European Banking Federation
Chief Executive

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Mr Achim PROSS
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OECD

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Subject: *EBF Comments on BEPS Discussion Draft on Hybrid Mismatch Arrangements*

Dear Mr Pross,

The European Banking Federation (EBF)[1] welcomes the opportunity to comment on the OECD's current work on neutralizing the effects of hybrid mismatch arrangements, Action 2 of the Base Erosion and Profit Shifting (BEPS) project.

The EBF believes that the recommendation in BEPS Action 2 may lead to a very broad set of rules that would be extremely burdensome to manage. It may also be contradictory if the tax administrations introduce locally tailored legislation based on different approaches.

Some countries may introduce an anti-abuse rule in their legislation. The tax administration expects to have prevented a tax planning opportunity and the intention is that the structures should not be used. In other countries the approach may be that there should be freedom to arrange financial transactions.

Legislation based in BEPS Action 2 recommendations is therefore unlikely to be uniform. Every country has its own concepts how to legislate and may also consider to use the same legislation for more than one purpose. This would most likely lead to an administrative burden for the tax payer when attempting to comply with different rules in different jurisdictions.

The EBF is very concerned that it will be impossible to fulfil all design principles as specified in paragraph 27. In order to not hamper international business and commerce, we therefore strongly urge the work group to introduce a carve-out in order to exempt all common and 'plain vanilla' transactions and exclude as much ordinary transactions as possible from the hybrid mismatch legislation. The targeted transactions should be limited to the tailor-made 'boutique constructions' with the primary reason to take advantage of the tax mismatch.

[1] Launched in 1960, the European Banking Federation is the voice of the European banking sector from the European Union and European Free Trade Association countries. The EBF represents the interest of some 4,500 banks, large and small, wholesale and retails, local and cross-border financial institutions. Together, these banks account for over 80% of the total assets and deposits and some 80% of all bank loans in the EU alone.

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Additionally, the approach of automatic application of the rules, without considering the existence of a real business purpose of the arrangements, may affect to the plain vanilla instruments and arrangements widely used in the markets for business reasons aside any tax planning concern; for example, the collateralised loan repo as an efficient tool widely used in the markets to raise funds and liquidity.

The following are examples of instruments that would benefit from a carve-out rule:

- Commonly and/or publicly traded financial instruments
- Financial transactions between unconnected parties
- Regulatory capital

Further to the above general comments, we would like to provide comments to the specific point in relation to regulatory capital raised in box 2 (page 43) on the discussion draft:

8. In relation to regulatory capital

Regulatory capital in banks is governed by Basel III and in EU by Regulation 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms. This means that the criteria to identify such financial instruments are agreed at global level and are designed to make the banking sector resilient.

The Basel III framework states that banks' regulatory capital is composed by Common Equity Tier 1, Additional Tier 1 and Tier 2. Banks should issue regulatory capital in order to be compliant with the relevant regulation.

The main difference between Basel II and Basel III frameworks lays on the provision which requires banks to convert their additional Tier 1 (and potentially Tier 2) instruments into Common Equity Tier 1 at a trigger point, already defined in the relevant legislation. This leads to the creation of a new types of regulatory capital instrument that convert to equity at a pre-defined trigger point, and therefore could be addressed as "hybrid" in addition to those that are hybrid because of contractual provisions.

This being said, it is now evident that all banks' regulatory additional Tier 1 and Tier 2 (AT1 and T2) capital should be addressed as "hybrid regulatory capital instrument" which arise from a regulatory provision (legally binding for banks) and not from an aggressive tax planning. The EBF therefore argues that the hybrid regulatory capital i.e. AT1 and AT2 should be excluded from hybrid mismatch arrangements.

Question 8 (b)

Are special provisions needed to create parity between a banking group issuing hybrid regulatory capital indirectly to the market through its holding companies and a banking group (or another industry group) issuing hybrid regulatory capital directly to the market?

In the example in paragraph 159, one jurisdiction in a group treats the hybrid regulatory capital as equity and the other jurisdiction as a loan relationship. This would lead to a different tax treatment when one banking group would issue the external hybrid regulatory capital from the holding company/parent company and cascade the loan down to the subsidiary bank and another group would have a right to let the subsidiary do the borrowing directly. Whether or not this will give an actual effect on the bottom line would depend on the tax legislation in the jurisdictions involved.

If a full carve-out from hybrid mismatch rules is not feasible it should at least be possible to have a neutral intra-group treatment in situations where the cascading is compulsory.

Question 8 (c)
Are hybrid regulatory capital instruments sufficiently different as to justify a full carve-out from hybrid mismatch rules? Are there inherent safeguards in place against the use of these instruments for tax-planning purposes or what safeguards could be introduced to ensure that any exemption from the general hybrid mismatch rules could not be abused?

The issuance of any AT1 or other regulatory capital has to be approved by the issuing bank's supervisory authority. The main reason for issuing such capital will always be to manage solvency and/or ratings, and tax-planning would be out of scope. Another point is that the investors will usually seek for clearance that there are no tax issues that could lead the borrower to call the loan prematurely, for example the risk that interest payments will be non-deductible. Given that it is unlikely that these loans should be issued solely for tax planning purposes, hybrid regulatory capital should be fully carved out from the hybrid mismatch rules.

We appreciate your consideration of our comments and suggestions and remain at your disposal to contribute further as the work develops.

Yours sincerely,

Guido Ravoet