#013

11 November 2016

Addressing hybrid mismatch arrangements
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
Wellington 6140

Dear Sir

Addressing Hybrid Mismatch Arrangements

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We refer to *Addressing hybrid mismatch arrangements: A Government discussion document* ("the Document"), which was released for consultation on 6 September 2016. We appreciate the opportunity to comment and do so below.

1. Insurance Australia Group Business

Insurance Australia Group Limited ("IAG") is an Australian resident company operating in Australia, New Zealand, and Asia. IAG is the leading general insurance provider in New Zealand across both the direct and intermediated channels. Insurance products are sold directly to customers predominantly under the State and AMI brands, and through intermediaries (insurance brokers and authorised representatives) predominantly under the Lumley and NZI brands.

2. Executive Summary

IAG supports the aims of the New Zealand government in addressing hybrid mismatches. Our submissions address aspects of the proposals which would negatively impact our New Zealand business model, rather than commenting on the entire package. We submit that:

- With regard to frankable/deductible structures in general, the New Zealand government should not deny an interest deduction. As such structures are not tax exempt in Australia, a hybrid mismatch is not generated
- Should our primary submission be declined, the government should exempt regulatory capital from the scope of any measures to address hybrid mismatches, given its commercial importance
- In the event that each of these submissions are declined, the government should grandparent existing instruments from the impact of the proposals, and
- Regardless of the government's views on the submissions above, any measures affecting taxation of insurance industry capital should be deferred given the current changeable regulatory and tax situation worldwide.

3. IAG's issue of Reset Exchangeable Securities

IAG's interests centre on the application of the proposals to regulatory capital for insurers. The New Zealand branch of IAG Finance (New Zealand) Limited, a wholly owned subsidiary of IAG, has issued perpetual reset exchangeable notes, known as

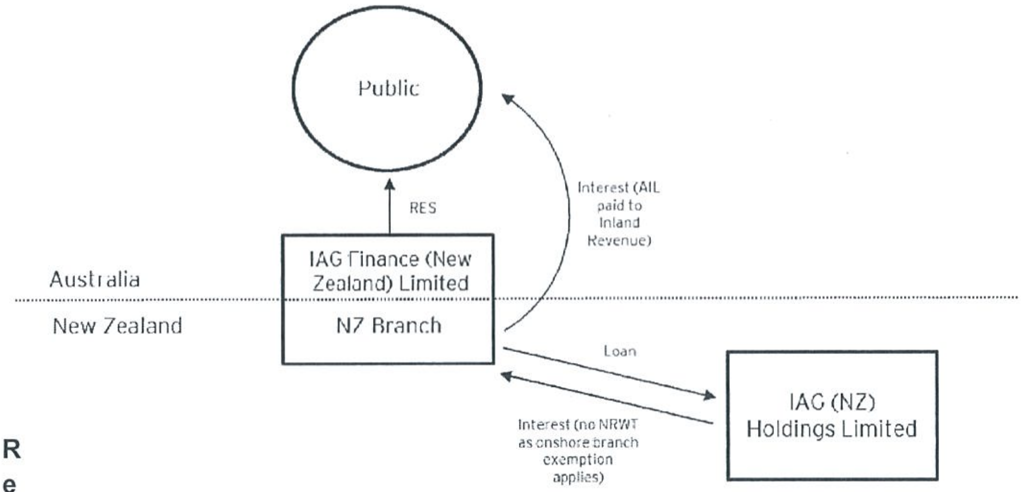
Reset Exchangeable Securities ("RES") to external investors. The $550 million funds raised have been loaned to IAG (NZ) Holdings Limited to fund IAG's New Zealand operations. The RES are used to raise funds and enhance IAG's capital structure by providing certainty of access to regulatory Tier 1 Capital if needed.

The RES may be exchanged by IAG or the holder on a reset date, or upon certain events. The next reset date is 16 December 2019. On exchange, IAG may convert RES into IAG preference shares, arrange a third party to acquire RES for their face value or redeem RES for their face value (subject to Australian Prudential Regulation Authority ["APRA"] approval).

The RES instrument, in its 2004 original form and its 2009 amended form, has been a key component of the IAG capital structure for 12 years. Since 2009, it has qualified as innovative Tier 1 capital and upper Tier 2 capital.

These arrangements are summarised in Figure 1.

Figure 1: IAG Finance (New Zealand) Limited existing funding arrangements



3.1. Relation to proposals in the document

At paragraph 2.14, the Document refers to *"frankable/deductible instruments issued by the New Zealand branch of some Australian banks to the Australian public"*. The RES broadly follows the tax treatment explained in that paragraph. Although issued to third parties and listed on the ASX, it appears likely that the RES would fall within the definition of "structured arrangement" summarised at paragraph 12.5, and therefore fall within the scope of the document's proposals.

The RES are regulatory capital, with IAG under the supervision of APRA. At paragraph 5.60, the document states that government does not propose to exclude regulatory capital from the implementation of hybrid mismatch rules.

4. Treatment of frankable/deductible instruments

We submit that New Zealand should not enact legislation to deny a deduction for amounts paid under deductible/frankable instruments such as the RES on the grounds that there is no hybrid mismatch against which action can be justified.

IAG does not agree with the assertion that *"there is no practical distinction between exemption and full imputation"*.[1] Amounts paid to RES investors are fully taxed in the investors' hands and in no way exempt. The franking credits attached represent

[1] See para 5.5, at page 32.

underlying Australian tax paid and are therefore no longer available to be attached to other profit distributions. The instrument does not produce a deduction no inclusion ("D/NI") result.

While we appreciate that that the Document's analysis of frankable/deductible instruments is consistent with that in the OECD's report[2], that analysis is flawed. As New Zealand and Australia are the only two closely integrated economies with imputation systems, there is no need here to seek to follow international norms: decisions taken by the New Zealand and Australian government regarding imputation will be the international norm.

5. Exempting hybrid regulatory capital from hybrid proposals

Submission point 5H specifically requests comments regarding regulatory capital. IAG submits that in the event of our primary submission regarding frankable/deductible structures being declined:

- A specific definition of insurance regulatory capital is introduced. That definition could be closely linked to the regulatory rules set by the parent company regulator, in this case, APRA, and
- Insurance regulatory capital is excluded from the implementation of hybrid mismatch rules in New Zealand.

We wish to make several points in support of our submission.

5.1. Efficiency of commercial insurance operations

Stringent rules could negatively impact the efficiency of commercial insurance operations. This will be due to the increase in the cost of capital without the present deductions. It may make New Zealand a less attractive destination with negative implications for the availability and price of insurance coverage. As a net capital importer this should be a major concern for any New Zealand government.

5.2. Commercial use of branches within insurance sector

The document implicitly assumes that the use of branches has limited, if any, commercial rationale. However, for many commercial, regulatory and operational reasons, insurers commonly operate internationally through branches. Rather than dispersing regulatory capital around a series of local subsidiaries, a "hub and branch" structure allows groups to free up capital and use it more flexibly by holding and managing it centrally. This approach is particularly common within the European Union and branches also play a part in the New Zealand market. The higher capitalisation possible through a hub and branch structure can give greater risk protection. It also gives access to lighter handed regulation and greater flexibility in doing business.

5.3. Importance of regulatory hybrid capital within insurance sector

Unlike most other industry groups, insurers face regulatory requirements to hold loss-absorbent capital as a proportion of their balance sheet size and risk. These requirements increase insurers' ability to deal with periods of high claims and reduce harmful effects for the wider economy.

Regulatory hybrid capital instruments have been popular within the insurance industry for around 15 years. Hybrid securities are considered an attractive, cost-efficient means of raising funds without diluting shareholders' rights. Forming an integral part of the regulatory capital of insurers such as IAG, instruments such as

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[2]See Example 2.1 at page 280, Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2015 Final Report (OECD, October 2015)

the RES have certain equity-like features relating to loss absorbency and interest deferral which are mandated by regulators such as APRA. These equity-like features are mandated by regulation, are not designed to give a tax mismatch and are essential in supporting the insurance industry.

Following the global financial crisis, the degree of regulation has increased, with enhanced capital requirements and greater transparency. Regulators continue to see hybrid capital as having a valuable function, rather than attempting to close down the opportunity to issue such capital. Although the regulatory environment remains subject to reform, IAG is concerned that New Zealand tax officials are seeking to substitute their judgment of the merits of such capital to that of the regulator concerned.

5.4. Regulatory capital and BEPS

The Document does not explain how the payment of interest on regulatory capital enables BEPS. The purpose of regulatory capital is to reduce risks associated with leverage, rather than to increase it. In those circumstances, it appears counterintuitive to apply rules designed to counteract "excessive" leverage to regulatory capital.

Given this there is little risk of regulatory capital for insurers giving rise to BEPS issues and, accordingly, regulatory capital that conforms to the requirements of the particular regulator should be outside the scope of these proposals. The amount of capital that a particular entity requires is determined by the regulatory regime to which it is subject, the responsible regulator in IAG's case being APRA. The terms of regulatory capital securities that lead to hybridity are consistent with regulatory requirements. Likewise, there are restrictions on how much of IAG's minimum capital requirements can be made up of the different tiers of capital. The precise percentages applicable to IAG are the subject of discussion with APRA.

Regulatory oversight therefore provides an objective measure of how much additional Tier 1 and Tier 2 capital IAG may need. We note that the United Kingdom, which has consulted widely on issues associated with regulatory capital, has determined that anti-hybrid measures concerning regulatory capital are not required.

5.5. Tax outcomes for regulatory capital

IAG is concerned that even though structures, such as the RES mentioned above, were not implemented with tax avoidance in mind, the government's proposals would result in payments by the New Zealand branch of IAG Finance (New Zealand) Limited being denied tax deductions in New Zealand.

The denial of tax deductions or imposition of tax charges could lead to unfair results for IAG and other insurers. Our cost of capital would increase, making New Zealand a less attractive place for inbound insurance and reinsurance business. This outcome appears contrary to the overarching goal for New Zealand's tax system of maximising the welfare of New Zealanders, in part by ensuring that taxes from inbound investment are as fair and efficient as possible and that New Zealand remains an attractive place to invest and base a business, and by minimising distortions so that investments are financed in ways that are most efficient and undertaken by those who can do so most efficiently.[3] In particular, the Document lacks any analysis of whether the policy considerations behind requirements for better capitalised financial services institutions outweigh any perceived BEPS risk.

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[3]As set out in New Zealand's taxation framework for inbound investment: A draft overview of current tax policy settings (June 2016), pp 3-4.

While commercial in nature, the RES have been designed with an expectation that the interest payments made by IAG are tax deductible. A tax deduction is necessary for the RES to provide a lower after-tax cost of capital for IAG. In effect, switching off the tax deduction is likely to make the RES an inefficient form of capital and, over time, remove investment opportunities and weaken capital markets in Australasia.

5.6. Consideration in overseas jurisdictions

Many jurisdictions have made conscious policy decisions to ensure that deductions are available in respect of coupons paid on Additional Tier 1 and Tier 2 capital instruments. This is the case within the European Union, where the majority of Member States have put in place rules which provide for payments under these types of instruments to be deductible, and elsewhere. It is not obvious to IAG that there is a need to harmonise conscious tax policy choices that individual countries have made in relation to regulatory capital and the application of anti-hybrid recommendations in respect of that capital.

6. Effective date for introduction of new rules

Submission point 11E requests comments on whether there are any special circumstances that would warrant departing from the general proposition of no grandparenting.

IAG submits that, in the event that our preceding submissions regarding frankable/deductible structure and insurance regulatory capital are rejected; then existing arrangements, in particular the RES, should be fully grandparented from the hybrid proposals. Alternatively, a lengthy grandparenting period should be the absolute minimum requirement.

6.1. Analysis in document does not consider structured arrangements

One of the crucial statements concerning the Document's discussion of effective date are inconsistent with IAG's circumstances. The Document assumes that the rules will "*generally apply to arrangements between related parties or within a control group*"[4], whereas the RES are issued to third parties and listed on the ASX. The RES will only be subject to the proposals because of the intended broad definition of structured arrangement.[5]

The Document goes on to state that the result should not generally be punitive, rather involving the loss of an unintended tax benefit. As we have submitted above, in IAG's case, the RES does not lead to a tax benefit or D/NI outcome.

Finally, the Document also states that the impact of the proposals will in most case be able to be established now, by reference to the OECD's Final Report. We consider that any assumption that OECD recommendations should be deemed to represent New Zealand law on complex, large, economically significant transactions, in advance of any government decisions on the matters in question to be an abuse of due process. Decision regarding New Zealand law should be made by Parliament, not asserted through discussion documents.

6.2. Inability to quickly unwind existing structure

The RES are a perpetual instrument held by third parties, with the next reset date not being until December 2019. Holders have chosen to invest based on current law and the RES have been costed on that basis. It would be prohibitively

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[4] See paragraph 11.20 to 11.22 at page 78.
[5] See paragraph 12.5 to 12.7 at pages 80-81.

expensive to seek to unwind the structure before that date as investors have a legitimate expectation of a particular return until that date.

If more targeted rules are not applied there should be a considerable grandparenting provision or a period during which restructuring of hybrids can be undertaken. Grandparenting, or delayed application for a period of at least five years from enactment, would be a reasonable compromise. This is consistent with the proposed application of non-resident withholding tax or the approved issuer levy for many of the branch lending proposals in the Taxation (Annual Rates for 2016-17, Closely Held Companies and Remedial Matters) Bill.[6] We also note that transitional arrangements proposed for measures in connection with employee share schemes will extend until 2022.[7] The financial impact of unwinding instruments such as the RES far outweighs that of changes to employee share schemes.

7. Changeable current regulatory and taxation environment for insurers

Finally, we submit that the current regulatory and taxation environment for insurers is sufficiently changeable that all New Zealand tax measures affecting the treatment of regulatory insurance capital should be deferred. We make this point regardless of the government's decisions on our points above.

7.1. Insurance prudential regulation is evolving

The insurance industry is subject to global economic factors such as weak economic growth, low inflation rates, volatile financial markets and near-zero interest rates.

Internationally, we are seeing unprecedented levels of interaction among various insurance regulators—with a strong push for global standards in a broad range of areas from capital requirements to risk management. The International Association of Insurance Supervisors (IAIS) is now developing the first-ever global capital standards for large insurance groups that are active in multiple jurisdictions. The International Capital Standard is intended to be a truly global group measure unlike any current regulatory practice.

While the development of global capital standards will be a significant hurdle, IAG suspects that there will be many changes for the insurance industry in the next few years. Standards are likely to continue to evolve, rather than face a single point of change. Capital standards will interact across jurisdictions and with other aspects of regulation, with unknown results. There will be change at both a local and global level.

In New Zealand, for example, the Reserve Bank is planning a review of the Insurance (Prudential Supervision) Act 2010 (IPSA).[8] IPSA provides the comprehensive framework for the prudential regulation and supervision of insurers

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[6] See clauses 5(4)(a), 5(4)(b) and 5(6) of the Taxation (Annual Rates for 2016-17, Closely Held Companies and Remedial Matters) Bill , which cover lending from a third party with a New Zealand branch, a foreign parent with a New Zealand branch and bank wholesale funding respectively. We consider these situations to be a much closer parallel to the RES than other parts of the non-resident withholding tax anti-deferral package referred to by the Document.

[7] See Tax treatment of employee share schemes – further consultation (September 2016), paragraph 38 at page 13.

[8] Terms of reference for the review can be viewed at http://www.rbnz.govt.nz/-/media/ReserveBank/Files/regulation-and-supervision/insurers/regulation/Terms-of-reference.pdf?la=en

in New Zealand. The Reserve Bank plans to publish an issues paper in late 2016. We consider that it makes sense to assess any proposals to change IPSA before seeking to make tax changes affecting regulatory capital for the industry.

7.2. Tax treatment of insurance industry globally remains uncertain

The tax environment for insurers is currently, if anything, less certain than the regulatory requirements. In addition to the proposals in this Document, insurers may also be subject to restrictions on interest deductibility through BEPS Action 4. In this regard, the OECD has noted that *"Further work would be conducted in 2016 to identify appropriate approaches to address BEPS risks in these entities, taking into account the risks posed, the role interest plays in banking and insurance businesses, and restrictions already imposed by capital regulation. In particular it was noted that any approaches adopted should not conflict with or reduce the effectiveness of regulatory capital rules intended to reduce the risk of a future financial crisis."*[9] Such work has not yet been completed, with the OECD currently considering public comments received regarding Action 4.

In IAG's view, it is important to examine all changes which will affect insurer's regulatory capital as a whole, rather than to separate reforms under BEPS Action 2 (as proposed in this Document) and pending reforms under BEPS Action 4.

IAG has yet to see other countries take action in isolation regarding regulatory hybrid capital. The Australian approach to date has been measured and represents an example which could be followed by New Zealand. The Australian Board of Taxation has reported that implementing changes to frankable/deductible hybrid regulatory capital structures *"would require a holistic review of Australia's tax treatment of regulatory capital, encompassing potential changes to section 215-10 and the franking streaming rules."*[10] The Board sought, and was granted, further time to consider:

- the complexities and interactions involved
- the limited time period in which this review was able to be undertaken, and
- the need to undertake a holistic review to assess and ensure unintended consequences do not arise.

We understand that the Board's report has been further delayed beyond its extended deadline of July 2016.

8. Conclusion

We would be keen to discuss the points raised in this submission in more detail. Please contact Craig Hespe [redacted]) in the first instance.

Yours faithfully

Craig Hespe
Head of Group Taxation

[9] See BEPS Action 4 Approaches to address BEPS involving interest in the banking and insurance sectors (OECD, 28 July 2016) at page 5.
[10] See Implementation of the OECD Hybrid Mismatch Rules: A Report to the Treasurer (The Board of Taxation, March 2016) at page 9.