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Addressing hybrid mismatch arrangements  
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## SUBMISSION: ADDRESSING HYBRID MISMATCH ARRANGEMENTS

### Introduction

1. This letter contains Westpac's submissions on the Government discussion document *Addressing hybrid mismatch arrangements* released on 6 September 2016 ("**Discussion Document**").<sup>1</sup>
2. In summary, our submissions are:
  - (a) regulatory capital instruments should be excluded from the scope of New Zealand's hybrid mismatch rules at least until it is clear to what extent other countries (and Australia in particular) will follow the United Kingdom's approach of excluding regulatory capital from the scope of such rules; and
  - (b) if regulatory capital instruments are not excluded from the rules, grandparenting in full should be available so that the rules do not apply to regulatory capital instruments issued prior to the release of the Discussion Document, or (in the alternative) at least to instruments issued prior to the release of the OECD Report.

### First submission: regulatory capital instruments should be excluded from the hybrid mismatch rules

#### *Discussion Document proposals*

3. The Discussion Document states (at paragraph 5.60) that it is not proposed to exclude regulatory capital instruments from the implementation of hybrid mismatch rules in New Zealand. The Discussion Document calls for submissions as follows:

#### Submission point 5H

Submissions are sought on whether there are any issues with providing no exclusion for regulatory capital.

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<sup>1</sup> The Discussion Document proposes that New Zealand adopt the recommendations contained in the OECD report *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2015 Final Report* ("**OECD Report**") released on 5 October 2015.

*Regulatory capital instruments should be excluded from the hybrid mismatch rules*

4. We submit that regulatory capital instruments should be excluded from the implementation of hybrid mismatch rules in New Zealand for these reasons:
- (a) The Discussion Document indicates (page 1) that "the OECD recommendations are targeted at deliberate exploitation of hybrid mismatches". Regulatory capital instruments, on the other hand, meet regulatory requirements (administered, in the Australasian context, by the Reserve Bank of New Zealand ("**RBNZ**") and the Australian Prudential Regulation Authority ("**APRA**") for banks to maintain capital. The terms of such instruments are prescribed by the RBNZ and APRA. Regulatory capital instruments are therefore not tax driven transactions, do not amount to what the Discussion Document describes as "deliberate exploitation of hybrid mismatches", and are therefore outside the core concern identified in the Discussion Document.
  - (b) The OECD Report (at page 11) on which the Discussion Document is based leaves open the question of whether hybrid mismatch rules that countries may enact to implement the OECD Report recommendations should apply to regulatory capital instruments or should instead exclude such instruments from their scope. An OECD public discussion draft *BEPS Action 2: Neutralise the Effect of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)* released in March 2014 ("**OECD Draft**") preceded the OECD Report. The OECD Draft indicated (at paragraph 158) that the separate consideration of regulatory capital was due to the "widespread recognition of the need for financial institutions to be appropriately capitalised and properly regulated". New Zealand would therefore be acting consistently with OECD recommendations were it to exclude regulatory capital instruments from its hybrid mismatch rules.
  - (c) The Discussion Document indicates (at page 1) that "[i]t is expected that most hybrid arrangements would be replaced by more straightforward (non-BEPS) cross-border financing instruments and arrangements following the implementation of the OECD recommendations in New Zealand". Given RBNZ and APRA requirements, regulatory capital instruments may not be simply replaced with more straightforward financial instruments.
  - (d) As the Discussion Document acknowledges (at paragraph 5.38) the OECD Report gives countries the option to exclude regulatory capital from their hybrid mismatch rules.<sup>2</sup> The rules implementing the OECD recommendations in the UK exclude regulatory capital. New Zealand should follow the UK's lead on this issue (especially while it is not certain what approach Australia will take).

*Alternatively, regulatory capital instruments should be excluded from the hybrid mismatch rules pending clarification as to how other countries will proceed*

5. Alternatively, if a permanent exclusion is not accepted, regulatory capital instruments should at least be excluded from the implementation of hybrid mismatch rules in New Zealand pending greater clarity as to how other countries (in particular Australia) will treat regulatory capital instruments under their hybrid mismatch rules. The effects of the

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<sup>2</sup> The OECD Report states (at page 11) "[a]s indicated in the September 2014 report, countries remain free in their policy choices as to whether the hybrid mismatch rules should be applied to mismatches that arise under intra-group hybrid regulatory capital". The reference to "intra-group hybrid regulatory capital" appears to reflect the assumption in the OECD Draft (at paragraph 160) that regulatory capital issued to third party investors would be "unlikely to be caught" by hybrid mismatch rules.

hybrid mismatch proposals on the New Zealand economy cannot be known or predicted without first knowing what rules other countries will implement. For the banking industry, the position Australia will take is significant and is currently unknown.

6. For example, the OECD Report recommends that where a mismatch arises under a frankable-deductible instrument (see Example 2.1 of the OECD Report) the primary response is for the jurisdiction providing the dividend relief (in this case Australia) to disallow that relief. It seems highly likely that Australia will implement the OECD Report proposals to some extent.<sup>3</sup> Accordingly, the circumstances in which a deduction may need to be denied under New Zealand's hybrid mismatch rules to counteract a hybrid mismatch under a frankable-deductible instrument would be if Australia:
  - (a) makes a policy choice to exclude certain frankable-deductible instruments from its hybrid mismatch rules; or
  - (b) has different implementation provisions from those applicable in the case of New Zealand's hybrid mismatch rules (eg, a different commencement date or approach to grandparenting).
7. In either circumstance, it would seem appropriate (when the OECD Report recommends that Australia provide the primary response to the arrangement) for New Zealand to consider Australia's position when formulating its own position. To avoid the risk of New Zealand adopting rules without regard to Australia's policy choices, regulatory capital instruments should be excluded from the hybrid mismatch rules at least until it is clear what approach Australia will take in respect of regulatory capital instruments.

**Second submission: grandparenting should be available - proposals should not apply to existing regulatory capital instruments**

*Discussion Document proposals*

8. The Discussion Document indicates that no grandparenting should apply if the hybrid mismatch rules are implemented in New Zealand. The Discussion Document also states (at paragraph 11.20):

The hybrid rules are intended to apply to all payments made after the effective date of the implementing law. This effective date should be far enough in advance to give taxpayers sufficient time to determine the likely impact of the rules and to restructure existing arrangements to avoid any adverse consequences (Final Report, paragraph 311). Since the rules generally apply to arrangements between related parties or within a control group, restructuring arrangements should not be as difficult as it might otherwise be. ...

9. The Discussion Document calls for submissions as follows:

**Submission points 11E**

Submissions are sought on whether there are any special circumstances that would warrant departing from the general proposition of no grandparenting, and whether the proposed effective date is appropriate.

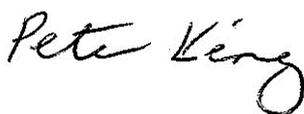
*Regulatory capital instruments should be subject to grandparenting*

10. If regulatory capital instruments are not excluded from the implementation of the hybrid mismatch rules, we submit that full grandparenting should be available for regulatory capital instruments issued prior to the release of the Discussion Document, or at least for instruments issued prior to the release of the OECD Report.

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<sup>3</sup> The Discussion Document (at paragraph 3.12) states that the Australian Government has committed to implementing OECD's recommendations.

11. Full grandparenting should be available for regulatory capital instruments for these reasons:
- (a) The main justification offered in the Discussion Document for no grandparenting (that the "rules generally apply to arrangements between related parties or within a control group [such that] restructuring arrangements should not be as difficult as it might otherwise be") is not applicable to many regulatory capital instruments because they are held by third party investors. Any redemption (even if permitted under an instrument's terms and approval is given by the relevant regulators, which cannot be guaranteed) would affect third parties, which typically include a large proportion of retail investors. In addition, the appetite for regulators to reduce the amount of regulatory capital on issue is low given global regulators are directing banks to increase capital levels.
  - (b) If regulatory capital instruments are not subject to grandparenting, existing instruments would likely need to be refinanced in the Australian or New Zealand domestic markets. Given that multiple banks would likely need to access these markets at the same time (if regulatory capital instruments are not subject to grandparenting), it would be difficult to refinance all of the affected instruments. This refinancing would be in addition to banks' existing Additional Tier 1 capital needs of approximately A\$4-\$6 billion per annum in aggregate. Given the limited capacity of the Australian and New Zealand domestic markets to absorb regulatory capital instruments in any year, multiple banks seeking to refinance regulatory capital instruments may cause market volatility and significantly increase the execution risk for such transactions, thereby undermining confidence in the markets. It is also possible that the Australian and New Zealand domestic markets would simply not be able to absorb all of the required regulatory capital issuances.
  - (c) The vast majority (if not all) regulatory capital instruments currently on issue were issued before the Discussion Document was released and, in most cases, prior to the release of the OECD Report. Further, prior to the OECD Report there was an expectation that any changes affecting hybrid arrangements would not apply to bank regulatory capital transactions, a position the OECD Report allows for and which the UK (one of the first jurisdictions to implement the OECD Report proposals) adopted.
12. For these reasons, if our first submission (that regulatory capital instruments should be excluded from the hybrid mismatch rules) is not accepted, our second submission should be accepted. That is, the hybrid mismatch rules should not apply to any regulatory capital instruments issued before the release of the Discussion Document, or (in the alternative) to instruments issued before the release of the OECD Report.



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