19th January 2017

Budget Policy Division
Department of the Treasury
Langton Crescent
PARKES ACT 2600

Via email: prebudgetsubs@treasury.gov.au

Dear Treasury

2017-18 Pre-Budget Submission

The Australian Financial Markets Association (AFMA) represents the interests of well over 100 participants in Australia's wholesale banking and financial markets. Our members include Australian and foreign-owned banks, securities companies, treasury corporations, traders across a wide range of markets and industry service providers. Our members are the major providers of services to Australian businesses and retail investors who use the financial markets.

We are pleased to provide a submission to Treasury to assist in the formulation of the Government's 2017-18 Federal Budget.

1. Executive Summary

The proposals which form the basis of AFMA's 2017-18 Pre-Budget submission are:

- **Provide a cohesive development strategy for financial markets:** The Government needs to provide stronger commitment to the enhancement of Australia's financial markets and Australia's attractiveness as a financial centre. This will require the formulation of a cohesive strategy integrating policy initiatives relevant to tax, international trade, innovation and business investment, as well as implementation of outstanding recommendations of both the Johnson Report and the Financial System Inquiry (**FSI**);

- **Board of Tax to review FSI taxation observations:** Given that the FSI was only able to make observations on taxation matters, with the view to these matters being considered by the defunct Tax White Paper process, the Government should commission the Board of Tax to undertake a formal review of the FSI's taxation observations;

- **Government to respond to Board of Tax Permanent Establishment Paper:** In April 2013, the Board of Taxation delivered to Government its report of its Review of Tax Arrangements Applying to Permanent Establishments. This report has some key observations and recommendations in terms of ensuring that Australia's taxation arrangements are aligned with key trading partners and financial centres. The Government has not responded to this report and should do so in the 2017-18 Federal Budget;

- **Prioritise the Johnson reforms:** The Government should prioritise the implementation of the following outstanding Johnson Report recommendations:

    - The phase-down of interest withholding tax for financial institutions; and

    - The abolition of the LIBOR Cap;

- **Exempt withholding tax on payments made to/from CCPs:** The Government should urgently conclude its consideration of industry submissions on the withholding tax treatment of payments made to/from Central Counterparties (**CCPs**) to ensure that Australia's derivatives markets are not undermined by the implementation of the G-20 OTC derivative reforms;

- **Improve the international competitiveness of the OBU regime:** The Government should announce a further review of the Offshore Banking Unit (**OBU**) regime, building on the momentum of the Johnson Report and the 2015 legislative amendments to the regime;

- **Post-implementation review of ASIC industry funding model:** The Government should commit to a post-implementation review of the industry funding model for ASIC within three years of commencement; and

- **Macroeconomic framework:** The exchange rate and monetary policy are well-placed to carry the burden of macroeconomic adjustment to further fiscal consolidation. A faster pace of fiscal consolidation can be maintained without impairing the short-term macroeconomic outlook while also improving long-run economic growth outcomes and protecting Australia's AAA sovereign credit rating.

2. Introductory Comments

Our 2017-18 Pre-Budget Submission largely mirrors that provided in relation to the 2016-17 financial year. Due to factors such as the Federal Election on 2 July 2016, a significant number of issues raised in AFMA's 2016-17 Pre-Budget submission were not able to be actioned by the Government. It is hoped that, either through the 2017-18 Budget or otherwise, the Government will acknowledge and give priority to the development of a cohesive strategy for enhancing Australia's financial markets and its attractiveness as a financial centre.

The building blocks to facilitate this commitment have been commenced; the Financial System Inquiry (FSI) has provided Government with a holistic perspective on the state of Australia's financial system and has provided recommendations to support the development of the system. Given that the FSI was unable, under its terms of reference, to provide any more than observations in relation to taxation matters that could have informed the Tax White Paper process, we have recommended that the Board of Taxation specifically consider these observations, given the Government's abandonment of the Tax White Paper process.

We note, however, that the FSI's Final Report does not provide a comprehensive strategy for guiding the future development of the financial system, its role in the Australian economy and its integration with the rest of the world, particularly the rapidly growing trade in financial services in the Asian region. While the government has appropriately prioritised the conclusion and implementation of regional free trade agreements (FTAs), these have not been linked to domestic financial system development objectives in a way that would enable the financial sector to capitalise on the opportunities presented by these agreements.

It remains incumbent on the federal government to formulate and then champion at all political levels a strategy that will integrate the FSI's Final Report recommendations with the government's policy agenda in related areas such as tax, international trade, innovation and business investment. This will require a stronger commitment of policy resources and political attention than has been previously forthcoming from successive governments. The long lag between the 2009 Johnson Report's recommendations and their actual implementation by government is symptomatic of this lack of political attention and the failure to integrate financial system development with broader policy objectives and priorities.

Further, as noted below, some key recommendations from the Johnson Report remain unimplemented, reflecting a lack of cohesive and holistic strategy with respect to the recommendations in the report. This undermines confidence about the extent to which the Government is committed to enhancing Australia's capability as a financial centre. Like the FSI, the Johnson Report is also only a partial agenda for progressing the development of Australia's financial system. While important, the Government should not view the implementation of the outstanding Johnson Report recommendations as completing the process of financial system development. The Johnson Report recommendations should be seen as a necessary but not sufficient condition for progressing Australia's positioning as an international financial centre.

3. Macroeconomic Policy Framework and Context

Australia is fortunate to have a macroeconomic policy framework based on a floating exchange rate and an independent inflation-targeting central bank. The Reserve Bank has a mandate and effective tools to stabilise aggregate demand and anchor long-run inflation expectations. In this context, fiscal policy need not be distracted by short-term demand management considerations and can focus instead on long-run fiscal sustainability and improving structural incentives in the Australian economy.

Maintaining a disciplined approach to fiscal policy will limit upward pressure on the exchange rate, supporting the contribution of net exports to economic growth and increase the flexibility available to monetary policy in managing aggregate demand. The exchange rate and monetary policy are well-placed to carry the burden of macroeconomic adjustment to further fiscal consolidation.

Fiscal policy can focus on the role of spending and tax decisions in conditioning incentives to work, save and invest, as well as the need to balance the budget over time and protect Australia's AAA sovereign credit rating. A ratings downgrade would be costly for Australian borrowers, including the federal government.

It is relevant to note too that Australia's financial markets play a central role in enabling the practical implementation of these policies and facilitating economic adjustment in an efficient way. For example, they allow business, investors and government to effectively manage balance sheet and cash flows risks associated with movements in foreign exchange and interest rates. It is important for the Government to manage its tax and regulatory policy settings in the manner that maintains the effectiveness of financial markets, especially given the likely adverse economic impact of any material deficiency in these settings.

3.1 The need for fiscal policy rules

There has been little change in the budget balance as a share of GDP since the Government's 2014-15 Budget. The expected underlying cash deficit of 2.1% of GDP based on the 2016-17 MYEFO broadly aligns with the actual budget outcome of -2.3% of GDP for 2014-15.

The adoption of formal fiscal rules is a useful way of disciplining fiscal decision-making and encouraging a more strategic and systematic approach to the budget. Just as the adoption of an inflation target has improved the credibility of monetary policy, adopting a rules-based framework for fiscal policy would improve the credibility of the Government's fiscal strategy and help protect Australia's sovereign credit rating.

The National Commission of Audit[1] recommended three fiscal rules and suggested the Parliamentary Budget Office report progress against the fiscal rules following the annual release of the Final Budget Outcome:

- Achieve a surplus of 1 per cent of GDP by 2023-24;
- Substantially reduce net debt over the next decade;
- Ensure taxation receipts remain below 24 per cent of GDP.

The fiscal strategy statements in recent Budgets have been consistent with this approach, although the 2016-17 Budget was notable for having abandoned the previously articulated timetable for a one percent of GDP budget surplus.

3.2 Fiscal Strategy Statements in Recent Budgets

- 2014-15 Budget: *The Budget repair strategy is designed to deliver budget surpluses building to at least 1 per cent of GDP by 2023-24.*
- 2015-16 Budget: *The budget repair strategy is designed to deliver budget surpluses building to at least 1 per cent of GDP by 2023-24.*
- 2016-17 Budget: *The Government retains the target of reaching a surplus of one per cent of GDP as soon as possible. This will be achieved by reducing payments to a lower and more sustainable share of the economy at around a quarter of GDP, while boosting revenues by supporting growth through economic policies that drive jobs and growth.*

AFMA recommends that the Government maintain a timetable for a return to a balanced or surplus budget, as well as numerical targets and/or ceilings for the net debt to GDP ratio and the expenditure and tax shares of GDP. A ceiling for real growth in Commonwealth outlays would also be a useful discipline on the budget process.

[1] National Commission of Audit, *Towards Responsible Government*, October 2013

4. Taxation recommendations

4.1 Alignment of regulatory and taxation outcomes

A fundamental pillar to ensuring that government reforms are undertaken to promote the efficiency and competitiveness of Australia's financial markets is to consider regulatory or other changes in a holistic manner through the adoption of a "whole of regulation" mantra. That is, to the extent that changes are required to the taxation system to ensure consistency with regulatory reforms, these be implemented consistently and not only where there is a perception that the amendments will be revenue accretive for the Government. The request for a specific interest withholding tax exemption for interest paid to or from Central Counterparties, as set out in more detail below, is an example of where the Government should adopt a holistic approach to the consequences of regulatory intervention.

4.2 Board of Tax Review of FSI Taxation Observations

The terms of reference for the FSI precluded the making of recommendations into taxation matters. This was due to the Government, at the time of the release of the final FSI Report, continuing to commit to a comprehensive review of the taxation system through the Tax White Paper process. Accordingly, the FSI terms of reference allowed the FSI Panel to:

> "examine the taxation of financial arrangements, products or institutions to the extent these impinge on the efficient and effective allocation of capital by the financial system, and provide observations that could inform the Tax White Paper."

The Government discontinued the Tax White Paper process in February 2016. As a result, the taxation observations made in the FSI Final Report have not been the subject of further government consideration/recommendation. In AFMA's view, had the FSI Panel known of the subsequent discontinuance of the Tax White Paper process, it may have made taxation recommendations, as opposed to observations, to the extent allowed by the terms of reference, with such recommendations being part of the Government's formal FSI response.

Many of the taxation observations in the FSI Final Report are germane to AFMA and its membership, and relate to matters set out below, particularly in relation to interest withholding tax, the LIBOR Cap and the application of interest withholding tax to interest paid to or from central counterparties. Further, the observations touch on more fundamental aspects of the Australian taxation system, such as the differential tax treatment of savings vehicles, which would benefit from further consideration and consultation. Accordingly, AFMA recommends that the Government, in the 2017-18 Federal Budget, commit to requesting that the Board of Taxation undertake a review of each taxation observation included in the FSI Final Report.

4.3 Government to Respond to Board of Taxation Permanent Establishment Paper

In 2012, the Government commissioned the Board of Taxation to conduct a review into the tax arrangements applying to permanent establishments. This was a key review, particularly for AFMA members, as the Board was asked to consider the advantages and disadvantages of Australia adopting the "functionally separate enterprise" approach to determining the profits attributable to a permanent establishment, as is adopted by the OECD Model Tax Convention, subsequent to changes in 2010. Our view is that aligning Australia's approach to other key trading partners and OECD countries will enhance Australia's standing as a financial centre. The Board also made a recommendation in this review for the abolition of the LIBOR Cap (refer below).

Unfortunately, and notwithstanding the public release of the Board's report in June 2015, there is yet to be any Government response to whether Australia will adopt the functionally separate enterprise approach and, if so, in which contexts. AFMA calls on the Government to formally respond to the Board's report in the 2017-18 Federal Budget.

4.4 Remove interest withholding tax for financial institutions

AFMA continues to strenuously object to the decision made by the government to discontinue the previously announced phase-down of interest withholding tax (IWT) for financial institutions. This announcement was formally made by the government as part of the repeal of the Minerals Resource Rent Tax.

There is a considerable body of commentary that clearly articulates the erosive nature of interest withholding tax on the Australian economy and Australian businesses. Starting with the Johnson Report, where the AFCF expressed the view that "the application of interest withholding tax to offshore borrowings by Australian based banks is inconsistent with Australia's need, as a capital importing country, to access a diversity of offshore sources of funding." The AFCF went on to state that:

> "the continuing application of interest withholding tax on financial institutions' borrowing offshore sits uneasily with the Government's desire to develop Australia as a leading financial centre and is putting Australia at a competitive disadvantage with respect to overseas financial centres."

These comments were echoed and endorsed by the Henry Tax Review in 2010, which recommended that "financial institutions operating in Australia should generally not be subject to interest withholding tax on interest paid to non-residents."

Further, and compellingly, the Final Report of the FSI, observed:

> "(w)ithholding taxes generally increase the required rate of return for foreign investors, which reduces the relative attractiveness of Australia as an investment destination. Where foreign investors can pass on the cost to domestic recipients, this raises the cost of capital in Australia…reducing IWT would reduce funding

distortions, provide a more diversified funding base and, more broadly, reduce impediments to cross-border capital flows."

In essence, the FSI Panel agrees with previous observations made in the Johnson Report and the Henry Tax Review that, as a nation that relies on the importation of capital to ensure continued growth, it is incongruous that the government persists with a measure that significantly hinders the free movement of capital into Australia and causes Australian businesses to pay a higher rate for debt finance. This ultimately renders Australian businesses less competitive relative to their global peers.

The government has publicly confirmed its commitment to the recommendations of the Johnson Report. The Coalition's "Our Plan for Real Action" document states that it would "give priority to the recommendations of the Johnson Report into Australia as a Financial Centre." The withholding tax recommendation is a core component of the Johnson Report package and the phase-down of interest withholding tax is accordingly consistent with the Coalition's key policy document.

AFMA is of the view that the government has not prosecuted this key Johnson recommendation purely on the perception that the former government was seeking to fund any reduction in revenue from the proceeds of the Minerals Resource Rent Tax, which the current government has abolished. AFMA urges the government to acknowledge the recommendations of the Johnson Report and consider the effect of the phase-down of interest withholding tax for the wider economy. As such we call on the government to commit to the implementation of the phase-down of interest withholding tax as per the Johnson recommendation, namely:

- on foreign-raised funding by Australian banks;
- to foreign banks by Australian branches; and
- on related party borrowings by financial institutions.

4.5 Exempt withholding tax on interest paid to CCPs

In February 2013, AFMA, the Australian Bankers' Association and the Financial Services Council lodged a submission with Treasury seeking a withholding tax exemption for interest paid to central counterparties (CCPs).

As part of the G-20's commitment to improving the transparency of OTC derivatives, systemically important OTC derivatives (such as AUD interest rate swaps) are required to be collateralised and cleared through an appropriately structured CCP. The concern expressed in the submission was that where the CCP was located outside of Australia, interest paid on the collateral could result in Australian interest withholding tax.

The submission sought an exemption for any withholding tax that would arise, on the basis that the cross-border interest flow arose solely due to regulatory reform and any withholding tax arising would adversely affect the Australian derivatives market, with the detrimental impacts vastly exceeding any government revenue.

The point was acknowledged by the Final Report of the Financial System Inquiry, which observed:

> "Australia's IWT regime also applies to derivative transactions. Under G20 commitments, certain standardised over-the-counter derivatives need to be collateralised and cleared through a regulated central counterparty. In Australia, outbound interest payments on collateralised positions may be subject to IWT (flows from Australian participants to offshore CCPs, or flows from Australian CCPs to offshore participants). This may increase costs for Australian participants and adversely affect liquidity in Australian derivatives markets."

AFMA has received no response from the government or Treasury with respect to the submission, nor to AFMA's 2015-16 Pre-Budget Submission in which the issue was again raised. This issue continues to be an ongoing threat to the Australian derivatives market and AFMA urges the government to consider the request made in the submission as part of the 2017/18 Federal Budget.

4.6 Abolish the LIBOR Cap

The Government should use the 2017/18 Budget as an opportunity to announce the removal the "LIBOR Cap," a statutory provision that operates to deny deductibility of intra-entity interest for an Australian branch of a foreign bank above the applicable LIBOR.

Our view continues to be that the LIBOR Cap unnecessarily inhibits the flow of capital into Australia through foreign bank branches and, therefore, increases pressure on the availability and cost of credit to Australian business. It is defective tax policy because it conflicts with internationally accepted transfer pricing norms that rely on arm's length pricing/conditions. It also has serious technical flaws, most notably because LIBOR is not a representative funding rate for individual banks or for funding at a maturity greater than twelve months.

The absurdity of the LIBOR Cap was exacerbated in 2013 when the British Bankers Association ceased to quote AUD LIBOR. This resulted in a situation whereby there was no applicable LIBOR in respect of AUD borrowings and consequently, in AFMA's view, no cap on the deductibility of interest where the Australian branch borrowed in AUD. The industry took a responsible approach in responding to this legal conundrum and negotiated an Administrative Solution with ATO that may be adopted by taxpayers to address AUD borrowings to which the LIBOR Cap previously applied. From a technical perspective, however, this can be no more than a temporary fix as there is now the untenable position where there exists a provision of the law which has no legal effect where the Australian foreign bank branch borrows in its own functional currency.

In addition, currencies in which LIBOR continues to be quoted, such as EUR and JPY, now exhibit negative interest rates, thereby creating issues with the application of the LIBOR Cap for such currencies. This again resulted in dialogue between AFMA and the ATO to confirm that a foreign bank branch would not derive assessable income on a payment made on a notional borrowing where the applicable LIBOR was a negative amount. The prevalence of negative interest rates highlights the impracticalities that may arise in applying the LIBOR cap and demonstrate the extent to which it is no longer fit for purpose.

The Government asked the Board of Taxation to review the appropriateness of the LIBOR Cap as part of its review into the Tax Arrangements Applying to Permanent Establishments. The Board of Taxation made only one recommendation in its report to the Government. This recommendation was:

> "subject to confirmation that the removal of the LIBOR Cap would result in no material cost to revenue, the cap should be removed. That would assist in fostering competition in the domestic market."

In providing context to the recommendation, the Report stated:

> "The Board agrees that the LIBOR Cap has the potential to reduce bank competition. Put another way, it is hard to see how a cap on the amount of deductions that can be claimed in respect of intra-entity debt can assist in promoting banking competition by foreign banks with their domestic counterparts that do not face the restriction. The LIBOR Cap has the effect of potentially increasing the funding costs for foreign bank branches and hinders their ability to compete in the business loan market. Moreover, new entrants into the Australian banking market are likely to be disproportionately affected by the LIBOR Cap because they are relatively more reliant on head office funding to which the cap applies."

Such comments are consistent with those included in the Johnson Report, which made the recommendation to:

> "remove the LIBOR Cap on deductibility of interest paid on branch-parent funding."

This recommendation was made on the basis that:

> "(a)s the financial crisis clearly demonstrated, in periods of stress in credit markets, there can be appreciable differences between the LIBOR rate and the rates that parent banks are able to offer their Australian branches on a commercial basis. While conditions in credit markets have eased significantly, Australia needs policies to ensure access to alternative funding sources at competitive rates should such tensions re-emerge. The Forum believes that any tax avoidance concerns from removing the LIBOR cap could be adequately dealt with by applying the usual transfer pricing guidelines in respect of interest paid to foreign banks by their Australian branches."

During the 2014 calendar year, and at the government's request, AFMA provided both the government and Treasury with revenue estimates of the cost of the removal of the LIBOR cap, based on survey responses from its members. These estimates demonstrated that the cost of removal of the cap was immaterial (i.e. there is no material cost to revenue) and would deliver significant deregulation benefits, in addition to materially enhancing banking competition and the provision of product and service innovation by foreign bank branches.

Given the defective nature of the LIBOR Cap from a policy perspective, the impracticality associated with applying the cap for currencies for which no LIBOR is quoted and the immaterial revenue consequences associated with its removal, AFMA again calls on the Government to abolish the LIBOR Cap as a matter of urgency. Abolition would give effect to another key recommendation of the Johnson Report, mirrored by that of the Board of Tax. It would also be consistent with the Government's objective to foster innovation in the economy.

4.7 Improve the international competitiveness of the OBU regime

In 2015, legislation giving effect to amendments to the Offshore Banking Unit (OBU) regime was passed through Parliament.

On balance, the amendments contained in the legislation were positive and provided a useful first step in ensuring the OBU regime continues to be contemporaneous in light of financial and product innovation and competitive with similar regimes in the region aimed at attracting mobile financial sector activity. However, the amendments did little more than give effect to some (but not all) of the OBU recommendations of the Johnson Report. Given the Johnson Report was delivered to Government in 2009, many of the recommendations may have been superseded and hence merely giving effect to these recommendations does not guarantee that the OBU regime is fulfilling its policy objectives.

Of particular concern is the apparent lack of rigour around ensuring that the OBU regime is updated in a timely and efficient manner where required. AFMA is concerned that given the current focus on investment on fintech, Australia may be left in the invidious position of being unable to retain successful financial services innovation due to the OBU regime, which would support the provision of financial services to non-residents from Australia.

Given the government's stated focus on innovation, we believe it is appropriate for the merits and potential improvements to the OBU regime to be reviewed to maintain the momentum started by the 2015 legislative amendments. We believe that the Board of Taxation would be well placed to conduct such a review and recommend that the review be announced in the 2017/18 Federal Budget, together with timing of both delivery of the Board's report and the government's commitment to respond to the recommendations contained therein.

5. Regulatory recommendation

5.1 Post-implementation review for ASIC industry funding

With the move to industry funding of ASIC from 1 July 2017, AFMA requests that the Government commit to conduct a formal independent external review of the industry funding arrangements no later than three years after the arrangements commence to operate. The review should have a terms of reference including but not limited to:

- Whether the arrangements adequately address ASIC's funding needs;
- Whether the arrangements achieve the stated policy objectives[2], which concern who bears the cost of regulation and improving ASIC's transparency and accountability;
- Whether the arrangements operate as anticipated at the time they commence, and if not, what changes might be necessary;
- Whether the imposition of the funding arrangements has any unintended or undesirable consequences that need to be addressed; and
- The effect of the funding arrangements on financial markets and financial services business activity in Australia.

The review should be conducted by an appropriate external body such as the Productivity Commission, the Australian National Audit Office, a professional services firm engaged by the Government, or an appointed review panel. This type of review, which should include detailed consultation with entities that are subject to the levies, will assist in addressing industry concerns about the lack of effective transparency and accountability arrangements. The findings of the review, and the Government's proposed response to any recommendations, should be made public.

* * * * *

Thank you for the opportunity to contribute to the Government's consideration of matters that should be addressed in the 2017/18 Federal Budget. We would be happy to discuss any of the matters that we have raised in this submission. Please contact me on (02) 9776 7996 or rcolquhoun@afma.com.au .

Yours sincerely,

Rob Colquhoun
Director, Policy

---

[2] http://sjm.ministers.treasury.gov.au/media-release/042-2016/