29 November 2018

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Via Email: James.Campbell@ato.gov.au

Dear James,

Discussion Paper
Proposed Compliance Framework
Liquidity Management

The purpose of this letter is to provide feedback on the ATO's Discussion Paper setting out a proposed compliance framework in relation to liquidity management (**the Discussion Paper**). The feedback builds on the comments made at the meeting of the AFMA Liquidity Management Working Group on 26 June 2018.

Introductory Comments

The approach adopted in the Discussion Paper is primarily to set out the circumstances in which, in the Commissioner's view, intra-branch dealings such as liquidity adjustments may represent a reasonable allocation of actual third party income and expenses incurred by a bank, or be a reasonable proxy for those amounts, so as to potentially allow for deductibility under Section 8-1 of the *Income Tax Assessment Act* 1997. The circumstances articulated in the Discussion Paper are essentially those that do not have a "red-flag" which will preclude deductibility of the liquidity charge. In the Commissioner's view, the following factors will be considered to be a "red-flag:"

- Management inputs that incentivise certain types of activity;
- Hypothetical funding constructions that have no relation to the real external costs, or the use of modelled costs;

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- A lack of transparency;
- Assets that are included in the liquidity model that have a number of potential uses, including funding a number of potential liabilities, such that the assets do not have the relevant nexus to the amount allocated as liquidity charges; or
- Assets that are held outside of Australia that, from a practical or legal perspective, would not be able to satisfy liabilities of the bank outside the jurisdiction in which the liquidity reserve is held.

In our view, the approach adopted in the Discussion Paper, through denying in total the potential deductibility of any liquidity charge by virtue of the existence of a red flag is inappropriate and unduly harsh, given that the enterprise will have incurred an external cost (directly or indirectly) to fund the acquisition of the liquid assets, and hence the appropriate question is to determine a reasonable proxy for that cost that is capable of being deducted by the Australian branch. The ATO has previously recognised the nuances specific to banks in terms of the inability to trace funds through to actual third parties, and the approach in the Discussion Paper is not aligned with the manner in which the ATO has previously administered such issues. Additionally, our view is that, in determining the assets with the relevant nexus to the Australian operations for the purpose of inclusion in the liquidity model, the ATO should place a higher weight on the satisfaction of prudential regulatory requirements. We elaborate on these issues below.

In addition, it is noted that the comments below in relation to liquidity apply equally to tenor mismatch charges. As was evident in the Global Financial Crisis, an institution will become vulnerable to the extent that long term assets are funded via short term borrowings. To the extent that the enterprise holds medium or longer term borrowings through a central hub and thereby allows the Australian branch to fund itself more efficiently on a shorter term basis, then an appropriate proportion of the additional costs associated with the longer term borrowings should be regarded as benefitting the Australian branch and attributed accordingly.

Regulatory context

As the ATO is aware, there are a number of drivers that determine the manner in which a multinational financial institution will manage its liquidity and funding requirements. These include regulatory adherence, such as those proscribed by Prudential Standard APS210 and global equivalents, but also market conditions, availability/location of financial instruments and pricing. As such, it is unlikely that the liquidity models that are generally adopted at the present time will remain static.

Accordingly, our view is that the Discussion Paper should acknowledge the potential fluidity of liquidity and funding models and that there is an appropriate process in place to ensure that the comments in the Discussion Paper remain contemporaneous and relevant.

Industry "green-zone" liquidity model

The ATO has specifically sought from AFMA an actual example of a liquidity model that would be considered to be in the green zone and AFMA has requested from its members, specifically through the Working Group process, such a model. Through this process, it became clear that the manner in which different AFMA member firms manage their liquidity requirements are sufficiently bespoke such that a generic industry model that existed in actuality and was representative from an industry perspective would not be feasible.

That being said, in our view, there are inputs into a funding model which should not disturb the deductibility of the funding cost on the basis that such inputs, on an objective and actuarial basis, represent the cost of funding for the institution and, as such, do not result in the funding cost no longer being a reasonable proxy for the external cost. That is, there are inputs that are included in the model not to alter behaviour or provide management incentives/disincentives, but rather to adjust for factors which, in the institution's experience, objectively reflect the external costs.

An institution will raise funds via different instruments with different tenors, rights/obligations and payment profiles. The interest payments on each of these instruments will represent the "external cost" for which the Australian operations will need to demonstrate a reasonable proxy.

Despite the lack of an actual example of a model that is sufficiently relevant from an industry perspective, we have set out below two generic examples of the types of scenarios which are likely to be of relevance to a number of industry participants:

a) Central liquidity buffer: The bank's head office (HQ) and its overseas branches (including Australian branch) are part of the same entity. The purpose of holding a central liquidity buffer is to ensure the survival of both the HQ and overseas branches during a liquidity crisis affecting the bank as a whole. For the purposes of this example, we assume that there are no legal, regulatory, or operational impediments to using the proceeds from a realisation of the liquidity buffer assets to provide funding to any branch that requires it. If the HQ or any branch in the bank is unable to meet its obligations, the whole entity (including the Australian branch) becomes insolvent. Therefore, holding the central liquidity buffer benefits the Australian branch and an appropriate proportion of the cost of maintaining the liquidity buffer should be regarded as being incurred in carrying on business in Australia and be deductible.

b) Centralised funding approach: As was evident in the global financial crisis, banks can become vulnerable to liquidity risk if they fund long-term assets with short-term borrowings. In order to mitigate this risk, they need to maintain a sufficient level of medium or long term borrowings to match the profile of their assets. Banks operating globally can do this in one of two ways. Firstly, they can arrange for each of their branches (including Australian branch) to fund themselves (either internally from other branches or from external funding sources) at the tenors appropriate to their asset composition. Alternatively, they may choose to centralize their term borrowings in a central hub location(s) and arrange for their other branches to fund themselves (either internally or externally) at short term tenors. The latter approach may be followed in order to maximize the overall funding efficiency of the bank (and hence reduce its borrowing costs). In such a case, holding the term funding liabilities in the central location(s) benefits the Australian branch (due to the branch's cheaper funding costs at the short term tenors) and an appropriate proportion of the cost of maintaining those central term funding liabilities should be regarded as incurred in carrying on business in Australia and be deductible.

Sufficient Nexus

In order to calculate the negative carry on the high-quality liquid assets, it is necessary that those assets are legally and operationally available to the Australian operations in a stress scenario. In a centralised model, this gives rise to an assessment as to the relevant high-quality liquid assets for inclusion in the model.

The Discussion Paper states (at paragraph 63) that:

> "the presumption must be that those assets, and the costs incurred to acquire and hold them, are attributable to the location in which they are most readily available for use. The fact that the size of the liquidity reserve is determined by reference to the global business would, without more evidence, be insufficient to disturb that presumption."

In essence, this appears to require that, in a centralised context, the assets available to the Australian operations to adhere to the liquidity requirements are ring-fenced both from other jurisdictions, and the prudential regulatory requirements of those jurisdictions, and also from meeting daily liabilities of the institution.

In AFMA's view, this assumption is ill-founded and inconsistent with both the intention and the requirements to adhere to the liquidity standards imposed by prudential regulators, such as APS 210 in an Australian context.

APRA's Prudential Practice Guide APG 210 – Liquidity sets out in extensive detail the requirements that an ADI will need to meet in order to adhere to APS 210. The Practice Guide specifies requirements in relation to:

- Liquidity risk management, including governance requirements and codification and approval of strategic objectives;
- Calculation of the liquidity coverage ratio for LCR ADIs, including stress testing protocols, diversification requirements and modelling assumptions for different types of liability;
- Minimum liquidity holdings requirements for MLH ADIs, specifying the legal and operational requirements for demonstrating that the ADI has access to a certain level of liquid assets.

For an LCR ADI (which will include all foreign bank branches on the basis that such branches are precluded, from a regulatory perspective, from undertaking retail business), APS 210 specifies the operational requirements that must be adhered to for the purpose of satisfying the LCR. These include:

- That the assets are available for the ADI to convert into cash at any time;
- That the assets are unencumbered and under the control of the specific function charged with managing the liquidity risk of the ADI, such as the Treasurer with not only the authority but also the legal and operational capability to monetise the assets;
- Control over the assets is evidenced either by maintaining the assets in a separate pool or by demonstrating that the function can monetise the assets at any point in the 30 day stress period and that the proceeds are available to the function throughout the 30-day period without conflicting with a business or risk-management strategy.

In addition, specifically for foreign bank branches, APS 210 requires that such branches undertake an assessment as to local operational capacity to liquidate assets and make/receive payments without assistance from staff outside Australia. In undertaking this assessment, the branch will need to consider factors such as time zones and different non-business days and model a scenario where the local team has operational capacity to make/receive payments for three business days without assistance from staff outside of Australia.

It is clear, therefore, that in order for APRA to be satisfied that an ADI has met the requirements under APS 210, that there is a pool of assets that are legally and operationally capable of being liquidated for the benefit of the Australian operations in a stress scenario, regardless of the location of those assets. As such, as opposed to the presumption set out in the Discussion Paper, AFMA's view is that the appropriate assumption should be that the assets that satisfy APS 210 (or a foreign equivalent) have sufficient nexus to the Australian operations to determine an assessable/deductible amount for Australian tax purposes based on the return on those assets and the funding used to acquire the assets.

Conclusion of non-deductibility

Under the approach adopted in the Discussion Paper, where an ADI is unable to demonstrate that the liquidity charges are a reasonable allocation of third party expenses, or a reasonable proxy for such expenses, then no amount of the liquidity charge will be deductible for Australian tax purposes. That is, applying the compliance guidance set out in the Discussion Paper, any "red-flags" will result in the Commissioner denying all deductions for liquidity charges.

AFMA's view is that this approach is overly punitive, inconsistent with the compliance approaches adopted by the ATO in analogous circumstances and will give rise to double taxation. Our view is that to the extent that a "red-flag" exists, such as modelled costs or hypothetical construction of funding costs without sufficient objectivity, then the effects of these red-flags may be stripped out to allow the ADI to determine the reasonable proxy for the external cost and for that amount to be deductible for Australian tax purposes. This is the approach adopted in the Discussion Paper with respect to modelled inputs designed to incentivise management behaviour, where the Discussion Paper states that "a liquidity adjustment cannot be deductible **to the extent that** it is not referable to actual transactions that the bank has entered into," thereby allowing the bank to strip out the effects of the liquidity adjustment.

Such an approach would be consistent with the approach articulated by the Commissioner in TR 2001/11, whereby the Commissioner recognised the impracticalities associated with tracing funds transferred through bank branches and accepted for tax purposes the amounts specified in the bank's accounts, with the transfer pricing requiring ensuring that the amounts treated as assessable/deductible for Australian purposes are at arm's length. Specifically, we note the comment in TR 2005/11 that:

> "the nature of the business of a bank means that it is not ordinarily practicable or possible to trace either the source or end use of the funds transferred between branches such that the entity's actual third party income or expense associated with those funds can be allocated or attributed between branches."

While it may be true in the context of a centralised liquidity pool that there are no actual funds transferred between the different parts of the enterprise, the fundamental point remains the same; it is impractical in a pool of funds environment for tracing of the third party expenses incurred by the enterprise to fund the acquisition of the relevant liquid assets. We note that the ATO appeared to agree with this point at the meeting on 26 June and for completeness request that the lack of requirement to trace be set out specifically in the Discussion Paper.

Taking into account the approach adopted in TR 2005/11, which acknowledges the impracticalities associated with tracing, the appropriate enquiry to undertake is a functional analysis to determine the appropriate attribution of the third party income and expenses to the Australian branch. That is, given that the enterprise will have incurred interest expense to fund the acquisition of the liquid assets (and indeed derived income from those assets) then the appropriate enquiry is to determine the amount that is attributable to the Australian branch and not to deny deductibility in total based on the existence of red flags.

Taxation Ruling TR 2005/11 states that "it is common for one part of a bank to perform treasury functions related to managing the institution's overall funding position, including funding deficits and investing surpluses, raising funds and making them available within the bank and managing market risks (interest and currency risks) and liquidity risk." That is, TR 2005/11 clearly accepted the potential for a centralised model to manage liquidity risk and focussed not on the deductibility issues but rather the appropriate attribution methodology to apply. Indeed, a similar position was adopted in paragraph 5.31 of TR 2001/11 and in PCG 2017/8 with respect to internal derivatives.

In summary, AFMA's view is that where there are red-flags that result in a conclusion that the liquidity charges of the Australian operation are not a reasonable proxy for an external cost, the appropriate enquiry should be to determine what a reasonable proxy would be, in accordance the attribution principles articulated in TR 2001/11 and TR 2005/11, as opposed to full denial of deductibility.

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AFMA remains committed to working with the ATO in relation to the taxation consequences of liquidity management and related issues, including the issues raised in the Discussion Paper and this submission. Please contact me if you have any queries.

Yours sincerely,

Rob Colquhoun
Director, Policy