INTERNATIONAL
BANKS AND SECURITIES
ASSOCIATION OF AUSTRALIA

COMMENTS ON THE OECD DISCUSSION DRAFT – ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENT

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2 October 2001

OECD DISCUSSION DRAFT ON ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS

Summary Comments

IBSA is the peak industry body for investment banks in Australia. The majority of our members are branches of foreign banks and the remainder all have a significant international dimension to their operations, being foreign owned or having overseas operations. IBSA has been involved in major reform of Australia's thin capitalisation rules for bank and security company branches and other entities. The legislation containing the new rules has just been passed by Parliament.

We welcome the OECD's initiative in reviewing Article 7 of the Model Tax Convention on Income and Capital and endorse the objective of securing an international consensus on the taxation of financial institutions that operate through permanent establishments (PEs). The general issue of profit attribution to a PE is important, but the major concern is the allocation of an international financial institution's capital between head office and its various PEs. This is a sensitive issue for industry given market pressure to optimise capital usage.

The main purpose of the Convention is to settle on a uniform basis the most common problems that arise in international double taxation. The absence of international consensus on the allocation of capital to PEs is unsatisfactory, as it results in double taxation in some instances and less than single taxation in others. Current trends suggest that this problem is likely to worsen for financial institutions, given the emergence of more extensive global operations and trading, electronic commerce and cross-border alliances between markets.

The Discussion Draft is a first step towards greater tax certainty and the decision to seek industry input at this point is sensible as the optimum outcome can only be achieved through a cooperative approach between industry and the tax authorities. In this regard, we have a number of significant comments to make on the analysis in the Discussion Draft in so far as it applies to banks and securities companies. While many of our comments refer to the situation for banks, the main points apply equally to securities companies. We do not address issues that might affect other companies.

Key points to emerge from our analysis of the Discussion Draft are listed below and are supported by more detailed comment in the body of the text:

- The functionally separate entity approach to determining the profits of a PE is generally the better method of taxing PEs and should be adopted as the starting point in assessing a tax liability.
- A serious practical difficulty with the working hypothesis (WH) is that it cannot be reliably implemented without access to complex analysis and information that often would not be available to PEs.
- Australia is just completing extensive reform of its thin capitalisation rules and if there is one lesson from this experience, it is that a pragmatic approach to PE capital allocation must be adopted, as theoretically pure models fail critical efficiency and compliance cost tests.

- Focussing on what it practically achievable, as distinct from theoretically pure, our recommendation is that the Convention should be revised to adopt a thin capitalisation approach that requires bank PEs to hold capital equivalent to 4% of their risk-weighted assets.
- Non-bank financial institutions (NBFIs) should be required to hold at least the minimum level of capital that an independent locally incorporated entity would be required to hold for regulatory purposes. Alternatively, a formal risk-weighted asset approach should be adopted, so that NBFIs maintain capital in proportion to their risk-weighted assets.
- It is essential that OECD countries adopt a symmetrical approach to the taxation of PEs, in whatever form the tax is finally assessed.
- The approach should be tax neutral and not distort financial sector business, thus maintaining the natural commercial balance between PEs and subsidiaries, bank and NBFIs, domestic and foreign entities etc
- The thrust of the analysis in the Discussion Draft is correct; though some detailed aspects, eg the treatment of credit rating, need to be corrected.
- The WH should attach greater importance to the booking location in attributing assets to a PE for tax purposes.

The OECD process has the potential to deliver agreement on PE capital allocation across a broad spectrum of countries. This would provide a consistent platform for global banks to allocate capital internationally for tax purposes and would largely remove the spectre of double taxation in this area.

We appreciate that the WH is an instrument of investigation, rather than a firm statement on how the Convention might work in the future. We hope that our comments here, along with the insights of other industry participants, help to progress the Steering Group's work. We look forward to the opportunity to comment on further updates of this work.

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1. Comments on the Various Discussion Draft Proposals

1.1 The General Approach in the Draft

It is evident from preceding OECD documents that the provisions in Article 7 do not deliver a clear and certain process for taxing PEs.[1] Indeed, taxpayers, their advisors and the tax authorities in Australia have experienced difficulties as a consequence of this ambiguity.

Therefore, we support the approach in the Discussion Draft to develop the WH without constraint from historical practice and interpretation of Article 7. This seems to be the only way to secure a viable long-term Convention that provides the desired certainty.

1.2 Functionally Separate Entity

We identified a number of factors that support use of the 'functionally separate entity' approach in preference to 'relevant business activity' to determine the profits of a PE. An important reason is that it better reflects the general economics of PE business, which tends to be highly dependent on the host economy and local clients. This may not always be the case; for example, profit attributable to a PE that has partial responsibility for a global book may be better reflected through the relevant business activity approach.

As the Discussion Draft suggests, the practical application and administration of the law is far easier when adopting this approach. In particular, it directly involves one taxpayer (taking the PE and parent as separate entities) and one tax authority with a clear set of attribution rules, rather than dealing with the aggregate of an entity's global operations in the absence of clearly defined rules to represent the interests of many tax authorities. In addition, the relevant business activity approach could be more contentious in application.

Conceptually, the separate entity approach is better aligned with the existence of the separate revenue authorities that have an interest in the global entity's business.

The separate entity approach is also more congruent with transactions tax law (eg VAT or GST in Australia) that treats PEs as separate entities to avoid economic and business distortions. There is no international convention to give uniform treatment of cross-border transactions.

1.3 Functional Analysis of Banking Business

The factual and functional analysis in Section B of Part II is intended to analyse the most important functions of a traditional banking business by considering the borrowing and on-lending of money by a bank (ie both assets and liabilities are to be covered). However, the analysis almost exclusively focuses on bank lending and does not capture the full implications of a bank's business. The result is that some important insights into a bank's capital structuring are missed.

Focussing on a bank's assets to the exclusion of its non-capital liabilities in the context of capital allocation is questionable because the key function of a bank's capital is to protect its deposit liabilities. The Discussion Draft could be read to imply that banks' deposit liabilities are homogeneous and, hence, there is no need to differentiate between them in the WH for capital allocation purposes. But of course that is not the case in reality.

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[1] *Transfer Pricing and Multinational Enterprises – Three Taxation Issues*, OECD 1984 and *Attribution of Income to Permanent Establishments*, OECD 1994.

The failure to consider liabilities is a significant omission in a model that purports to drive off regulatory capital - regulators do have regard to the deposit base when they set prudential standards. For example, 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 (large/small, short-term/long-term, wholesale/retail, negotiable instrument etc) will require the same amount of economic capital to cover it for a sustainable business. However, the WH seems to suggest that this is the case, which can be misleading (for example, see the discussion on credit rating below).

1.4 ISSUES IN APPLYING THE WH CAPITAL ALLOCATION MODEL

Paragraph 87 of Part B states that the WH should recognise that the 'BIS ratio approach' is the most appropriate approach currently available to attribute capital of a bank to a PE in accordance with the arms length principle. Broadly, the BIS ratio approach would allocate a bank's capital across its head office and PEs in proportion to their attributed risk-weighted assets.

A Common Pool of Funds

The implication of the WH is that a global bank's capital should be spread proportionately across its head office and PE operations in accordance with risk weighted assets is based on the assumption of a common pool of capital to support the bank's global operations. The corollary of this is that the bank's cost of funds is derived from a common pool of funds, which includes both equity and debt, as debt and equity (and their costs) are not independent of each other.

The 1984 OECD report considered arguments of this nature on the fungibility of money and, in our view, correctly concluded that it would produce results that are inconsistent with the arms length principle. One reason cited for this is that the activities of the global bank may differ from those of its PEs. Indeed, this is frequently the case in Australia where PEs conduct wholesale business only, while parent banks have significant retail business too. We understand that this situation is not unique to Australia. The leads to the conclusion that the 'fungibility' approach is inconsistent with the 'separate entity' approach.

Separate Entity Issues

Bank PEs must be fully assessed as a functionally separate entity to deliver the outcome intended in the Discussion Draft, but the WH does not do this. One reason is that this is a difficult and subjective task because PEs operate as an integrated part of a global entity but typically are a far from perfect analogue of the parent entity. To complicate matters further, the whole of a global bank is greater than the sum of its parts in the various jurisdictions in which it operates. This reflects the synergies that arise from a large-scale, global operation.

The device to create a hypothetical separate entity relies largely on the recognition of internal dealings between the PE and its parent and requiring that they be accounted for tax purposes at arms length rates. However, this is only half of the story because the integrated relationship between the PE and its parent also significantly impacts on the PE's dealings with third parties. The WH appears to be spasmodic in its recognition of this – eg the effect of the credit rating is accorded a high weighting, but there is no reference to a need to adjust expenses to reflect the consequence of breaking the nexus between the parent and the PE.

By virtue of its size, a global bank can fund itself at a lower cost than an analogous but smaller bank. Hence, if the branch were a separate entity, it would have to pay a guarantee fee for credit enhancement or pay a higher borrowing expense (including for internal borrowings). Similarly, operational costs for a PE are lower than for a subsidiary for a variety of reasons, including access to parent resources and lower corporate regulatory costs. In addition, a stand-alone subsidiary would not have the same depth of market and client access as a PE of a global bank and could not conduct the same range of activities, though it may be able to conduct other types of business not open to a PE (eg retail banking in Australia). In theory, some adjustment must be made for these factors, though in practise this would be difficult to implement.

The corollary of this is that there would be some offset between the denial of some part of a PE's interest expense deductions in lieu of capital (assuming that it does not hold any) and deemed higher operating costs for tax purposes than those actually recorded by the PE. Similarly, it logically follows that a bank PE should be attributed tier 2 capital, as well as tier 1 capital, because it would typically need both as a separate entity. Tier 2 capital includes expensive debt funding, so there should be a commensurate increase in the interest expense of the PE to take account of the allocation of tier 2 capital to the branch.

The Steering Group did not have a consensus view on this point (ref paragraph 91 of the Discussion Draft). In our view, the WH should take a consistent approach in creating the hypothetical separate entity. Thus, if equity capital is to be allocated in the manner proposed under the WH, then PEs must be deemed to have incurred the relatively higher interest expense arising from tier 2 capital for internal consistency.

Attributing Assets to a PE

Paragraph 52 of the Discussion Draft (Part II) states that "Where the functional analysis has determined that the PE alone has performed the sales/trading function, the PE will be attributed the newly created financial asset".[2]

There is some uncertainty about the intended meaning and application of this, as it gives undue weight to the sales/trading function and is inconsistent with our understanding of transfer pricing. In our view, it is reasonable for an asset to be booked for tax purposes in a location other than that where the sale/trading function takes place, if the business unit in which the loan is booked holds the risk in respect of the loan and if the business unit (PE or parent) that performs the sales/trade function is properly compensated for its services.

A better approach to that proposed would be to assume that an asset is attributable for tax purposes to the business unit in which it is booked, unless the substance of the facts and circumstances surrounding the transaction deem a separate approach to be necessary. Then, if necessary, income adjustments for compensation paid to other business units involved in the creation of the asset; for example, where elements of the sales/trading function take place offshore.

1.5 Credit Rating

The Discussion Draft states that third parties, credit agencies etc, do not perceive a PE as having a separate credit rating from the bank as whole.[3] Further, the consequent analysis presumes a direct and strongly

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[2] Sales trading includes negotiating contractual terms with the client, including terms and conditions.

[3] Paragraph16, Part II, states "Importantly, a credit rating is assigned by the agency to the bank as whole and not to individual branches (either directly by evaluating the bank itself or indirectly by assigning a credit rating to the banking group that is treated as applying to all its members)."

positive relationship between a financial institution's capital level and its credit rating by recognised agencies.

The line of argument underpinning the WH capital allocation model seems to be as follows:

i. The bank PE has the same credit rating as the parent bank;
ii. This credit rating determines the PE's cost of funds;
iii. The parent bank's credit rating depends on its capital base;
iv. Therefore, the PE should be allocated an amount of the parent bank's capital that is proportionate to its share of the bank's global business.

The Discussion Draft is correct in citing credit rating as an important factor in the relationship between a PE and its parent and in identifying it as a valuable indicator that is independent and objective. However, it takes this line of analysis too far and incorrectly portrays the relationship between a bank's credit rating and capital. Consequently, the reasoning behind the WH gives insufficient weight to other factors that would determine a fair allocation of capital to a PE and gives an unbalanced outcome.

We base our comments here on the following facts:

- Bank PEs usually have the same credit rating as the parent bank, but this is not always the case due to the effect of sovereign ceiling limits;
- A bank's credit rating is not determined solely by its capital ratio – ratings agencies actually make a point of emphasising the uncertain nature of the relationship between capital and credit rating;
- Significant components of a bank's funding may depend more on its regulatory status than on its credit rating.

These arguments each warrant separate consideration and comment.

A Common Credit Rating

Both Moody's and Standard & Poors state that a foreign branch bank may not have the same rating as its parent See below). This matters in practice, for example,

- Moody's have given Rabobank globally a credit rating of Aaa, but the lower Australian sovereign ceiling of Aa2 would apply to the foreign currency liabilities of its Australian branch (30% of the branch's total liabilities).[4]
- Citibank's global rating is Aa2, but ratings for its branches in Chile, Argentina and Brazil are Baa1, B2 and B3, respectively.

The absence of common credit ratings in some instances is one reason why capital should not automatically be allocated proportionately across a global bank. There are other reasons too, as discussed below.

Moody's Investor Services says -

"Foreign branches of rated banks are rated at the lower of the bank's deposit rating and the country of domicile's sovereign ceiling for bank deposits.

Example: Deutsche Bank – Hong Kong Branch

- Deutsche Bank Deposit Rating Aaa/Prime-1

[4] Ratings mentioned in this submission are taken from *Moody's Credit Opinions,* September 2000.

- Hong Kong deposit ceiling A3/Prime-1
- The branch's rating A3/Prime-1"

– M*oody's A Counterparty's Guide to Moody's Bank Ratings,* December 1995. [5]

Standard & Poors says -

"If it is determined that the obligation is payable only out of branch assets or if the case is ambiguous and no legal opinion to the contrary can be provided, then the (branch's) host government's local or foreign currency rating, as appropriate, will limit the rating of the obligation in question" – *Financial Institutions Criteria*, January 1999.

Effect of Credit Ratings on Cost of Funds

Credit ratings have a significant impact on the cost of funds, or more precisely on the margin above the risk-free rate that a bank can borrow. However, credit ratings *per se* are not the over-riding factor in a bank's cost of funds.

As discussed above, a bank's deposit base is not homogeneous and this is relevant here because different categories of deposit will have different levels of sensitivity to a bank's credit rating. In particular, while a bank's wholesale funding will be very sensitive to movements in a bank's credit rating, retail depositors would be much less so (probably relying more on the depositor protection role of the prudential regulator or deposit insurance schemes in some countries).

Uncertain Link Between Credit Rating and Capital Base

The direct and determining link that is purported to exist between a bank's credit rating and its equity capital base does not exist; rather it is partial and indirect. This is perhaps the most serious flaw in the Discussion Draft analysis that underpins the WH.

Equity capital is a factor that is taken into account in determining a bank's credit rating, but it is not a dominant factor. Indeed, Moody's go to some length to emphasise the risk in assuming a strong relationship between a bank's capital level and its credit rating (see attachment 1 for more details):

> "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."
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> *Rating Methodology, Bank Credit Risk*, Moody's Investors Services, April 1999

Not surprisingly in view of the above comments, there is a correlation factor of less than 0.15 between banks' tier 1 capital and their credit rating for 50 international banks that have operations in Australia. The correlation factor would have to be at the far end of the spectrum to support the analysis in the Discussion Draft. The nature of the relationship for banks with operations in Australia is illustrated in figure 1.

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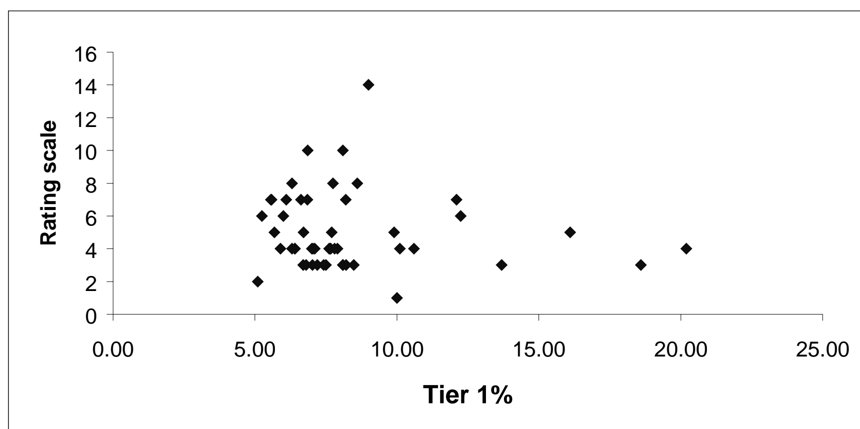
[5] The rationale for Moody's stance is – "Domestic branches of foreign banks are subject to local law and, as such, are subject to exchange controls, rescheduling, moratoria, and other forms of transfer risk. A depositor in such a branch may or may not be able to seek recourse to the bank's head office, which may or may not chose 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. Standard & Poors offer similar reasoning.

Figure 1

The Relationship Between Tier 1 Capital and Credit Rating



Note: Credit rating scale values are inversely related to credit ratings; the lowest value corresponds to the highest credit rating, with Aaa given a value of 1, Aa1 given a value of 2 etc. Data are taken from *Moody's Credit Opinions, Financial Institutions*, September 2000.

Finally, we note that global banks do not have a uniform allocation of capital across the parent bank and its foreign subsidiaries, which often have the same credit rating as the parent. This questions the assumption that the capital ratio accorded to PEs for tax purposes should be constrained to be equal to that of the parent entity, purely because it shares the same credit rating.

Need To Revisit the WH Assumptions and Analysis

Credit ratings are a very useful analytical tool for capital allocation but, given our comments above, it seems fair to conclude that an objective analysis of the credit rating process does not support the over-riding importance accorded it in the WH. Hence, the Steering Group should refine its arguments to more accurately capture the effect of credit ratings and their value as an indicator for capital allocation.

Unfortunately, the necessary recasting of credit rating in the analysis will remove much of the simplicity associated with the WH model. The perceived smoothing effect of the common credit rating in ironing out differences between a parent bank and its PEs does not exist. Consequently, it is more important to consider the distinctive features of PEs in the context of global capital allocation.

1.6 Differences Between Parent Banks and their PEs

The WH casts the PE as a hypothetical functionally separate entity, independent of the parent bank. This is appropriate in part because the PE is not an analogue of the parent bank; it may conduct a different mix of business, operate in a different regulatory and business environment etc. These factors affect a PE's relative need for capital and its cost of funding, so it cannot be assumed that a PE should be given the same capital ratio as the parent under an economic analysis, simply because it has the same credit rating. We briefly outline below some of the distinguishing factors we have encountered in our experience.

Regulatory Factors

Although a parent bank and its PEs form a single, seamless legal unit, the PEs may not be treated in this manner for regulatory purposes. For example, section 11F of the Banking Act 1959 in Australia 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. This effective guarantee for the PE reduces the amount of capital that should be allocated to it under the WH, as it bears relatively less proportionate risk than the rest of the global bank.

There is another dimension to this too, as prudential regulation is designed to satisfy consumer protection and systemic risk policy objectives. To the extent that PEs are excluded from the retail banking market, it follows that their capital adequacy requirement would be reduced too. This may seem rather theoretical but it can be taken account of since the separate entity PE is merely a hypothetical fiction under the WH. This is also an example of the issues arising from inadequate consideration of the liability base of a PE that we identified above.

Further, it should not be assumed that regulatory standards are the same in all markets. For example, Singapore has traditionally had relatively high capital requirements, so consequently many Singaporean banks still hold tier 1 capital ratio in excess of 15%. These banks would be commercially disadvantaged if they were required to operate with this level of capital for tax purposes in jurisdictions that record much lower average levels of capitalisation.

Competitive Markets

The intensity of competition in financial markets varies across countries and also may not be equal across the spectrum of markets in a given jurisdiction. This matters here because the most competitive markets support the least amount of capital, given the relative tightness of margins.

Wholesale banking and security markets are typically more competitive than retail markets. This is important because foreign banks and PEs often compete more extensively in wholesale markets than in retail markets.

In addition, open markets are more competitive than markets with controlled access and, therefore, may support less capital. Some banking and securities markets are very open to international competition but others (especially retail banking markets) are not quite so open. This may be reflected in the margins available to support business and provide an adequate return on capital.

Acquisitions Capital

Global financial institutions are still undergoing consolidation that has generated an enormous number of mergers and acquisitions in the recent years. Many banks hold capital in reserve to facilitate a speedy acquisition or merger with a third party, or for defensive purposes. Capital of this nature is often of no relevance to the business of PEs and should not be allocated to them.

Excess Capital

A commendable objective of the WH is to achieve symmetry in the cross-jurisdictional treatment of global banks. The Discussion Paper focuses on the distribution of a bank's capital across its PEs and head office. The parent bank and its PEs will not typically hold the same ratio of capital to risk-weighted assets.

A PE that holds less capital than required under the WH would need capital allocated to it for tax purposes, or else lose some interest expense deductions. The corollary of this is that if head office or a PE holds more capital than is required for tax purposes, it must be given tax credits for the excess amount. If a tax credit is not given the global bank would suffer double taxation globally, since excess capital in one location under the WH means a shortfall elsewhere. Excess capital can arise from practical difficulties in managing a bank's global capital in an ever-changing economic and commercial climate.

If the WH proposal is to be taken further, then explicit allowance must be made for tax credits in respect of excess capital holdings.

Global Portfolio Diversification

It is not clear how the WH model takes account of the negative correlation benefit from diversification in a portfolio that extends across the parent and PEs in a number of countries. With the benefit of diversification, the global bank's risk will be less than that for the sum of its individual parts. The global bank could never have enough capital for tax purposes if proper account is not taken of this.

2. Implementing the WH Model: Lessons from Australia

Australia is introducing a new thin capitalisation regime that will apply to banks, security companies and other financial institutions, as well as companies. The new regime contains rules for international subsidiary and PE operations, which were formulated against the backdrop of the OECD's work on PEs. The legislation to implement the new regime was passed by Parliament at the end of September and takes effect from 1 July 2001, though the first key test date is in 2002. The Steering Group should consider Australia's experience to identify the lessons that can be learned from it.

2.1 The Australian Approach

The Australian authorities initially proposed a capital allocation model that was substantially the same as that under the WH. It quickly became apparent during discussions with industry that a WH type model is very difficult to implement in practice, so an alternative set of rules, including a safe harbour, had to be negotiated. This was a sensitive issue as bank PEs in Australia typically do not hold capital and require either a capital allocation from head office or, in the absence of this, home country tax credit for interest expense denied in Australia.

Key features of the original proposal for bans were similar to the 'BIS ratio' approach:

- Capital allocation in proportion to risk-weighted assets - If the Australian PE of a global bank holds 10% of the bank's global risk weighted assets, then the PE would be required to hold 10% of the bank's equity capital.
- Equity determined under local rules - The amount of the global bank's equity capital would be determined for this purpose under the Australian tax rules.

Problems emerged at a number of levels, which we believe would be likely to occur in most countries if the WH were to be adopted in its current from:

- It proved too difficult to develop arms length rules that provide adequate certainty for financial institutions – for much the same reasons as outlined above in regard to the WH. A safe harbour level of capital had to be included as an option, which it is expected will be widely used by financial institutions given the uncertainty with the length rule (which in application is likely to be similar in key respects to the WH).
- Bank PEs in Australia are typically very small in relation to their parent bank - many account for less than 1% of the global parent bank's assets. Consequently, access to information necessary to undertake the relevant calculations and the receipt of it on a timely basis was a problem – which the safe harbour overcomes in practice.
- It was not a realistic proposition to require bank PEs in Australia to assess all security issues by their global parent under the Australian debt/equity tax rules, as they are simply not resourced for this task.
- The initial emphasis on credit rating (as per the WH) tended to dominate the capital allocation analysis and insufficient attention was given to other relevant factors, like variation in the intensity of competition and openness of banking markets across jurisdictions.

The general approach in the new thin capitalisation rules is to set a minimum capital ratio for all entities; subsidiary and branch. Bank PEs are assessed on the basis of risk-weighted assets and because securities companies compete with banks in the wholesale financial markets, it has been necessary to introduce a test that approximates a risk-weighted outcome for them too. Indeed, it appears that the best long-term solution will be to provide securities companies and brokers with the option to use a formal risk weighting approach.

In short, our experience demonstrates the need for a consistent approach across financial institutions for competitive neutrality and that the risk weighting of assets is helpful, at least for non-bank financial institutions participating in the wholesale markets. It also illustrates the importance of an adequate safe harbour mechanism, given the difficulty with arms length rule.

We acknowledge that OECD agreement to the WH, or some variant of it, could significantly reduce the associated information compliance costs. For example, if there were a single capital allocation process undertaken by a global bank for tax purposes, basic information should be readily available to even the smallest PEs. However, it would still be unrealistic to apply rules to characterise capital instruments as debt and equity that differ for the PE and its parent. In addition, serious practical problems would still remain in applying the WH, taking account of the differences in the businesses conducted by a PE and its parent.

2.2 A Pragmatic Alternative to the WH for Banks

A pragmatic alternative to the WH is a thin capitalisation test that requires PEs to satisfy the minimum regulatory capital threshold for a bank, that is hold capital equal to 4% of risk-weighted assets:

Bank PEs Required Capital = 4% of PE's Risk Weighted Assets

This forms the basis of the safe harbour in Australia's new rules. It is possible to use an internationally accepted method, the Basel Capital Accord, to risk weight assets. The Accord is being updated to reflect the evolution of finance and development of better internal risk assessment systems by banks, as well to take advantage of external credit ratings. The appropriateness of the updated risk weighting process will have to be evaluated in this context, but there is a reasonable expectation that it would be satisfactory for tax purposes and may provide more accurate information.

Either the local regulator's risk weighting process or that of the parent bank's regulator could be adopted for the purpose of the test to lower compliance costs. Dealings between the parent bank and its overseas entity would be given a zero risk weighting.

This test has several advantages:

- It is relatively easy for both PEs and the parent bank to self-assess and for the tax authorities to check compliance, as the information needed to perform the capital adequacy calculation would generally be held locally;
- It would be possible to rely on local tax definitions of debt and equity, which seems to be a preference for tax authorities;
- PEs would be required to hold a minimum level of capital, but banks would be given some level of flexibility in the management of their global capital.
- Less than single taxation would be avoided, so there is a healthy element of tax revenue protection, while the chances of double taxation would be substantially limited by the adoption of the minimum regulatory capital ratios.

A perceived disadvantage of this approach might be that it is not a pure economic allocation of capital that precisely reflects a PE's functions, assets and risks. However, the thrust of our analysis here, and indeed our practical experience, suggests that the pure approach does not deliver a tractable solution and could create a lot of contention between taxpayers and tax authorities. Indeed, the pure approach may not remove the spectre of double (or less than single) taxation, as there is no guarantee that different tax

authorities would assess factors, like the effect of regulatory restrictions on a PE's business activity, in the same manner when determining their capital requirement for a PE.

Finally, we note that the WH does not deliver a pure economic allocation of capital either. We have outlined above some of the adjustments to the WH allocation that would have to be made to take account of the particular characteristics of a PE. Since our proposal is also based on a risk-weighted measure of a PE's business assets, it should be acceptably close to a pure economic allocation for tax purposes, given the practical constraints.

2.3 A Capital Allocation Model for Security Companies

The management of financial risk is central to the secure operation of all financial intermediaries and it means that many non-bank financial institutions (NBFIs) are likely to risk-weight their assets; especially those that have international operations. Risk weighting of assets may be done for business reasons and/or to meet regulatory requirements (for example, stock exchange regulations).

In contrast to banks, there is no internationally accepted method to risk-weight assets of NBFIs, like security companies. Therefore, it would be more difficult to apply the WH in a consistent manner to NBFIs than it would be to banks. Nevertheless, it is still necessary to pursue a risk weighting approach to determine their capital requirement, as gearing tests based on accounting balance sheets give spurious results for NBFIs that trade in instruments like sale repurchase agreements (which gross-up standard balance sheets) and derivatives.

The problems that arise by adopting a gearing test based on regular accounting balance sheets are evident from the difficulties encountered in implementing Australia's new thin capitalisation regime. Under the safe harbour rules originally proposed, the capital adequacy of NBFIs was to be assessed by reference to accounting balance sheets (ie unweighted assets). This would have forced most security companies out of business, even though there are significant 'concessions' for business that involves on-lending.

To avoid this, a large number of complex adjustments had to be made and the result is that the final rules passed by Parliament effectively approximate a risk-weighted balance sheet. This has the effect of preserving existing business and removing the most striking competitive arbitrage opportunities that would emerge from the new rules in the absence of these adjustments. However, apart from being unnecessarily complex and difficult to understand, the solution is not fully tax neutral and some awkward problems still remain to be dealt with (for example, the treatment of derivatives mark-to-market positions is unsatisfactory). Therefore, we do not see the Australian thin capitalisation rules for NBFIs as the optimal method to attribute profit to PEs.

As with banks, it is necessary to adopt a pragmatic approach to determine the capital allocation requirement for NBFIs and there are two approaches that should be considered in this regard. First, NBFIs could be required to hold at least the minimum level of capital that an independent locally incorporated entity would be required to hold for regulatory purposes.[6]

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[6] For example, the Australian Stock Exchange has a minimum equity requirement of $100,000, and stipulates that a specific amount of capital (which includes certain subordinated debt) be held in proportion to risk exposures. It does not require a specific level of equity capital, above and beyond the $100,000 base, but certain deductions must be made from capital before testing for adequacy.

If this approach were not accepted, then it would be necessary to consider a formal balance sheet gearing test. The clear lesson from Australia is that a risk-weighted asset capital allocation model must be adopted in this circumstance, as this is the only gearing method that makes economic or commercial sense.

In this circumstance, we agree with the WH proposal to risk-weight assets as the first step in attributing capital to an NBFI PE. The level of capital then required should be balanced to reflect the highly geared nature of financial markets business and maintain a level playing field with banks. The precise level needs further analysis and input from local industry, since there is no international standard available.

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Attachment 1.

9.1. No Direct Correlation Between Moody's Ratings and Capital Levels

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. More specifically on ratings, some market observers, investors, and banks themselves assume sometimes that there is a direct correlation between the level of bank capital and Moody's bank ratings. Sometimes banks inform Moody's analysts of a capital hike, and appear to expect a rating upgrade as a consequence. Conversely, bank managers contemplating a stock repurchase are apprehensive about a rating downgrade. Both assumptions may be wrong.

Stated differently, 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. Moody's analysis of bank capital goes deeper, focusing primarily on the following elements:

- Importance of capital for bank credit risk
- Regulatory solvency versus economic capitalization
- Correlation between economic capital and overall risk profile
- Key importance of a bank's earning power as main capital-building avenue
- Capacity to raise new equity
- Internal capital allocation.

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