Australian Financial System Inquiry

Submission

31 March 2014

HSBC

PUBLIC

Australian Financial System Inquiry

Submission

Background

Founded in 1865 to finance trade between Asia and the West, HSBC is today one of the largest banking and financial services organisations in the world.

With more than 6,300 offices in both established and emerging markets, we aim to be where the growth is, connecting customers to opportunities, enabling businesses to thrive and economies to prosper, and, ultimately, helping people to fulfil their hopes and realise their ambitions.

Our aim is to be acknowledged as the world's leading international bank.

We serve around 54 million customers through our four Global Businesses: Retail Banking and Wealth Management, Commercial Banking, Global Banking and Markets, and Global Private Banking. Our network covers 75 countries and territories in Europe, the Asia-Pacific region, the Middle East, Africa, North America and Latin America.

HSBC first started operations in Australia in 1965 and was awarded a commercial banking licence in 1986.

Today, Australia is a priority growth market for the HSBC Group and HSBC offers an extensive range of financial services through its network of 37 branches and offices focusing on Retail Banking and Wealth Management, Commercial Banking and Global Banking and Markets.

HSBC is committed to growing its presence in Australia as the country's leading international bank, and our strategic focus on international connectivity puts us in an unparalleled position to do this.

HSBC is connecting local and international customers with the opportunities coming from Australia's growing trade and investment flows with Asia and putting its international banking to work for more retail customers in Australia as its population continues to grow and become more international.

Introduction

As one of the original international banks to obtain a banking licence in Australia, HSBC is today one of the longest serving international banks here and Australia is a priority growth market for the HSBC Group.

This submission outlines what HSBC sees as key steps that will benefit the Australian financial system as a whole, and international banks operating within it:

1. Increasing retail funding opportunities – encouraging savings and providing a deeper domestic funding source.

2. Developing wholesale domestic funding sources – encouraging greater use of project bonds, securitisation and covered bonds.

3. Abolishing interest withholding tax – removing the key impediment to the growth of foreign banks in Australia.

4. Abolishing the LIBOR Cap – removing an unnecessary increase in cost of funds for foreign bank branches.

Increasing retail funding opportunities

Current tax arrangements benefiting superannuation, equities and property investment, may be doing so at the expense of growing Australian savings and developing a domestic bond market.

The shortage of Australian deposits has increased the reliance of banks in Australia on wholesale funding, and with it a whole raft of challenges relating to funding sources.

The tax benefits of investing in superannuation and equities have also detracted from the development of a domestic bond market in Australia, further increasing pressure on institutional and infrastructure funding.

In terms of incentivising deposits, in the 2010 Federal budget the Government announced the introduction of a tax discount on interest income. Applicable on income earned on bank accounts, savings accounts, term deposits, bonds and annuities, the tax change was to take effect on 1 July 2011. The Government subsequently withdrew the discount in 2012.

In terms of the development of a domestic corporate bond market, the Treasury has done considerable work in reviewing the barriers to issuing bonds to retail investors with its 2011 paper *Development of the Retail Corporate Bond Market: Streamlining Disclosure and Liability Requirements*. This should be further investigated.

HSBC recommends tax concessions be investigated/introduced to encourage greater diversification of Australian retail investment into interest income investments.

Developing wholesale domestic funding sources

Australia has the world's 13th largest economy but only 52nd largest population. As a result, it is reliant on foreign savings to fund its domestic investment. Pressure on Australia's long term current account deficit has been exacerbated by the government's focus on reducing government debt, leading to an increasing reliance on the private sector for Australia's funding requirements. For financial services in Australia, customer deposits have historically provided the bulk of funding to banks but institutions have been forced to supplement retail funding with funding from the capital markets. Competition for capital markets has been strong because of beneficial tax arrangements for equities.

Franking incentives for investment in equities has contributed to a strong reliance of corporates on equity funding and the relative underdevelopment of Australia's domestic corporate and infrastructure bond markets. Superannuation funds are understandably attracted to equities and their tax advantages. Australia's less mature debt market features smaller sized issues and shorter tenors. For a market with large and long-term infrastructure investment requirements and a large market for long-term mortgages, projects and institutions are forced overseas for funding.

HSBC recommends greater consideration by the Government of measures to support the development of funding opportunities in Australia for project/infrastructure bonds, securitisation and covered bonds. Part of this should include investigating ways to increase the attractiveness of fixed interest investments to superannuation funds.

Interest withholding tax

Under current interest withholding tax arrangements, authorised deposit taking institutions in Australia are required to pay a 10 per cent interest withholding tax on the interest they pay for funds borrowed from their parent or affiliated banks offshore. Similarly, foreign bank branches in Australia are required to pay five per cent interest withholding tax on the interest they pay to their parent company.

Interest withholding tax is a real cost for Australian borrowers as the foreign lender requires compensation for the interest withholding tax because they do not receive full tax credits in their own jurisdiction. It effectively discourages ADIs and foreign bank branches from bringing surplus funds held by their parents in other markets into the Australian economy to fund their loan book. With the global mobility of capital, it has to date been the key impediment to the growth of foreign banks in Australia.

In May 2010, the Government announced in its Federal Budget that the interest withholding tax applicable to such offshore borrowings will be reduced to 7.5 per cent in 2013-14, to five per cent in 2014-15, with an eventual aspiration of zero per cent. These reductions were withdrawn by the Government in 2013.

Both the Johnson Report and the Henry Review recommended the abolition of this tax.

HSBC recommends making Australian ADIs and foreign bank branches exempt from interest withholding tax as soon as possible to allow them to better service Australian borrowers without being penalised for lending in Australia those savings held by their parent company in other markets.

LIBOR cap

Part IIIB of the Income Tax Assessment Act 1936 (Tax Act) treats a foreign bank branch as if it were a separate entity from its parent for key transactions, like intra-bank lending. Ordinarily, this would see a foreign bank branch taxed on its income only after allowance is made for expenses incurred in earning that income. Section 160ZZZA(1)(c) of the Tax Act, however, introduces an exception to this rule by limiting the tax deductibility of interest paid by a branch on borrowings from its parent to the London Interbank Offered Rates (LIBOR). When funds are provided at a rate in excess of the applicable LIBOR rate, the excess is not tax deductible. This is known as the 'LIBOR cap'.

The LIBOR cap was introduced as a convenient way to administer the tax law relating to intra-bank funding. Initially it was possible for bank branches to absorb the costs involved, however as foreign bank lending has increased in Australia, so has the LIBOR cap constraint.

The impact of the LIBOR cap on competition in Australian banking is:

1. It increases the cost of funding for foreign bank branches.

2. This tax cost is further exacerbated by regulators (including APRA) who as part of more stringent liquidity risk management are now requiring banks to have longer term funding. LIBOR does not prescribe any rates for lending terms of greater than 12 months. Hence, the tax deductibility of borrowing costs of longer than 12 months is artificially and unfairly capped at the LIBOR 12 month rate.

3. It subjects foreign bank branches alone to a technically inaccurate transfer pricing rule: LIBOR is not an accurate representation of the cost of funds from a foreign bank parent.

4. Foreign bank branches incur an additional tax compliance cost as they are required to manage and record processes verifying each borrowing against its relevant LIBOR rate.

5. Banks entering or trying to increase their presence in the Australian market are most impacted by the LIBOR cap as they do not have existing funding programs in Australia. As a result, they are more reliant on parent bank funding, to which the LIBOR cap applies.

Recommendation 3.5 of the Australian Financial Centre Forum report *Australia as a financial centre: Building on our Strengths* (the Johnson Report) released in January 2010 recommended that the LIBOR cap be removed. In May 2010 the Government asked

Treasury to review the LIBOR cap, stating it will respond to Treasury's recommendation when the review is completed.

Both the Johnson Report and the Henry Review recommended the abolition of this tax.

With the British Bankers' Association ceasing in 2013 to publish AUD LIBOR rates from May, the relevance and effectiveness of the LIBOR cap for Australian banks borrowing in AUD is increasingly questionable.

HSBC recommends the LIBOR cap on deductibility of interest paid on branch parent funding be removed as soon as possible.

Conclusion

HSBC is pleased to provide this submission to Australia's Financial System Inquiry.

With more than 6,300 offices in more than 75 markets in established and emerging markets, HSBC aims to be where the growth is, connecting customers to opportunities, enabling businesses to thrive and economies to prosper, and, ultimately, helping people to realise their ambitions.

As a priority growth market for the HSBC Group, HSBC is supportive of this Inquiry's efforts to foster a more efficient, competitive and flexible financial system within Australia, consistent with financial stability, prudence and public confidence.

This submission outlines what HSBC sees as key steps that will benefit the Australian financial system as a whole, and international banks operating within it.