

## Media Release

### FOR IMMEDIATE RELEASE

## Proposals threaten interest deductions for Australian banks, says Deloitte

**Wednesday, 25 August 2010:** A recently-released Basel Committee consultation paper contains proposals that, if implemented by APRA, will put at risk substantial interest deductions on subordinated debt issued by Australian banks, according to professional services firm Deloitte.

Emanuel Hiou, Deloitte Banking Tax partner, said the objective of the proposals is to ensure that all subordinated capital instruments (Tier 1 hybrid capital instruments and Tier 2 subordinated debt) are able to bear an appropriate share of losses if the bank is unable to support itself.

The proposals will require the terms of these instruments to include a permanent write off of the instruments, and may require the bank to convert them to common equity, where the bank would otherwise not be viable.

“This so called ‘bail in capital’ is expected to improve the quality of bank capital. During the global financial crisis, investors in subordinated capital instruments of some global banks that required Government capital support did not bear any losses,” Mr Hiou said.

“In effect, the Government bail-outs protected investors from incurring losses on these types of capital instruments.”

The major Australian banks currently have over \$30 billion in Tier 2 subordinated debt. Most of this funding is from term subordinated debt, which has been raised in offshore capital markets under their global funding programs.

Under Australian tax law, interest on Tier 2 term subordinated debt is generally deductible where the obligations to pay interest and principal are effectively not contingent. Earlier this year, the Government issued tax regulations confirming that Tier 2 term subordinated debt, where the obligation to pay interest and principal is contingent on capital levels and solvency, will be treated as debt for tax purposes on the basis that these contingencies will be ignored.

These types of contingencies, which are currently required by bank capital standards, allow payment of the interest and principal to be deferred. The tax regulations, however, require certain conditions to be met. This includes that any deferred interest and principal on the debt must accumulate and the issuer must not have a right to waive the obligation to pay interest and principal.

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Mr Hiou said if the Basel proposals are adopted by APRA there is a real risk that interest on Tier 2 subordinated debt will no longer be tax deductible under Australian tax law.

“This is because the obligations to pay interest and principal on the subordinated debt will be regarded as effectively contingent obligations, so the subordinated debt will not meet the test for debt treatment,” Mr Hiou said.

“Based on the terms of the subordinated debt, the obligation to pay interest and principal will be contingent on the bank not being required to write off the subordinated debt or convert the subordinated debt to common equity where the bank would otherwise be regarded as not being viable.

“The debt write off will be permanent, meaning that the amount will be waived rather than deferred and accumulated. In addition, under Australian tax law governing the treatment of debt, the conversion of debt to equity by an issue of shares is not regarded as satisfying an obligation to pay interest or principal on the debt. ”

Mr Hiou said under these circumstances there is also a risk that the subordinated debt will be regarded as equity for tax purposes, with the consequences that the interest will be frankable.

“Non deductibility and franking of interest are likely to result in a substantial increase in the after-tax cost of capital for Australian banks,” Mr Hiou said.

“Given that the Basel proposals are being developed for support by the G20, and APRA generally follows global capital standards developed by the Basel Committee, APRA can be expected to adopt the proposals if they are supported by the G20.

“Accordingly, the progress of these proposals will require close monitoring by the Australian banking industry to ensure that appropriate consultation takes place to address the future tax treatment of Tier 2 subordinated debt should these proposals be implemented,” Mr Hiou concluded.

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