20 September 2022

Greg Wood
Director, Corporate Tax Policy Unit
Corporate & International Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Greg,

Bail-In Instruments – Request for Updated Regulation

The Australian Financial Markets Association (AFMA) represents the interests of over 120 participants in Australia's 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. They are the major providers of wholesale banking and financial market services to Australian businesses and investors.

A significant number of AFMA's members operate in Australia through a foreign bank branch. The purpose of the submission is to highlight a technical issue that has arisen through engagement with the Australian Taxation Office (**ATO**), to provide data in relation to the implications should the technical issue remain unresolved and to propose a solution that should provide necessary clarity.

In presenting the technical issue and the proposal for resolution, it is noted that discussions between AFMA and the ATO have highlighted agreement that the outcome, were the ATO to apply its technical view, would be entirely inappropriate from a policy perspective and, on this basis, the ATO has not, to date, applied compliance resources to enforcing its technical view. The ATO has advised that its preference would be for the matter to be resolved through legislation/regulation, which is the basis of this letter.

The Issue

As noted above, the technical issue relates purely to those foreign banks that operate in Australia through a branch. In relation to bank branches, it is the jurisdiction of head office that has primary responsibility for prudential regulation. Specifically, this means that in respect of

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instruments issued out of the Australian branch, it is the powers of the prudential regulator in the home office jurisdiction that take precedence.

The technical issue arises where, in respect of an instrument that is legally and commercially debt, the head office prudential regulator has the ability to step in to cause that the instrument is either written off or converted to equity in the event of financial stress. Specifically, where the prudential regulator forms the view that issuer has ceased, or is about to cease, to be viable, then the regulator can mandate that the instrument is either written off or is converted to equity of the issuer (known as the **bail-in trigger**). The particular form of the bail-in trigger may vary between jurisdictions.

It is important to note that, for all other purposes, the instruments in question qualify as debt under Division 974 of the *Income Tax Assessment At* 1997 (**the 1997 Act**).

The ATO have advised that that the existence of the bail-in trigger causes the instrument to fail the debt test under Section 974-135 of the 1997 Act. This is on the basis that the existence of the trigger means that the issuer does not have an “effectively contingent obligation” (**ENCO**) to repay a financial benefit at least equal to that received. The ATO have considered arguments that the bail-in trigger does not impact the “pricing, terms and conditions” of the instrument and therefore, the ENCO requirement remains satisfied; however, this position was not accepted by the ATO. Similarly, the ATO has not accepted that the contingency that *prima facie* gives rise to the failure of the ENCO requirement is so remote that it should result in the obligation being contingent “in substance or effect,” on the basis that the existence of the bail-in trigger is required to be disclosed as a risk in the issuance documentation by the issuer.

It is noted for completeness that given Section 974-145 allows for regulations to be made as to what constitutes a non-contingent obligation and what does not constitute a non-contingent obligation, Regulation 974-135F specifies that the fact that an “obligation is subject to a non-viability condition does not in itself prevent the obligation from being a non-contingent obligation.” However, the Regulation applies only to term subordinated notes with certain characteristics, and hence applies more narrowly than the instruments issued from Australian branches of foreign banks.

Board of Taxation Review

The issues regarding the existence of non-viability triggers and other prudential regulatory requirements and the effect on the characterisation of instruments under Division 974 was considered by the Board of Tax in its review of the debt and equity tax rules. While the Board of Tax considered the implications of prudential regulation on the tax characterisation of instruments in the context of APRA regulation, the Board stated that:

> “The Board considers that there are advantages in having a regulation stating that the inclusion of APRA-required features in a financing arrangement does not of itself prevent an obligation from being a non-contingent obligation. This will avoid making regulations from time to time stating that the particular APRA requirements do not prevent an obligation from being non-contingent. This would also provide increased certainty to the banking sector regarding the tax treatment of…capital following any changes to APRA policies. It would also reduce compliance costs for the banking sector

as there would be less need to take tax considerations into account, or seek advice on likely tax treatment."

Practical Effect

From a practical perspective, the obvious effect of the ATO applying its technical view would be that returns on the instruments would not be deductible for the issuer, thereby significantly raising the cost of capital for such issuers relative to domestic banks, foreign bank subsidiaries and other foreign bank branches without a head office prudential regulator bail-in trigger. This would have significant implications for banking competition in Australia.

AFMA Proposal

Noting existing Regulation 974-135F, which applies to non-viability triggers on a term subordinated note to ensure that the non-viability trigger does not, of itself, cause the ENCO requirement to be failed, and noting the comments from the Board of Tax, AFMA recommends that a regulation be inserted to the effect that the existence of a bail-in trigger as required by a prudential regulator does not, of itself, cause the ENCO requirement to be failed.

*   *   *   *   *

We have set out in Appendix A high level information regarding the jurisdictions that AFMA is aware of that have a head office prudential regulator bail-in trigger, the form of the trigger, the number of foreign bank branches that operate in Australia from each jurisdiction and the total collective liabilities issued by Australian branches of these banks. This provides an order of magnitude as to the implications, were the ATO to treat such instruments as equity.

Please let me know if you would like any further information.

Yours sincerely,

Rob Colquhoun
Director, Policy

Jurisdiction	Description of Trigger	Number of Australian FBBs	Total Liabilities Issued ($million) (June 22)
Canada	• Conversion of liabilities to common equity of a bank or any of its affiliates • Exercisable by the Canada Deposit Insurance Corporation when the bank has ceased, or is about to cease, to be viable • Where the governing law of the relevant instrument is not Canadian law, there is a requirement to insert a contractual trigger	3	6,155
France	• Write down or conversion to equity of liabilities • Exercisable when the Single Resolution Board deems a bank to be at the point of non-viability • Where the governing law of the relevant instrument is not French law, there is a requirement to insert a contractual trigger	3	20,110
Hong Kong	• Powers to cancel, write-off, modify or replace all or part of the instrument or to alter the contractual provisions • Exercisable by the HKMA when it decides that the bank ceases to be viable	2	32,364
Switzerland	• Power to convert debt into equity or have it written off • Exercisable when the bank is unable to recover independently and is in danger of insolvency or illiquidity • Power sits with the Swiss Financial Market Supervisory Authority	2	8,560
United Kingdom	• Cancellation of the principal and/or interest of the instrument, conversion into shares or other instruments or any other variation • Exercisable by the Bank of England at the point that the bank has reached the point of resolution or will cease to be viable, absent the write-down/amendments • Where the governing law of the relevant instrument is not UK law, there is a requirement to insert a contractual trigger	1	0

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USA	• Write down of instruments, conversion into equity and/or recapitalisation through the US Federal Deposit Insurance Corporation; • Exercisable either at the time of resolution or receivership.	5	49,718
Total		16	117,176