bases. As we are much less confident that these banks are generating supernormal profits rather than returns on a riskier asset base, the threshold for the supernormal profit levy should exclude them.

30. Given that our evidence indicates the four largest banks are those most likely to be earning supernormal profits, officials consider that the simplest way of limiting the levy to only those banks that are more likely to be generating supernormal profits would be to apply an income threshold. Banks that are above this threshold would be required to pay the levy, and those below that threshold would be excluded.

31. If you wanted the proposal to target the banks most likely to be making supernormal profits, we suggest a straightforward way might be a $1 billion threshold in both the 2021 and 2022 years. If any banks are earning supernormal profits, we have higher confidence that the banks above the threshold are earning supernormal profits than those below the threshold.

32. Applying this threshold does come with risk, as it is set ultimately as a simple mechanism to restrict the levy to those taxpayers that our analysis suggests are more likely to be making supernormal profits, rather than any particular tax principle that would suggest a particular threshold is appropriate or not. This could exacerbate risk that the tax is seen as being targeted specifically at particular taxpayers,

33. The main downside of this approach is that it makes no allowance for the size of the bank. One bank may end up paying higher taxes merely because it is lending more in New Zealand, not because its profits are large relative to the size of its lending (a better indicator of supernormal profits). While this is a downside in theory, in New Zealand the four banks to which the levy would apply both lend more, and achieve a consistently high return on equity over time.

34. A different approach might be to have a two-step test. The first threshold would be the $1 billion profit threshold, but the second would be allowing a deduction for a "normal" return on equity, with only amounts above that being subject to the new tax. In the time available we have been unable to design or forecast the costs associated with such an approach.

35. We also wish to reiterate that it is possible that smaller banks may also be making supernormal profits, but that these could not be detected with the data currently available to officials. If Ministers are concerned that these banks should also be included in the base for the levy, it would be possible to extend the levy to all New Zealand banks by simply removing the threshold entirely, or applying the levy with a return on equity test, but this could carry additional risks for financial stability and could run counter to your stated aim of taxing those banks making supernormal profits.

36. Additionally, you have asked us to design a levy with retrospective effect. You indicated an interest in levying the high nominal profit growth experienced by the large banks in the 2021 and 2022 income years. The proposal below has been designed within this scope.

A temporary levy could target previous supernormal profits

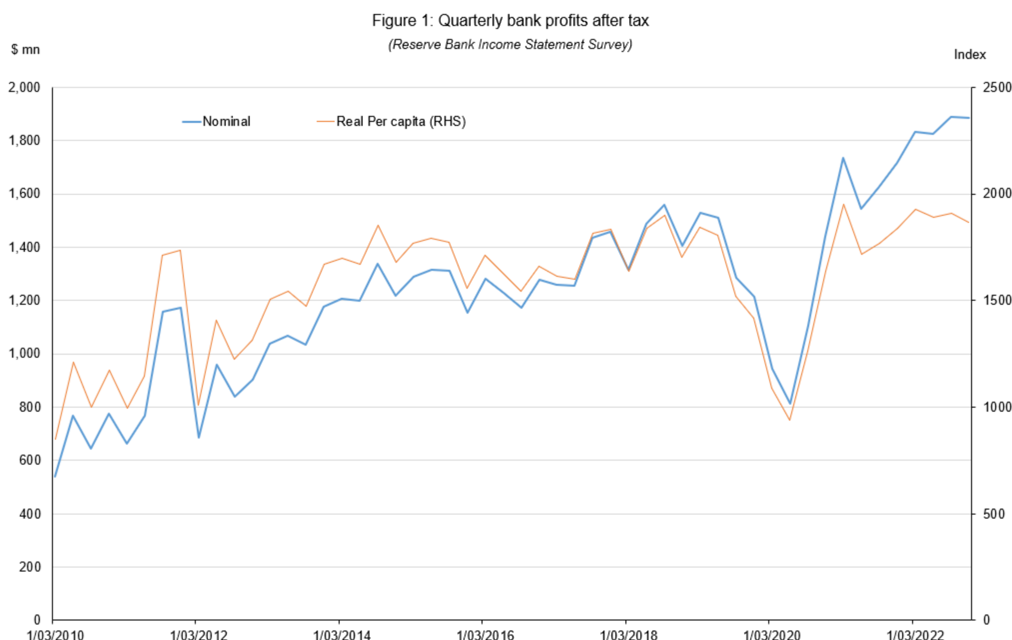
Overview

37. The temporary profit levy operates by imposing a new levy due in a future income year (in this case, 2024) that is calculated based on the net profit reported in the previous income year(s) ("target years"). The levy rate is the primary lever available to Ministers to adjust the revenue collected under this option. The higher the rate, the higher the revenue expected.

38. While not recommended, the years that the levy is assessed within can also be adjusted. The more years that are assessed, the higher the revenue expected. If you wish to apply a temporary levy, we recommend that the target years for the levy be the 2022 and 2021 years only.

Targeting 2021 and 2022 captures elevated COVID-era profits

39. Bank profits have increased in real terms since the early pandemic period (early 2020), and although part of this increase can be explained by inflation and population growth, real profits were the highest on record[4]:



40. Our previous advice noted that this increase was not a result of windfall profits, and was likely instead driven by a combination of banks reversing provisions for impaired losses, elevated inflation, loan volume growth, and widening net interest margins.

41. Notwithstanding the commentary provided earlier in this report, officials acknowledge that if there are supernormal profits within the banking sector, then targeting the 2021

[4] Although real profits per capita are a better indicator of profitability than nominal profits, real per capita profits are mainly higher post-COVID as a result of asset growth, presumably reflecting strong customer demand (as noted in previous advice).

and 2022 years appears appropriate as prima facie there would be a higher nominal amount of those profits in those years:

a. As no year can be targeted as the “beginning” of supernormal profits, a retrospective levy must either be limited to a specified number of years, or be retrospective to the establishment of the banks in New Zealand (which we consider non-feasible). In that context, a shorter period of specified years is preferable.

b. When accounting for the elevated uncertainty about whether banks are earning supernormal profits, limiting the levy to a short retrospective period mitigates a degree of the risks identified, as compared to a levy with a longer period of applicability.

42. Therefore, noting high profits growth in the 2021 and 2022 years, levying those years specifically would best meet Ministers’ broader distributional objectives while keeping unintended consequences relatively low. However, we note there is not a scientific basis for limiting the levy to these years alone.

Rate could reflect degree of confidence of supernormal profits

43. We note that without conclusive evidence by which we can identify what proportion of profits are supernormal, a relatively high rate would be more difficult to justify. Likewise, a lower rate would fail to meet the Government’s revenue and distributional objectives.

44. As highlighted in figure 1, the four largest banks have elevated net profit as a proportion of equity, as compared to the rest of the sector. If the four largest banks had a tax rate of 56% (i.e., a 100% uplift on the standard corporate rate) their return on equity would be roughly equal with the average of all other banks. But that would imply that all additional return on equity was supernormal profits, which is not our view.

45. There is no analytically precise method by which this rate could be set. Ultimately, the rate chosen should reflect the confidence that Ministers’ have in degree of supernormal profits within the banking sector. Given the uncertainties involved, we recommend that you set a relatively conservative rate if you do decide to impose a levy. Indicatively, the following rates would raise the following revenue:

a. 1.4% - (e.g. 5% the rate implied in paragraph [43]). This option would raise approximately $230m.

b. 2.8% - (e.g. 10% the rate implied in paragraph [43]). This option would raise approximately $470m.

c. 4.2% - (e.g. 15% the rate implied in paragraph [43]). This option would raise approximately $700m.

46. The above forecasts are based on modelling that has been completed based on the recommended administrative options provided.

[36]

[36]

Alternative designs may be preferable, but are outside of the scope provided

48. If it is the case that banks are generating supernormal profits, then an alternative prospective levy may have been a preferable approach for disincentivising those profits. Officials note that various jurisdictions have implemented permanent prospective levies in response to supernormal profits, and in theory, a similar levy could be imposed in New Zealand.

49. We consider the following international examples of supernormal profit levies as being relevant for a wider investigation on prospective options:

    a Australia - banks with over $100bn AUD in liabilities are charged a levy of 0.06%p.a. on each cent of liability. This levy was designed to recover supernormal profits arising from implied guarantee against failure that large banks benefit from in Australia.

    b The United Kingdom – UK resident banks are charged a levy on bank balance sheet liabilities. The rate of the liability distinguishes between short (less than 1 year maturity) and longer-term debt; with the former charged at 0.05% per cent of liability, and the later at 0.10% per cent. Similar to the Australian levy, this also targets the benefit of implied liabilities but is also applied to smaller banks.

    c Germany – A levy is charged on a progressive basis for liabilities held by German banks; liabilities of up to €10 billion at 0.02%p.a., liabilities between €10 billion to €100 billion are at 0.03%p.a., and liabilities in excess of €100 billion at 0.04%. This model is effectively a hybrid between the Australian and UK models.

50. We do not believe that any of these models can practically replicated if they were to be applied retrospectively as they rely upon being permanent, and were therefore not explored. Additionally, while the proposed levy could have been designed to apply to liabilities (as opposed to profit) when applying retrospectively they have near identical impacts. Without applying that levy on a prospective basis, we do not feel that it would result in materially different benefits and costs.

51. Alternatively, we note that Canada has recently introduced the "Canada Dividend Recovery", which is relatively similar to this proposal, but bears a few key differences. That measure was targeted at windfall profits (not supernormal profits), and was also accompanied with a permanent increase to the income tax rate of banks. Given these key differences would not align with the scope provided, we have not considered proposing a similar option.

Additional design considerations of levy options

52. Given the temporary nature of the levy, the small number of taxpayers, and the time to set up the system, officials are keen to make the administration of the levy as simple as possible. We recommend that the levy be treated as a tax for administration purposes, but not as income tax or company tax, so that:

    a **GST –** GST would not apply to the levy.

    b **Deductibility** – The levy would not be deductible for income tax for banks.

    c **Provisional tax** – as the levy is non-deductible and is not treated as income tax, the affected taxpayers would not need to make backwards adjustments to their provisional tax. This mitigates any need to make specific adjustments to the provisional tax rules.

    d **Imputation credits** – as the levy is not an increase to the corporate tax rate and is intended to increase the final tax paid by banks, it would not generate imputation credits for the affected banks.

    e **Definition of "bank**" – the existing definition of "New Zealand banking group" per section FE 33 of the Income Tax Act 2007 should be used for captured banks. This definition would include the registered bank and its subsidiaries, the NZ holding company and any other members of the group that are owned directly or indirectly outside New Zealand including the NZ branch of the foreign parent (if

applicable).

Section FE 35, which is referenced in section FE 33, excludes a number of entities such as life insurers and these should likewise be excluded for the purposes of this levy.

To reduce compliance and admin costs each banking group should only make a single payment rather than being required to make separate payments for each subsidiary/branch. This could be a "registered bank" as that term is defined in section YA 1 which refers to the same term in section 2 of the Banking (Prudential Supervision) Act 1989. A registered bank that is a member of a consolidated group for income tax should have the SNPL assessed against the consolidated group.

53. Treating the levy as a tax for administration purposes means that all the normal tax administration rules would apply, including the rules around disputes, penalties, use of money interest.

54. If Ministers have concerns with any of the implications carried with the design elements noted above, we would be able to reconfigure the levy as a tax with relative ease.

55. Officials note that further technical issues may arise in relation to the administration of the levy. We recommend that Ministers seek delegated authority for the Minister of Revenue to make decisions regarding technical amendments to the administration of the levy (that do not come with revenue impacts).

Risks associated with a retrospective supernormal profit levy

56. Notwithstanding the fact that there may be underlying uncompetitive behaviour that could partially be addressed through a levy, we are concerned that this levy would have significant unintended consequences. If it is the case that banks are operating in a relatively competitive manner, then our concerns intensify. The possible unintended consequences include:

- The incidence of the levy may not fall on the banks; and
- The levy may damage New Zealand's reputation and deter future investment decisions; and
- The levy may discourage banks from participating in any future funding for lending programmes in any possible future crises; and
- The levy may not disincentivise any uncompetitive behaviour

57. We note that this list of risks is not exhaustive. Given the high degree of uncertainty in relation to this proposal, and the short time frame within which this levy has been considered, it is possible that there are additional risks that have not been identified and addressed.

The incidence of the levy is uncertain, and may fall on businesses and individuals

58. In theory, a one-off retrospective tax will not affect behaviour (as their future behaviour does not change the liability for the retrospective tax) and therefore will be borne by shareholders of the banks. We would expect that banks could, over time, attempt to recoup the costs of the tax from customers. That could be from interest margins, other charges, and lending activity. Their ability to do this will be constrained by the structure

of the market and other factors but we have no guarantee that there will be no passthrough to customers.

59. The risk that this cost pass-through occurs, and the extent that it occurs, is dependent on whether banks perceive this levy as genuinely "one off". If it is the case that bank's see a high likelihood that the levy will be re-applied in the future (i.e., following future natural disasters or periods of high profitability), then we would expect that the level of cost pass through would be higher as banks would adjust their behaviour in expectation of future tax changes.

60. While there is uncertainty about the degree of pass-through, there is a material risk that some of the costs ultimately fall on the consumers of the underlying service. In respect of a levy on banks, this would likely be reflected in an increase to costs passed through to customers (i.e., interest rates, fees, etc).

61. From a wellbeing perspective, we note that recent Treasury cost of living indices show that the largest increases have been experienced by individuals with mortgages. To the extent that the levy did result in additional rate increases over time for mortgage holders it would worsen an already disproportionate cost increase for a portion of society. Noting concerns raised in our analysis under He Ara Waiora principles below, there are potential unknowns as to how this may impact Māori specifically.

62. To the extent that the incidence falls onto depositors or business or home borrowers, the levy would reduce their financial capital. Specifically, the increased cost of the borrowing or reduced return from the investment would impact on the overall financial resources of the individuals or businesses.

The levy may damage NZ's reputation and deter future investment decisions

63. The favourable position of New Zealand as an investment destination is due in part to the relatively high confidence in our principled approach to the development of tax policy. Applying a retrospective levy without having sufficient evidence for taking this approach risks being viewed as arbitrary, damaging confidence in future investment decisions.

64. [29]

65.

The levy may discourage banks from participating in any future funding for lending programmes in any possible future crises

66. Banks may view the levy as overly punitive in the context of lending activity in the early pandemic period. If the perception is that the returns earned by participating in the Government's funding for lending programme will be subject to future levies, banks may be reticent to participate in the future.

67. To the extent that banks are discouraged from lending activity during crises this would reduce New Zealand's financial capital by impacting business and individual resilience during crises.

68. There are also additional risks that linking the levy explicitly to Cyclone Gabrielle comes with the implication that future levies may be introduced in the event of natural

disasters. This could disincentivise banks from providing assistance in these events as they have an anticipation that their social contribution will come through that mechanism.

69. This precedential risk can be mitigated, to some extent, by signalling further action to the market at the same time as announcing the levy.

The levy may not disincentivise any uncompetitive behaviour

70. Imposing a temporary levy imposes costs on previous uncompetitive behaviour but does not disincentivise future behaviour. If there is underlying uncompetitive behaviour, the proposed levies may not prevent this in future years.

71. Additionally, without imposing future focused proposals we are concerned that a levy will be seen as a license to act in an uncompetitive way; potentially exacerbating any pre-existing issues. This too can be mitigated by signalling to the market at the same time as the levy is announced; for which we prefer a market study.

Wider financial stability concerns

72. Depending on the quantum of revenue anticipated from either levy, we do not anticipate that the levy will significantly conflict with current moves to increase capital within financial institutions before 2028. However, this is based on limited consultation; critically lacking consultation with the banks that would be affected. If Ministers opt for a higher rate, we advise additional consultation be completed to understand any potential risks.

73. Additionally, levies that are implemented retrospectively are inherently punitive, as they are in response to actions deemed inappropriate. If this levy were imposed without significant evidence of impropriety the affected banks may view it as arbitrary, impacting future investment decisions. As officials do not have evidence that banks are generating supernormal profits, this risk is considered significant.

Concerns for New Zealand tax norms

74. Tax policy officials advise Ministers on matters of retrospectivity according to a set of well-understood principles. One of those principles is that significant policy change should only be made on a prospective basis. This preserves the ideas of legal stability, and that people should be aware of their potential tax liabilities in advance of making business and investment decisions.

75. Unless a change is taxpayer-friendly, retrospectivity is generally only used when there is a gap or error in the legislation or where the wording of the legislation is clearly contrary to the policy intent. The proposed levy would cut against these principles, and we expect it will draw strong criticism on that basis – even from unaffected parties.

[36]

[36]

Assessment against He Ara Waiora framework

82. Officials have considered the impacts of the proposal against the He Ara Waiora framework. In the context of the levy, we believe this is an important exercise in re-framing the risks presented from tikanga-centric perspective, and highlighting broader wellbeing impacts. To assist us in articulating these considerations, we have relied upon the five principles or "means" of He Ara Waiora:

Principle / mean	Description
Kotahitanga	Kotahitanga is ensuring that agencies work in aligned, coordinated way across the system and alongside iwi and Māori as Treaty partners, and other affected communities and groups.

Whanaungatanga	Working together to foster meaningful, reciprocal and enduring relationships with iwi and Māori, and affected communities and groups.
Tikanga	Tikanga is when decisions are made by the right decision-makers, following a tikanga process, according to tikanga values.
Manaakitanga	Manaakitanga is a focus on improved wellbeing and enhanced mana for iwi and Māori, and for other affected communities and groups, demonstrating an ethic of care and mutual respect.
Tiakitanga	Tiakitanga focuses on providing a guardianship or stewardship. This econmpasses responsibility to work with iwi, Māori, Māori businesses and other agencies to improve their wellbeing.

83. While best endeavours were made within the constraints of the sensitivity of this project, our coordination has been with a limited number of individuals within the public service. As a result, officials have not consulted with our Treaty partners in a material way.

84. Though we do not anticipate that the risks of the levy will fall disproportionately on Māori, that assessment is made without Māori voices. Ideally, this analysis would have explicitly included the views of Māori, as well as those of other potentially affected communities. Without those voices, there are potentially unknown risks we have not considered.

85. Symptomatic of this, our report does not consider the wellbeing objectives at a community level, and presents our potential risks at an aggregate "customer" level. We believe there may be a nuance to the level of flow through to various groups that is not being considered using this approach.

86. Ultimately, the limitations noted above can be re-cast through the goals or "ends" of He Ara Waiora:

Goals / ends	Description
Wairua	Spirit - is at the centre to reflect that it is the foundation or source of wellbeing. Values, beliefs and practices related to wairua are essential to Māori conceptions of waiora.
Te Taiao	The natural world and the environment - is paramount and inextricably linked with human wellbeing. Humans have responsibilities and obligations to sustain and maintain the wellbeing of Te Taiao.
Te Ira Tangata	The human domain - encapsulates human activities and relationships, including the relationships between generations. The concept of mana (power, authority) is seen as key to wellbeing.

87. While the levy would allow Ministers to meet their broader distributional objectives and strengthen Te Ira Tangata, doing so without fully understanding the extent of supernormal profits heightens incidence risks, and moves against this goal at the same time. While this risk is noted above, viewed through this lens we can see a more

complete picture of the impact on wellbeing. Therefore, Ministers' more holistic goal of distribution may be lessened.

Administration

88. Inland Revenue expects that their systems could be configured to administer the levy within 4 – 6 months of the legislation being enacted. As the implementation date via legislation is anticipated to be April 2024, then this could be accomplished by November 2024 (acknowledging expected pressures from GST filing near this time).

89. This would mean banks would pay the levy during the 2024-25 fiscal year. However, the revenue would likely be recognised in the 2022-23 fiscal year as that is the year in which the levy liability arises. However, the timing of the revenue may change depending on the final design of the levy and legislation, and the timing of both Cabinet decisions and the introduction of the legislation.

90. As Inland Revenue has existing relationship managers for the banks that would be affected, Inland Revenue does not anticipate a requirement for significant on-going additional funding to implement the levy, other than depreciation and capital charge. These expenses are expected on the basis of a system upgrade to administer this levy, and future similar levies.

91. At the upper-end of the cost range, implementation is expected to cost $3 million as a one-off expense to configure Inland Revenue's systems to manage the levy. On that basis, ongoing costs for depreciation and capital charge are estimated at $1.65 million over the forecast period.

92. However, additional complexity may arise if Ministers request adjustments to how the proposal interacts with the imputation and provisional tax rules. This would impact the estimates provided here.

93. Inland Revenue is reviewing the overall impact of possible Budget 2023 initiatives, including this proposal. Inland Revenue, with the Treasury, will report back to you in mid-March on the potential for Inland Revenue to self-fund the capital and/or operating impacts of this initiative and other Budget 2023 initiatives. The level of any self-funding will be dependent on the total financial, resource, and capacity impacts of all proposed initiatives. The report will also identify any new Budget 2023 funding required for all the initiatives in any package.

Consultation

94. We have sought specific comments from relevant Government ministries on the proposed changes, and have included these below:

Reserve Bank

95. The Reserve Bank views a profitable banking system as supporting our objective of financial system stability, as it enables banks to generate or attract the capital base needed to absorb potential losses over economic cycles. We also recognise the desirability of an efficient, inclusive and dynamic financial system and the importance of competition in supporting these outcomes.

96. We agree with the Treasury's analysis that the major New Zealand banks have sustained relatively high profitability compared to smaller peers and international

comparators over many years, but that there is inconclusive evidence that this represents “supernormal” profitability or is a result of uncompetitive behaviour.

97. We agree with the Treasury that a Commerce Commission market study would be the best approach to establishing such an evidence base. At the proposed ranges of levies suggested, and being limited to the 2021/22 tax years, such a levy would not on its own have a material impact on overall financial system stability, however it would at the margin delay the major banks’ transition to the Reserve Bank’s incoming higher capital requirements. Higher levy rates would have larger adverse impacts on financial stability.

Recommendations

98. Officials do not recommend that a supernormal profits levy be imposed on banks. We do not believe a sufficient evidentiary threshold has been met to confidently impose a rational rate, or target the levy at genuine supernormal profits.

99. We also view the risks associated with the levy as high. Before accounting for uncertainty in the extent of supernormal profits, the unintended consequences of the levy run contrary to a number of Ministers’ broader objectives. Once the uncertainty is accounted for those risks are elevated, and outweigh revenue benefits in our view.

100. If Ministers are concerned with potential supernormal profits in the banking sector, we recommend that a market study be considered. A market study would provide more definitive evidence of supernormal profits, the extent of that profitability, and the causes behind it. If Ministers continue to see a levy as an appropriate response following the findings of that study, those findings could be leveraged to develop a much better targeted tax option.

Next steps

101. If you wish to proceed with the proposed levy, we can prepare a Cabinet Paper for that measure. Please indicate the rate at which you would prefer the levy be set, and whether you would prefer to limit the levy only to the 2021 and 2022 years.