IBSA
INTERNATIONAL
BANKS AND SECURITIES
ASSOCIATION OF AUSTRALIA

IBSA Submission to the Review of Business Taxation

- Foreign Bank Taxation

8 April 1999

Executive Summary

Proposals in the Review's second discussion paper, *A Platform for Consultation*, would harm foreign banks and reduce their potency as providers of competition in the domestic financial markets, which to date has produced substantial benefits to both corporate and retail consumers. They would also significantly weaken the competitiveness of Australia as a regional financial centre.

Foreign branch banks would be worst affected, being penalised relative to subsidiary operations under each of the three options for taxing entity distributions. The deferred company tax regime would be the most harmful option for both foreign branch banks and subsidiaries.

Foreign Branch Bank Concerns

The deferred company tax regime would undermine the competitiveness of the branch bank tax regime and threaten the position of branch banks. Problems with this option include:

- Inability for branches to manage their distributions to head office;
- Double taxation of tax preferred income;
- Unavailability of foreshadowed tax credits in many cases;
- Significant increase in effective tax rate;
- The benefit of the offshore banking (OBU) tax regime would be eliminated;
- Failure to address serious transitional issues.

Similar problems would arise with the resident dividend withholding tax and inter-entity tax options but they would be less harmful to branch banks, primarily because the withholding tax rate is less than the corporate tax rate.

The proposed entity regime for branches could exacerbate the difficulty posed for branch banks by the proposed options for taxing entity distributions. The entity regime contains:

- A notional equity requirement that impedes the competitiveness of foreign branch banks – an outcome of the absence of a revenue sharing agreement between national jurisdictions;
- A possible requirement for branch banks to satisfy both thin capitalisation and notional equity hurdles (the purpose this would serve is not understood by industry);
- A more severe interest withholding tax regime for intrabank dealings;
- An absence of arrangements to compensate for branch banks' inability to consolidate with related Australian subsidiaries.

These problems can be overcome and, indeed, they are largely dealt with in the existing taxation arrangements for foreign branch banks, contained in Part IIIB of the *Income Tax Assessment Act*. The Part IIIB provisions are in effect a quasi-entity regime for branch banks. For example, foreign branch banks are required to hold notional equity and intrabank dealings (including borrowing) must be conducted on an arms length basis. Recognising the need for some form of grouping provision, Part IIIB regime provides a means to transfer losses between the branch and Australian subsidiaries of the parent bank.

The Part IIIB provisions represent a fair attempt to preserve the integrity of the tax system, without unduly compromising the commercial drivers of branches that are an integrated part of a global bank. They are imperfect and have been the subject of discussion between industry and the authorities but they are far more advanced than the proposals put forward by the Review. It is disappointing that the Review did not draw more effectively upon the extensive pool of analysis and experience with branch banking that has been developed over the past six years.

Foreign Bank Subsidiary Concerns

The Review's proposal would also create particular problems for foreign bank Australian subsidiary operations:

- The deferred company tax regime would increase tax payable on unfranked distributions to the parent;
- The value of the OBU concession would be greatly reduced under the deferred company tax regime;
- The thin capitalisation proposals are quite unclear in terms of their application to foreign banks and could harm existing business;
- Foreign bank operations that cannot group under a single holding company in Australia will not be able to consolidate but will lose existing benefits (like loss transfer) available under existing law that consolidation is to replace.

Recommendations

Given the above, IBSA urges the Review to recommend to the Government that:

- The deferred company tax option be rejected;
- Foreign branch banks be allowed to determine the timing and amount of their profit repatriation;
- Foreign branch banks' retained earnings should be able to be offset against their notional equity requirement;
- The Government, in partnership with industry, continue to improve the existing branch tax regime and preserve key elements, like the ability to transfer losses and repatriate profits free of a withholding or remittances tax;
- Interest withholding tax on intrabank funding be abolished;
- Industry be involved in the development of thin capitalisation guidelines;
- Transfer of losses and asset rollover relief be available to related foreign bank subsidiaries that cannot benefit from the proposed consolidation provisions;
- The measures to counter the use of offshore related entities to avoid capital gains tax include a screening test to ensure that legitimate commercial transactions are not adversely affected by the anti-avoidance measures.
- The competitiveness of the OBU regime is enhanced by permitting a flow-through of income from OBUs to parent entities without the imposition of further tax.

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1 March 1999 - 45 Members

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Bank of China
Bank of Tokyo-Mitsubishi Australia Ltd
Bankers Trust Australia Limited
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Warburg Dillon Read Australia Limited
WestLB - Sydney Branch

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RBT's Foreign Bank Tax Proposals Misguided

1. Introduction

The International Banks and Securities Association of Australia (IBSA) represents investment banks that operate in Australia. These banks are predominantly foreign-owned and are major players in the capital markets, project and infrastructure finance, corporate advice, risk management and wholesale banking. They provide stiff competition for the major domestic banks in these business areas and dominate some markets. Member banks provide a range of international banking services and some serve as regional or global centres for part of their parent bank's operations.

IBSA's membership covers 21 licensed foreign branch banks, 10 licensed foreign bank subsidiaries, one licensed domestic bank and 18 merchant banks and securities companies. Several member banks have both a licensed branch bank and licensed subsidiary bank and many own a merchant bank or securities company subsidiary.

This submission concentrates on the impact on foreign banks of proposals in the Review of Business Taxation's second discussion paper, *A Platform for Consultation* (*APFC*). It is particularly important that the Review's recommendations deliver a competitive tax regime for foreign-owned banks in order to sustain competition in the domestic financial markets and to press home our advantages as a regional financial centre. IBSA is concerned that important aspects of the *APFC* proposals would be a retrograde step in this regard.

The submission considers issues arising from *APFC* that affect foreign bank branch and subsidiary operations. Foreign branch banks would be worst affected by the proposals, being penalised relative to subsidiary operations under each of the three options for taxing entity distributions. The deferred company tax regime would be the most harmful option for both foreign branch banks and subsidiaries.

The submission begins in Section 2 by considering the impact of the Review's proposals on foreign branch banks in some detail. After this it considers a range of issues, like consolidation, thin capitalisation and capital gains tax, that could affect all foreign bank operations in Australia to some degree.

2. Impact of the Taxation of Foreign Branch Banks

In *APFC*, the Review canvasses three options for taxing entity distributions, being deferred company tax, resident dividend withholding tax and taxation of inter-entity distributions. It is of great concern that branch banks operating in Australia are significantly worse off under each of the three options, by reference to both their current tax position and to their position relative to bank subsidiaries. The deferred company tax option would be most harmful and could threaten the ongoing viability of some branch banks, as the opportunity cost of the branch operating structure would increase significantly.

This outcome conflicts with the Review's objective of achieving tax investment neutrality, irrespective of the entity through which the investment is made (for example, see paragraph 33.49). These matters are discussed in more detail below.

By way of background, some brief comments on the current tax arrangements for foreign branch banks are worth noting.[1] Many IBSA members have evaluated the branch bank option and they typically report that existing taxation arrangements firmly favour a subsidiary structure over a branch structure. However, the non-tax advantages to a branch structure, like better market access and improved international standing, outweigh the tax disincentive in many cases. Therefore, the preferred choice of operating structure differs across individual banks.

2.1 Profit Repatriation and Retained Earnings - Tax Penalties

The impact of each option on branch banks is dependent upon their ability to easily and readily identify the quantum, components (tax profit, untaxed profit or capital) and timing of a distribution from Australia to the non-resident investor.

Paragraph 30.50 of *APFC* sets out a possible method of ascertaining the quantum of a remittance from branch to head office. The meaning of that paragraph is unclear and it could be construed as effectively deeming a full remittance of branch profit to head office each year. This interpretation was not ruled-out by Review officers during consultations. Indeed, in paragraphs 30.53 and 30.55 the discussion paper notes the "significant complexity" that would otherwise be involved in measuring the "dividend equivalent amount" for a branch.

The timing of the notional remittance from branch to head office also requires detailed consideration, as under each of the three options considered by *APFC*, the tax impact will be dependent on the time the remittance is deemed to be made. Unfortunately, the discussion paper appears to be silent in this regard.

To achieve tax neutrality with subsidiaries, a branch must have the ability to control/manage its distributions to head office. That is, it must have the ability to retain profit and not distribute it to head office, to allow it to manage the tax impact and, with respect to temporary tax preferences, the potential double tax impact, of the options. This ability would be denied under the *APFC* options if there were to be an effective deemed full remittance of profits.

In addition, to preserve equity and balance in the tax system, it would be necessary to make branch retained earnings creditable against any notional equity requirement levied on branches under the new regime. This would make sense within the framework of the entity tax system that is being proposed, as otherwise branches with retained earnings would be doubly capitalised for tax purposes in Australia. In the absence of a credit being given, locally incorporated entities would have a competitive advantage over branch operations.

2.2 Double Taxation of Tax Preferred Income

[1] Appendix 1 provides a detailed review of the branch banking and the current tax arrangements.

The examples in Table 1 show the impact on a branch bank of each of the three options for taxing entity distributions. Whilst assumptions have been made for simplification, the examples clearly show that a significant tax increase would occur under each of the options, when compared with the present taxing of branches. The apparent loss of a foreign tax credit for the dividend withholding tax (DWT) paid under each option (see below) renders a branch comparatively worse off than a subsidiary.

Table 1

Impact of Distribution Tax Options on a Branch Head Office "Dividend"

Assumptions (to simplify illustration of impact of proposals on temporary tax preferences)

- No franking credit surplus in year 1
- Full distribution of after-tax profit each year
- Temporary tax preference in year 1, which reverse in year 2
- Accounting profit only in year 1

	Current		**DCT**		**RDWT/Inter-entity dist tax**	
	Year 1	***Year 2***	***Year 1***	***Year 2***	***Year 1***	***Year 2***
Accounting profit before tax	100	0	100	0	100	0
Taxable income	0	100	0	100	0	100
Tax on taxable income	0	(36)	0	(36)	0	(36)
Income tax expense	(36)	-	(36)	-	(36)	-
After tax distributable profits	64	-	64	-	64	-
Deferred company tax	-	-	(23) [64x36%]	-	-	-
15% DWT	-	-	-	-	9.60	-
Cash to H.O.	64	-	41	-	54.40	-
Overall tax to ATO	Nil	36	23	36	9.60	36
	Total tax **36%** (years 1 & 2)		Total tax **59%** (years 1 & 2)		Total tax **45.6%** (years 1 & 2)	

Note: Franking credits arise in year 2 to shelter tax preferred income in future years. The entity tax/DWT switch has no impact on branch/HO dividends – HO is not a portfolio investor. Assumes branch profit does not include any tax-preferred distributions from an Australian company.

The deferred company tax option results in an effective tax rate on timing differences of approximately 59% and has the effect of taxing permanent differences (such as the "non-assessable" OBU income). The resident dividend withholding tax and taxing of inter entity distributions options provide similar outcomes, which although not as severe, result in a significantly worse position for branches than is currently the case.

The examples assume that the various options for taxing entity distributions are levied on profits that are earned by a branch through its own activities and then are remitted to head office. They do not consider the likely treatment of a branch's remittance to head office of dividends that it has received from an Australian resident company in which it has an investment. This is because the analysis in *APFC* does not address this issue and it is quite unclear on its treatment under its proposals.

It is important that this matter is clarified because a separate entity branch will remain a non-resident (it is unable to consolidate) and, thus, the dividends received by a branch from an Australian company will constitute a dividend paid to a non-resident foreign investor. Currently, dividends received by a branch from an Australian resident company would be subject to 30% withholding tax and constitute exempt income of the branch (section 128D). If the branch were treated as a separate entity, this would exacerbate the inequity identified above.[2] This seems to be an unintended outcome that would need to be addressed before implementation of the new proposals were contemplated.

At this point, it should be noted that foreign bank subsidiaries would also face in increase in tax levied on unfranked dividend payments to their parent under the deferred company tax regime. This would significantly reduce the value to them of existing assets or benefits, like accumulated losses and the OBU tax rate.

2.3 Notional Equity Complications

APFC (paragraph 33.53) states that a consequence of a branch being taxed as a separate entity would be that, for tax purposes, the branch would be treated as being capitalised, including with equity. Issues that require consideration or clarification as a result of this comment revolve around the potential interaction of that concept with the notional distributions that may arise from branch to head office. That is, whether and if so how, a branch could taint its (notional) share capital account and how the “profits first rule” and the “slice rule” apply, if at all, to the branch remittances to the head office (which, by paragraph 30.50, include the concept of a <u>net</u> capital injection by head office) require detailed consideration.

2.4 Foreign Tax Credits Often Unavailable

The discussion of the impact of deferred company tax on non-residents (see paragraph 15.38) contemplates a credit being allowed for deferred company tax to non-portfolio foreign investors in countries that operate foreign tax credit systems. However, a number of jurisdictions in which foreign bank branches operating in Australia are resident provide an exemption system for foreign source income rather than a foreign tax credit system. Foreign banks resident in such jurisdictions will be significantly disadvantaged.

There are also significant difficulties in jurisdictions that provide a foreign tax credit system. Each of the options contemplates dividend withholding tax being paid by the non-resident in respect of dividends paid to it (including the deferred company tax option via the DWT switch outlined in chapter 30 of *APFC*). Under each of the options, the withholding tax is taken to provide a foreign tax credit in the home jurisdiction and, thereby, minimise the overall impact of the respective option.

However, the application of withholding tax to a dividend flowing between branch and head office needs to be clarified. It would appear that most of

[2] Withholding tax limitations contained in double tax agreements do not apply where the dividend is derived by a branch.

Australia's double tax treaties would not regard a branch remittance as a dividend unless it was treated as such or as income "assimilated to income from shares" by the tax law of the overseas jurisdiction. This raises questions as to the ability of Australia to impose such a dividend withholding tax on the branch remittance. The creditability of such "dividend withholding tax" in overseas jurisdictions is to be doubted in respect of branch/head office "dividends". This further puts a branch bank operation behind a subsidiary bank in terms of tax neutrality.

2.5 Notional Equity Tax Disadvantage

The *APFC* proposal to levy a notional equity requirement on branches requires more consideration than it is given in the discussion paper. A notional equity requirement currently applies to foreign branch banks and it is the most serious disadvantage endured by them under the current tax system (see appendix 1). It is also the subject of a vigorous ongoing discussion between the ATO and IBSA. The problem is that the requirement involves a clash between two objectives – that of equitable sharing of revenue across jurisdictions and tax neutrality within the domestic banking market.

The Government originally argued that the foreign branch bank notional equity requirement would help to maintain competitive neutrality with Australian banks. In fact, it does not do this but rather penalises foreign branch banks by requiring them to carry a greater capital cost per transaction than locally capitalised banks must. In accordance with the Basle Concordat provisions, the prudential supervisor of the parent bank requires it to hold regulatory capital to cover transactions in its Australian branch. This is reflected in the banks' charges for branch transactions that use its capital and is matched by the regulatory capital requirement imposed by APRA.

Table 2

Pricing Regulatory and Notional Equity Costs – Simple Example

	Government Bond	**Corporate Loan**
Regulatory risk weight	10%	100%
Regulatory capital requirement	4%	4%
Regulatory capital cost (tier 1 only)	4 basis points	40 basis points
Notional equity charge	8 basis points	8 basis points
Total domestic bank capital charge	4 basis points	40 basis points
Total foreign branch capital charge		
– No foreign tax credit	12 basis points	48 basis points
- Full foreign tax credit	4 basis points	40 basis points

The notional equity requirement in effect requires notional capital to be held for tax purposes that is <u>additional</u> to the capital that must be held for regulatory purposes. This is a competitive constraint that offends tax neutrality, as locally incorporated banks are required to meet only the regulatory capital element. Neutrality would be restored if the notional equity charge generated an offsetting tax credit in the parent bank's jurisdiction, but this often is not the case.

This point is illustrated in table 2, based on a simple example that assumes an equity premium of 10% and bank borrowing rates of 5.5%. The example refers to Tier 1 capital only, as part of Tier 2 capital may not subordinated loans.

In summary, there is a strong case for the Review to recommend the suspension of the notional equity requirement until all banks can obtain an offsetting tax credit in their home jurisdiction, as this would enhance tax neutrality within the domestic banking market. However, it would also cause a loss of revenue to the Australian Government of $35-40 million.

To maintain balance in the Australian banking market, it would be necessary to only require notional equity of branches when an offset is permitted in the parent bank's home jurisdiction. Since the notional equity requirement involves a reduced deduction for interest paid, it is a difficult tax to obtain a credit for in many foreign jurisdictions. The best way to resolve this problem is through a multilateral agency, like the OECD. The tax reform process should provide support to the Australian authorities in their international negotiations in this area.

2.6 Notional Equity and Thin Capitalisation

The Review appears to suggest that the thin capitalisation provisions should be applied to branch banks that already meet a notional equity requirement (paragraph 33.54). This could also be concluded from discussions with Review officers during focus group discussions.

The rationale for this approach is not at all clear, as notional equity is considered to be an alternative to thin capitalisation, because thin capitalisation provisions cannot be applied to branches. Indeed, the notional equity requirement provisions in Part IIIB of the *Income Tax Assessment Act*, that governs foreign branch banks, were put in place specifically to ensure consistency with the thin capitalisation provisions that govern subsidiaries.[3]

2.7 Withholding Tax

The Review, in its discussion in *APFC* of treating branches as separate entities for tax purposes, contemplates the introduction of withholding tax on intra-entity interest and royalty payments. With regard to branch banks, there is an inference that the existing 5% (effective 4.8%) interest withholding tax levied on intrabank interest payments could be increased to 10% (paragraphs 33.56 and 33.57). This would be a retrograde step that would run counter to the understanding developed between industry and the Government on the taxation of foreign branch banks (see appendix 1).

Indeed, there is a good case for removing interest withholding tax on intrabank funding, as the parent bank in effect simply stands as a conduit between the providers of funds and the branch. Governments in the past have cited risk of revenue loss and budgetary constraints as reasons for not removing this impediment, while recognising the adverse effect that it has on the

[3] See Banking policy Statement by the Treasurer, June 1993.

competitiveness of branch banks. There are good grounds for correcting this position.

Apart from this problem, there are other interest withholding tax disadvantages faced by foreign branch banks that the Review does not address in *APFC*. For example, unlike locally incorporated banks, they have not been able to access non-resident funds that are free of withholding tax (and may only be able to do so indirectly, if legislation before Parliament is enacted). Any recommendation that the Review makes in regard to interest withholding tax and branch banks should be based on a thorough analysis of the existing situation and a proper assessment of the impact of any proposed new measures.

2.8 Serious Transitional Issues Not Addressed

Each of the three options for tax entity distributions would be extremely onerous on a branch bank operation that was in existence prior to the commencement of the reform measures. A branch bank, however profitable and irrespective of what level of tax was paid by it, would not have generated any franking credits under the current imputation system. Thus, the entire accumulated branch profits (or branch retained earnings) that existed immediately prior to the commencement of the reform measures would constitute tax preferred income, if it were distributed (or deemed to be distributed) after the commencement of those measures. There would be no franking credit surplus to shelter it. Thus, under the deferred company tax regime, such profits will ultimately be taxed again – even if all the profit was tax paid! This is an absurd policy result.

Also impacted would be the realisation, after the commencement of the regime, of future income tax benefits that arose prior to it (for example, carry forward tax losses, unrealised losses on revenue assets, unrealised gains on pre-CGT assets and the indexation component of post-CGT assets). Each of those accumulated benefits would generate a tax preference and the impact of a deferred company tax will result in those amounts suffering tax at 36%. Accounting requirements may cause the immediate write-off of such benefits that to date may have been treated as an asset in the company’s books.

Branch banks should be allowed to convert these prior tax paid profits and tax preferred balances into contributed capital of the branch to ease the impact of these new measures. Alternatively, a starting franking account balance should be allocated to a branch. Unlike subsidiaries, a branch would not otherwise have any franking credits at the commencement of this regime and unless all distributions to head office are halted until sufficient credits arise, the branch will not be in a position to manage the impact of the proposals and avoid double tax arising. As noted above, there are numerous difficulties with a branch managing and controlling its notional distributions to head office.

This transitional issue is critical for branch banks and would have to be addressed in advance of the introduction to these measurers, if that course is decided upon.

3. Inability to Consolidate

APFC contains a proposal to consolidate companies within a group for business tax purposes, with the objective of reducing compliance and administrative costs, including less burdensome anti-avoidance provisions. However, foreign branch banks and Australian subsidiaries of non-residents not held via an Australian resident holding company would not be able to consolidate under the proposals (see paragraph 26.47). Consequently, no loss transfers or asset rollovers would be permitted between non-consolidated Australian subsidiaries of foreign banks or between subsidiary and branch (or vice versa), nor in respect of taxable Australian asset transfers between non-resident companies (paras 26.48 and 26.50).

It is recognised that there are many practical difficulties associated with the consolidation of foreign branch banks with locally incorporated companies. However, it is important to preserve economic neutrality in the tax treatment of dealings between companies that are able to consolidate and those that are denied the opportunity to do so. Neutrality would not be achieved under the proposed measures. Branches would not be able to be group their losses with Australian resident companies and losses of Australian resident companies would not be able to be grouped with taxable income of branches, notwithstanding the fact that there is 100% ownership between the bank and the Australian resident subsidiaries. Similarly, there would be tax implications arising from the transfer of assets between subsidiary and branch.

Many foreign bank subsidiary companies do not operate within the framework of an Australian resident holding entity and would not be able to restructure in this manner in order to participate in consolidation due to commercial factors and regulatory concerns. These companies would lose the benefit of existing grouping provisions and, like branches, would be disadvantaged compared to entities that have the consolidation option.

Since it is the intention to exclude branches and these foreign-owned subsidiaries from the consolidation provisions, the Review must recommend alternatives that facilitate the normal grouping of losses and transfer of assets that could reasonably be expected to occur for commercial reasons, if it is to preserve tax neutrality. For example, this would mean that the existing provisions, like subdivision 170-A of the *Income Tax Assessment Act 1997*, would have to be preserved to enable existing Government policy embodied in the Part IIIB provisions to continue to be applied.

4. Thin Capitalisation Proposals are a Concern

Two options for tightening the thin capitalisation provisions are presented in *APFC*. In application, the options would draw upon on worldwide group gearing, an independent operation arms length gearing ratio and a fixed ratio to determine the extent of interest rate deductibility (see paragraphs 33.36-33.39). No specific consideration is given to the treatment of banks in this regard, even though under the current law they are subject to a different set of rules to those governing corporates. For the *APFC* proposals to work, the particular commercial characteristics of banks would have to be taken account of under the new rules.

The Review's proposals could have a serious adverse impact on foreign banks (both branches and subsidiaries), if they are not carefully designed to preserve balanced competition in the marketplace and are not skilfully implemented. The guidance provided in *APFC* is too broad to give a clear insight into the intended effect, but caution is warranted as it is envisaged that a considerable amount of revenue will be raised through this proposal.

IBSA conducted a limited analysis of foreign branch banks' parent capital base in the recent past, as input to an ATO project, and several points emerged that are worth commenting on in the context of the Review's proposals, as they would apply to foreign banks:

- Data on worldwide gearing ratio could be difficult to obtain on a consistent basis across banks and countries;
- Comparisons across countries would not be very meaningful, given the range of gearing structures in existence, and application of the worldwide ratio could penalise some foreign banks operating here relative to others;
- The worldwide gearing ratio may not be appropriate as the mix of business conducted by foreign banks in Australia can differ significantly from that conducted by the global bank;
- Determination of reliable arms length ratios within the Australian investment banking market would be very difficult given the range of activities conducted and variety of operating entities.

Therefore, the fixed 'safe harbour' gearing ratio is likely to be very important to foreign banks. However, the Review does not state the level at which the safe harbour gearing ratio would be set, so it is not possible to comment on its merit. Officials during Review consultations have suggested that the APRA regulations might provide some guidance. However, these are based on risk weighted assets and contain depositor protection benefits that do not apply to all banks. In addition, merchant banks are not regulated by APRA, or indeed by ASIC[4], though a financial markets licence issued by ASIC may be required if the Government's recently released Corporate Law Economic Reform Program proposals are implemented.[5]

[4] Unless they operate as a securities dealer or as an authorised foreign exchange dealer.
[5] *Financial Products, Service Providers, and Markets – An Integrated Framework,* an implementing CLERP 6 consultation paper.

In summary, there is considerable uncertainty and concern amongst foreign banks about the proposed tightening of thin capitalisation conditions. It is vital that the Review strongly recommends to Government that industry should be invited to actively participate in the development process for finance industry gearing ratios. An excessive tightening would harm the competitive position of foreign banks industry and fail the competitive neutrality test.

5. Capital Gains Tax Proposal Needs Qualification

The Review proposes measures in Chapter 30 of *APFC* to counter the use of offshore related entities to avoid capital gains tax, by focusing on non-resident control of an asset. The need to tighten existing measures is accepted but it is important that this is done in a manner that does not impinge upon normal commercial transactions. For example, consolidation of industry players have been a prominent feature of the global rationalisation of the banking industry and the measures must be designed so as not to penalise foreign banks in Australia whose parent banks have been involved in related mergers and acquisitions.

The measures should include a screening test to ensure that legitimate commercial transactions are not adversely affected by the anti-avoidance measures. For example, capital gains tax could be levied on branches (and subsidiaries) for <u>indirect</u> transfers of assets (see paragraphs 30.74 to 30.76) where control of the entity changes offshore. This would be an anomalous outcome, which could be avoided by appropriate testing for continuity of indirect beneficial ownership.

6. The Review Must Build Upon The Existing Base

A disappointing feature of *APFC* is its failure to draw more effectively upon the extensive pool of analysis and experience with branch banking that has been developed over the past six years.

The existing foreign bank branch tax regime, in Part IIIB of the *Income Tax Assessment Act* was introduced in 1994 and many of the issues alluded to in *APFC* were the subject of considerable debate during the preceding consultation process with industry. The provisions enacted contained many compromises and, as such, are imperfect. However, they do represent a fair attempt to preserve the integrity of the tax system, without unduly compromising the commercial drivers of branches that are an integrated part of a global bank. It is not the most competitive branch tax regime in the region but it is sufficient to make branch banking worthwhile, given a range of commercial considerations.

The Review should draw upon this experience in developing its recommendations on branch taxation, especially in so far as it affects branch banks. For example, *APFC* notes that the proposal to adopt a separate entity approach to the taxation of branches would have a number of tax implications, including an equity requirement, arms length internal debt funding and other intra-entity dealings (see paragraph 33.1).

33.1 The separate entity approach would have a number of implications. For example, it would mean that at least for tax purposes:

- the branch would be treated as being capitalised (including with equity) in an arm's length manner;
- internal debt funding would be rewarded with an arm's length interest rate; and
- other intra-entity dealings would be rewarded with arm's length prices and not via an allocation of actual income and expenses.

However, these issues are explicitly dealt with for branch banks in the Part IIIB provisions, which apply certain important provisions as if the Australian branch of a foreign bank were a separate entity. In addition, there is a significant overlay with transfer pricing provisions. Significantly, the Part IIIB provisions permit the transfer of losses between branch and subsidiary and state that thin capitalisation provisions do not apply to branches.

Any proposal to alter the tax arrangements governing branch banks should take proper account of the existing situation and similarly seek to strike a fair balance between the tax and commercial considerations. The Review has an opportunity to build on the current arrangements to enhance domestic tax neutrality and improve our international competitiveness. There is great concern that existing deficiencies in branch bank tax arrangements could be magnified by the proposals presented in *APFC*.

7. Offshore Banking Units – A Clear Statement Needed

It is unfortunate that the Review does not deal with the tax treatment of offshore banking units (OBUs), as they are a central element in the Government's push to create a regional financial centre in Australia. There is particularly concern about the impact of a deferred company tax on OBUs, as it would effectively eliminate the benefits of the OBU concession, as OBU income would be tax preferred income. Branch banks would be most disadvantaged relative to the current situation, yet it is branch banks that would be the cornerstone of a successful regional financial centre.

The OBU 'concession' is in a separate category to other tax preferences arising from concessions given by the income tax laws. The rationale behind the OBU provisions and the generous tax treatment of OBU income is that, without such concessions, that business would not find its way to Australia at all. In reality, it is foreign source income derived by non-residents that is merely routed through Australia because the OBU concession is present. Any diminishing of that concession, whether directly or indirectly via a deferred company tax mechanism, can only lead to a cessation of that business coming to Australia. This is implicit in the Government's *Investing for Growth* statement of December 1997, in which an expansion and encouragement of the OBU regime was announced.

To maintain the viability of offshore banking business, the OBU non-assessable income should be carved out of each of the proposed options, presumably by allocating franking credits in respect of that amount. This should not be seen as a tax cost but rather as a means to realise tax revenue potential, as the 10% tax on the OBU income that is currently received could be lost if there is no carve out mechanism.

Appendix 1
Foreign Branch Banking – Currently a Tax Inferior Option

1. Background

Foreign banks in Australia operate as either:

1. A licensed branch bank - wholesale banking only;
2. A merchant bank (money market corporation) – wholesale banking only,
3. A locally capitalised licensed bank subsidiary – retail and wholesale banking;
4. Some combination of the above three.

The origins of branch banking lie in the 1991 Martin Committee Report on the financial system, which recommended that branch bank licences be issued to foreign banks.[6] Foreign banks had sought this initiative and the Government agreed to it to further increase competition in the financial sector, especially in the treasury products and corporate finance markets.

The tax law governing the taxation of branch banks was introduced in November 1994, after consultation with industry. The arrangements for taxing foreign branch banks are not tax neutral and are the main disincentive to adopting a branch bank structure, compared to a merchant bank operation, which is the main alternative. However, tax is just one of several factors in a foreign bank's decision to operate as a branch or not, so many do operate as a branch despite the tax disadvantages.

Commercial factors tend to favour adoption of a branch structure. Regulation has a variable influence depending on the nature of the business under consideration, though APRA strongly favours the conversion of large merchant banks to a licensed bank entity. These are discussed in more detail below.

Typically, foreign banks that operate through a branch also have a merchant bank subsidiary. A small number of foreign banks have both a licensed branch bank, which focuses on treasury and wholesale banking activities, and a locally capitalised subsidiary that is required by regulation for the conduct of retail business.

The importance of the various advantages and disadvantages to each potential operating form differ greatly across individual banks. An objective of tax reform is to deliver a balanced set of tax arrangements that have no substantial influence on the decision about the form of operation that is adopted, so that commercial factors are predominant. In this regard, it is disconcerting that proposals in *APFC* would exacerbate the existing disincentive towards the use of branch banks.

[6] The Government announced its acceptance of the recommendation in its "One Nation" policy statement in February 1992.

2. Converting to a Branch Structure – Tax Considerations

One of the most important factors in evaluating the branch conversion decision is taxation. There are taxation advantages and disadvantages to each form of operation. However, there is a general view amongst merchant bank and licensed bank subsidiaries of foreign banks that their tax burden would increase if they were to change their status to that of a branch.

Table A1

Tax Consequences of Different Foreign Bank Structures

		Foreign bank – licensed as		
	Merchant bank	**Subsidiary**	**Branch In Part IIIB**	**Branch Out Part IIIB**
Notional capital requirement	✗	✗	✓	✗/uncertain
Thin capitalisation	✓	✓	✗	✓
Direct IWT free funds	✓	✓	✗	✗
Dividend withholding tax				
- Corporate tax paid	✗	✗	✗	✗
- Tax preferred income	✓	✓	✗	✗
OBU	✓ (some only)	✓	✓	✓
Grouping of losses	✓	✓	✓	✗
Foreign tax credits	✓	✓	uncertain	uncertain

2.1 Notional Equity Requirement

Branch Banks Taxed under Part IIIB Provisions

The greatest disadvantage endured by foreign branch banks taxed under Part IIIB of the *Income Tax Assessment Act* is the notional equity requirement. A notional equity equivalent of four percent of total funds received by the branch is applied, so that only 96% of the interest paid to service its borrowing is deductible for tax purposes. The 4% ratio is a rough approximation to some desired level of local equity which the Government requires foreign branch banks to hold.[7]

The annual ongoing cost of notional equity for an average sized foreign bank, with a balance sheet of $3 billion and an average cost of funds of 5.5 per cent, would be $2.2 million (or 8 basis points per dollar liability).[8] In contrast, locally incorporated licensed banks and merchant banks are entitled to full deduction of their interest rate expense.

An important commercial advantage of electing to convert to branch status is the ability to make better use of the parent bank's global capital. The notional equity requirement negates this by imposing a requirement to maintain double capital in respect of transactions undertaken by the local branch (see section 2.5 of the submission).

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[7] The origin of the notional equity charge level may the Basle capital adequacy requirement for Tier 1 capital of 4%, though the Basle ratio applies to risk weighted assets (including off balance sheet items), as opposed to the notional equity base of unweighted balance sheet liabilities.
[8] This cost is calculated as follows [($3bn X 6%) X 4%] X 36%.

The notional equity amount has no regulatory or commercial standing. The Reserve Bank does not recognise the tax notional capital requirement for supervisory purposes and, consequently, does not allow branches to access retail deposits. The credit standing of branch banks in financial markets is substantially dependent on that of their parent bank and the notional capital does not reduce risk for its transaction counterparties.[9] These inconsistencies add to the competitive disadvantage suffered by branch banks.

Branch Banks Outside Part IIIB

There is considerable uncertainty amongst foreign banks about the appropriate notional equity treatment of banks that opt to be taxed outside of Part IIIB. Based on legal advice, some have formed the view that there is no notional equity requirement. They would not necessarily have acted upon this advice, given uncertainty about the ATO's position and if notional equity is to be applied, what the appropriate level would be.

Professional advisers have been unable to alleviate this uncertainty. The ATO has indicated in discussions that it will not accept a zero capital allocation to branches that opt out of Part IIIB but has not categorically stated this publicly nor stated the level of notional equity that it would require in this circumstance.

However, in *APFC, the Review* presents an interpretation of the law that appears to contrast with that of the ATO and adds to the confusion;

> "The treatment of funding of branches is particularly unclear. The law does not clearly state anywhere that branches have to be funded in part with equity, as would a subsidiary. Intra-company interest payments are generally ignored because the transfer of funds to a branch as a loan is not a transaction recognised under the tax law. It is therefore possible under the current rules for a branch to be 100 per cent debt financed."
> *APFC* (paragraph 33.51).

2.2 Interest Withholding Tax

The interest withholding tax treatment of foreign bank branches differs from that of domestic banks and foreign bank subsidiaries. This also places branch banks at a competitive disadvantage, but it is of much less concern than the notional equity requirement.

For the purposes of section 128F, foreign branch banks are deemed to be non-residents because they are an integrated part of their parent bank and are thus denied access to withholding tax free funds from non-residents. However, branch banks will be able to use a local subsidiary (typically a merchant bank) to raise section 128F funding and pass-on those funds to the branch.[10] This would involve

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[9] If anything, the notional equity charge would have a negative effect on a bank's credit standing, as it reduces profitability. In practice, this is not an issue as the amount involved is tiny relative to the total size of a global bank.
[10] The measure to facilitate this is in Taxation Laws Amendment Bill no. 2 1999,

a cost that locally incorporated banks can avoid, because they do not need to maintain a section 128F financing subsidiary.

In addition, even though foreign branch banks are considered to be an integrated part of the parent bank and, thus, deemed to be non-residents, they must still pay interest withholding tax (at half the normal rate) on intrabank borrowing. Therefore, unlike locally incorporated banks, branches cannot access any foreign source funds that are withholding tax free.

Governments in the past have cited risk of revenue loss and budgetary constraints as reasons for not removing the tax impediment to intrabank funding, but there is strong evidence that this risk has been overstated. The main threat to revenue appears to be re-routing of inter-company loans involving related entities through foreign bank branch operations. This would only occur if it were cost effective and, even then, commercial factors may prevent it. Significantly, it can be shown that banks' capital costs firmly militate against re-routing of the loans.

It should also be noted that by imposing interest withholding tax on intrabank funding, Australia is an outlier amongst the developed countries and our main competitors in the region. Removal of this barrier would improve the foreign banks' perception of Australia as a location to conduct their international business, as well as simplifying the tax regime that governs their operations here.

Finally, the LIBOR interest rate limit on interest rate deductions for intrabank funding under Part IIIB is another problem for branches. In practice, short term borrowing from related parties can be conducted at commercial arm's length rates that exceed the LIBOR rate. However, this is the exception rather than the norm. Examples cited by banks include short-term funding to square-off a book at the end of the day. Often such funding can only be obtained from related parties and external funding would be used if charges by related parties were not competitive. Apart from the non-deductibility of amounts greater than the LIBOR rate, this creates an irritating tax compliance cost. This problem could be alleviated and greater efficiency achieved by relying on the transfer pricing provisions of the tax law to penalise any dealings that are not at arm's length basis. This would improve the tax system without compromising its integrity.

2.3 Thin Capitalisation

The thin capitalisation rules limit the deductibility of interest paid on debt by a foreign bank to related offshore entities, to the extent that its foreign debt exceeds a ratio of internal debt to equity of 6:1. The thin capitalisation provisions do not apply to branches that opt to be taxed under the Part IIIB provisions, as the notional equity requirement applies in that case.

2.4 Grouping of Tax Losses

Groups of subsidiary and related companies are taxed as separate entities. However, losses may generally be transferred from one company to another within the same group provided that there is 100% common beneficial ownership throughout the years in which the loss was incurred and transferred (and intervening years) and both the transferor and transferee are resident companies.

Foreign branch banks have an exemption to the residency rule for grouping of tax losses. The Government decided, at the time that branch banking was introduced and Part IIIB was put in place, that losses can also be transferred between foreign branch banks and other 100% owned local subsidiaries of the parent bank. This avoids a further tax disadvantages being placed on branch banks.

2.5 Profit Repatriations

Foreign bank subsidiaries and branch banks both pay tax on their profits from their normal business activities at the normal corporate tax rate, the same as other companies. Like domestic institutions, foreign banks pay income tax of 10% on the offshore banking unit OBU profits.

The franked component of foreign bank subsidiary dividends paid to a non-resident parent is not subject to dividend withholding tax. A withholding tax (typically at a rate of 15%) is levied on the unfranked component of dividends paid to their parent. The unfranked component can include OBU profit, timing differences in tax payments and GCT items, amongst other things. Foreign bank branches do not receive franking credits but can repatriate all of their profits free of withholding tax, since this is treated as an internal bank transaction.

2.6 Offshore Banking Units (OBUs)

Foreign branch banks and licensed subsidiary banks are eligible to operate an OBU. However, merchant banks are not amongst the range of entities that are eligible to apply for OBU status, though merchant banks that are authorised foreign exchange dealers (or fund managers, if *Taxation Laws Amendment Bill no. 4 1998* is enacted) are eligible. It is understood that the restriction on merchant bank OBU activity is being reviewed, as in practice it imposes an unfair competitive constraint.

3. Converting to a Branch Structure – Regulation Factors

Table A2 below summarises some of the main regulatory factors that differentiate the treatment of licensed banks (subsidiary and branch) and merchant banks. These can have a significant influence on the organisational form selected by a foreign bank for its Australian operations. APRA has a strong preference for large merchant banks to operate as licensed banks and has firmly encouraged them to obtain a banking licence.

3.1 Licensed Bank Supervision

Licensed banks must meet certain regulatory obligations including a requirement to hold non-callable deposits at the Reserve Bank and observe a minimum risk weighted capital ratio. Also, a range of other controls on ownership, equity investment and business operations, amongst other things, must be observed.

Under the Basle Concordat, supervision of the solvency of foreign branch banks is primarily the responsibility of the parent bank's supervisory authority, because their solvency is indistinguishable from that of their parent. Supervision of the solvency of subsidiary banks is jointly shared by the APRA and the parent bank supervisor. Supervision of foreign bank liquidity is weighted towards APRA, since as the host country supervisor it is best placed to intercede through the provision of liquidity to the branch if necessary.

Table A2

Regulatory Consequences of Different Foreign Bank Structures

		Foreign bank – licensed as	
	Merchant bank	**Subsidiary**	**Branch**
NCD cost (to be abolished)	✗	✓	✓
Retail deposit market access	✗	✓	✗
Depositor protection	✗	✓	✗
Local capital requirements	✗	✓	✗
APRA levy (to be introduced)	✗	✓	✓
ASIC prudential supervision	possibly in future	✗	✗
Ownership Spread Requirement	✗	✓	✓
ESA Account	possible	✓	✓
Parent Guarantee	market incentive	not required	not required

Foreign bank subsidiaries must observe all the Reserve Bank's prudential guidelines, however, branches of foreign banks have some exemptions. Foreign banks can maintain both subsidiary and branch operations, but must operate in a way that makes clear its separate legal status and banking authorisation. Foreign banks can also have a merchant bank subsidiary alongside its branch, but the branch must conduct the bulk of the bank's intermediation business, with a concession to take account of section 128F funding.

3.2 Non-Callable Deposits (NCDs)

Licensed banks (subsidiaries and branches) are required to place one percent of their total liabilities (less shareholder funds) in a NCD at the Reserve Bank. This is effectively a tax on bank operations, as NCDs pay a penalty interest rate that is five percentage points below the market rate. This is a major disadvantage to licensed banks compared to merchant banks – the NCD cost to the average foreign bank is over $1 million per annum.

The NCD cost will probably be abolished from mid-1999 and replaced with a levy to cover the cost of supervising banks and other authorised deposit takers. The levy is to operate on a 'user pays' basis, but foreign banks would be penalised under the proposed arrangements compared to other deposit takers.

At present, merchant banks are often regulated as a security dealer or authorised foreign exchange dealer. The likely cost for regulating merchant banks under the single financial markets licensing regime that emerges following the implementation of all the Wallis reforms is unknown at this stage.

3.3 Access to Deposit Funding

A banking licence is of significant commercial value to the holder because it provides them with the right to offer certain financial services that are otherwise restricted. The most important advantage is the right to accept deposits from the public without the need to issue an accompanying prospectus.

However, foreign bank branches are not permitted to take retail deposits, because of APRA concern about its ability to provide the same degree of protection to their depositors, as it can for deposits of locally capitalised banks. Unlike subsidiaries, foreign branch banks do not have locally dedicated capital to protect depositors. Thus, foreign banks are required to maintain a capitalised subsidiary to participate in the retail deposit market. This imposes a significant cost to banks that wish to operate a branch and, at the same time, accept retail deposits.

3.4 Participation in the Payments System

An important benefit from a banking licence (both branch and subsidiary) is the right to hold an Exchange Settlement Account (ESA) with the Reserve Bank. ESAs are settlement accounts for transactions between banks and for transactions with the Reserve Bank. Holders of ESAs can issue cheques in their own name and participate directly in the cheque clearing and settlements system. Most importantly for banks involved in the wholesale market, they can settle certain transactions on a same-day basis and participate in the market for same-day funds.

Holders of bank licences also have access to (limited) zero cost intraday funds to meet liquidity through automatic repurchase facilities with the Reserve Bank. These aspects of the RTGS increase the value of a bank licence, even though the payments system has recently been opened to non-bank entities, including merchant banks that are adequately supervised.

3.5 Regulatory Trends

Implementation of the Wallis Financial System Inquiry reforms is likely to reduce the difference in the regulatory burden borne by licensed banks and merchant banks. The Inquiry recommended that merchant banks be left outside of regulatory control of APRA. However, corporate law reforms currently under consideration by the Government would stipulate licensing conditions to be met by all providers of financial services (including merchant banks) that include criteria like appropriate financial resources and internal controls.[11] ASIC would be the responsible body for implementing the licensing regime.

4. Converting to a Branch Structure - Commercial Factors

There is a range of commercial advantages to operating as a branch, as distinct from a licensed bank subsidiary or a merchant bank. These are particularly important given the tax disincentives discussed above and regulatory advantages enjoyed by merchant banks, in particular. In fact, the commercial factors in many cases have dominated the other factors and, consequently, there has been an impressive growth in the number of foreign branch banks in recent years.

Some of the commercial advantages to branch banking that have been cited by foreign banks are:

- More efficient use of capital;
- Better integration with global operations;
- Dealing limits imposed by transaction counterparties are larger;
- Better market exposure;
- Customer preference for dealing with a branch (for example, permits reliance on parent credit rating);
- Capital limitations reduced, increased funding capability;
- Parent preference for branch, and
- Lower costs (directors' fees, administrative costs and parent guarantee).

Foreign-owned bank branches can take advantage of their parent's balance sheet strength and draw on its capital and resources. This enhances their capacity to undertake certain types of business, allows banks to participate in more transactions and in deals with larger exposures.

The strength of the parent's balance sheet can also provide for a lower average cost of funds for banks. These provide an additional incentive for merchant banks to seek a branch banking licence in addition to those outlined above. However, the loss of access to retail deposits is a disadvantage faced by foreign licensed bank subsidiaries that convert to branch status.

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[11] See the CLERP consultation paper, *Financial Products, Service Providers, and Markets – An Integrated Framework*, released on 3 March 1999.

Branch operations are especially valuable to banks that wish to conduct regional or global financial markets transactions through their Australian operation, because of their seamless commercial integration with the parent bank. This is important to both the parent bank and to its counterparties in financial transactions.

4.1 Consolidation and Globalisation

The global investment banking market is undergoing a period of consolidation, including a reorganisation of regional operations, which is impacting on investment banks in Australia. Over a third of IBSA's members, which include the world's major investment banks, have been subject to merger and acquisition over the past few years.

This backdrop of global re-organisation within the investment banking industry intensifies the need to create a competitive tax regime, so that Australia can take advantage of the opportunity to capture business that is mobile during the rationalisation and consolidation process. It is particularly important that the branch tax arrangements are favourable, as this is generally the preferred option for expanding regional operations. Therefore, business tax reform is taking place at an opportune time and can be a major input to the Government's drive to create a vibrant regional financial centre in Australia.

Appendix 2

The Importance of Foreign Investment Banks

Foreign banks have a substantial presence in Australia's investment banking market, which is largely a product of the historical development of the market and financial deregulation. Their activities include securities, foreign exchange and derivatives trading, traditional credit intermediation, payments facilities, investment management services, corporate advisory services and stockbroking. The 36 licensed foreign investment banks at end-1998 accounted for just over 15% of all banks' assets. Merchant banks are more numerous, but tend to have smaller balance sheets and accounted for the equivalent of 10% of bank assets.

The business of foreign bank investment banks is best understood by considering the role of investment banks in general, given their central place in the market. A range of typical investment bank services is provided on table A3.

Table A3

Typical Investment Bank Services

Corporate finance	Mergers & acquisitions Advice Project finance Infrastructure finance Structured finance
Capital markets	Syndicated loans Debt security issues Equity issues Broking, trading & market making Offshore funding Securitisation Leasing Trade finance & guarantees Underwriting
Money market	Deposit taking & cash management Trading Financing Derivatives
Foreign exchange	Spot/forward/swaps Options and exotics
Electronic banking	Currency transactions Payments processing Documentation
Payments	Standard facilities (cheques etc) Global custody & payments
Commodities trading	Bullion Exchange traded derivatives Commodity hedging facilities
Offshore banking	Lending, advice, trading
Economics research/advice	Macroeconomic Sectoral

Investment banks are defined as a group by the range of financial services that they provide. Though they are typically foreign owned, there is no ‘model’ investment bank, as many offer specialist products and services. Their clients are mainly the corporate sector and government, and competition for business is intense.

Investment Banks Provide Competition for the Major Banks

Investment banks contribute to the efficient performance of the financial sector and the economy through a variety of mechanisms. The most important channel is the intensification of competition in the financial sector and, as shown below, the investment banks provide stiff competition for the major banks in the wholesale financial markets.

Although investment banks operate substantially in the wholesale markets, their operations also benefit retail consumers. For example, the securitisation of home mortgages has led to a major shake up in the home financing market, which caused a sharp fall in home loan margins and provided a wider range of better quality loans. Investment banks played a critical role in this process by arranging the necessary finance for home loan originators to compete with the major banks.

Corporate Finance

Corporate finance is a business area in which investment banks have particular specialist skills and are market leaders. They have been particularly innovative and have developed a comparative advantage over other financial institutions. Their business extends well beyond credit intermediation, to cover a broad range of both advisory and financing services. The nature of this business requires the banks to work closely with their clients in developing solutions to meet their specific needs.

Table A4

Market Leaders in the Australian Syndicated Loan Market 1998

Bank	Value US$ mn	Share (%)	Loans
The Chase Manhattan Bank	3,631	19.2	12
Westpac Banking Corp.	2,041	10.8	15
National Australia Bank	1,816	9.8	4
Deutsche Bank	1,796	9.5	7
ABN AMRO	1,277	6.8	5
Barclays Capital	1,235	6.5	3
ANZ	1,215	6.4	11
Warburg Dillon Read	945	5.0	2
CBA	876	4.6	7
Bankers Trust	748	4.0	9

Note: IFR Securities Data - *Australian Financial Review,* 18 January 1999.

Investment banks are an important source of finance to the corporate sector, through loan facilities that are tailored to individual corporate needs and as holders of securities issued by companies. They also arrange project finance, syndicated loans and structured finance facilities (see table A4). Their asset base is substantial and the bulk of this is accounted for by lending to the corporate sector.

Table A5

Mergers and Acquisitions Advisers 1998

	Adviser	Value $mn	Share %	No. deals
1	Warburg Dillon Read	9,215	27.0	29
2	Goldman, Sachs & Co	7,047	20.6	7
3	Salomon Smith Barney	6,976	20.4	16
4	Morgan Stanley Dean Witter	6,249	18.3	4
5	Macquarie Corporate Finance	4,742	13.9	23
6	Schroder Australia Corp. Finance	4,619	13.5	8
7	Deutsche Bank AG	3,995	11.6	14
8	Merrill Lynch & Co	3,758	11.0	17
9	Credit Suisse First Boston	3,632	10.6	6
10	JP Morgan & Co Inc	3,384	9.9	8

Notes: Corporate Advisers Securities Data - *Australian Financial Review*, 19 January 1999.

On the advisory side, the banks provide a range of technical and financial expertise, covering banking, accounting, taxation, law, engineering and business development. For example, investment banks provide strategic advice to bidders and targets involved in mergers and acquisitions, formulate restructuring plans for business, assist in liability management, design equity and debt financing programs, undertake risk assessments and evaluate project and infrastructure developments, amongst other things.

Capital Markets

Investment banks are major players in both the primary and secondary markets for debt and equity securities and have been an important impetus to the development of these markets. They facilitate the issue of corporate securities in several capacities; for example, as lead arrangers, investors or as regular members of a tender panel.

The Australian Stock Exchange has a central place in the financial sector and is a major source of equity capital for companies. IBSA members owned eight of the top ten stockbrokers, in terms of market share in 1998. New equity issues through the stock market have been strong in recent years, partly reflecting some major listings, like Telstra and AMP. Apart from raising capital, the stock market contributes to economic performance by mobilising saving, re-distributing risk and signalling the cost of equity capital, amongst other things.

The corporate debt security market is much less well developed than the equity market. The market for asset backed bonds is perhaps the most advanced element of it. This is an innovative market, in terms of structures developed and assets securitised, and it is likely that it will continue to deepen as investors search for more efficient ways to use capital. For example, leases on government car fleets and origination fees have been securitised, as have corporate loans.

Table A6

Domestic Bonds - Top Lead Managers 1998

Bank	Value $mn	Share %	No. Bonds
Warburg Dillon Read	3,938	49.2	24
Bankers Trust	1,035	12.8	7
Westpac	796	9.9	10
CSFB	410	5.1	3
Citigroup	367	4.6	3
Deutsche Bank AG	350	4.4	2
ABN AMRO	317	4.0	4
Merrill Lynch	316	3.9	3
CBA	235	2.9	3
ANZ	90	1.1	2
figures exclude self-led deals			

Note: IFR Securities Data - *Australian Financial Review*, 18 January 1999

A small market for infrastructure bonds, that finance private infrastructure projects, has been established. This market also has considerable growth potential. The straight corporate bond market has recently grown strongly from a small base and has significant potential for further growth, given recent withholding tax changes and technical market conditions.

The Australian government debt market is the most advanced in the region and investment banks are the leading market makers and traders in the market. They also play an important role in the distribution of government securities in the primary market.

Risk Management

Investment banks participate, directly and indirectly, in the exchange traded derivatives markets of the Sydney Futures Exchange and the Australian Stock Exchange, as traders, brokers, advisers and investment managers. They also provide a broad range of customised over-the-counter derivatives to corporate and government clients, as well as to other financial sector institutions. These mainly cover foreign exchange, interest rate and equity exposures. In addition, investment banks are global leaders in the provision of commodity risk management services, with some banks basing regional and global operations in their Australian operations.

Transactions and Payments Services

Investment banks provide a range of specialist services that support financial transactions and economic activity. Most banks are authorised foreign exchange dealers and offer a full range of foreign exchange facilities. The also have a significant presence in the electronic banking market, through which they provide services, such as currency transactions, payments processing, account information retrieval and trade documentation.

International Business

Australia has important comparative advantages as a location for the conduct of the international business of global investment banks and this lies behind the Government's thrust to develop a vibrant regional financial centre in Australia. Foreign banks already conduct significant regional business through their local operations, which generates significant employment and income. However, it is generally viewed within the industry that Australia is falling far short of its potential – indeed, a significant amount of business that was conducted here has been lost to Singapore and Hong Kong. The administration of tax and tax reform will be an important influence on our success in retaining current business and attracting new business to Australia.