The Treasury

Budget 2023 Tax Initiatives Information Release

July 2023

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[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

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TE TAI ŌHANGA
THE TREASURY

Treasury Report: Windfall gains in the New Zealand banking sector, and responses

Date:	Friday, 10 February 2023	Report No:	T2023/53
		File Number:	4742275

Action sought

	Action sought	Deadline
Minister of Finance (Hon Grant Robertson)	**Agree** to your preferred recommendations of this report	None

Contact for telephone discussion (if required)

Name	Position	Telephone		1st Contact
Dan Doughty	Analyst, Tax Strategy	[39]	N/A (mob)	✓
Stephen Bond	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

Executive Summary

This report responds to your request for advice on the extent to which the New Zealand banking sector is generating windfall or supernormal profits, and tax options for responding to any windfall profits in the banking sector. You have also asked whether officials view other industries as having experienced windfall profits.

The large New Zealand banks have persistently elevated levels of profitability relative to comparators in other countries

Excess profits are defined as profits above the level that would be expected in a workably competitive market. Evidence on the competitiveness of the New Zealand banking sector is mixed. The large New Zealand banks have persistently elevated levels of profitability relative to comparators in other countries, in part due to the relatively low costs of the large New Zealand banks. It is possible that an enduring structural issue, such as weak competition between the large banks, may be allowing excess profits to persist (referred to as ongoing supernormal profits in this report).

The assessment of windfall profits involves subjective judgements, but should take into account the scale of owners' investments in the firm

Windfall profits are a form of temporary excess profit that arise from an extraordinary external event (rather than an enduring structural issue) that the firm is not responsible for (i.e. the firm did not anticipate the event, and the firm's actions did not contribute to the windfall profit). There is no standard definition of windfall profits, but it often carries connotations of being unearned or undeserved. In practice distinguishing between windfall and non-windfall profits is difficult because it involves subjective judgements about the degree to which a firm anticipated the event, and whether profits were appropriate compensation for risk.

In Treasury's view, the extent of windfall profits should be primarily assessed based on whether the owners of the firm have made excessive returns on their investment. Relative measures of profitability, such as return on equity or assets, are better indicators of profitability as they account for the size of the firm (e.g. the assets employed, and the equity invested). Rather than representing a windfall, an increase in the nominal profits of a firm could result from an increase in the general price level, increased volume growth as a result of rising customer incomes or wealth, or larger investments in the firm exposing owners to greater risks.

Banks' profits were likely supported by favourable economic conditions arising from the fiscal and monetary response to the COVID-19 crisis, but there is no clear evidence of windfall profits

Bank profits have increased in dollar terms since the early pandemic period (early 2020), driven by the improving economic outlook allowing banks to reduce provisions for impaired losses, elevated inflation, loan volume growth, and widening net interest margins. However, we have not identified clear evidence for windfall profits, on top of the sectors usual elevated level of profitability, given that the profitability of the banking sector relative to its size (return on equity or assets) is around pre-pandemic levels and is not exceptional relative to typical levels in recent decades.

If windfall profits existed, they were not large enough to be apparent in sector-level profitability measures or were offset by confounding factors that lowered profitability.

We also looked at whether banks may have made windfall profits in relation to specific potential aspects of the COVID-19 fiscal and monetary response, including from the reduction in impaired loan provisioning, the implementation of the additional monetary policy tools, increased credit demand, and widening average net interest margins. While banks' profitability was likely supported by the generally favourable economic conditions generated by the COVID-19 fiscal and monetary response, this was also the case for other sectors, and it is difficult to disentangle the impact on bank profits from any specific fiscal or monetary policy.

We do not recommend a windfall tax in the banking sector given risks to confidence in the certainty and predictability of the tax system and the effectiveness of future monetary and fiscal policy responses to economic crises

Due to the risk of unintended consequences from introducing a tax on windfall profits, we do not believe there is sufficient justification to recommend a windfall tax. A windfall tax may undermine confidence in the certainty and predictability of the tax system, with potential flow on impacts on investment decisions and long-term economic growth and wellbeing. The incidence of a windfall tax is subject to elevated uncertainty, and there is a risk that the costs are borne by depositors and borrowers rather than shareholders. Moreover, applying a windfall tax on profits arising from the growth in bank lending risks undermining the effectiveness of monetary and fiscal policy responses at influencing credit conditions and growth in future crises.

You have two main options if you wished to pursue a windfall tax on bank profits

We have identified two potential options, being:

a	a one-off levy applied to windfall profits as assessed in prior periods; or

b	a temporary top-up of the corporate tax rate.

Both of these options carry risks, and we have not expressed a preference for which would be the preferred approach at this stage. There are several factors that would need to be weighed against either potential option, on which we can provide further advice. There are alternative options if you were interested in more permanent increases in the effective tax rate applied to the banking sector.

There is limited evidence of windfall profits in other sectors, and a windfall tax on those sectors also has significant downsides to confidence in the certainty and predictability of the tax system and the Governments wellbeing objectives in those sectors

Other sectors may have experienced windfall profits. Our initial review suggests that sectors most likely to have experienced windfall profits where there is the strongest likelihood of these gains targeting the relevant sectors may have undesirable consequences for the Government's wider wellbeing objectives.

Next steps

If Ministers wish to progress a windfall tax on the banking sector, we will report back with more detail on the design of the two tax options outlined in this report. This would include more extensive consultation with Inland Revenue on the administrative complexities of implementation, and mechanisms of applying the tax.

If Ministers wish to investigate ongoing supernormal profits in the banking sector, we recommend you discuss initiating a Commerce Commission-led market study into the banking sector with the Minister of Commerce and Consumer Affairs. A market study would be the best avenue to identify the cause of, and solutions to, any enduring competition issues that may be allowing ongoing supernormal profits, but it would need to be weighed against other candidates for a market study. Following the findings of that report (expected to take 18 months from when it is initiated), we can investigate tax measures that better target the factors of ongoing supernormal profits.

Recommended Action

We recommend that you:

a **note** the large New Zealand banks have persistently elevated levels of profitability relative to comparator banks in other countries which may indicate enduring excess profits (i.e. ongoing supernormal profits).

b **note** banking sector profits were likely supported by favourable economic conditions arising from the fiscal and monetary response to the COVID-19 crisis, as were other sectors, but we have not identified clear evidence for windfall profits (i.e. temporary excess profits) above the sector's persistently elevated levels of profitability given:

- the profitability of the sector relative to its size (return on equity or assets) is around pre-pandemic levels, and
- it is difficult to disentangle the impact of specific fiscal or monetary policies on bank profits.

c **note** that, although the assessment involves subjective judgements, there is no clear evidence that banks made windfall profits during the recovery from COVID-19, on top of their usual elevated level of profitability

d **note** we do not recommend a windfall tax in the banking sector given the risks to confidence in the certainty and predictability of the tax system, the possibility of the tax burden being borne by bank customers, and the effectiveness of future monetary and fiscal policy responses to economic crises.

EITHER

e **Agree** to not progress work on a windfall tax on bank profits.

Agree / disagree

OR

f **Direct** officials to report to you with detailed options for a windfall tax on bank profits to be progressed for announcement at Budget 2023.

Yes / no

g **Refer** this report to the Minister of Revenue.

Yes / no

Stephen Bond
Manager, Tax Strategy

Hon Grant Robertson
Minister of Finance

_____/_____/_______

Treasury Report: Project Cricket

Purpose of Report

1. You have requested advice on the extent of any windfall and supernormal profits experienced by the New Zealand banking sector. You have also requested advice on whether a one-off tax measure could be used to respond to windfall profits. Within this report, officials have outlined:

   a the extent to which the New Zealand banking sector continues to experience supernormal profits (page 5);

   b the extent to which the New Zealand banking sector has experienced windfall profits (page 8);

   c potential tax responses to windfall profits within the New Zealand banking sector (page 10);

   d initial indicative views as to whether other sectors have experienced windfall profits (page 16).

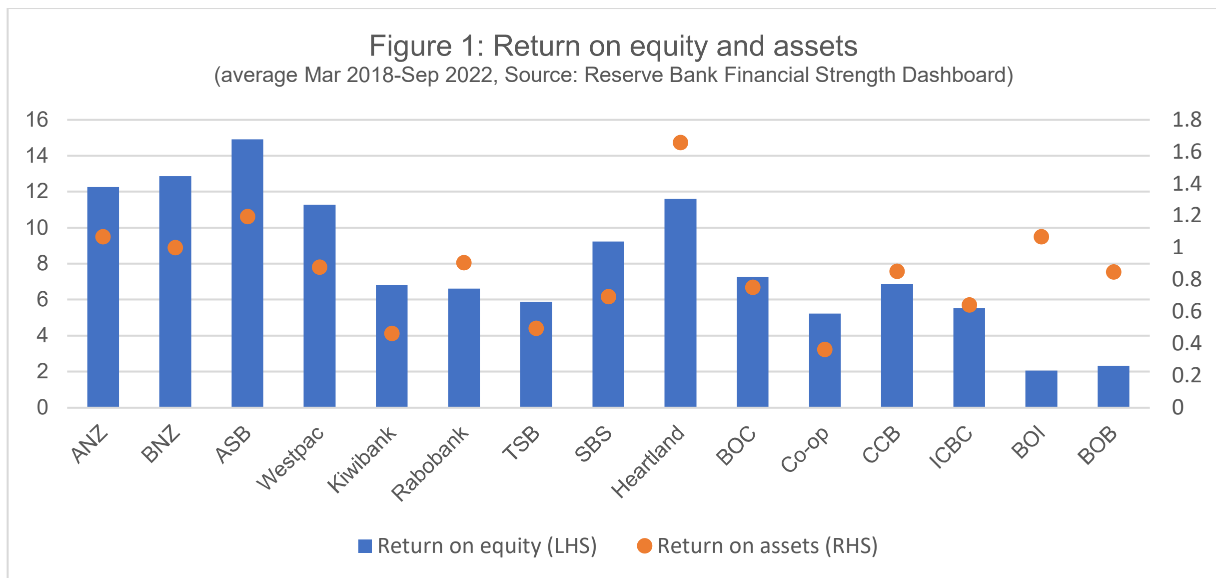
2. Based on the findings of this report, you may wish to direct officials to commence detailed design work on a tax response to windfall profits. If this is the case, the findings of this report will inform the design of that response.

3. Alternatively, you could direct officials to conduct additional research into specific issues identified in the report. In this case, the findings of this report will provide scope for any additional research, and whether alternative responses may be necessary.

Supernormal Profits in the New Zealand Banking Sector

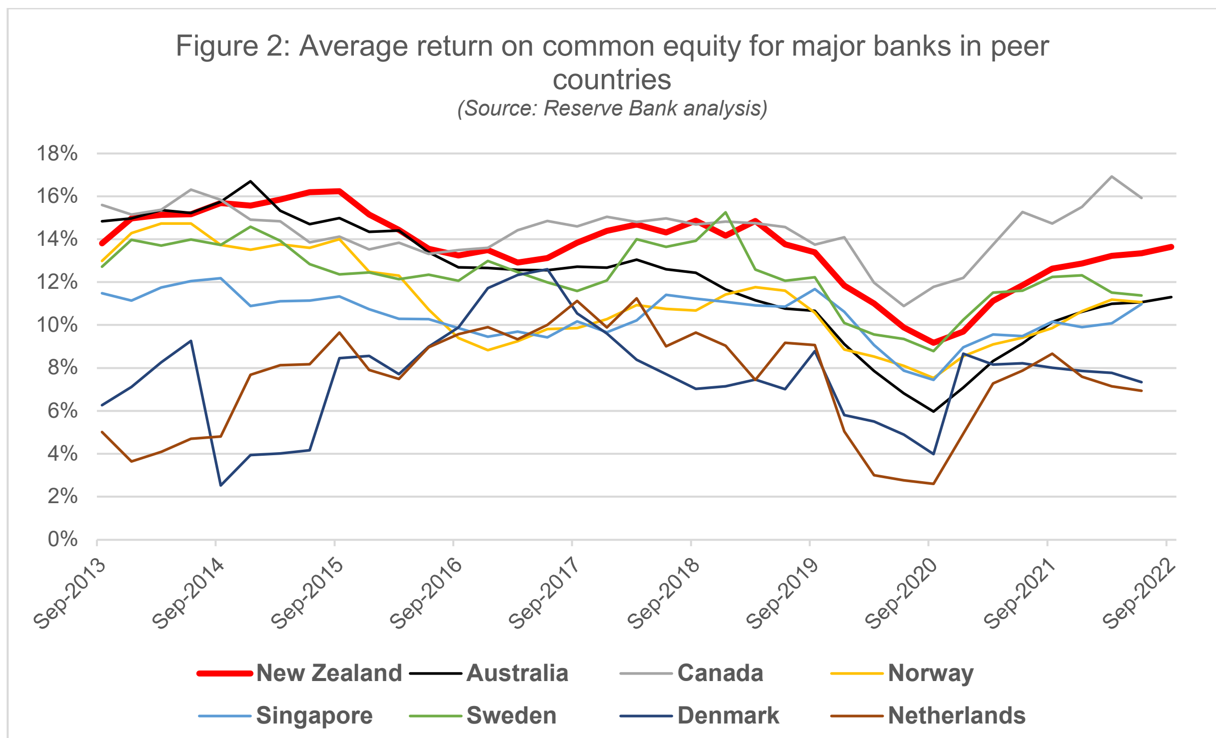
4. The New Zealand banking sector is made up of four main banks (ANZ, BNZ, ASB, and Westpac), referred to as the large New Zealand banks in this report, and several significantly smaller banks, including Kiwibank, Rabobank, TSB, SBS, and Heartland Bank. The four large New Zealand banks account for around 84% of total assets held by New Zealand-registered banks.

5. The large New Zealand banks have had persistently elevated levels of profitability compared to the rest of the banking sector, measured by return on equity and return on assets.

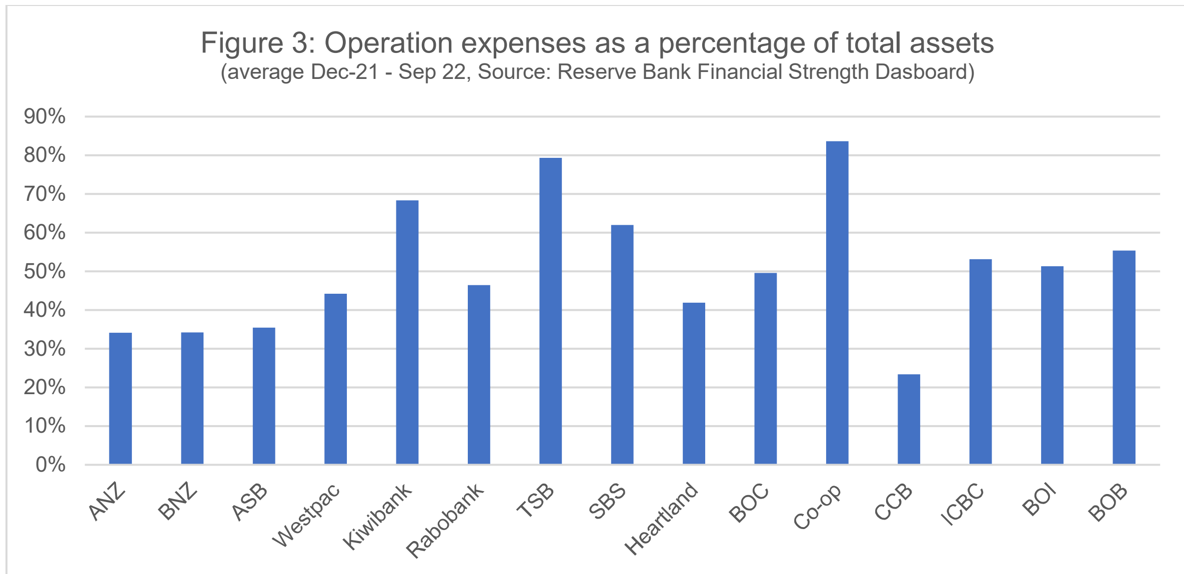


6. The large New Zealand banks are also relatively more profitable than key international comparators. Reserve Bank analysis for the period 2016-2022 found the large New Zealand banks' return on common equity was generally the second highest of the comparator group, after Canada.

7. The Reserve Bank 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.



8. The large New Zealand banks lower costs may be due to economies of scale (in comparison to the small New Zealand banks) and cost-savings derived from being the subsidiary of a larger banking group. New Zealand is the only country within the comparator group assessed by the Reserve Bank where all the large banks are subsidiaries of larger banking group businesses.



How do the large New Zealand banks generate persistently elevated profits relative to their international peers? Are the large New Zealand banks making supernormal profits?

9. Excess or supernormal profits are defined as profits above the level that would be expected in a workably competitive market. In a competitive market, an efficient firm would achieve profits that, after covering its costs, are sufficient to compensate the providers of debt and equity capital. The ability of firms to persistently generate supernormal profits is often constrained in competitive markets by new players entering and innovating, driving out excess returns, while firms that are operationally inefficient or unable to innovate lose market share until they are no longer viable or are purchased by the owners of more efficient firms.

10. It is unclear why the large New Zealand banks' relatively elevated profitability has not been eroded by competition between the large New Zealand banks (i.e. why haven't the large banks' relatively low costs driven interest rate margins and fees down further?). One possibility is that the large banks' profits are not supernormal, if current levels of profitability are necessary to compensate the providers of equity for an elevated risk premium associated with general New Zealand equity investments. Credit reporting agencies note the large New Zealand banks would have credit ratings 2-3 notches lower if not for the expectation of financial support from their parent bank. The parent bank, therefore, may require a higher return on their New Zealand banking operations to compensate for the higher risk.[1]

[1] Another possible driver of persistently high profitability for large New Zealand banks is disproportionate risk-taking (high leverage) relative to international peers that is possible due to unpriced, implicit government support. However, some degree of unpriced implicit government support also likely to exist for the large banks in comparator countries, which does not explain New Zealand's disproportionate standing. Implementation of the RBNZ's higher capital levels and the depositor compensation scheme may reduce the contribution of this to profitability over time.

Previous research has found mixed evidence of banking sector competition

11. In 2018 a Treasury review of the banking sector found mixed evidence on the level of competition. On the information available, we concluded that there did not appear to be significant issues with a lack of competition. For example, there were not any significant concerns about anti-competitive conduct in the banking sector, barriers to entry were considered low, and bank customer satisfaction was relatively high in New Zealand. However, the report noted that the sector is relatively concentrated in four large banks, measures of banking innovation were trending downward, customer switching was lower than in the past, and it was considered possible that large, well-resourced banks may not to enter the retail banking market due to New Zealand's relatively small size.

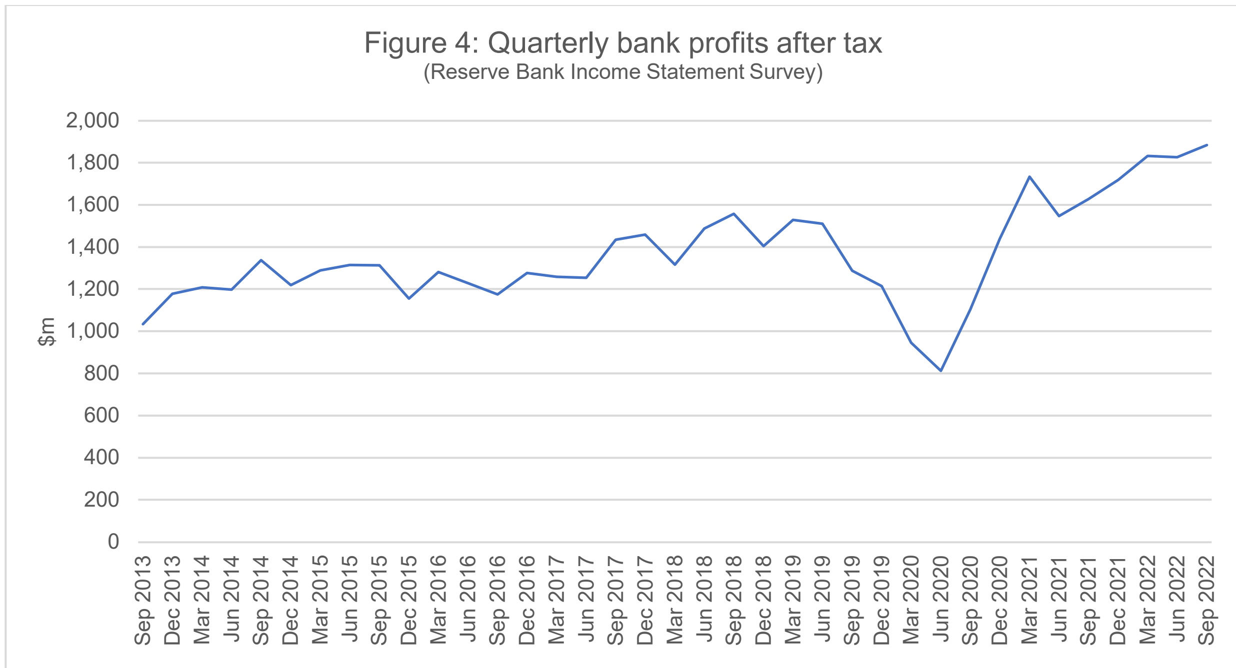
12. Conclusive findings have not been possible without more extensive research and investigation, including information obtained internally from banks about their profitability drivers, and the competition practices between the major banks.

Windfall Profits in the New Zealand Banking Sector

13. Windfall profits are a temporary excess profit that arises from an extraordinary external event (rather than an ongoing structural issue like weak competition) that the firm is not responsible for (i.e. the firm did not anticipate the event, and the firm's actions did not contribute to the windfall profit). As such, windfall profits draw connotations of being unearned or undeserved. For example, an increase in a firm's profits due to an unanticipated increase in extractive prices may be described as a windfall profit, whereas profits arising from productivity gains from an investment would generally not. However, there is no standard definition of windfall profits. In practice distinguishing between windfall and non-windfall profits is difficult because it involves subjective judgements about the degree to which a firm anticipated the event, and whether profits were appropriate compensation for risk.

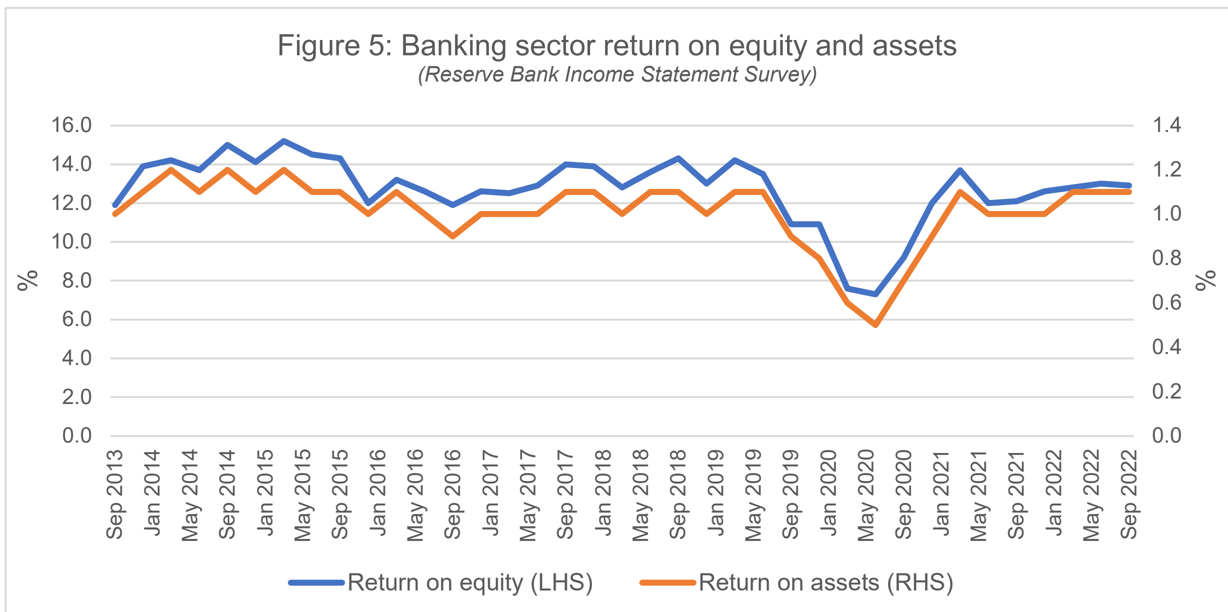
The strong economic recovery from the early pandemic period, accompanied by strong demand for lending and high inflation, has seen bank assets grow, leading to a rise in the dollar value of profits

14. Bank profits have increased in dollar terms since the early pandemic period (early 2020). Nominal bank profits in the September 2022 quarter were the highest on record (since 1991) and reflect an ongoing upward trend in nominal profits over the past three decades.



15. In Treasury's view, the extent of windfall profits should be primarily assessed based on whether the owners of the firm have made excessive returns on their investment. Relative measures of profitability, such as return on equity or assets, are better indicators of profitability as they account for the size of the firm (e.g. the assets employed, and the equity invested). Rather than representing a windfall, an increase in the nominal profits of a firm could result from an increase in the general price level, increased volume growth as a result of rising customer incomes or wealth, or larger investments in the firm exposing owners to greater risks.

16. Banking sector profitability, when measured by return on equity and return on assets, fell during the early pandemic period but has returned to near average for the period 2013-2022. While nominal profits have increased recently, banking sector equity and assets have also increased, meaning relative returns remain around pre-pandemic levels. Equity and assets increased as banks have been increasing capital in anticipation of the Reserve Bank increasing regulatory requirements. The fall, and then recovery, in the return on equity and assets for the large New Zealand banks over 2020-2022 is consistent with international peers (see figure 2 above on average return on common equity for major banks in peer countries).



Possible specific arguments for windfall profits in the banking sector

17. We also looked at whether banks may have made windfall profits in relation to specific aspects of the COVID-19 fiscal and monetary response, including from the reduction in impaired loan provisioning, the implementation of the alternative monetary policy tools, growth in bank loans due to increased loan demand, and widening average net interest margins. Profits from these events may not show up in the sector-level profitability measure if:

    a the windfall profits are too small to materially affect quarterly sector-level return on equity, or

    b the windfall profits are offset by reduced profits in another segment of the banking sector (e.g. agricultural lending) or other banking businesses (e.g. smaller banks).

18. The main potential arguments we have identified for windfall profits, and our assessment on whether they are a windfall profit, are summarised below. Further information is set out in Annex 1.

    a Lower than expected impaired losses in 2020 due to the improved economic outlook in late 2020 and 2021 are arguably not a windfall profit because the majority of loans on issue during the early pandemic period had been issued *before* March 2020. This means the improving economic outlook in 2021 would have *restored* some of the profitability banks had anticipated at the time they issued the loans (i.e. the improved economic outlook softened the windfall *loss* from the pandemic).

    b There is not sufficient information to draw firm conclusions about the degree to which alternative monetary policy (Large Scale Asset Purchases (LSAP) and the Funding for Lending Programme (FLP) contributed to bank profits. The extent of any windfall profits from LSAP depends on whether banks changed their balance sheet structures to benefit from rising interest rates, taking on interest rate risk (i.e. risk of losses if interest rates fell). Regarding the FLP, as a subsidy for lending, it likely supported bank profitability, but it appears there was a reasonable degree of pass-through of lower lending costs to borrowers.

    c While the COVID-19 fiscal and monetary response likely supported increased loan volumes, increased loan volumes have not translated into returns on assets or equity above pre-pandemic levels. In addition, total bank lending as a proportion of GDP is also roughly equivalent to pre-pandemic levels suggesting bank lending has grown largely in line with the wider economy.

    d Increased net interest margins due to the rising interest rate environment from the second half of 2021 has likely supported bank profits but we expect this to be temporary as depositors shift their money from low or zero interest transactional accounts to higher interest term deposits in response to higher interest rates.

19. Overall, while bank profitability was likely supported by favourable economic conditions created by the COVID-19 fiscal and monetary response, it is difficult to disentangle the impact on bank profits from any specific fiscal or monetary policy, and the broader economic conditions that benefitted many sectors. Further investigation of the drivers of increasing net interest margins and the impact of the LSAP would be needed to draw clear findings of windfall profits.

20. We have identified two potential options if you wish to consider a tax on any windfall profits in the banking sector, being:

    a a one-off levy applied to windfall profits as assessed in prior periods; or

    b a temporary top-up of the corporate tax rate.

21. The costs and benefits of these options are assessed below, but both options carry significant risks. In the absence of clear windfall profits, a windfall tax may undermine confidence in the certainty and predictability of the tax system, with potential flow on impacts on investment decisions and long-term economic growth and wellbeing. Additionally, the favourable conditions for bank lending, and the associated lending growth was one of the intended channels through which monetary and fiscal policy supported the economic recovery from the COVID-19 crisis. Applying a windfall tax on profits arising from the growth in bank lending risks undermining the effectiveness of monetary and fiscal policy responses at influencing credit conditions and growth in future crises.

22. Overall, we do not recommend a windfall tax in the banking sector given risks to confidence in the certainty and predictability of the tax system and the effectiveness of future monetary and fiscal policy responses to economic crises.

23. If you wish to proceed with a windfall tax, we will provide further information on both options. We have not made a recommendation between these options at this stage. Option one (one-off levy) better targets windfall gains, but in the absence of clear evidence of those gains, it will be difficult to design in a way that is meaningfully targeted. However, a one-off levy design has lower administrative implications compared to an adjustment to the annual income tax rate for a very small subset of taxpayers.

24. In contrast, option two would treat all income earnt as having a windfall component, though it could be narrowed to a specific subset of banks over a certain income threshold. This approach intentionally abandons targeting windfall gains in favour of a more simplistic design. However, this design would require additional work to determine the secondary impacts on broader tax administration – which may be significant depending on final design decisions.

Definition of a windfall tax

25. As discussed in the earlier sections of this report, windfall profits are an increase in profits that arise from an unanticipated, extraordinary and external event. A windfall tax is a tax that is levied specifically on profits that can be attributed to those windfall profits. Typically, these are one-off taxes that are imposed retrospectively, and often take the form of a levy; being a charge on a taxpayer that is above and beyond their normal tax obligations.

26. Windfall taxes are distinct from similar taxes that target specific industries. For example, officials note that various jurisdictions impose taxes on banking sectors where the stated intention is to extract some of the sectors apparent ongoing supernormal profits.

Option one - Year-on-year profit levy

27. A levy on year-on-year profits directly targets one-off windfall profit events by comparing the assessment year against the prior year (or an average of prior years). Where profits have grown by a proportion greater than an implied natural rate of growth, that growth would be deemed to be a result of a "windfall" event and would be levied at a special rate.

28. In the New Zealand banking sector this could take the form of a levy on the net reported profit as stated for a given income year. The reported growth in profit over the period would then be compared against a predetermined implied natural rate of growth for profits in the banking sector (e.g., 5%). For example, a bank that had experienced profit growth of 9% for the year would be levied on the difference between the actual profit growth and the implied natural rate of profit growth (i.e., 4%).

29. Recent international comparisons include:

    a *Netherlands* – a special levy of 33% is imposed on "excess profits" earned by energy producers in the year ended 2023; being net profit that is more than 20% above the average level of net profit in the 2018 – 2021 years.

    b *The Czech Republic* – a special levy of 60% is imposed on the difference between net profits earned by energy producers in the year ended 2023, and net profits averaged across the prior five years.

30. Of note is that both examples were introduced in response to European energy producers experiencing relatively clearer windfall profits due to the war in Ukraine and subsequent supply disruptions. While the cause and severity of windfall profits in the New Zealand banking sector are not directly comparable, officials consider the core design could be replicable.

31. Additional work would be required to appropriately set the rate of growth over which the levy would be collected. As discussed in prior sections, it is not clear that recent growth is as a result of a windfall event. Therefore, setting that rate too low risks capturing non-windfall growth; effectively penalising the banking sector for its risk-weighted profit-making decisions. Additionally, setting the rate too high risks collecting a minimal amount of revenue and making the levy redundant.

32. Officials also recommend that the design use average growth over various prior years, as opposed to a direct year-on-year comparison. As evidenced in the sections above, COVID had a significant distortionary impact on growth margins, and measuring from that depressed position may attract significant criticism as an artificial measure of growth. As such, officials recommend any design specifically exclude the COVID period to best model growth under more normal conditions.

33. Overall, officials consider that there would be significant complexities in designing an effective year-on-year profit levy. Specifically, the balancing exercise needed to set the rate of growth over which the levy would apply would be complex and controversial. If this balance is not achieved, the negative economic impact of option one is likely to be significant.

Option two - Top-up of corporate tax rate

34. The second option is a top-up of the corporate tax rate applied to the net profit of banks who are considered to have experienced a windfall gain. Unlike option one no comparison is made to prior periods to determine a natural rate of growth, and instead the top-up tax is levied on the entirety of the net profit reported for the period.

35. For example, when a bank has reported a net profit of $1b for the 2021/22 income year, that bank would have a normal income tax obligation of $280m. A top-up windfall rate of 5% would generate an additional $50m tax obligation for the bank.

36. It would be possible to design the levy to only apply to the largest banks on an income threshold basis. This may be desirable if there were concerns with levying smaller banks, or an expectation that only the largest banks operating in New Zealand had experienced a windfall gain.

37. Option two would likely be easier for officials to design than option one as it would apply to the entirety of a bank's net profit and would not need to account for the differences in rates of growth between banks. However, officials would need to consider several factors to ensure the rate was commensurate to the average windfall profit experienced by the banking sector.

38. Recent international comparisons include:

    a *The United Kingdom* – two recent examples - an 8% (soon to be 3% for an effective 28% tax rate) top up of the corporate tax rate for banks, and a 25% top-up for oil, gas and energy companies to apply until "prices normalise"; initially intended until the 2025 year.

    b *Canada* – a one-off 15% levy on banks and insurers with profits over $1bn (CAD) for the 2021 tax year.

    c *Spain* – a one off-tax of 4.8% on the net income derived on interest and fees (but exclusive of other income types) in the 2019 financial year by banks with greater than €800m net income.

    d *Hungary* – a levy of 10% on net income in the 2022 year, and 8% levy in the 2023 year for all banks.

39. International evidence suggests that many comparable jurisdictions have favoured a windfall tax designed like option two. It is expected that these jurisdictions have also acknowledged the design complexity inherent in option one and have favoured a broader base response as a result. However, comparable jurisdictions do not have imputation regimes, which (in the New Zealand context) is expected to significantly complicate the detailed design process.

Assessment criteria for both options

40. Officials have considered both options below

Criteria	Assessment
Efficiency and Growth	International evidence suggests that windfall taxes, when applied retrospectively and as a one-off response to a specific event, are relatively non-distortionary. To the extent that impacted taxpayers understand the rationale for the tax, and that it will not be repeated (without similar circumstances), these taxpayers and their investors are unlikely to significantly alter their behaviour. This suggests that the proposals are unlikely to significantly negatively impact New Zealand's financial capital. Given the lack of evidence of windfall profits noted in earlier sections of this report, there is a risk that impacted taxpayers will not accept the rationale for imposing either option. In this case, these taxpayers may change their future behaviours in anticipation of other levies. Additionally, the introduction of either levy may have a downstream impact on the international competitiveness of the New Zealand banking sector and lower the availability of international capital. This could undermine the banks' role in safeguarding and building wealth and overall wellbeing.
Equity and Fairness	The fairness of a given windfall tax rests primarily on whether a clear windfall profit has been earned. As discussed in prior sections the evidence does not suggest a clear windfall profit event has occurred. As a result, the imposition of a windfall tax on the banking sector risks being viewed as arbitrary, and otherwise reduces the fairness of the tax system. Specifically, to the extent that increased bank profits are taxed more highly than other sectors that have also earned increased profits, this reduces the horizontal equity of the tax system.
Revenue Integrity	As one-off retrospective measures targeted at a small number of taxpayers, neither options come with any significant integrity concerns. However, revenue generated from the levy would be in one fiscal year only and should not be relied upon as a sustainable revenue base. If either of the options was made permanent, there may be significant integrity concerns that would need to be considered when designing the full proposal.
Fiscal impact	Either option would be fiscally positive, though exact modelling would be required if Ministers decided to progress either option. The fiscal impact would be highly dependent on the final design of a proposed levy.
Compliance and Administrative Cost	As a one-off levy, compliance costs should be relatively low for taxpayers. Inland Revenue officials have advised Treasury that, depending on the design of the levy, the administrative costs of option two are likely to be greater than option one.
Coherence	There are no significant coherence concerns to the extent that the levy is applied as a one-off and no other proposed measures are introduced.

Administrative complexities to be addressed

41. If Ministers wish to pursue a windfall tax, additional consideration will need to be given to the administrative impacts of that tax. Specifically, officials anticipate that either option will need to account for impacts on the imputation credit regime (i.e., will the levy give rise to imputation credits?) and the provisional tax regime (i.e., will the current year provisional tax obligation need to retrospectively account for the levy?).

42. If these and associated questions are not resolved before the implementation of a final design officials are concerned that adverse impacts on confidence in the tax system could be exacerbated. This is likely a greater concern under option two than under option one.

Recommendations

43. If Ministers decide to pursue a windfall tax on the banking sector, officials view the choice as between minimising negative impacts on confidence in the tax system and minimising negative impacts on the administrative coherence of the tax system.

44. Option two does not attempt to limit the levy based on a specific area of income growth. However, as a flat increase to the corporate tax rate for banks, the top-up tax does not limit itself to windfall gains explicitly; every dollar earned by affected taxpayers would be subject to the higher rate. This approach risks being considered arbitrary where affected taxpayers disagree that the entirety of their taxable profits are as a result of windfall events.

45. Officials consider it would be worthwhile pursuing a more targeted option if there was clear evidence that growth was (either partially or wholly) a result of windfall gains. In the absence of that evidence attempting to design a targeted tax is likely to be complex and may not result in a materially more equitable tax than the broader approach of option two. To the contrary, officials believe that a more targeted levy under option one is open to more criticism as it would be arbitrary if the selected target cannot be coherently explained by evidence.

46. Weighed against this, officials acknowledge that there are significant administrative complexities in adjusting the corporate tax rate per option two. Associated regimes such as the provisional tax and imputation systems will need to be carefully considered, with potential implications branching off further depending on decisions made. This will be complex for taxpayers to administer, and for officials to effectively design.

47. Inland Revenue anticipates that administering a change to the corporate tax rate for a limited number of taxpayers within their system will be significantly complex regardless of final design decisions. This complexity is minimised (though not altogether eliminated) by pursuing option one as a one-off levy would not have as many administrative interdependencies.

48. On the basis of the above, officials cannot, at this stage, make a recommendation between the options presented. If Minister wish to pursue a windfall tax under either option, officials can explore the associated costs in more detail.

49. Inland Revenue agrees with the conclusions and recommendations in this report and in particular does not recommend a tax on windfall profits in the banking sector. If Ministers seek to progress a windfall tax on the banking sector Inland Revenue recommends that, if designed as a one-off tax on a small number of banks, the proposal be integrated into existing income tax filing requirements as much as possible to minimise administrative costs.

Fiscal considerations

50. As officials have not designed a windfall tax at this stage, there is no reliable way to model the potential fiscal impact of any of the options contained in this paper. Officials anticipate that any revenue generated by a windfall tax is likely to be in the order of tens to several hundred million dollars, though this is highly variable depending on design decisions. This would also be a one-off sum if imposed as a one-off measure (as recommended below), and should not be expected beyond the year it is collected in.

Recommendation for retrospectivity and timing

51. Officials consider it important that the design of either levy be based on retrospective windfall profits to avoid income structuring that might otherwise occur. For example, if a levy were imposed on profits earned in the 2023/24 income year, it would be possible for affected taxpayers to shift profits to future years to avoid the additional tax obligation. If obligations were instead measured from prior income years taxpayers would be limited from structuring out of the levy, as these profits would already have been reported.

52. Additionally, officials recommend that either option be designed as a one-off measure. If continued for more than one income year officials would need to address several potential integrity concerns. If Ministers were to pursue a multi-year solution for banks, it is recommended that Ministers instead consider a flat corporate tax rate increase for banks. This would mitigate the integrity concerns with an indefinite windfall tax, although it would be a highly distortionary and inequitable approach once windfall profits decline.

53. Lastly, officials consider it necessary that, either the levy or the top-up tax rate, be due prospectively (i.e., due in the 2023/24 income year or later) so as not to have serious unanticipated cashflow impacts. If the tax obligation were due retrospectively the actual cost to the affected taxpayers will be increased and will have secondary impacts on their reporting obligations. Given the concerns raised on the introduction of a windfall tax generally, officials strongly recommend against retrospective tax payments.

Incidence of windfall taxation on banks

54. Officials can complete further analysis if Ministers wish to understand where the incidence of taxation will lie if a windfall tax is imposed. There is mixed evidence: for example, RBNZ research indicates banks passed through the benefits of the FLP programme (a lending subsidy to banks). However, the general incidence of company taxation is usually primarily on a combination of shareholders or employees. The incidence would likely be influenced to some extent by the competitiveness of the market, and therefore how much market power individual banks have in different markets. Furthermore, a windfall tax in the context of increasing bank capital requirements may also influence the incidence of the tax if banks were relying on retained earnings to build capital.

Possible responses to supernormal profits or competition concerns.

55. As noted above, there is some evidence ongoing supernormal profits are occurring within the banking sector – rather than one-off windfall profits.

56. If Ministers wish to investigate ongoing supernormal profits in the banking sector, we recommend you discuss initiating a Commerce Commission-led market study into the banking sector with the Minister of Commerce and Consumer Affairs. A Commerce Commission-led market study would have the resources, expertise and information acquisition powers to identify the cause of, and solutions to, any weak competition and elevated profitability in the banking sector. Similar studies in other countries (e.g. Australia) have yielded useful information in recent years. A banking sector market study would need to be weighed against other potential candidates for a market study.

57. Following the findings of that report (expected to take 18 months from when it is initiated), we can investigate tax measures that better target the factors of ongoing supernormal profits.

Additional Sectors Examined for Windfall Profits

58. Ministers have asked for advice on whether there are any other major sectors where further investigation of windfall profits might be warranted. Officials have previously examined changes in profitability for the energy, construction and aged-care sectors in an Aide Memoire provided 16 September 2022 (T2022/2068), and summarise those findings below in the context of windfall profitability:

    a *Energy sector* – profits in 2022 grew by 41% as compared to 2019, though this was driven in large part by one business. Excluding that outlier, the sector grew by 27%. Our research did not suggest clear evidence of windfall gains in the sector.

    b *Construction sector* - profits in 2022 grew by 36% as compared to 2019, with a large variance between profits (and losses) within that sector. To the extent that growth was experienced, it was driven by high demand for housing which could be viewed as a windfall event. However, as demand is now subsiding, many of these businesses will now be experiencing decreases of profitability and applying a windfall tax to this sector may have adverse impacts on the Government's broader wellbeing objectives.

    c *Aged-care sector* - profits in 2022 grew by 88% as compared to 2019, largely driven by a growing demand for aged residential care facilities increasing the fair-value movement of properties. Officials consider that this is a second-order symptom of rising housing prices, and could be considered a windfall gain, though the actual gain is as a result of capital gains which would not otherwise be taxable, and declining house prices may be unwinding recent windfall profits.

59. Additionally, officials note that there is some initial evidence that the agricultural sector may have derived windfall gains during and after the pandemic, though reviewing the extent of those gains would require a specific research project given the breadth and complexity of the sector in New Zealand.

60. If Ministers wish to examine a windfall tax in relation to any of these sectors additional research would be required. Officials note that they have not had sufficient time to comprehensively consider these sectors in this report, but initial views suggest that the windfall tax options considered in the section above could be applied without significant alterations.

Next Steps

61. Officials are available to discuss this report and its findings at your request.

62. If you wish to progress a windfall tax on the banking sector officials will require additional direction on the design of that proposal. Noting the various complexities inherent in that exercise, we request that you discuss your initial preferences with us ahead of any further commissioning.

63. If you wish to investigate ongoing supernormal profits in the banking sector, we recommend you discuss a Commerce Commission-led market study into the banking sector with the Minister of Commerce and Consumer Affairs'.

Annex 1: Detailed assessment of potential arguments for the existence of windfall profits in the banking sector

Did lower than expected impaired losses due to improved economic outlook in late 2020 through 2021 lead to windfall profits in the banking sector?

64. Nominal bank profitability fell significantly in 2020 as banks increased provisioning for impaired loans in anticipation of a pandemic-driven economic downturn. During the March to September 2020 quarters, the large banks added around $1.3b to provisioning for impaired assets.

65. The improving economic outlook from late 2020 through 2021 allowed banks to reduce their provisioning for losses, resulting in lower impairment expenses and increased profits. For the five quarters from December 2020 to December 2021, impaired asset expense for the large banks was *negative*, meaning revisions to estimated loan losses *added* around $336m to profits over the period. For comparison, impaired asset expenses for the large banks over the five quarters pre-pandemic (December 2018-December 2019) *reduced* profits by $390m. If underlying impaired asset expenses had remained at this level over December 2020 to December 2021, revisions to loan loss provisions (e.g. due to an improving economic outlook) would have contributed around $726m to profits over the period.

66. Whether the improved bank profits arising from lower provisioning for impaired asset expense are a windfall depends on whether the profits were anticipated (with corresponding actions taken to generate those profits).

67. The Treasury considers that bank profits arising from the improving economic outlook in 2021-2022 are not a windfall because at the point the loans were issued, those profits were anticipated. We think the point of loan issuance is the preferred starting point for assessing any windfall profits because origination decisions are the main action banks can take to manage impaired asset expenses. The majority of loans on issue during the early pandemic had been issued well *before* March 2020, meaning the improving economic outlook in 2021 would have *restored* some of the profitability banks had anticipated at the time they issued the loans. For the improvement in expected loan losses to be a windfall, the banks would have had to have anticipated the pandemic when originating the loans prior to March 2020.

68. In addition:

    a. The improved profitability in late 2020 through 2021 was not unique to the banking sector. The improved economic outlook in late 2020 benefitted many sectors of the economy.

    b. Loan loss provisioning is subject to significant revisions as estimates rely on economic forecasts and assumptions, which were particularly difficult during the pandemic crisis.

    c. Low losses in part reflected significant actions by banks to support their customers (businesses and households) through the pandemic, such as the COVID-19 mortgage deferral scheme. This approach was encouraged by Government and regulators.

Did alternative monetary policy during the pandemic lead to windfall profits in the banking sector? Were the benefits of alternative monetary policy not fully passed on to bank customers in the form of lower interest rates and fees?

Large Scale Asset Purchase Programme

69. The Reserve Bank implemented the Large Scale Asset Purchase (LSAP) programme in March 2020 to provide further support to the economy, build confidence, and keep interest rates on government bonds low. The LSAP programme involved the Reserve Bank purchasing New Zealand Government Bonds and Local Government Funding Agency Bonds on the secondary market, funded through the electronic creation of money and the crediting of banks' settlement accounts with the Reserve Bank. The LSAP programme results in:

    a Increased bank assets – the money created to pay for these purchases shows up as an asset to banks in their settlement accounts with the Reserve Bank, which receives a floating rate of the OCR in interest payments from the Reserve Bank. The LSAP increased bank settlement balances from an average of around $7.5 billion in the decade up to 2020 to around $50 billion in September 2022.

    b Increased bank liabilities – the proceeds from the sale of the bonds are deposited in the bank account of the seller of the bond, with these deposits being liabilities to the bank.

    c A switch in the type of assets held by the bank – if a bank is the seller of the bond, their asset mix changes as they've converted a long-term fixed interest asset (the bond) into a short-term floating interest asset (settlement cash).

70. From the perspective of the banks when executing a bond sale on behalf of a customer under the LSAP programme, it effectively created additional floating rate assets (their settlement balances with the Reserve Bank) and additional liabilities (in the form of deposits held by the seller of the bond) at an unknown rate, either a fixed term deposit or a floating on-call deposit or transactional account.

71. Rising interest rates have generated a loss on the LSAP transaction to the Crown, but a corresponding gain to those parties who shifted their net asset position away from long-term fixed low interest rate bearing assets. Because they weren't locked-in to low long-term fixed interest rates, those parties have benefitted from rising interest rates. . As advised in T2022/2562, our latest best estimate of the expected direct fiscal loss from LSAP is approximately $11.1 billion in higher interest payments.

72. There are three main ways in which the banks may have benefitted from the LSAP, being.

    a if the banks would have been holding low-interest, fixed-rate bonds if the Reserve Bank had not purchased them, and/or

    b if the banks materially shifted the structure of their assets and liabilities in anticipation of increasing floating interest rates on settlement cash balances (e.g. by increasing long-term fixed term deposits at the prevailing low interest rates).

    c if the banks did not fully pass-on the increased interest rate on settlement cash to customers in the form of higher deposit interest rates and lower fees, increasing the banks' net interest margin. The role of net interest margins in bank profitability is discussed in the next section.

73. While the Crown is paying around $11.1 billion more in higher interest rates, it is not clear who in the financial system is benefitting from it.

74. We note that you have received advice from the Reserve Bank on interest on settlement cash. We have not compared this option to the others identified in this report.

Funding for lending programme (FLP)

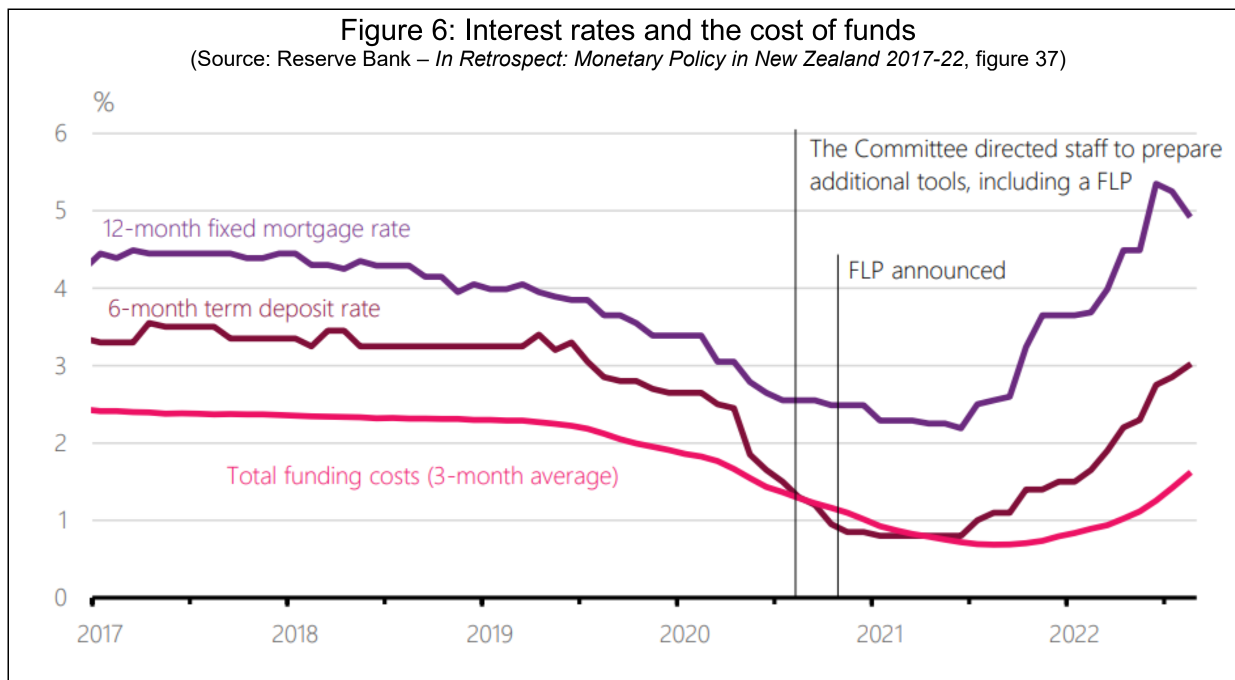
75. From December 2020 to December 2022, the Reserve Bank offered three-year funding to banks priced at the OCR in return for high quality collateral. The FLP was designed to provide monetary stimulus by reducing bank funding costs and retail interest rates.

76. In effect, the FLP was a subsidy to banks for lending (and one that wasn't available to lending market competitors such as non-bank deposit taking lenders). The FLP in effect guaranteed that relatively low-cost stable funding would be available to banks even if funding conditions worsened, and that guarantee reduced the need for banks to pay up for buffers of more expensive sources of long-term stable funding such as term deposits or wholesale funding (even in the absence of actual drawdowns).

77. A key question therefore is whether banks profited from the FLP by not passing on the benefit of lower funding costs to customers in the form of lower loan interest rates. Reserve Bank research estimated that the FLP caused six-month term-deposit rates to decline by 15 basis points and mortgage rates to fall by a similar amount following the FLP announcement. The Reserve Bank's recent review of monetary policy[2] noted "net interest margins on bank lending have remained around their historical level, consistent with ongoing pass-through of lower funding costs to lenders due to the FLP".

78. Any impacts of the FLP on bank profitability have likely begun declining as the expiry date of the programme approaches, meaning that banks need to start competing for retail deposits more again.

Figure 6: Interest rates and the cost of funds
(Source: Reserve Bank – *In Retrospect: Monetary Policy in New Zealand 2017-22*, figure 37)



Increased loan volumes due to monetary and fiscal stimulus during the pandemic

79. Bank lending growth was high from late 2020 to late 2021 compared to pre-pandemic lending growth (2017-2019) though not above the period of high credit growth in 2015-2016. According to the Reserve Bank's credit conditions survey, lending growth during this period was largely driven by high demand for residential mortgage loans. However,

[2] In Retrospect: Monetary Policy in New Zealand 2017-22

total bank lending as a proportion of GDP remains equivalent to pre-pandemic levels suggesting over bank lending has grown in line with the wider economy.

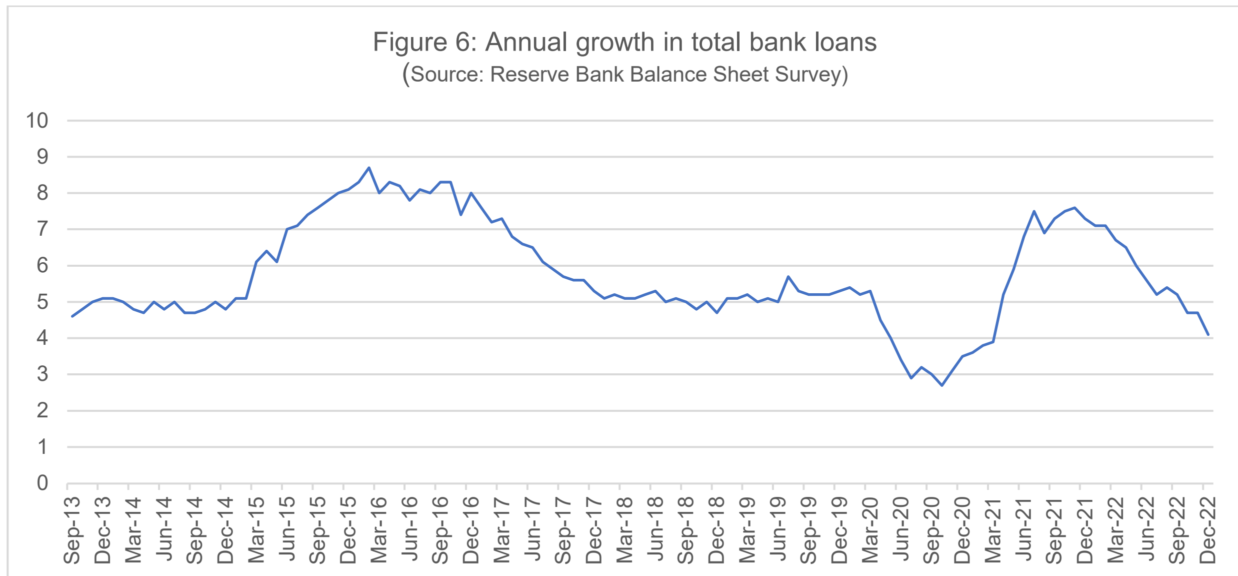


Figure 6: Annual growth in total bank loans
(Source: Reserve Bank Balance Sheet Survey)

80. Credit growth during the pandemic (2020 onwards) was driven by residential lending, in turn driven by low mortgage rates interacting with restricted housing supply. Business lending declined. Demand for credit is expected to moderate as the economy slows over the next year. In that context, policymakers are again looking to banks to support customers and avoid tightening the supply of credit in a way that would worsen the downturn.

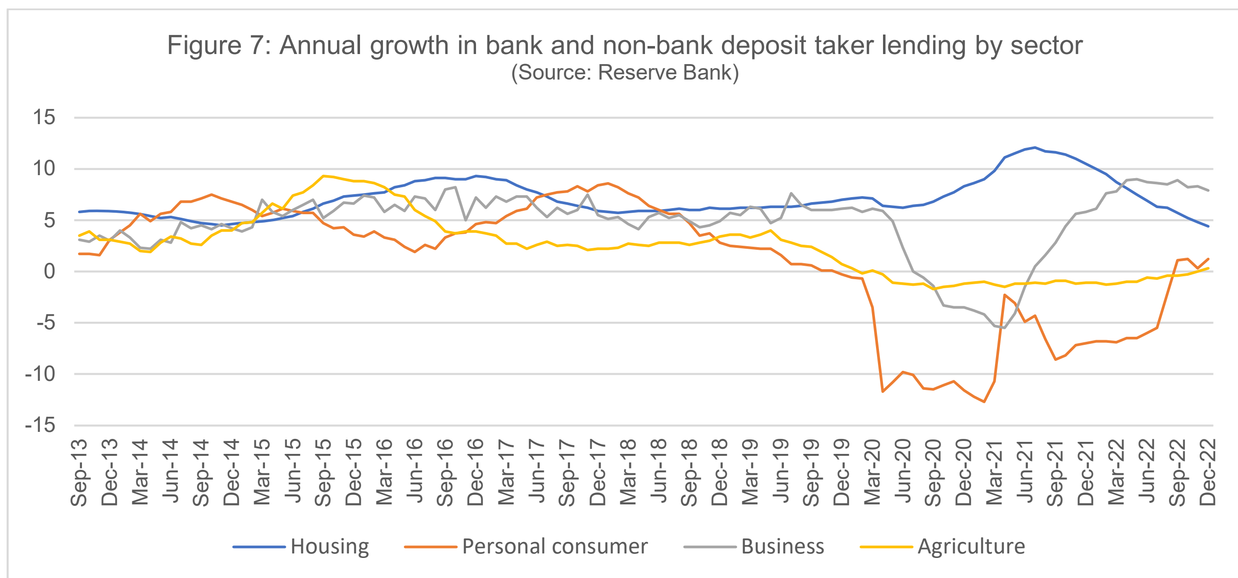


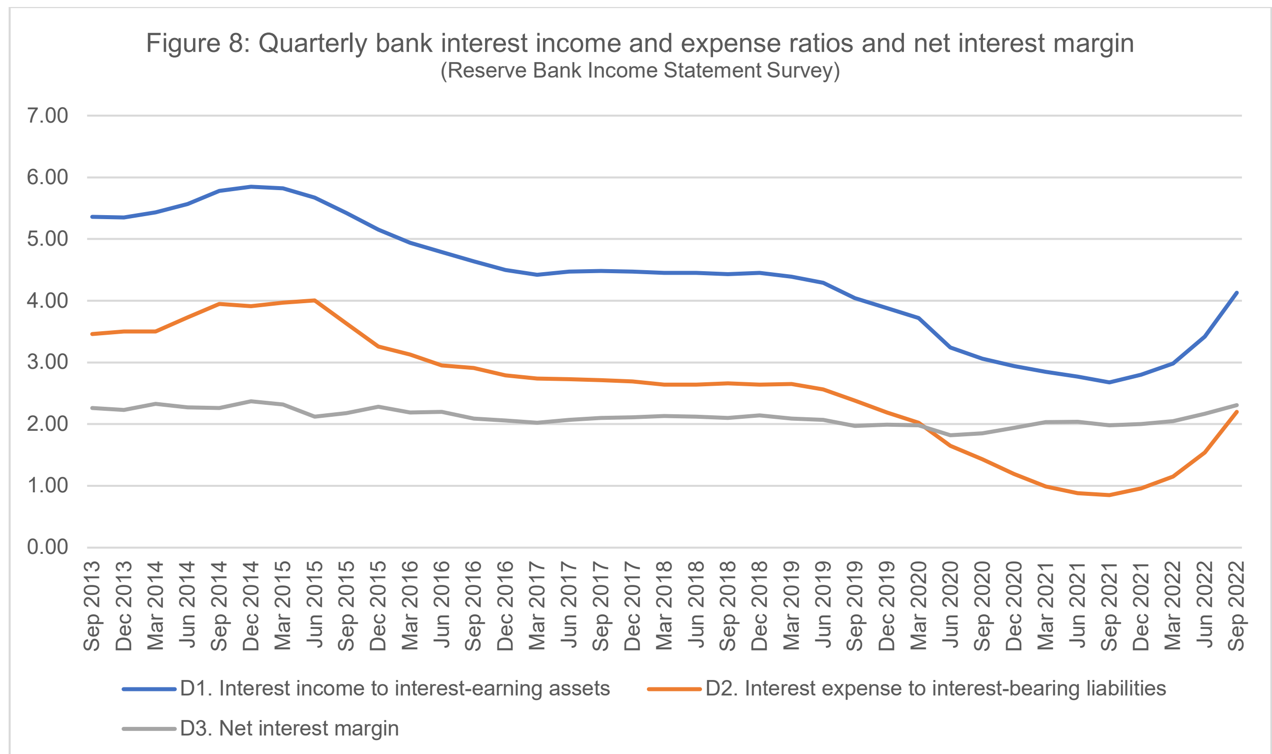
Figure 7: Annual growth in bank and non-bank deposit taker lending by sector
(Source: Reserve Bank)

Increasing net interest margins due to rising interest rates

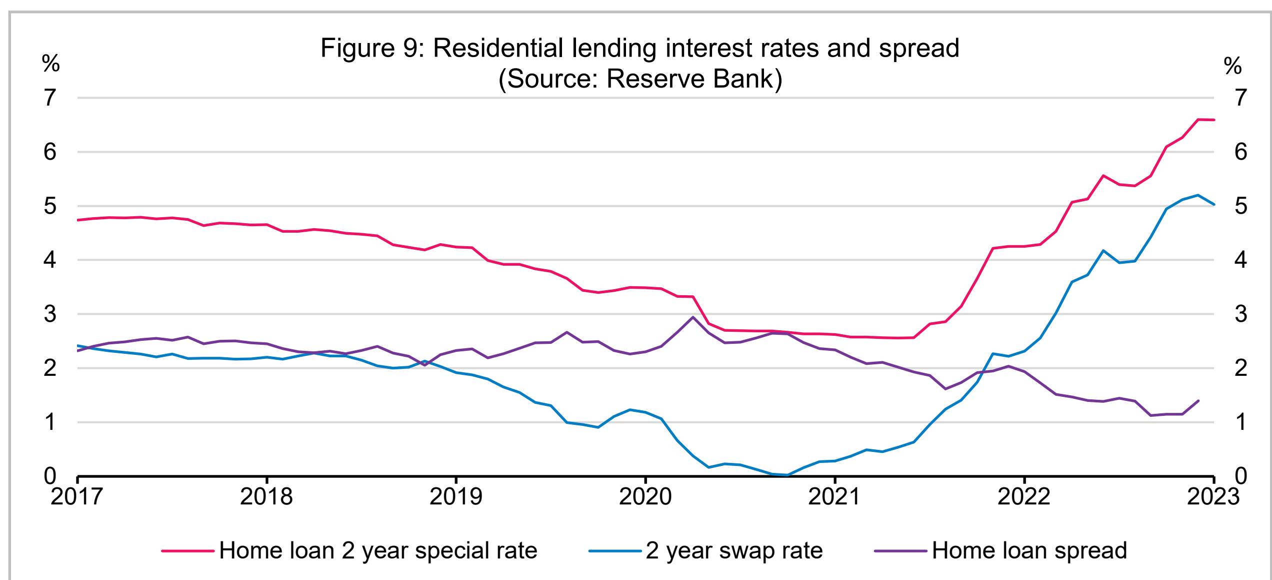
81. Rising interest rates can support net interest margins [3]. Because banks have significant amounts of transactional deposits earning low interest, sharp increases in interest rates often boost short-term profitability. This effect may have been amplified by higher liquid assets / settlement cash than is typical due to the LSAP programme.

[3] Net interest margin measures the difference between the interest income a bank makes on its lending and the cost of the funds used to finance that lending. NIM is therefore a key measure of how profitable a bank is at its core business of borrowing and lending.

82. Increasing net interest margins (NIM) since Sep 2021 explain some of the increases in profits, particularly for the June and September 2022 quarters for which the net interest margin was above recent averages.



83. Comparison of lending and term deposit rates relative to a benchmark for the cost of funds suggests recent increases in NIM are largely driven by lower term deposit rates. The indicative margins on new or repriced mortgages and business lending were relatively elevated in 2020 compared to wholesale interest rates but have fallen during 2022 (purple line below).



84. On the other hand, the margin on term deposits, which were previously relatively expensive for banks (a positive spread to wholesale funding, partly because term deposits support banks' liquidity/funding prudential requirements) improved over 2021 and 2022 (purple line below). We expect recent increases in NIM will be temporary as depositors shift from low or zero interest accounts to higher interest term deposits in response to higher interest rates. Moreover, sharp increases in interest rates will provide a strong incentive for borrowers to shift to the most competitive rates.