SwissBanking

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Public Discussion Draft – BEPS Action 4: Approaches to Address BEPS Involving Interest in the Banking and Insurance Sectors

Dear Mr. Pross,

The Swiss Bankers Association (SBA), founded in 1912 in Basel, is the leading professional organisation of the Swiss financial centre. Its main purpose is to maintain and promote the best possible framework conditions for the Swiss financial centre both at home and abroad.

The SBA would like to thank the OECD for the opportunity to comment on the present discussion draft.

The discussion draft recognizes that interest plays a particular role for banks and in this respect, the banking sector differs from the other sectors of the economy. Further, it is also noted that the banking industry, unlike other economic sectors, is highly regulated, which considerably restricts any room for manoeuvre.

1. General remarks – particular features of the banking industry

Overall, we remain concerned about the risk of unintended consequences, especially from measures designed to combat specific and contrived avoidance strategies which take insufficient account of the potential impact on ordinary commercial transactions. For instance, imposing a “one size fits all” rule on interest deductibility would be completely inappropriate if it fails to take account of the very different circumstances in the financial services sector, where borrowing and lending are integral to the commercial operations and interest plays a different role than in other industries (i.e. interest paid is equivalent to the "cost of goods sold" by non-banking businesses).

The banks' asset and liability structure is determined by the local and global regulatory requirements, giving little leeway for banks to structure their activities. Banks conduct business with special purpose vehicles which facilitate intermediation. Vehicles resident in low tax jurisdictions are chosen to ensure tax neutrality, e.g. reducing double taxation, but not to secure tax advantages.

In addition, we would like to underline that the discussion draft ignores arm's length tests on interest deductions. We regret that such a basic and well established principle is simply not considered. For a company, the consequences of ignoring arm's length tests are straightforward: deductions might be disallowed even though the related payments fully reflect market conditions. The Arm's length principle meets the concerns of the BEPS project.

2. Questions for consultation

We limit ourselves to answer some of the questions, which we consider of particular relevance for us. For the other questions, please refer to our general remarks above.

> ***Question 3:*** *Are there other any general issues related to the impact of regulatory capital rules on the level of leverage in a bank or insurance company that should be taken into account? It should be clearly identified where these are issues relevant to all or a large number of countries or where they concern a particular country's regime.*

As mentioned in the discussion draft, banking groups are subject to regulatory capital requirements that restrict their ability to place debt in certain entities. By ensuring that a bank or insurance company is capitalized with an appropriate level of equity, these rules may also to some extent provide protection against excessive leverage for tax purposes. The capital requirements, as defined and implemented by the Basel capital framework, reduce the leeway for optimizing the structure of debt instruments for tax purposes.

Due to the preference of local regulatory authorities for higher local capital buffers, there are indications that capital requirements for subsidiaries are often higher than the minimum requirements defined for the group, thus limiting the scope for balance sheet optimization for tax purposes on a group level.

As a specific example, the new international standards, which were developed by the Financial Stability Board (FSB) require that global systemically important financial institutions (G-SIFIs) must issue and maintain Total Loss Absorbing Capital (TLAC) on the top level of their holding company. The goal of TLAC is to ensure that G-SIFIs have enough equity and additional loss-absorbing capital in the form of bail-in bonds for a potential resolution without the use of taxpayers' money. The Swiss capital ordinance requires that such instruments be issued by the top-holding company in Switzerland. This requirement is to ensure the legal enforceability of any processing and conversion of the bail-in of bonds, which is in line with the FSB directives and requirements of international authorities assessing the resolution plans of G-SIFIs. Therefore, Swiss head-quartered G-SIFIs are required to issue and hold large amounts of subordinated debt in Switzerland (approximately CHF 80-100 bn in total for the two Swiss G-SIFIs to be built up in the coming years). Apart from the regulatory requirement to issue such instruments in Switzerland, which already reduces the scope of tax optimization, the issuance of such funds and the necessity to allocate them within the group in line with regulatory requirements, may lead to increased (profit) tax burden for Swiss-G-SIFIS due to additional income from investments, which are not fully deductible under current Swiss corporate tax rules.

Moreover, liquidity requirements provide for an additional layer of constraints to a bank's asset and liability management, thus increasing the protection against excessive leverage for tax purposes further. A banks' liquidity risk management aims to maintain a sound liquidity position to meet all liabilities when due and to provide adequate time and financial flexibility to respond to a firm-specific liquidity crisis in a generally stressed market environment, without incurring unacceptable losses or risking sustained damage to the businesses. Similar to capital requirements, there are indications that requirements from local regulators often exceed the requirements applicable on a group level, thus reducing the scope for (tax) optimization with interest-bearing instruments:

- The liquidity coverage ratio (LCR) measures the short-term resilience of a bank's liquidity profile by comparing whether sufficient high-quality liquid assets are available to survive the expected net cash outflows from a significant liquidity stress scenario, as defined by the relevant regulator. Therefore, the LCR is a key metric used by banks and regulators within a liquidity management framework. In addition to the international standard (Basel Committee on Banking Supervision), systematically important banks in Switzerland are subject to local liquidity requirements. The calculation of the relevant metrics are prescribed by Switzerland's financial-markets regulator (FINMA), based on the standards stemming from the Bank for International Settlements (BIS).
- The net stable funding ratio (NSFR) framework is intended to limit over-reliance on short-term wholesale funding to encourage a better assessment of funding risk across all on- and off-balance sheet items, and to promote funding stability.

Question 13: *Are there any additional practical issues arising from the modifications to the fixed ratio rule described in the discussion draft, as it applies to an entity in a group with a bank or insurance company –*

> *a. application of the fixed ratio rule to the local group excluding banks and insurance companies*
> *b. the treatment of interest expense on debt supporting banking or insurance activities*
> *c. other issues?*

Question 14: *Should any other modifications be considered in applying the fixed ratio rule to an entity in a group with a bank or insurance company?*

Interest rates may vary widely across jurisdictions, between currencies, over time not to mention the negative interest that banks have to pay for deposits they hold at a number of central banks. Furthermore, interest rates related to debt financing may vary within the same group because of different ratings that entities belonging to the group may have. These factors, with the exception of the negative interest only imposed on banks, may impact other economic sectors as well. Given the particular role played by interest for banks however, banks are more sensitive to developments in this area than other sectors.

In our submission of 6 February 2015, we had already indicated that rules referring to measures of earnings such as EBIT or EBITDA are not appropriate for the banking industry since in general, interest is a key source of a bank's profitability, which can be compared with revenue and cost of goods sold in other industries. We think that even a modified fixed ratio rule, taking into account that EBIT or EBITDA as such are not appropriate for the banking sector, would be difficult to implement for the banks and for the tax administrations to assess. The risk that banks are confronted with conflicting rules might increase exponentially and therefore create additional uncertainty. This would be true in general, but in particular for banking groups with international presence: these would face a real risk to have to comply with a number of different domestic rules applying to their entities, which could not be reconciled at group level.

We therefore think that a fixed ratio rule should not apply to any entity of a banking group. Such rules might be overly restrictive and might not be applicable in an appropriate manner (by banks and by the tax authorities). Considering that the constraints imposed on the regulated entities of a banking group impact the unregulated entities as well, BEPS risks are very low or non-existent in the case of banking groups.

Question 15: *Are there any additional practical issues arising from the approaches for applying the group ratio rule to an entity in a group with a bank or insurance company that should be taken into account?*
Question 16: *Are there any other approaches to applying the group ratio rule to an entity in a group with a bank or insurance company that should be considered?*

As mentioned above, we think that a fixed ratio rule is not appropriate for the banking sector. We are also of the same opinion as far as a group ratio rule is concerned.

Moreover, one has to consider for banking groups with international presence that tax rules differ across jurisdictions, local GAAPs differ across jurisdictions (definitions differ and financial ratios might not be comparable, consolidation rules might not lead to the same outcome), timing mismatches can occur (different periods for accounting and taxation periods). Group-wide approaches might lead to double taxation if the matching of third party interest expenses with intra-group loan agreements is not possible. We recognize that the challenges represented by a group ratio rule are also faced by other sectors, however, a combination of those rules with the rules that are specific for the banking industry would considerably add complexity to the implementation, for no benefit as far as BEPS is concerned.

The SBA is therefore of the opinion that limitation on interest deductions should not apply to the banking industry, since the banking industry is highly regulated and even non-regulated entities of a banking group cannot fully ignore the requirements set by prudential regulators. Banks' operations and requirements to hold debt instruments or debt-like capital instruments is constrained by liquidity, funding and capital requirements, that are generally governed by the BIS, with implementation governed by the home regulators. As such, there is limited possibility for tax evasion / optimization. Separate requirements from a tax perspective would likely collide with the already existing requirements.

The SBA thanks the OECD for taking due account of these comments.

Yours sincerely,
Swiss Bankers Association

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