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4 June 2012

Australian Productivity Commission and
New Zealand Productivity Commission
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Dear Australian Productivity Commission and New Zealand Productivity Commission,

Strengthening economic relations between Australia and New Zealand

The Australian Bankers' Association (ABA) welcomes the opportunity to provide feedback on the Australian and New Zealand Productivity Commissions' joint paper, '*Strengthening economic relations between Australia and New Zealand*' (joint paper).

The movement towards closer economic ties and a single economic market (SEM) between Australia and New Zealand provides benefits to both countries and has been supported by both governments. The ABA and its member banks support moves to streamline the ability of individuals and companies to interact and engage across the Tasman. However, a number of restrictions on this interaction remain, including restrictions on the free flow of capital due to a lack of the mutual recognition of franking credits/imputation credit (which is highlighted in the joint paper). This issue has previously been raised by regulators and governments of both countries, including the Australian Government's 'Australia's Future Tax System Review' and the New Zealand Treasury and Inland Revenue's submission in response to that report. The removal of this and other restrictions to the free flow of capital would provide benefits to both countries.

The ABA provides the following comments for consideration.

1. Tax

1.1. Mutual recognition of franking credits/ imputation credit

An important driver towards a SEM between Australia and New Zealand is the free flow of capital between the two countries. Australia and New Zealand cannot progress to a genuine single economic and investment market without mutual recognition of franking credits. Under mutual recognition the capital markets of Australia and New Zealand would become more integrated and competitive. The pool of investors from which capital could be sourced would be expanded and the cost of capital reduced, as equity returns would no longer carry the tax inefficiency of double taxation.

However, existing policy settings regarding the recognition of imputation credits in Australia and franking credits in New Zealand impede the free flow of capital across the Tasman. This distorts investment decisions and creates a barrier to full harmonisation. The problem with the existing policy setting is that, while franking credits can be used by Australian shareholders and imputation credits by New Zealand shareholders, New Zealand imputation credits cannot be used by Australian shareholders (and vice versa). Mutual recognition of Australian franking credits and New Zealand imputation credits removes this problem (by allowing Australian shareholders to use New Zealand imputation credits and vice versa), thereby promoting the free flow of capital between Australia and New Zealand.

Significant progress has been made by the Australian and New Zealand Governments in addressing “triangular tax” through the recognition of New Zealand imputation credits for New Zealand shareholders of Australian companies with New Zealand subsidiaries and Australian imputation credits for Australian shareholders of New Zealand companies with Australian subsidiaries. However, the key issue in trans-Tasman taxation is the lack of recognition of reciprocal imputation credits.

Progress needs to be made towards the development of a model between the two countries that allows companies in each country to generate imputation credits or provides some other appropriate form of tax credit for domestic shareholders for income tax paid in the other country, in order to reduce tax distortions on trans-Tasman investments. This is fundamental to reducing the cost of capital for Australian and New Zealand companies and improving the overall global competitiveness of Australian and New Zealand companies. It would produce flow on positive effects for the Australian and New Zealand economies in the form of increased after tax returns to shareholders, increased demand for shares in Australian and New Zealand companies, increased capacity for companies to raise cost effective capital and increased growth opportunities for these companies.

The ABA continues to hold the view that more generally, an integrated approach to attracting equity capital for offshore expansion should be pursued such that:

- dividend streaming be permitted to enable foreign shareholders of Australian multinationals to receive dividends directly from foreign earnings, without the imposition of Australian franking penalties;
- to the extent that unfranked dividends are paid to Australian resident shareholders out of foreign source income, to provide Australian resident shareholders with an appropriate non-refundable tax credit (at a rate which is sufficient to substantially eliminate the double taxation of foreign earnings); and
- Australian multinationals are permitted to continue paying unfranked dividends out of foreign source income to foreign shareholders without the imposition of Australian dividend withholding tax.

1.2. Dividend withholding tax

From 1 May 2010, the new Australian and New Zealand double tax convention provides that dividends are subject to a maximum withholding tax rate of 15 per cent. Dividends received from companies where the recipient is a company which owns at least 10 per cent of the voting power are subject to a maximum 5 per cent withholding tax, dropping to 0 per cent withholding tax where beneficial ownership is 80 per cent or greater.

However, this adversely distinguishes ‘less than 80 per cent holders’ compared to ‘more than 80 per cent holders’ in respect of un-imputed dividends. By way of comparison, there is no UK dividend withholding tax on dividends paid to Australian resident entities. The ABA recommends a reduction in the dividend withholding tax rate to zero per cent on all dividend flows from both countries irrespective of the share ownership interest. This would support the goal of facilitating the free flow of capital between the two countries.

1.3. Interest Withholding tax

Withholding tax imposed on interest paid from New Zealand currently constrains access to offshore markets at competitive prices and hampers the ability of New Zealand banks to leverage the Australian parent’s position. While recent developments have been made to the New Zealand Approved Issuer Levy regime, these developments remain too narrow and, generally, do not apply to accessing offshore debt market. The ABA recommends that the New Zealand withholding tax regime be aligned with the Australian withholding tax exemption within Section 128F. In addition, consideration should be given to broadening the withholding tax exemption to offshore deposits.

The ABA acknowledges the concern with removing withholding taxes in that withholding tax on interest provides a protection for the New Zealand income tax base on lending margins; that is, the situation where offshore parties can lend directly to New Zealand borrowers, with the consequence being that the margin earned is earned in an offshore jurisdiction and taxed in that jurisdiction, and hence not collected in New Zealand.

However, the ABA is of the view that relaxing the withholding tax regime should have a net positive impact on the New Zealand tax base by providing New Zealand banks with a source of funds which are currently not being accessed. This would reduce the reliance on wholesale funding, which would have a positive impact for customers via lower interest margins. When considering the flow on effects, this would be expected to have an overall positive impact on the New Zealand tax base.

2. Prudential

There are a number of areas of current and proposed divergence in the prudential regulation of Australian and New Zealand financial institutions by the Australian Prudential Regulatory Authority (APRA) and the Reserve Bank of New Zealand (RBNZ).

Given New Zealand's major banks are largely owned by Australian banks, minimising this divergence is particularly important to avoid any disincentives for Australian parents banks to continue investing in New Zealand subsidiaries.

2.1. Implementation of Basel III reforms

There are significant differences in the proposed implementation of Basel III reforms in Australia and New Zealand. Both APRA and the RBNZ are proposing to introduce Basel III capital reforms in a more conservative form than international standards and ahead of agreed international timetables. The RBNZ is proposing an even faster implementation timetable than APRA and there are substantial differences between the APRA and RBNZ proposals.

In particular, the proposed criteria for qualifying capital instruments (Additional Tier 1 and Tier 2) are different. There is currently an established New Zealand market for hybrid Tier 1 securities and Tier 2 subordinated debt. To ensure this market remains viable it is important that New Zealand and Australian definitions of capital are aligned.

Alignment should aim to:

- Avoid future capital issues by New Zealand banks having to comply with two different sets of rules to ensure qualification in both the RBNZ's capital calculations and APRA's parent company capital calculations. Having to comply with two sets of criteria will potentially increase the level of complexity required in structuring these capital instruments, potentially making them less attractive to investors and more expensive to issue; and
- Ensure consistency in issuance structures for Australian and New Zealand banks issuing in the New Zealand market, avoiding a situation where one group of issuers has reduced access to or higher pricing of capital instruments in the New Zealand market because of less investor friendly criteria.

2.2. New Zealand Open Bank Resolution (OBR)

The RBNZ is implementing an OBR scheme involving a liability haircut for New Zealand banks. This approach is inconsistent with both APRA's approach for Australian banks and the approach being taken in other jurisdictions, and risks making New Zealand an outlier internationally. It could lead to a number of unintended adverse consequences, including:

- A negative impact on the cost of funding for New Zealand banks;
- Higher capital charges for Australian parent banks exposures to their New Zealand subsidiaries, which may result in reduced investment in New Zealand by Australian banks; and
- Adverse ratings consequences for New Zealand banks.

2.3. APRA related party exposure limits and related entities

APRA has flagged to Australian banks that it is considering changes to its existing related party exposure limits, which may, restrict Australian banks ability to invest in and support their New Zealand bank subsidiaries.

2.4. APRA associations with related entities

Another example where coordination is required is in relation to APS 222, Associations with Related Entities. It is the ABA's understanding that APRA intends to reduce limits for exposures to related entity banks from 50 per cent of Level 1 total capital base to 25 per cent of Common Tier 1 Equity. This may have impacts on New Zealand bank credit ratings, dependence on wholesale funding and funding costs.

It is unclear to what extent the RBNZ and APRA have discussed these issues bilaterally. Additionally, the need for such a change remains unclear to the ABA, especially given New Zealand banks' capital levels and conservative balance sheets.

Yours sincerely,

Tony Burke