

The income tax treatment of certain Tier 2 Capital instruments under the Basel III capital reforms

Discussion paper
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CONSULTATION PROCESS

Request for feedback and comments

The Government seeks your feedback and comments on the issue outlined in this consultation paper. To assist those wishing to make a submission, questions for consultation are located at the end of each section. However, you should feel free to address any issue raised in this paper, and should not feel obliged to address every question. The information obtained through this process will inform the Government's approach on the way forward and also assist in meeting the requirements of the Office of Best Practice Regulation.

All information (including name and address details) contained in submissions will be made available to the public on the Treasury website, unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who wish that part of their submission to remain in confidence should provide this information marked as such in a separate attachment. A request made under the *Freedom of Information Act 1982* (Commonwealth) for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please email responses in a Word or RTF format. An additional PDF version may also be submitted.

Closing date for submissions: 10 August 2012

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1. BACKGROUND

1. In the 2012-13 Budget, the Government announced that it will amend the income tax legislation in light of the Australian Prudential Regulation Authority's adoption of the Basel III capital reforms.
2. From 1 January 2013, certain capital instruments issued by authorised deposit taking institutions (ADIs) and certain other related entities regulated by the Australian Prudential Regulation Authority (APRA) will not be precluded from being characterised as debt for income tax purposes.
 - Under the Basel III capital reforms such instruments will have to be written-off or converted into ordinary shares if APRA decides that the ADI would otherwise become non-viable. If the current tax law applied to the instruments, it is likely they would be treated as equity for income tax purposes and their funding costs would not be tax deductible.

1.1 BANK CAPITAL REQUIREMENTS UNDER BASEL II

3. Australian banks are required to meet the prudential standards issued by the APRA. The prudential standards are concerned with the stability of the financial sector including the protection of depositors. These standards set out, among other things, the capital that banks must maintain. Regulatory capital supports the operations of APRA-regulated entities by providing a buffer to absorb unanticipated losses incurred by that particular entity. This capital is classified according to the ability to absorb such losses.

1.1.1 Tier 1 capital

4. Tier 1 capital comprises the highest quality components of capital that:
 - provides a permanent and unrestricted commitment of funds;
 - is freely available to absorb losses;
 - does not impose any unavoidable servicing charge against earnings; and
 - ranks behind the claims of depositors and other creditors in the event of winding up.
5. Tier 1 capital is divided into Fundamental Tier 1 capital, which includes paid up ordinary shares, and Residual Tier 1 capital which is subdivided into Non-innovative Residual Tier 1 capital (perpetual non-cumulative preference shares) and Innovative Tier 1 capital.

1.1.2 Tier 2 capital

6. The other category of regulatory capital is Tier 2 capital, which falls short of the quality of Tier 1 capital but nevertheless contributes to the overall strength of a bank. It is divided into Upper Tier 2 capital (which may include perpetual cumulative subordinated debt) and Lower Tier 2 capital (such as a term subordinated debt).

7. Upper Tier 2 capital instruments are more of a hybrid nature (that is, they have debt and equity characteristics) than Lower Tier 2 capital instruments.

2. CURRENT LAW

2.1 DEBT/EQUITY RULES

8. The debt/equity rules in Division 974 of the *Income Tax Assessment Act 1997* (ITAA 1997) are designed to classify interests based on their economic substance rather than legal form. Broadly speaking, an interest is a debt interest if there is an effectively non-contingent obligation of the issuer to repay the amount invested, in nominal value if the term is 10 years or less, or in net present value if the term will or may exceed 10 years.
9. Section 974-135 of the ITAA 1997 sets out the criteria for the concepts of 'non-contingent' and 'effectively non-contingent' obligations.
10. An obligation is generally non-contingent if it is not contingent on any event, condition or situation (including the economic performance of the entity, or a connected entity of that entity, that has the obligation), other than the ability or willingness of that entity or a connected entity to meet the obligation.
11. An example of a non-contingent obligation is a requirement to make regular interest repayments under an ordinary loan agreement. The obligation is non-contingent to the extent that payment must be made irrespective of whether the borrower is profitable or not, and irrespective of whether the borrower will become insolvent if it does.
12. Further, an obligation is 'effectively non-contingent' if, having regard to the pricing, terms and conditions of the scheme, there is, in substance or effect, a non-contingent obligation. Thus a scheme under which an entity has a right but not a legal obligation to provide a financial benefit could nevertheless be debt if, having regard to the pricing, terms and conditions of the scheme, the entity is in substance or effect inevitably bound to exercise that right. This would occur where not to exercise the right would result in the entity having to sustain a greater loss (in present value terms) from the scheme than if it exercised the right. A simple example of this would be where the issuer of a financing instrument has a right to redeem it after a certain period but is compelled to provide accelerating returns on the instrument if it does not exercise that right; the accelerating returns would make it uneconomic for the issuer not to redeem the instrument so that it is under an 'effectively non-contingent obligation' to do so.

2.1.1 Debt/equity taxation and the prudential framework

13. The capital adequacy standards in the prudential framework encourage instruments with equity-like characteristics. Conversely, issuers looking for tax deductibility seek to stress the debt-like characteristics of hybrid financing instruments. This creates a tension between tax treatment and prudential supervision that needs to be balanced.
14. Income tax regulations ensure that ADIs and certain other related entities regulated by APRA are not at a competitive disadvantage compared with non ADI corporate taxpayers who could raise

capital through the issue of what are in essence debt without being restricted by the pricing, terms and conditions imposed by prudential standards:

- Regulation 974-135D of the *Income Tax Assessment Regulations 1997* (ITAR 1997) ensures that conditions of insolvency or capital adequacy do not preclude Lower Tier 2 instruments from being treated as debt for tax; and
- Regulation 974-135E of the ITAR 1997 ensures that certain conditions of profitability, insolvency or negative earnings conditions do not preclude Upper Tier 2 instruments from being treated as debt for tax purposes.

3. IMPACT OF BASEL III CAPITAL REQUIREMENTS

15. In December 2010, the Basel Committee on Banking Supervision announced measures to strengthen global capital rules in *Basel III: A global regulatory framework for more resilient banks and banking systems*. APRA is preparing to apply these reforms on 1 January 2013.

16. Basel III will introduce new categories of regulatory capital and will provide minimum requirements for their categorisation as regulatory capital. These proposed categories are Common Equity Tier 1, Additional Tier 1, and Tier 2.

- Common Equity Tier 1 Capital comprises the highest quality components of capital that fully satisfy all of the following characteristics:
 - provide a permanent and unrestricted commitment of funds;
 - are freely available to absorb losses;
 - do not impose any unavoidable servicing charge against earnings; and
 - rank behind the claims of depositors and other creditors in the event of winding-up of the issuer.
- Additional Tier 1 Capital comprises high quality components of capital that satisfy the following essential characteristics:
 - provide a permanent and unrestricted commitment of funds;
 - are freely available to absorb losses;
 - rank behind the claims of depositors and other more senior creditors in the event of winding up of the issuer; and
 - provide for fully discretionary capital distributions
- Tier 2 Capital includes other components of capital that, to varying degrees, fall short of the quality of Tier 1 Capital but nonetheless contribute to the overall strength of an ADI and its capacity to absorb losses.

17. These requirements will need to be met by ADIs from the commencement date of Basel III as set out in the draft prudential standards released on 30 March 2012. These draft standards state that all regulatory capital instruments must be capable of bearing loss by including loss absorbency provisions in Additional Tier 1 and Tier 2 capital at the point that the institution becomes unviable.

18. On 31 May 2012, APRA released a set of draft prudential standards as part of its review of capital standards for general and life insurers. We note that from 1 January 2013, capital rules similar to ADIs (including the loss absorbency requirement) will apply to these insurers generally.
19. The announced Budget measure applies to 'certain Tier 2 regulatory capital instruments issued by ADIs and certain other related entities', that is APRA-regulated general and life insurers that are related to ADIs.
20. However, it is noted that life insurers and general insurers are also regulated by APRA but not all will be related to ADIs. Those life and general insurers related to ADIs would raise tax deductible debt but general and life insurers not related to ADIs would not receive the same tax treatment.

Question 1

We seek your views on the impact of Basel III on APRA-regulated, non ADI-related insurers are in the industry. If you are an APRA-regulated, non ADI-related insurer, are you likely to issue Tier 2 capital?

3.1 TIER 2 CAPITAL

21. In contrast to Basel II, Basel III does not impose an upper limit on the amount of capital within each category. The effect of this is that an excess amount of one category of capital will not 'spill over' into a lower category of capital.
22. Additionally, ADIs need to satisfy more stringent requirements in the documentation and treatment of new issues of Tier 2 capital (for more information see *Prudential Standard APS 111 Attachment G: Tier 2 Capital*).
23. The minimum standards that an instrument must comply with to be included in an ADI's regulatory Tier 2 capital include:
 - subordination to all but Common Equity Tier 1 and Additional Tier 1 capital;
 - no guarantee on amounts paid in or payable;
 - a minimum term of five years;
 - no acceleration of repayments, except under certain circumstances;
 - a loss absorbency clause that is triggered at the point of non-viability; and
 - a pre-determined payment schedule.
24. Except the loss absorbency requirement detailed in Prudential standard *APS 111 Attachment I: Loss absorbency at the point of non-viability: Additional Tier 1 and Tier 2 Capital instruments*, instruments issued with the above features would likely be treated as debt for tax purposes. While this is the case, Basel III Tier 2 regulatory capital appears to share more features of Basel II Lower Tier 2 regulatory capital and is much more debt-like in nature than Basel II Upper Tier 2.

Question 2

We seek your views on how much regulatory capital, in nominal and relative terms, you plan to issue, or have issued, under Basel III for each category of regulatory capital and the proportion of your total capital base it will make up. Furthermore, what are the main characteristics of the instruments you plan to issue, or have issued, in each category?

Question 3

Do you anticipate that you will increase your level of Tier 1 regulatory capital as the capital conservation and countercyclical buffers are phased in?

3.2 LOSS ABSORBENCY REQUIREMENT

25. Under Basel III, Additional Tier 1, and Tier 2 instruments of an ADI must be capable of absorbing losses if APRA determines that it is no longer able to operate in the private sector.
26. Under this requirement, the contractual terms of regulatory capital instruments that are not ordinary shares must include a clause that allows the instrument to be written off or converted to common shares if APRA determines that a trigger event has occurred. An exception to this is where the governing jurisdiction of the bank has in place laws that require such instruments to:
 - be written off upon such an event; or
 - fully absorb losses before tax payers are exposed to loss.
27. A trigger event comprises a decision by APRA that an institution will become non-viable unless the capital instruments are written off or converted into ordinary shares (that is, Common Equity Tier 1). A decision by APRA to make a public sector injection of capital, or equivalent support, without which the institution would have become non-viable, as determined by APRA, is also classified as a trigger event.
28. APRA has discretion regarding the occurrence of a trigger event and as such it may abstain from activating the loss absorbency clause contained in the capital instrument, thus allowing an ADI to fail.
29. The loss absorbency clause is likely to result in certain Tier 2 instruments (which are currently classified as debt interests) issued by APRA-regulated entities being treated as equity interests under the current debt/equity income tax rules. This would result in the payment of returns on these instruments being non-deductible.

3.2.1 Proposed Changes

30. The Government intends to ensure all Tier 2 instruments issued by ADIs and related general and life insurers will not be precluded from being treated as debt interests for tax purposes by amending the ITAR 1997 so that the inclusion of a loss absorbency clause as required by APRA, or a comparable regulator, does not preclude these Tier 2 instruments from being classified as debt interests for tax purposes.

31. Assuming that the Basel III Tier 2 capital is akin to Lower Tier 2 capital, eligible notes would have to have the following features under the proposed changes, consistent with the current drafting of regulation 974-135D of the ITAR 1997:

- have a maximum term of 30 years;
- distributions are cumulative and compounding;
- be classified as an accounting liability; and
- satisfies the Tier 2 capital loss absorbency requirement.

3.2.2 Date of effect

32. The Government will ensure that on commencement of the Basel III capital reforms on 1 January 2013, eligible capital instruments, issued on or after that date, by ADIs can be treated as debt for income tax purposes.

33. This change will apply to certain Tier 2 regulatory capital instruments issued by ADIs and certain other related entities regulated by the APRA on or after 1 January 2013.

Question 4

We seek your views on whether the implementation outlined above (if adopted) would achieve the suggested outcome.