COMMENTS RECEIVED FROM A JOINT WORKING GROUP REPRESENTING:
THE BRITISH BANKERS ASSOCIATION (BBA)
THE LONDON INVESTMENT BANKING ASSOCIATION (LIBA)
THE ASSOCIATION OF FOREIGN BANKS (AFB)

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

1. The British Bankers' Association (BBA), London Investment Banking Association (LIBA) and the Association of Foreign Banks (AFB) welcome the opportunity to comment further on the issues raised by Part II of the revised OECD discussion draft on the Attribution of Profits to Permanent Establishments. We will be commenting separately on Part III (global trading). The three associations represent the large majority of UK and foreign owned banks and securities houses operating in the United Kingdom. Our representations have been drawn up by a working party which includes representatives of groups headquartered in eight countries, while the draft response was circulated for comment to over 300 banks and securities houses.

2. As the city with the greatest number of international banks in the world the OECD proposals are very important to the operations of our members in London. Hence we submitted written comments on the original 2001 proposals and participated in the discussions held in Paris in April 2002. In addition to these further written comments we look forward to participating in any future debate on the important issues raised here before any final decisions are taken.

3. Indeed, as we commented in our earlier submission, we firmly believe that a further period of study will be required in order to arrive at any acceptable and workable solution. Hence we continue to urge that no immediate action be taken before all aspects have been fully worked out; in particular the relationship to Parts I, III and (if still to be issued) IV. Any implementation must also only be on a prospective basis to allow for necessary systems/law/treaty etc. changes. It is equally necessary for the commencement date to be co-ordinated if confusion, uncertainty and, inevitably, double taxation are to be avoided.

Summary

4. Whilst we regret that a number of the points made in our previous paper were rejected, and we continue to believe in their validity, we have focused this response on the new points raised by the changed emphasis of the revised draft, rather than simply re-iterate all the points previously made. We hope that this will be seen in the constructive spirit of dialogue in which it is meant.

5. In particular whilst the option of having an approach that starts with the existing accounts and records was rejected we note that some potential alleviation of the compliance burden issue that concerned us in relation to the original WH requirement to split assets may have been put forward now in the recognition of a single asset.

6. We are however extremely concerned that the risk of double taxation being incurred has been increased significantly by the abandonment of any single measure of capital allocation. This is exacerbated by the fact that the draft does not allow the taxpayer the option of choice of 'acceptable method of allocation' within the framework of the draft paper. It appears that the

original principle that there should not be double taxation or less than single taxation has now been superseded. It is regrettable that the OECD could not reach agreement on one method, but it is essential that this should not be allowed to result in double taxation.

7. One area where we feel that we must re-visit our earlier comments, despite their rejection, relates to the issue of deemed guarantees (particularly in circumstances where a thin capitalisation approach is used for free capital attribution purposes).

Detailed Comments

8. In paragraph 3 the term 'interest' is stated as being intended to have a broad meaning in order to encompass a wide range of receipts and payments in the nature of business profits earned by a bank from the borrowing and lending of money. We agree with this statement in view of the number of means in today's markets whereby payments economically equivalent to traditional interest can be made and the need to avoid uncertainty arising in this area. We would like to see a more detailed discussion of this and the adoption of a simple guideline – such as any expenditure incurred by reference to the payment by time for the use of any cash or near cash equivalents e.g. repos – for use by all tax authorities.

Asset location

9. In our previous paper we noted that the integrated nature of portfolio risk management raises significant question marks as to the allocation of profits by reference to risk weighted assets (RWAs) and that the location of RWAs on a geographical basis was also by no means as simple in practice as the WH suggested. The trend in global banking is quite clearly towards central booking, or booking in a small number of locations and we were very concerned that, almost inevitably, most assets would need to be split – and for tax purposes only – so that the underlying linkage with the regulatory reporting regime would be lost. We also found it illogical that whilst the RWAs were to be split between PEs in order to calculate the deemed capital requirement, the Profit and Loss approach was different in that individual functions were to be rewarded. This would also result in a need for costly systems changes that would require significant lead-time for implementation.

10. We note now however that in paragraph 10 there is an acknowledgement that it is important to identify not just what functions are performed but also their relative importance. The 'key entrepreneurial risk-taking functions' are those which are likely to impact most directly on the profitability of the bank and so will normally result in the loan asset (together with its associated income and expense) being attributed to the location performing this.

11. The sales/trading function is regarded as 'key' for the creation of an asset and the risk management function as 'key' to its on-going management.

12. We regard this as a step forward in simplifying the process but consider that in fact the risk management processes described as 'key' e.g. deciding whether risks should continue to be borne by the bank or eliminated in some way (e.g. by hedging) are so separate from the creation of the asset that, whilst they should of course be rewarded separately for P+L purposes, the risk weighted asset (reduced if appropriate) retained on the books should be allocated to the originating PE for the purposes of calculating capital requirements.

13. We consider that this is consistent with the key driver of profitability being assumption of risk. (In view of the clarification of the approach to be adopted we now accept that this should include 'off-balance sheet' risk assets.)

Application of the WH to banks operating through a PE

Capital allocation

14. A central aspect of the proposal is the allocation of 'free capital' as appropriate to a PE. In our original paper we regarded this issue as the key, important area where an internationally agreed solution is vital. We are therefore very disappointed by the approach now being adopted. Despite an acknowledgment (in paragraph 119) that the allocation of capital is "pivotal to the process" in the following paragraph it is stated that "the consultation process has also shown that it will not be possible to develop a single internationally accepted approach for making that attribution of capital, including 'free' capital".

15. We regard this as unacceptable in that it will leave taxpayers, in the absence of a common standard, almost inevitably facing the risk of double taxation with only the limited protection offered in practice by option of seeking competent authority relief. Even where available this increases the compliance burden and uncertainty for the taxpayer.

    There must be flexibility of method given to the taxpayer. It is unacceptable that a taxpayer with branches in say 30-40 countries should be expected to develop and maintain at least 3 main systems for allocation of capital plus those to cover the inevitable variations introduced by each country. As long as the taxpayer determines the allocation of capital in accordance with the methods prescribed and that the method is consistently applied then such method should be acceptable to the fiscal authority of the country of the PE.

16. The definition of 'free' capital still needs clarification.

17. On a related matter the WH proceeds on the basis that there is only one clear set of Basle rules being applied. In practice individual regulators apply some discretion and hence there are variations. We presume that the applicable rules should be as applied by the home country regulator but this also needs to be made clear so as to ensure consistency of treatment globally for the bank and to avoid the potential for double taxation arising.

Guarantees

18. We made the point in our previous paper that the WH did not achieve the stated aim of achieving neutrality between residents and non-residents. The original draft document had stated that a failure to achieve such neutrality "would be unacceptable on tax policy grounds" as (inter alia) it would produce "a discrepancy between the tax results of a branch and of a subsidiary carrying on similar operations. The latter provides considerable scope for tax avoidance." However, instead of amending the WH to achieve the stated aim, the response in the revised draft appears to have been to change the stated aim itself (it is now said at paragraph 5 that "the aim of the WH is not to achieve equality of outcome between branch and subsidiary in terms of profits"). This seems to undermine the integrity of the process and of the WH. To repeat the point made in our previous paper, traditionally branches may have had only a modest amount of free capital allocated to them, but the quid pro quo is that they benefited from the entity's overall credit rating (and hence from its associated funding rate). Subsidiaries require their own free capital, but will fund themselves at their own appropriate funding rate (or, alternatively, may pay a guarantee fee to the parent to

achieve its lower funding rate). Under the WH proposals, branches would have a capital attribution broadly in line with the capital of a subsidiary. Yet no funding margin on borrowings from the head office (or payment of a guarantee fee) is to be allowed, due to the attribution of the same credit rating. This therefore appears to make it disadvantageous for foreign banks to operate through branches rather than subsidiaries (when a branch network may be preferred for commercial reasons).

19. The revised paper dismisses this, albeit without to our minds presenting any clear arguments as to why this is unacceptable – see paragraph 20 of Annex 2. This refers only to the debate at section D-1 (ii). We accept the premise of the first part of this section i.e. that creditworthiness is fundamental to the profitability of a bank. Assuming that a PE will be treated as having the same rating as the parent entity, our view remains that there is double counting when the capital of the entity is then allocated to the branch without any adjustment. There appears to be no disagreement with the premise that in capital terms the whole is indeed greater than the sum of its parts. Accordingly when postulating a series of distinct and separate enterprises for an entity's PEs would result in there being a shortfall of capital, this needs to be recognised by a payment for guarantee to cover this shortfall.

20. The response to this appears to be to rest on the second leg of the presumption contained in Article 7(2) of the OECD Model Treaty i.e. that the PE must also in addition to being hypothesised as a distinct and separate enterprise (and thus requiring capital) also be carrying on the same or similar activities under the same or similar conditions (i.e. to have the same credit rating). This then appears, somewhat circularly and illogically, to justify the need for sufficient capital to ensure such a credit rating. In our view this will inevitably lead to double taxation and despite noting the comment in paragraph 5, that the aim of the WH is not to achieve equality of outcome between branch and subsidiary, we believe that this should be the case. Accordingly we continue to advocate strongly the position that, once a PE has had its share of the entity's actual capital allocated to it, if this is insufficient to support the assumed credit rating, an appropriate guarantee fee should be deducted from the profits earned by that PE. This is particularly the case if a thin capitalisation, rather than capital allocation, approach is followed for free capital purposes. In those circumstances, it seems to us clearly wrong to impute separate entity (i.e. effectively subsidiary) status for free capital purposes but not for credit rating purposes.

Appendix 1

Other issues outstanding from our previous paper

We would continue to welcome further discussion on the practicalities of the calculations involved. The consultation papers illustrate the proposals with very simple examples and these provide no guidance as to how various important timing issues would be addressed. For example, at what point is the ratio of capital to RWAs to be measured, only as at the year-end? If not, will some form of weighted average be required? Such a basis would significantly increase the complexities involved. The guiding principle here must be to require nothing that is not already necessary to meet the underlying regulatory reporting requirements.

We assume that whatever basis is adopted, the same exchange rates will be required to be used in calculating both the capital and assets sides of the equation.