

**COMMENTS RECEIVED FROM INTERNATIONAL BANKS AND SECURITIES
ASSOCIATION OF AUSTRALIA (IBSA)**

**OECD REVISED DISCUSSION DRAFT ON THE ATTRIBUTION OF PROFITS TO
PERMANENT ESTABLISHMENTS - PART II (BANKS)**

1. Introduction

IBSA is the peak industry body for investment banks in Australia. All of our member banks have a significant international dimension to their operations, being foreign owned with subsidiaries or permanent establishments in Australia or domestic banks with overseas operations.

We welcome the opportunity to provide further input to the OECD's review of Article 7 of the Model Tax Convention on Income and Capital. We endorse the objective of securing an international consensus on the taxation of financial institutions that operate through PEs and appreciate the proactive consultative process adopted by the OECD. Our comments here supplement those made in our response to the February 2001 version of the Discussion Draft as it applies to banks and securities companies.

The current version of the Discussion Draft represents significant progress and, in this regard, we are grateful that it takes account of comments in our response to the original draft. There are a number of outstanding issues that we would like to provide further comment on, which we deal with below.

Our main conclusions are:

1. The OECD should adopt a consensus position that capital allocation to PEs should be based on a quasi-thin capitalisation approach that includes a safe harbour. This approach has been adopted and tested successfully in a competitive international banking environment through Australian domestic law. This position would align the approaches in Articles 7 and 9 of the OECD Convention.
2. Each asset should be attributed to the business unit in which it is booked, other than in exceptional circumstances, and assets should be booked to only one part of a bank (parent or PE).
3. The method for attributing capital to PEs of securities companies should be based on risk weighted assets, as it is the only practical way to effectively reflect business risks.

In addition, IBSA wishes to commend the Australian Bankers' Association (ABA) submission of 8 August 2003 to you, as it proficiently covers several important points, including the first two above.

2. General Comments

We wish to reiterate several points made in our response to the February 2001 version of the Discussion Draft that are still relevant. In brief these are:

- First, the proposal to split assets across PEs in different jurisdictions for tax purposes in paragraph 68 of the Discussion Draft is impractical. The ABA succinctly explains the nature of the significant administrative problems that would result in their August 2003 submission. A sounder approach would be to attribute each asset to the business unit in which it is booked, unless the substance of a transaction provides a compelling reason for tax authorities to adopt a different approach. An asset should be booked to only one business unit (parent or PE) and, if necessary, arms length compensation could then be attributed to other parts of the bank involved in the creation of the asset to achieve the appropriate tax balance.

The Discussion Draft accords greater importance to regulatory arbitrage than may be necessary for banks,¹ especially given the efforts of international agencies like Bank for International Settlements (eg the *Core Principles for Effective Supervision*), IMF and World Bank to promote sound standards for financial regulation.

- Second, the ‘BIS ratio’ method of capital allocation rests on the assumption of a common pool of capital to support a bank’s global operations. The corollary of this is that a bank’s cost of funds is derived from a common pool of funds, as the amount of debt and equity and their relative cost are interdependent. However, this gives rise to a conceptual inconsistency in the BIS ratio approach, as a PE’s interest expense for tax purposes is the amount actually borne by it and is not dependent of the global bank’s global cost of debt finance.²

In contrast, the thin capitalisation approach adopted in domestic Australian law provides an internally consistent model for taxing PEs that permits a reasonable allocation of capital to PEs and recognises interest expenses that are directly incurred by the PE.

- Third, the Discussion Draft focuses substantially on the assets side of a bank’s business and gives insufficient weight to liability management that is a key part of banking. For instance, the composition of deposit liabilities can be relevant to the level of capital required for regulatory purposes.

3. PE Creditworthiness

Assuming a Common Creditworthiness

The Discussion Draft states that a PE will *generally* have the same creditworthiness as the bank.³ This is correct but much of the subsequent analysis then effectively assumes PEs will *always* have the same credit rating as the bank and, thus, it does not achieve the right balance in its conclusions.

For instance paragraph 76 states that it is an “observable condition that a PE is treated in general as having the same creditworthiness as the bank”. However, it could equally be stated that it is an observable fact that many PEs do not have the same credit rating as their parent.

¹ Paragraph 37.

² One reason for this is differences in the business activities of a PE and its parent bank. For instance, bank PEs in Australia typically conduct only wholesale business, while often their parent banks have significant retail business too.

³ For example paragraphs 29 and 76.

In practice, global banks often obtain separate credit ratings for their overseas branches. For example, Deutsche Bank has ratings for its London, Sydney and Paris branches.⁴ This would not be necessary if PEs were automatically attributed the credit rating of their parent bank. In many cases, PEs are given the same credit rating as their parent entity (as in the Deutsche Bank example) but in many other cases they are not. For example, as we observed in our response to the February 2001 Discussion Draft, Citibank's global rating from Moody's was Aa2, but ratings for its branches in Chile, Argentina and Brazil were Baa1, B2 and B3, respectively.

Differences can occur within the OECD area as well as outside; for example, Moody's apply a global credit rating of Aaa to Rabobank, but the lower Australian sovereign ceiling of Aa2 would apply to the foreign currency liabilities of its Australian branch.

The rationale that Moody's provide for this stance, which is similar to Standard & Poors, is –

“Domestic branches of foreign banks are subject to local law and, as such, are subject to exchange controls, rescheduling, moratoria, and other forms of transfer risk. A depositor in such a branch may or may not be able to seek recourse to the bank's head office, which may or may not choose to honour its defaulting branch's obligations. We are not prepared to impute a head office guarantee in the absence of an explicit undertaking.”- *A Counterparty's Guide to Moody's Bank Ratings*, 1995.

The fact that sovereign credit ratings within the OECD area are less variable than those outside the area is insufficient reason to automatically attribute to a PE the same creditworthiness as its parent bank for two reasons. First, many OECD banks have PE operations outside the OECD area (especially in regional financial centres like Hong Kong). Second, it would be inappropriate to base the profit attribution policy on an “observable condition” that could change over time; that is, there could be greater variability of sovereign credit ratings in the OECD area in future years and the policy framework for profit attribution to PEs should automatically accommodate this and not be fixed in the current ratings structure.

Implications of a Common Credit Rating for PE Capital

The Discussion Draft acknowledges that factors other than capital such as reputation, management quality and risk diversification also effect creditworthiness. However, it goes on to say that it is hard to understand why these factors would be concentrated in one part of the enterprise.⁵ Thus, the rationale underpinning the analysis in the Draft appears to be:

1. PEs have the same creditworthiness as the parent bank (though, as discussed, this is not always the case in practice);
2. A bank's creditworthiness (or credit rating) is a function of several factors, one of which is capital:
$$\text{Creditworthiness} = f(\text{capital}, \text{management quality}, \text{reputation}, \text{etc})$$
3. Management quality, reputation etc are proportionately distributed throughout the bank (i.e. the parent bank and its PEs);
4. Therefore, it follows that capital must be distributed throughout the parent bank and PEs in direct proportion to the risks held in a given location.

⁴ All reference to credit ratings in this submission are taken from Moody's Credit Opinions, Financial Institutions, September 2000.

⁵ Paragraph 77.

This line of reasoning does not accurately reflect the nature of global banking.

Factors that credit rating agencies build into their credit rating assessment include capital and ‘non-capital’ items such as economic and industry risk, funding composition, management and strategy, earnings and market position, amongst many others.⁶ The ‘non-capital’ factors are very important to a bank’s credit rating and credit rating agencies explicitly warn against assuming that capital and credit rating are closely correlated for a bank.

“One common misconception is that the higher the level of capital the stronger the bank, regulatory solvency being considered as the defining factor for bank safety. This however is an analytical shortcut that most often leads nowhere and in fact has repeatedly proven to be wrong.....

Moody’s sees no automatic correlation between a bank’s level of regulatory capital and its credit ratings. Any additions or subtractions from equity, in and of themselves, should not trigger automatically rating actions.”

Rating Methodology, Bank Credit Risk (An Analytical Framework for Banks in Developed Markets), Moody’s Investors Services, April 1999.

As the Discussion Draft suggests, it would be unusual for the ‘non-capital’ factors in the credit rating function to be concentrated in one part of a bank’s global operation (e.g. head office). However, we believe that it is just as unlikely that these elements would be distributed across the entity in proportion to risk-weighted assets.

This has significant implications in the context of the Discussion Draft, as if the non-capital factors are not proportionately distributed across an entity, then the assumption of a proportionate distribution of capital across a parent bank and its ‘distinct and separate enterprise’ PEs would give an incorrect reflex of the entity’s business for tax purposes.

A brief review of important ‘non-capital’ factors reveals they typically vary across jurisdictions:

- Economic and industry risk – Matters like macroeconomic performance, the stability and maturity of the banking sector, quality of regulation etc that affect financial institution risk are largely specific to individual jurisdictions;
- Funding composition – This varies between retail banks and wholesale operations. PEs are more prevalent in wholesale markets where greater reliance is placed on the professional markets that are most sensitive to credit ratings;
- Management and strategy – The efficiency, quality and depth of management varies across global organisations, with many global operating regional management units and centres of excellence (as recognised elsewhere in the Discussion Draft);
- Earnings – Interest margins and fees depend in part to the degree of competition in a market and its maturity, each of which are known to vary across jurisdictions, so it cannot be assumed that the institutional business conditions faced by the PE and its parent bank are always the same.
- Market position – The market share and pricing power of a bank will vary across its global operations, with banks often relatively strongest in their home market.

⁶ In this context, we note that credit ratings agencies look to quantity and quality of capital, but the Discussion Draft analysis considers only the quantity factor. That is, the Discussion Draft does not consider other factors, like the ability to raise additional capital that ratings agencies consider when making their creditworthiness assessments.

Therefore, though the line of analysis adopted in the Discussion Draft is sufficient as a first step in the attribution of capital to a PE, it should not be taken as the end point of the analysis that is required to give the right answer for tax purposes. Even if the analytical convenience of a common credit rating could be assumed (as we agree it can be in many cases), it does not automatically translate into the proportionate distribution of capital across the entity.

In short, this suggests that the ‘BIS ratio’ approach should not be adopted, at least without modification for the ‘non-capital’ factors that help to determine an entity’s creditworthiness. The Discussion Draft acknowledges that a range of factors may require an adjustment of the BIS ratio approach (paragraphs 98 and 99), but it tends to treat these circumstances as more the exception than the norm. In contrast, we think it likely that the specifics of a PE’s business, the nature of the banking sector within which it operates and the local economy will regularly be a factor in the allocation of capital to PEs.⁷

Recent Australian experience in the development of new PE capital allocation rules bears this out. The BIS ratio model was initially considered for capital allocation to PEs but it did not always deliver sensible results, so an alternative approach eventually had to be taken.

Problems encountered in applying the BIS ratio method in Australia included:

- It was widely acknowledged that the BIS ratio method would have attributed an unrealistically high level of capital to several PEs – a level that would have materially harmed their competitive position. The most competitive markets, like Australia’s, are most demanding in terms of efficient capital usage and banks that operate with significant ‘excess’ capital are disadvantaged. In effect, the BIS ratio method assumes all markets are equally competitive, whereas the institutional structure and intensity of competition in financial markets varies across both markets and jurisdictions.
- No mechanism exists to grant tax credits to a bank in a jurisdiction where it holds excess capital (that is, an amount greater than the BIS ratio method would require) and without this form of compensating adjustment banks would face double taxation.⁸
- The BIS ratio method assumes a common business and regulatory structure for a global bank and its PEs, which is not an accurate reflection of the Australian market place. Australia bank PEs are restricted to the wholesale market and operate with a quasi-guarantee in economic terms under the legislation governing the sector.⁹

⁷ Because of its focus on a bank’s assets, the Discussion Draft could be read to imply that banks’ deposit liabilities are homogeneous and, hence, there is no need to differentiate between them for capital allocation purposes. In practice, bank regulators do have regard to the nature of the deposit base and demand more capital of retail banks. For example, merchant banks in Australia have access to the wholesale deposit market only, because they are not required to hold a minimum level of regulatory capital for prudential purposes. Similarly, foreign bank PEs in Australia are not permitted to take retail deposits, largely because they are not required to have prudential capital on the ground in Australia. Therefore, it cannot be assumed that the capital requirement for each category of deposit will be the same. The analysis in paragraph 99 needs to be reconsidered in this context.

⁸ A PE that holds less capital than required for tax purposes would need capital allocated to it for tax purposes, or else lose some interest expense deductions. By definition, the parent bank would hold more capital than required and would need a tax credit for the excess amount.

⁹ Section 11F of the Banking Act 1959 effectively quarantines the Australian assets of a bank PE to meet its Australian liabilities. Thus, the PE has call on the assets of the global bank, with no *quid pro quo* until Australian liabilities are satisfied.

In addition, IBSA's experience is that the human capital available within a global bank is not spread evenly across the enterprise (in proportion to risk weighted assets). For instance, information from a variety of sources confirms that the Australian financial services workforce is highly skilled compared to most other jurisdictions.¹⁰ This is partly the reason why our members are a significant net exporter of personnel to overseas jurisdictions and some see Australia as a good training ground for their overseas staff. Also, the wholesale investment banking that PEs conduct is more of a 'people business' than retail banking, which is more process driven.

Thus, it is clear that the assumptions that must be satisfied for the BIS ratio method to work in the manner contemplated by the Discussion Draft are unlikely to adequately reflect the economic reality of global banking. While the Discussion Draft correctly identifies credit ratings as a useful analytical tool for capital allocation, the BIS ratio method over-emphasises their value in this regard.

Our conclusion is that the OECD should not pursue the BIS ratio approach and should instead propose that capital allocation to PEs should be based on a quasi-thin capitalisation approach, with a safe harbour similar to that adopted in Australian domestic law. Amongst other things, this would provide an internally consistent approach to capital allocation to PEs, align the approaches in Articles 7 and 9 of the OECD Convention and provide an efficient practical implementation model.

3. Allocating Capital to Securities Company PEs

We recommend the OECD to adopt a thin capitalisation rule to permit non-bank financial institution (NBFI) PEs, such as securities company PEs, to hold capital in proportion to their business exposures, as measured by risk-weighted assets. The capital requirement itself should be based on a 'quasi'-thin capitalisation approach that includes a safe harbour that reflects the minimum regulatory capital requirement for a comparable locally incorporated entity.

It is not feasible to set out in detail the risk weighting model (or models) and associated rules, as circumstances vary across jurisdictions. However, it is possible to adopt principles that provide sufficient flexibility in the design of the law to facilitate the optimal solution for a given circumstance.

We have come to this view following our experience in developing thin capitalisation rules for securities companies in Australia. Gearing ratios based on the standard balance sheets are of little value for the purpose of assessing the business risk of financial institutions and related capital requirement of financial institutions. Prudential regulators have long recognised this problem and require specific records for their own purposes. The tax authorities in Australia have come to the same conclusion and permit risk weighting of assets by securities companies for thin capitalisation purposes.

Differences in the thin capitalisation rules for banks and NBFIs can generate anomalies that would distort the economic outcomes. Banks and NBFIs compete in key areas of business; for example, merchant banks compete with licensed banks for corporate lending business and securities companies and banks compete in the capital markets. Risk weighting has helped to overcome this problem and preserve the competitive framework that has delivered substantial benefits to users of financial services.

¹⁰ For example, the World Competitiveness Yearbook 2003.