AFMA

28 February 2011

John Hawkins
Secretary
Senate Standing Committee on Economics
PO Box 6100
Parliament House
CANBERRA ACT 2600

Dear Mr Hawkins

Schedule 2 - Tax Laws Amendment (2010 Measures No. 5) Bill

The Australian Financial Markets Association (AFMA) represents participants in Australian wholesale banking and financial services markets. Our members include all of the leading issuers of capital protected borrowing products. AFMA welcomes the opportunity to make a submission to the Committee in relation to its inquiry into Schedule 2 of the Tax Laws Amendment (2010 Measures No. 5) Bill (TLAB5).

This letter outlines our principal concerns about the measures in TLAB 5 and the policy analysis that underpins it. An attachment to the letter presents more detailed information and analysis of these matters.

1. Policy and Practical Background

Capital protected borrowings are limited recourse loans provided by bank and non-bank financial institutions to fund the purchase of securities. They include protected equity loans and instalment warrants and are an efficient investment tool for Australian investors (including many retirees) to manage their financial risk in a prudent way and grow their equity over time by investing in the Australian economy. They are not an aggressive tax product but like all financial products, the net return they provide to investors is affected by taxation.

The capital protected borrowing provisions in Division 247 of the Income Tax Assessment Act 1997 require the dissection of limited recourse loans into an underlying loan and a capital protection amount. These components are an artificial creation under the tax law, which presents Treasury with a significant practical challenge in designing rules to satisfactorily divide these borrowings into the underlying components.

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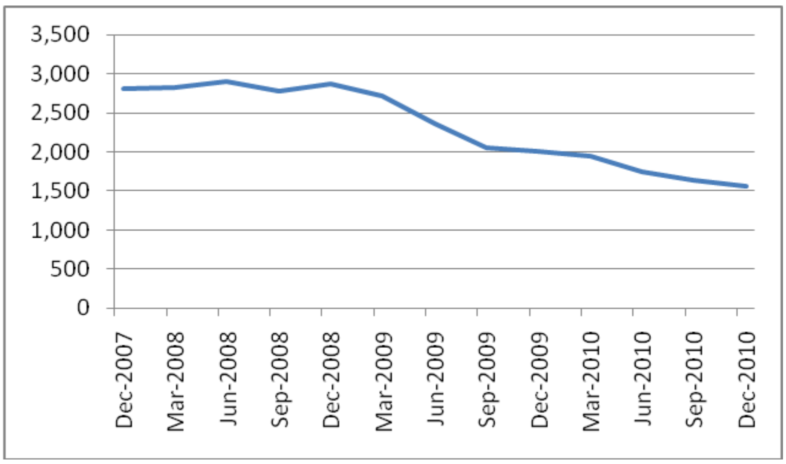
While theoretical analysis has unbounded potential for creating tax policy rules, it is impossible in practical terms to design and implement rules that give a theoretically pure tax outcome in this area. The challenge facing the industry and policy makers is to achieve a balance that facilitates investors who seek capital protection, adequately protects tax revenue and contains taxpayer compliance costs to a reasonable level. The measures in TLAB 5 do not meet this challenge.

2. Summary of TLAB 5 Issues

The proposal in TLAB 5 to reduce the benchmark interest rate for deductibility of interest on capital protected borrowings from the personal unsecured loan rate (currently 15.25%) to the standard variable home loan rate plus 100 basis points (currently 8.80%) has the following effects:

- It penalises cautious investors who seek capital protection. For example, an investor will receive full interest deductibility of interest paid on a margin loan or personal loan to purchase shares, whereas only part of their interest expense is deducible if they instead utilise a capital protected loan. This outcome, which disadvantages risk reduction, seems contrary to the broader Government policy to promote prudent investment behaviour.
- It is felt by many thousands of ordinary investors who are regular users of products like protected equity loans and instalment warrants. Investors in capital protected borrowings are largely from 'middle' Australia. For example, instalment warrant application sizes vary, averaging around $10,000 - $20,000 but are often for amounts as small as $2,000. This reflects their simplicity and wide acceptance for both advisers and investors.
- It does not reflect the economic costs an issuer incurs when providing the loan component of capital protected borrowings.
- It increases tax compliance costs for many thousands of investors who were outside scope of the provisions until the proposed change was announced.
- It has had a highly detrimental effect on the market for capital protected borrowings; eg capital protected loans have fallen by over 45% (see Figure 1).

Figure 1: Capital Protected Loan Market ($ million outstanding)



Note: Data obtained from Reserve Bank of Australia Bulletin.

- We think the net gain to tax revenue is much less than anticipated and may even be negative, given the collapse in capital protected borrowings following the May 2008 announcement.

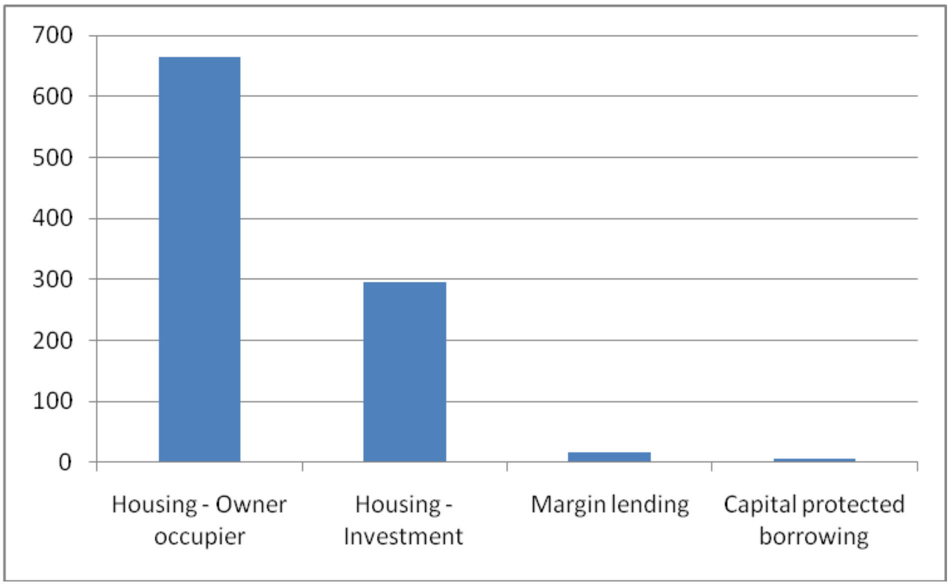
Constantly changing tax rules for capital protected borrowings have been a problem for investors for more than a decade now – see the appendix to the Attachment for a summary table. It is time to resolve this problem and provide certainty for once and for all with a sustainable benchmark rate.

The current tax law was enacted in 2006 after a comprehensive, 3 year consultation process with Treasury and the Government. The detailed reasoning that underpins the policy change announced in 2008, decreasing the benchmark interest rate to the home loan interest rate, is not available. AFMA's discussions with Treasury around that time suggest the analysis underpinning the policy change did not completely bridge the gap between academic theory and the actual conduct of investment lending business.

For instance, theory might suggest that a risk-free loan can be funded at the risk free rate but this is often not the case in practice. This was evidenced during the global financial crisis when investors demanded yields on bank borrowings guaranteed by the Government that were significantly higher than yields on Commonwealth government bonds. In practice, banks cannot raise funds at the risk free rate and non-bank lenders typically face higher funding costs than banks. Moreover, while theory may assume away transactions costs, they exist in practice and have real implications for the conduct of business that must be fully factored into the policy analysis.

In addition, the policy analysis assumes a level of comparability between home loans and capital protected borrowing loans that does not actually exist. The purpose and management of these loans are very different; as is the scale of business (the capital protected borrowing market is about 0.3% the size of the home loan market – Figure 2).

Figure 2: Relative Loan Market Size ($ billion) – June 2010

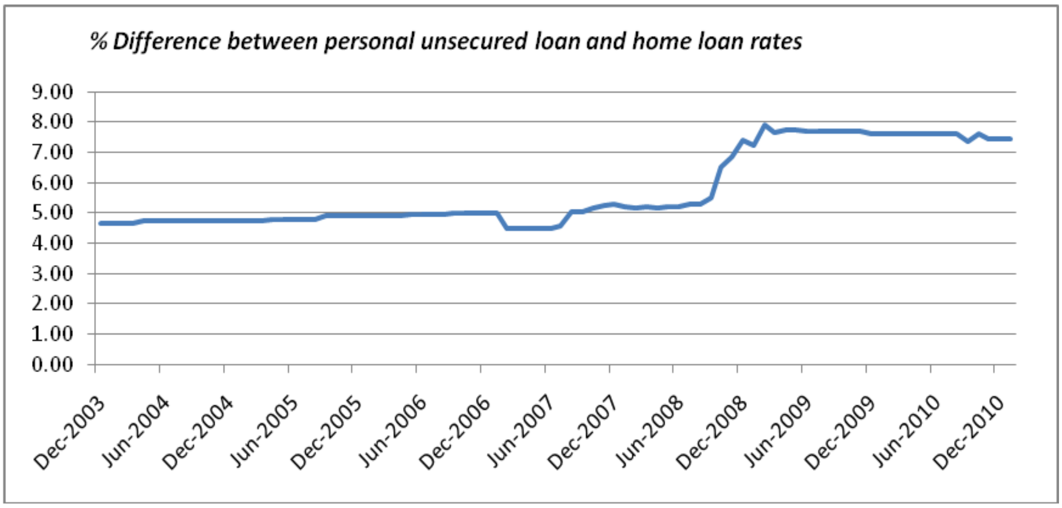


Note: Housing loan, margin lending and capital protected loan data are taken from the Reserve Bank's statistical tables. Capital protected borrowing includes capital protected loans and instalment warrants outstanding (data for which were taken from an internal survey of AFMA members conducted in June 2010.)

As a result of these factors, we think the policy analysis systematically underestimates both the *credit risk* in many capital protected borrowings and the associated *loan administration costs*. The attachment explains this perspective in more detail.

Another factor relevant to determination of a realistic benchmark rate is that the home loan market is more competitive than the capital protected borrowing market (which has 8 significant providers). Further, given its importance to the community, the interest rate margin on home loans is compressed to the maximum possible level.

Figure 3: Interest Rate Differentials



The home loan interest rate has declined more significantly during the recent economic cycle than personal and business loan rates. Indeed, the differential between the pre-2008 Budget benchmark interest rate and the home loan interest rate has expanded **by 250** basis points relative to its historic average (see Figure 3), increasing the disadvantage suffered by affected investors.

Finally, and significantly, the use of the personal unsecured loan interest rate for the benchmark rate is a specific design feature of Division 247. AFMA was told during consultations in 2006 that the effectiveness of the law in meeting its objective relied upon a benchmark rate that would exclude a range of uncontroversial loan arrangements for business and individuals. A significantly lower benchmark interest rate will undermine this position, with adverse consequences for the efficiency of the tax system and taxpayers.

3. Benchmark Interest Rate Recommendation

Having regard to the matters described above, AFMA suggests that the Committee should recommend that the benchmark rate be amended to be the mid-point of the benchmark rate proposed in the May 2008 Budget and the benchmark rate in the current law. In other words, it should be **the mid-point between the indicator rates for standard variable rate housing loans and personal unsecured variable rate loans**, as published by the Reserve Bank of Australia.

We think this approach would provide a stable and workable solution that protects tax revenue and enable investors to go about their business in a prudent manner under certain and reasonable tax rules. It would also greatly reduce the potential for commercial and other loans to be inadvertently caught by the law.

We would further note that a benchmark interest rate at anything less than the margin loan interest rate is not credible and would not significantly address the inequity and harm to investors who would ordinarily wish to use capital protected borrowings.

We appreciate the opportunity to make a contribution to the Committee's inquiry and would be happy to provide evidence before the Committee if desired.

Yours sincerely

(...)

Duncan Fairweather
Executive Director

Attachment to Submission on Schedule 2 of the Tax Laws Amendment (2010 Measures No. 5) Bill

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1. The Policy Framework

Division 247 of the Income Tax Assessment Act 1997 splits capital protected borrowings into two artificial components:

- an underlying loan; and
- a put option (capital protection).

This is an entirely synthetic exercise that is conducted for tax purposes; the 'put option' is not tradable by the investor in the way that normal put options are and it does not have a life independent of the 'underlying loan', which itself does not exist in the absence of the put option.

The interest expense on the underlying loan is deductible for tax purposes but the cost of the capital protection is not. This is put into practice by imposing a limit on the amount of interest that is deductible on a capital protected borrowing by reference to a benchmark interest rate.

For example, if the interest rate charged on a $100 protected equity loan is 18% and the reference benchmark interest rate is 10%; then $10 of interest expense is deductible for tax purposes and the remainder ($8) is not.

The pre-2008 Budget benchmark interest rate (the personal unsecured loan rate) is a <u>policy design feature</u> of Division 247. The efficient operation of the Division is dependent on this benchmark rate, as it in effect excludes most ordinary finance arrangements from the scope of the provisions. This rate resulted from an exhaustive consultation process over three years. AFMA has accepted the policy decision to introduce Division 247, although it does create non-neutralities into the tax law.

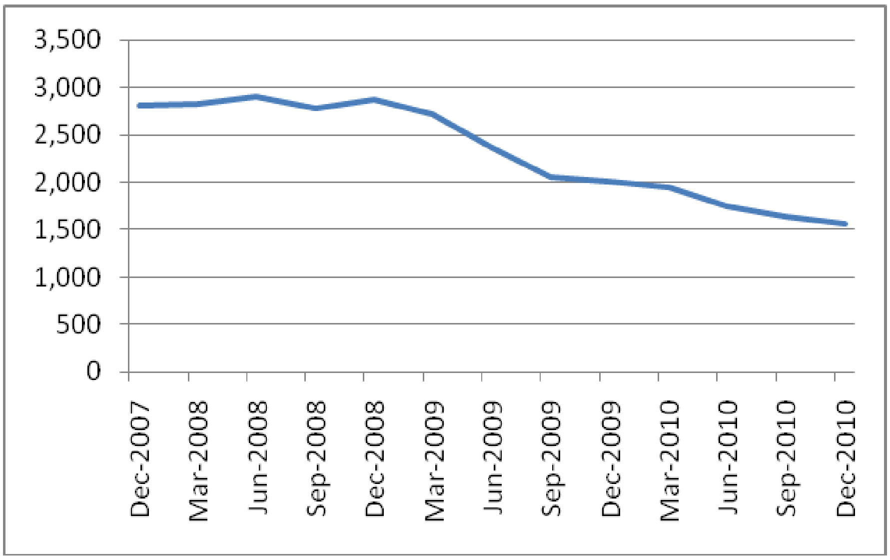
2. The Current Problem

The Federal Government's Budget in May 2008 included an announcement to reduce the benchmark interest rate from the personal unsecured loan rate (currently 15.25%) to the Reserve Bank's Indicator Rate for Standard Variable Housing Loans (currently 7.8%), which dramatically reduces the tax deductibility of capital protected borrowings.

The Tax Laws Amendment (2010 Measures No. 5) Bill (TLAB 5) would improve this situation by amending Division 247 to change the benchmark interest rate to the home loan rate plus 100 basis points.

AFMA agrees with the Government's assessment that the original proposal is flawed and that the benchmark limiting tax deductibility of interest expense should be higher than the standard variable home loan rate. However, AFMA believes the proposed increase in TLAB 5 is too low to reflect the reality of the market and, therefore, is at odds with the policy objectives of the legislation.

Figure 1: Capital Protected Loans ($ million)



Note: Data obtained from Reserve Bank of Australia Bulletin.

AFMA is very concerned about new policy adopted in TLAB 5, which has already had a serious, harmful impact on the market for capital protected loans (see Figure 1). As explained to us by Treasury, the theoretical model of the market that underpins the 2008 Budget announcement is predicated on the underling loans being risk free. This position is not an accurate reflection of the real world situation for many common capital protected borrowings (as explained below). The proposed 100 basis point increase above the rate originally announced in May 2008 acknowledges the concerns raised by the industry in this regard but it does not satisfactorily address the problems identified.

The sharp and continuous decline in capital protected loans since the May 2008 announcement does not mean that capital protected borrowings are tax driven – indeed, the profile of investors and the history of the products suggest otherwise. Rather, the decline reflects the effect of the tax penalty imposed on investors seeking capital protection by the reduction in the benchmark rate.

AFMA made a submission to Treasury on the exposure draft to TLAB 5 outlining our concerns about a range of deficiencies in the proposed Bill. In response, Treasury stated that the issues raised in AFMA's submission regarding design features of the law will be considered separately by the Treasury in consultation with industry and the Australian Taxation Office. This line of dialogue has not yet been opened up.

3. The Investors

When Division 247 was introduced, we were advised that it was expected to primarily impact on high net worth investors. In practice, this has not been the case as many ordinary investors have been caught under the provisions and the changes in TLAB 5 would exacerbate this effect.

Investors in instalment warrants, protected equity loans and other capital protected products are largely from 'middle' Australia. For example, instalment warrant application sizes vary, averaging around $10,000 - $20,000 but are often for amounts as small as $2,000. This reflects their simplicity and wide acceptance, making it easier for both advisers and investors to understand them.

Analysis of loan applicants over the last 5 years by one major product provider concluded that the great majority of investors have an annual income of less than $150,000, with many earning somewhere in the region of the average weekly earnings rate for full time employees.

Many investors, particularly those planning for their retirement, value the peace of mind that capital protection provides in volatile markets. A fair and reasonable tax treatment of capital protected borrowing is necessary to enable investors to meet their financial goals. In the absence of this, investors will be biased towards riskier investments; for example, choosing a margin loan instead of a capital protected product because it provides a better tax outcome.[1]

4. Effects of the New Benchmark Interest Rate

The proposal in TLAB 5 creates a bias for investors to use riskier investment loan facilities, like margin loans and personal loans, as illustrated in table 1.

Table 1: Examples of Investment Interest Expense Deductions

Method of financing:	*Capital protected*	*Interest rate*	*Tax deductibility*	
Margin loan	No	9.65%	100%	
Personal loan	No	15.25%	100%	
			Budget	*TLAB 5 (Bill)*
Protected equity loan (portfolio)	Yes	Varies	55%	62%
Instalment warrant (range approx)	Yes	Varies	47-82%	53-93%

[1] The industry worked with the Government to develop and introduce the new margin lending regulatory regime, which took full effect in January. This has addressed the consumer protection risks for margin loan investors that had concerned the Government, for example, through the Storm Financial situation. However, a margin loan inherently has greater market risk than a comparable capital protected loan.

As a consequence of this:

- Investors have lost capital protection opportunities due to the higher tax cost. For example, the amount of protected equity loans fell by over 45% between June 2008 and December 2010 – a period when higher demand for capital protection would ordinarily be expected.
- A taxpayer who invests via a margin loan will get full interest deductibility but an investor who takes capital protection will not.
- A margin loan investor who decides to purchase capital protection (eg through a put option) from their lender would consequently have the interest deductibility of their margin loan reduced – even though the protection is separate from the margin loan;
- The Explanatory Memorandum to TLAB 5 states these amendments are expected to have a low transitional compliance cost for issuers of capital protected borrowings but no increase in ongoing compliance costs. This statement takes no account of the impact on investors or of the much wider scope of application of the measures with many more thousands of investors now caught by the provisions because they hold products with interest rates lower than the pre-May 2008 benchmark mark rate. Taxpayers' compliance costs increased markedly, as more products are caught and both tax complexity and uncertainty has increased for borrowers.

5. Why the Proposed Benchmark Interest Rate is Too Low

The fundamental flaw in the TLAB 5 approach to taxing capital protected borrowing is reflected in the assertion in the Explanatory Memorandum that the 'adjusted loan rate' achieves a better allocation of the cost of capital protection for borrowers. In fact, the proposed reliance on the home loan rate (as adjusted) as a benchmark rate does not properly account for either the credit risk borne by the lender or the loan administration costs for a capital protected borrowing.

We will explain the reasons for our view on this, but would at the outset note that the position in TLAB 5 is predicated on assumptions about the products in question and the financial markets that are not correct in reality. The policy proposal in TLAB 5 assumes a close similarity between a home loan and a capital protected borrowing that does not exist. They are very different markets in terms of scale, service provision, credit risk and business costs.

The Explanatory Memorandum to TLAB 5 states:

2.13 The 'adjusted loan rate' achieves a better allocation of the cost of capital protection and the interest expense of a capital protected borrowing borrower as it better reflects both the credit risk (including credit risks for the cost of capital protection that is paid on a deferred basis) and the administration costs of the issuer of a capital protected borrowing.

2.14 The credit risk borne by the issuer of capital protected borrowings is considered to be more aligned with housing loans rather than personal unsecured loans. The addition of 100 basis points is to reflect the typically relatively small additional credit risk of the issuer for the cost of capital protection that is paid on a deferred basis.

5.1. Lender's Credit Risk

As explained to us by Treasury during consultations in 2006 when the home loan rate was first suggested as the benchmark rate, the proposal to use the home loan rate for this purpose is predicated on an expectation that the cost of protection in a protected equity loan is paid for in full by the investor at the beginning of the loan and, hence, the lender has no credit risk on the underlying loan. This assumption is wrong because:

1. most protected equity loans have at least a 3-year maturity at the outset (many extend to 5 years), with interest prepaid for one year at most – thus, there is a significant unsecured credit exposure before maturity;
2. there is a trend towards interest being paid monthly in arrears, increasing the credit exposure; and
3. in some cases, the provider lends the investor the funds required to prepay the first interest instalment (ie the interest cost is capitalised), increasing the lender's credit exposure.

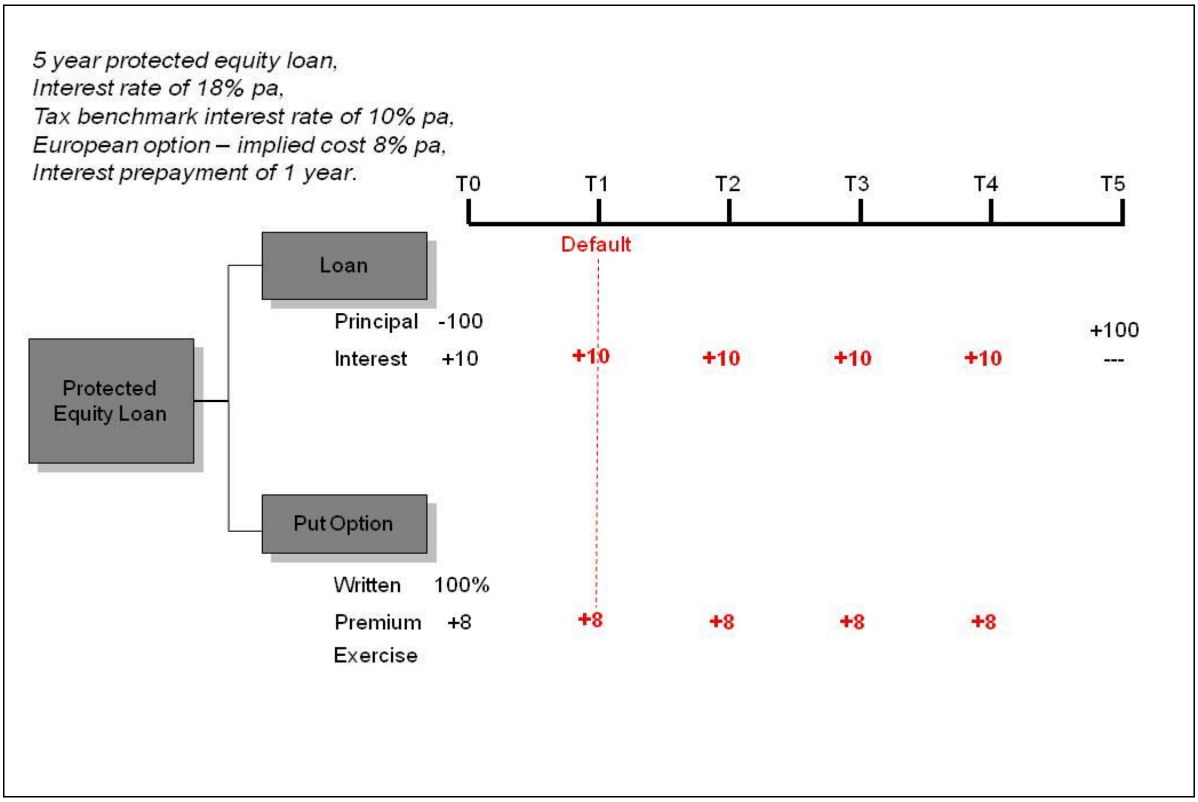
Example - Credit Risk in a Protected Equity Loan

Since a capital protected borrowing is bifurcated for tax purposes, it is necessary to separately analyse the impact of default on the underlying loan and put option components. Figure 2 presents a schematic outline of a typical protected equity loan[2]; there is an underlying loan with 100% gearing, the principal on which is 'protected' by the implied European put option, and the premium is paid for by the investor over the term of the arrangement. The example presents a framework to understand the risk to the lender in the event that the investor defaults on a protected equity loan.

If the investor defaults after one year, the cash flows in bold red font in the Figure 2 are all at risk to some degree. An investor would only default if the shares purchased under the loan had fallen significantly in value. Consider separately the option premium risk, the interest payment risk and the $100 principal repayment risk.

[2] The protected equity loan product was used by Treasury in its policy discussions with industry.

Figure 2: Example of Investor Default Situation



(i) *Option risk*

The implicit European option in a protected equity loan (as outlined in Figure 2) is different to a normal European put option because the premium charged for it is <u>spread over the term of the loan</u>; whereas the premium charged on an ordinary option is paid in full at the time the option is written. Hence, the lender has a credit exposure to 4 'premium' payments of $8 that is not covered by the capital protection.

Looking at this another way, the lender provides a loan of $32 to the investor to purchase the option, which is repaid over the term of the underlying loan. The loan for the option premium is an unsecured personal loan that is in addition to the capital protected loan of $100.

As an aside, we note that even if the option premium was paid for in full upfront, the lender would still face credit risk through its exposure to the option writer (which would be a material amount).

(ii) *Interest receipt risk*

If an investor defaults on the loan, they will discontinue making regular interest payments so the lender is exposed to the loss of this income - 4 interest rate payments of $10. The lender will recover some funds through sale of the shares held as security which would be invested to earn interest and offset some of this cost. The capital protection is in the form of a European put option and so would not be payable until year 5, which imposes a time value of money cost on the lender for this residual amount. If the protection were to be paid immediately, the amount of protection would be discounted by the time value of money, so a cost would still be incurred. In addition, in the event of a complete or partial early repayment of principal, the lender may face a market related funding cost through the interest differential between short and long term funding.

Other costs must be recovered such as commissions and fees paid in establishing the loan and loan administration costs already incurred. These costs are in part reflected in the interest rate charged on the loan and, thus, the bank would suffer a loss even if the underlying loan was fully repaid and the proceeds invested in the bill market. This is because the bill rate does not embody the amortisation of these charges.

(iii) *Principal repayment risk*

The principal outstanding, or underlying loan amount ($100), should be covered by the capital protection provided by the put option. In practice, the option holder would receive the value of the protection less the amount of the unpaid option premium and other costs - potentially by quite a significant amount, as evidenced in Figure 2.[3]

The scale of the above credit exposure to the lender is significant. For instance, members have assessed the probability of default given default factors as giving rise to greater credit risk and a larger economic capital allocation than by a margin loan. This risk requires compensation through a high interest rate in relation to the credit exposed amount. This is reflected in practice in the break fees charged on protected equity loans. For example, issuers often warn that break fees are about 5-10% of the loan amount multiplied by the remaining number of years to maturity. If there was no credit exposure to the issuer upon default of the loan, then there would be no cause for a break fee. Usually lenders seek to recover break fees on a full recourse basis, which reflects the likelihood that protection will be imperfect and this imperfection will be reflected *pari passu* in the riskiness of the underlying loan.

Some relevant differences between home loans and capital protected borrowings

Home loans and capital protected borrowings have intrinsic differences that also impact on their relative riskiness. Home loans are secured by assets that are relatively resistant to downward price movements and are infrequently re-valued. In contrast, capital protected loans are issued over assets with relatively volatile prices, movements in which are reported widely on a daily basis. Moreover, individual share prices are more susceptible to

[3] It is worth observing that an 'independent' provider of the option may not be obliged to provide protection to the option holder, since the holder has failed to satisfy their side of the bargain (because they have not paid for the protection in full).

idiosyncratic risk and the market has the potential to 'jump' or 'gap', where prices move dramatically within a short period of time.

Accordingly, capital protected loan investors are more likely to encounter circumstances where the asset that underpins their loan loses significant value and they would be immediately aware of this situation. Faced with the ongoing commitment to pay high interest payments to fund an asset that in their judgement may have no upside, there is a relatively greater risk of default to capital protected loan lenders when compared to home loan lenders that must be reflected in the associated lending margin and, hence, the interest rate charged is always going to be higher.

Perhaps most importantly, home ownership is acknowledged as having a particularly high priority amongst Australians and housing meets an essential need. In contrast, geared investment in shares is a discretionary demand so, again, there is a relatively greater risk that capital protected loan investors may default.

Another relevant factor is that home loans have ongoing principal repayments, so the amount of debt outstanding automatically falls to zero over the term of the loan (in other words, equity in the security builds up over time), while capital protected loans are interest only loans and have a single repayment of the full amount of the principal at the end of the loan. Thus, the average line of credit outstanding is greater for a capital protected loan than it is for a home loan for the same initial loan amount and loan term. This is relevant in the context of break fees and interest forgone in the event of default, as the protection feature only ameliorates credit risk in respect of the principal lent at maturity of the loan and it does not eliminate the asset risk of default to the issuer/lender.

Pursuant to the relevant agreement, the maturity date on a capital protected loan may be brought forward on the occurrence of certain events like corporate actions or a change in law. For example, if the 'approved securities' are subject to compulsory acquisition following a successful cash takeover offer, it is expected that the capital protected loan will be repaid early on the completion date of the takeover, and the cash takeover proceeds will be applied to repay the liabilities under the capital protected loan agreement (including any break costs which may apply as a result of this early repayment). Another example is the nomination of an early maturity date following delisting of an approved security, which can also result in break cost liabilities. Break costs may be significant and may offset or exceed any capital gains realised on the approved securities, and the capital protection feature will not apply, increasing risk taken on by the issuer.

5.2. Loan Administration Costs

The fundamental purposes of home loans and capital protected borrowings differ and this results in quite different loan administration costs. Home loans enable a householder to purchase a home, while capital protected borrowings enable an investor to purchase shares and other securities. The management of these loan types are quite different, as outlined below. Together with the enormous scale differences in the markets, this means that capital protected borrowings are significantly more expensive to administer in practice than are home loans. This issue is separate from the degree of risk in the underlying loan in a capital protected borrowing.

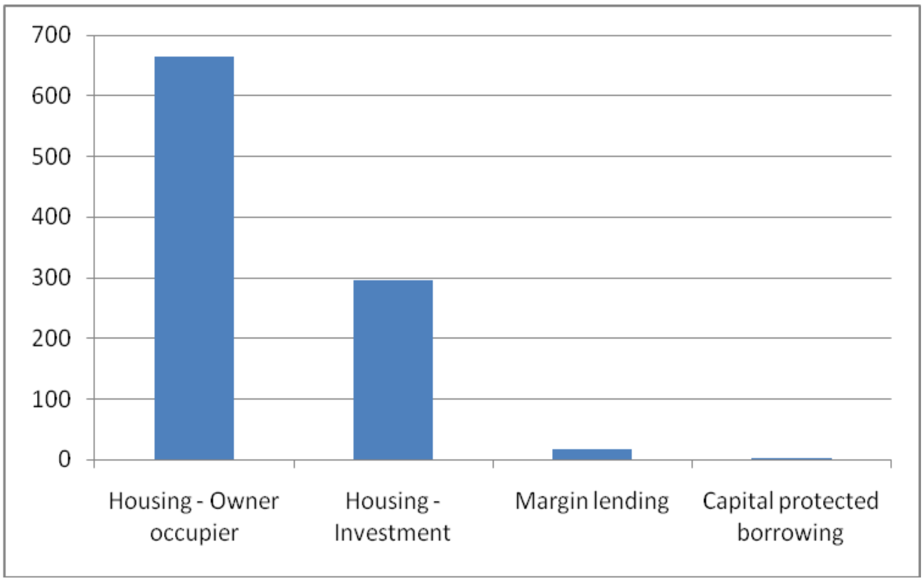
Market scale

The home loan market is easily the largest lending market in Australia; significantly larger than the commercial lending market.

By contrast, the market for capital protected borrowings is miniscule - about 0.3% the size of the home loan market – see Figure 3. Lenders in the housing market have very substantial scale of business benefits that are not available to capital protected product lenders. The major banks each have housing loans outstanding in excess of $150 billion and even the smaller banks active in the home loan market have loan books well in excess of the size of the total market for capital protected borrowings.

The margin loan market, which itself has contracted consequent to the GFC, is estimated to be about 6 times larger than the market for capital protected borrowings.

Figure 3: Relative Loan Market Size ($ billion) – June 2010



Note: Housing loan, margin lending and capital protected loan data are taken from the Reserve Bank's statistical tables. The capital protected borrowing data include capital protected loans and instalment warrants outstanding, taken from an internal survey of AFMA members conducted in June 2010.

Significant cost efficiencies are possible in the home loan market given its size, whereas the market for capital protected borrowing is smaller, less homogenous and more specialised. For example, resources required to support product development, marketing strategies, loan documentation and other loan related operations can be spread over a much wider cost base in the home loan market. Meanwhile, the sharp fall in the size of the market for capital protected borrowings since May 2008 has accentuated the cost advantages from scale in the home loan market.

Different Loan Administration Costs

Operational processes for capital protected borrowings cannot be streamlined into categories in the same manner as for home loan products to achieve administrative efficiencies. Therefore, administration costs for capital protected borrowings will always be higher per dollar borrowed.

The following is a summary of differences between home loans and capital protected borrowings:

(i) *Initial booking of the loan*

A capital protected borrowings is usually more than one stock (all treated as separate loan tranches) which, therefore, can be drawn down on different days. A client's facility can consist of many separate trading transactions, all of which need to be booked and reported and confirmed to the client separately via formal correspondence.

(ii) *Product management*

Scale is a relevant factor for other aspects of 'product management', such as developing and maintaining the loan documents and client agreements. The task is similar, and the effort is probably comparable, to that for a mortgage provider but the cost of this 'infrastructure' accounts for a larger component of revenue than would be the case for a mortgage provider managing a loan book measured in the billions of dollars.

(iii) *Infrastructure*

Systems infrastructure must be developed with the smaller business size tending to make development of sophisticated mainframe solutions sub-economic and even piecemeal solutions more expensive per dollar of loan book. The nature of the business also requires that additional risk management systems be acquired as well as additional staff to manage the risk on a real-time basis.

(iv) Client reporting

The protected lender must report to the client on the asset side of the arrangement as well as the loan, informing borrowers of developments with respect to corporate actions, valuing assets daily, reporting movements in values and transactions in the assets themselves (including taxation reporting). During the life of the loan many corporate action adjustments are made to stocks. An average capital protected loan portfolio consists of around 5-8 stocks with most companies paying out dividends twice yearly which require reporting. Also, special dividends, rights issues, demergers, takeovers etc require adjustments to be made to stock holdings and protection levels in a capital protected loan portfolio. Client reporting also involves end of financial year reporting and valuation statement advice and the upkeep of an internet site with up-to-date information on client trades for all capital protected loan holders. In contrast to all of this, with a secured home loan on the other hand, only transactions on the loan must be reported.

(v) Custody

Residential property is a more 'set and forget' security class than is the case for direct equities. Once a mortgage is in place on property, the lender can file the mortgage and title for safe-keeping and will not have to revisit it until it is time to discharge the mortgage at the conclusion of the loan. However, a protected loan requires constant monitoring of the security to ensure any corporate actions are dealt with in such a way that the lender's security position is not adversely impacted.

(vi) Interest rate quotes

The fact that different interest rates attach to different stocks, terms etc requires the protected lender to prepare individualised interest rate quotes for each client. This quoting process requires the maintenance of models and involvement of sales staff at a level that is not required for a mortgage loan, where the rate is set with reference to the generic asset type. This process has to be undertaken daily, as opposed to monthly in the case of home loans.

(vii) Unwind quotes

Because shares are valued daily by the market, the temptation is stronger for investors to sell their security early. Clients looking to do so need to have break costs calculated – both as an input to their decision to sell and in the event they proceed with the sale. Once again, this requires modelling and resources to estimate break costs, which are significantly more complex than an estimation of mortgage loan to be repaid if property was to be sold.

(viii) Additional client services

Client servicing extends beyond the provision of break analysis (for early unwinds) and settlement reporting, and includes loan extensions, the provision of trading and call sale facilities, as well as the costs embedded in educating clients and explaining facility options, costs and quotes.

(ix) Compliance costs and risks

Given the relative complexity of capital protected loans, they involve greater regulatory challenges and legal risk when dealing with retail clients than home loans. To some degree this is reflected in the nature of the documentation surrounding capital protected loans (such as Product Disclosure Statements and tax opinions, that are not required for home loans) but it is also reflected in the 'know your client' procedures and staff training requirements to deal with clients on an assured basis. This translates to a higher regulatory compliance cost.

(x) Sales expenses

There is a layer of specialised sales staff that market capital protected borrowings and work with financial planners on their distribution. Members report that the sales distribution network is operationally more expensive to manage than home loan distribution. The amount involved varies from firm to firm and by product but the increased cost is well over 1% of the loan amount in many instances.

(xi) Loan maturity

Services provided at maturity may include the transfer of stock to client or margin loan accounts, the creation of new accounts for paid out stock, sale and settlement of unpaid stock.

(xii) Product rulings need to be obtained

The ATO has taken the view that issuers of capital protected borrowing products, and other investment products, should obtain a product ruling before a product is issued or an existing product is rolled over. Our members estimated in December 2010 that the incremental cost for obtaining a product ruling is in the range of $25,000 - 50,000 per product ruling, although it can be higher than this in some instances. This figure does not include internal costs involved by way of time spent reviewing ruling applications (eg by the legal division), collecting information in response to ATO requests for information and reviewing draft rulings once provided. These processes can easily double or triple the external costs, depending on the circumstances. There is no requirement for ordinary home lenders to obtain product rulings from the ATO.

(xiii) Tax certainty needs to be maintained

Management time is required to deal with ATO guidance to the industry and legislative change is a material input into the overall process of earning the margin, which attaches to a relatively small business (much smaller at least than bank mortgage providers).

5.3. Different Funding Costs

Providers of capital protected borrowings may be either a bank or a non-bank financial institution (eg a securities company). Not all banks have access to wholesale funding at the same rates (the difference may be large at times, as evident during the GFC) and non-bank financial intermediaries typically face significantly higher funding costs than banks. Against this backdrop, the selection of the home loan interest rate as a benchmark for this purpose is inappropriate, as it is fundamentally a bank lending interest rate that is most influenced by the funding costs of the major banks. Thus, it would underestimate the cost of funding for many providers in the capital protected borrowing market.

6. Technical Complications in the Law that Frustrate its Application

When the Division 247 provisions were enacted in 2006, the personal unsecured loan rate as the benchmark interest rate was adopted as a specific design feature of the law. In other words, the level of the benchmark rate interacted with the other provisions in Division 247 to produce the desired policy outcome. In particular, it was made clear to AFMA during consultations at the time that the effectiveness of Division 247 in meeting its objective depended on a benchmark interest rate that would exclude a range of normal and uncontroversial loan arrangements for business and individuals.

Consequently, there are areas where the provisions in Division 247 have not been developed to operate effectively alongside a benchmark interest rate that is much lower than the personal unsecured loan rate. This includes:

(i) An exceptionally broad definition of capital protected borrowing, which both bifurcates <u>and</u> aggregates financial products to bring them within scope of Division 247;

(ii) The absence of provisions to permit the exclusion of loan and option arrangements that are separately priced and independent of each other; and

(iii) The application of Division 247 to business loan arrangements.

Legislating the benchmark interest rate as the home loan rate plus 100 basis points will both change the role of the benchmark interest rate within the workings of the law and effectively extend the scope of Division 247 to many more financial products than it is currently designed to deal with.

It will be necessary to amend other parts of Division 247 to ensure that the law works effectively, including amendments to:

- exclude situations where a geared investor acquires an explicit put option; to satisfy the stated objective of the law;

- exclude loans to finance small and large business;
- exclude employee share schemes that involve an employee share trust;
- differentiate between situations where the level of capital protection is significant and those where it is trivial;
- introduce an additional benchmark interest rate (or rates) to take account of both the higher funding costs for lenders and lower capital protection cost as the term of the capital protected borrowing is increased; and
- provide issuers with the option to price the implied loan or put option in accordance with the economics of their particular product for tax purposes.

In the absence of these measures, the law will not operate in an integrated and effective manner under the scenario of the proposed benchmark interest rate. As a result, investors in capital protected borrowing products will face higher tax compliance costs and activity in the market will remain depressed below normal levels due to the tax penalty incurred by investors. The level of tax uncertainty will also increase and with it the cost of tax compliance.

6.1. The Role of a Benchmark Rate

The purpose of adopting a benchmark rate in legislation in 2006 was to provide a pragmatic and sensible solution to a theoretical problem that would otherwise be impossible to implement in a sensible manner.

The alternative, conceptually 'pure' approach involves assessing a unique interest rate for tax deductibility for each and every transaction of the many thousands of transactions that occur involving a potential capital protected borrowing. Another alternative is to determine the price for each and every implied option, which is an even more difficult (and less desirable) proposition because options are especially difficult to price accurately and there is not a deep market across the full maturity range of capital protected borrowings.

Our concern is that the benchmark rate proposed in TLAB 5 unwinds the rationale for a benchmark rate and undermines a core element in the construct of Division 247. If this approach is implemented, then balance and fairness would require that product issuers be given the option to determine that the cost of providing their underlying loan in a capital protected borrowing is at a level greater than the legislated benchmark rate, or alternatively that the cost of providing their protection is at a level less than that estimated under the benchmark interest rate. While we think this outcome would be a dreadful turn of events from the point of view of tax system efficiency at the operational level, it would be a necessary step to counter the significant adverse effect of an unduly restrictive benchmark interest rate.

We reiterate AFMA's belief that a benchmark rate set at the appropriate level is the only sensible way forward. We acknowledge that the benchmark interest rate is an average rate, so while individual products may fare better or worse under the benchmark rate than they should do conceptually, a pragmatic balance that is achieved delivers a more efficient and less costly outcome for all involved. The problem with TLAB 5 benchmark interest rate is that it sets the benchmark rate at the absolute lower end of the spectrum, so it does not operate as an average in this manner but rather is very aggressive by penalising all taxpayers who use capital protected borrowings.

6.2. Aggregation Issues

The objective of the Division as presented in s.247-1 states:

> *"Capital protection provided under a relevant capital protected borrowing to the extent that it is not provided by an explicit put option is treated (for the borrower) as if it were a put option."*

Issuers of capital protected products are concerned that the operating provisions in Division 247 do not give effect to this objective because, as the law is administered by ATO, they capture situations where a geared investor acquires an explicit put option. While the consequences of this deficiency in drafting the law may be tolerable when the unsecured personal loan rate is the benchmark interest rate, this is not the case under the much lower benchmark rate proposed in the exposure draft legislation.

Example - Hedging a Margin Loan Investment

The cost of the deficiency of the law identified above is significant in practice because there is a broad range of situations under which there is unacceptable risk that Division 247 would be applied in a way that would effectively constrain retail investors' ability to manage their investment exposures.

For instance, if Client A acquires an explicit put option from Bank X that is priced at market rates to protect the value of shares it has acquired using a margin loan from Bank X, then this will be treated as a single arrangement under Division 247 as it is applied by ATO. The Division will firstly aggregate the independent loan and option products into a single arrangement and then divide that arrangement into two separate parts in a way that will disadvantage the investor from a tax perspective (as the new benchmark interest rate is less than the margin loan interest rate).

There is no economic or policy justification for this approach. To the contrary, we believe this outcome is at odds with the Government's policy objectives to promote sound risk management practices by retail investors, especially given the bad experience of Opes Prime and Storm Financial, amongst others. Oddly, if the investor were to acquire a similar option from Bank Y, then we understand that ATO[4] would agree that its margin loan interest expense would remain fully deductible.

6.3. Broad Definition – Business Loans

During consultations in the lead up to Tax Laws Amendment (2006 Measures No. 7) Bill 2006, AFMA was advised that it is not the policy intention to capture project finance and other business finance transactions under Division 247. This is because these transactions do not pose a risk to tax revenue in this context and also because there would be a cost to economic performance if tax deductions for interest payments on business investment were limited in this manner.

Nonetheless the law was not written to limit its application to retail investors only – we understand this was done to avoid the technical challenge of distinguishing between retail investors and business for the purpose of this part of the law. This apparent inconsistency was resolved by excluding a wide range of common loan products because their interest rates fell comfortably below the unsecured personal loan rate and also because of targeted limitations on the application of the Division in s247-15. Through these measures it was expected that Division 247 would not apply to limit interest expense deductions on borrowings by business.

However, the extraordinarily broad definition of a capital protected borrowing in s.247-10 does capture common business loan arrangements. For example, consider a small business that holds financial assets on its balance sheet as part of a strategy to manage its liquidity and investment needs, including a small share portfolio which is partly capital protected. If this business enters a full recourse loan with a bank to acquire new equipment, then Division 247 will deem there to be a capital protected borrowing in place – s247-10(2); "the borrower uses the protected thing as security for the borrowing or provision of credit".

Since the small business loan rate is 9.70% compared to the standard variable home loan rate of 7.8%, the business would be denied almost 10% of their interest expense as a tax deduction.[5] Interest would be deductible in full if either the margin loan rate or the unsecured personal borrowing rate were used as the benchmark interest rate.

There are a number of ways to deal with this problem. One solution is to effectively confine the application of the measures to the retail market – this would better target the measures at the primary revenue concern, as companies are not eligible for a reduced CGT

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[4] Consistent with example 7.4 in the Explanatory Memorandum of Tax Laws Amendment (2006 Measures No. 7) Bill 2006.

[5] Interest rates are taken from the Reserve Bank of Australia's website: http://www.rba.gov.au/statistics/tables/index.html#interest_rates

rate. A better solution, adopted in 2006, was to set the benchmark interest rate at a level high enough to avoid capturing typical small business loans.

6.4. Broad Definition – Level of Protection Issues

The application of Division 247 is significantly extended in practice by the fact that any level of capital protection for a relevant asset held by a company or person seeking finance on a full recourse basis (or on a limited recourse basis that include any amount of protected shares as collateral or security) will trigger the application of Division 247. In other words, the law quite explicitly does not differentiate between a loan for which the underlying security is 1% capital protected and a loan for which the underlying security is 100% capital protected.

By its very nature, this gives rise to unfair and unreasonable outcomes for certain classes of taxpayers. In particular, borrowers who offer for security relevant assets that have a trivial amount of capital protection are treated in the same way under Division 247 as borrowers who have complete capital protection for their security assets. Obviously, the capital protection benefit would be marginal in one case and substantial in the other but Division 247 would deny the same amount of interest expense deductions in each case (assuming the same loan interest rate).

In addition, as a result of the failure of Division 247 to properly distinguish between different levels of protection, many large and small business loan arrangements may be inadvertently caught under Division 247, many of which would consequently face denial of deductions for interest expenses legitimately incurred during the course of their business.

Again, this is a situation where the pre-May 2008 benchmark interest rate effectively overcame in practice, but the new benchmark interest rate cannot fill the same role in filtering out regular loans that pose no mischief within the framework of government policy and, thus, gives rise to much less efficient law.

6.5. Employee Share Plans

Employee share plans commonly involve either:

- employees borrowing under a limited recourse loan to acquire shares (directly) which are subject to vesting; or
- a trustee of an employee share trust borrowing under a limited recourse loan to acquire shares and allocating the shares to the employees, subject to vesting.

There is a carve-out from the capital protected borrowing provisions in circumstances where both:

- an employee share scheme (ESS) interest is acquired under the borrowing; and

- subdivision 83A-B or 83A-C applies to the interest: s.247-15(3).

This carve out appears to be drafted specifically for employees who borrow to acquire shares (directly).

There are some technical issues as to whether the carve-out can apply to a limited recourse loan entered into by the trustee of an employee share trust to fund the acquisition of the relevant shares. For example, although the trustee could be said to acquire an ESS interest (ie, the beneficial interest in a share) Subdivision 83A-C does not apply to that particular ESS interest – rather, that Subdivision applies to a different ESS interest (ie, the employee's beneficial interest in the relevant share).

There is no coherent policy basis for carving out borrowings by employees from Division 247 but not carving out borrowings by an employee share trust. Accordingly, an amendment to clarify Division 247 is necessary.

7. Tax Revenue

AFMA analysed the revenue projections at the time of the announcement in 2008 and concluded that given the impact of the global financial crisis and the market impact of the Budget measure, we can be certain that these revenue targets will not be met. We felt it is highly doubtful that any net revenue will be raised for the following reasons:

Direct adverse impacts on revenue -

- The severe harmful impact of the announcement on product demand.
- The general deterioration in financial market conditions in 2008.

Second round tax effects on revenue -

- Capital protected product providers will return less profits (hence, less tax) because their business is sharply reduced as a result of the Budget measure.
- The reduction in business has caused job losses in the industry.
- This tax treatment has deterred investors who would have used these products to finance share purchases, reducing support for share prices.

In addition, a 4 year revenue analysis may be misleading as capital protected borrowings often have a maturity of 5 years or more. While the revenue estimates increase cumulatively year-on-year for the first 4 years, as more borrowers become subject to the new rule, the Capital Gains Tax (CGT) revenue receipts in the following years are not captured, serving to inflate the revenue estimates. Future CGT receipts are significantly reduced by the lower benchmark for two reasons:

- CGT liability at sale of the underlying share is reduced by the higher cost of the notional put option under the new benchmark rate; and
- less use of the product means less capital gains will be earned and less CGT is paid.

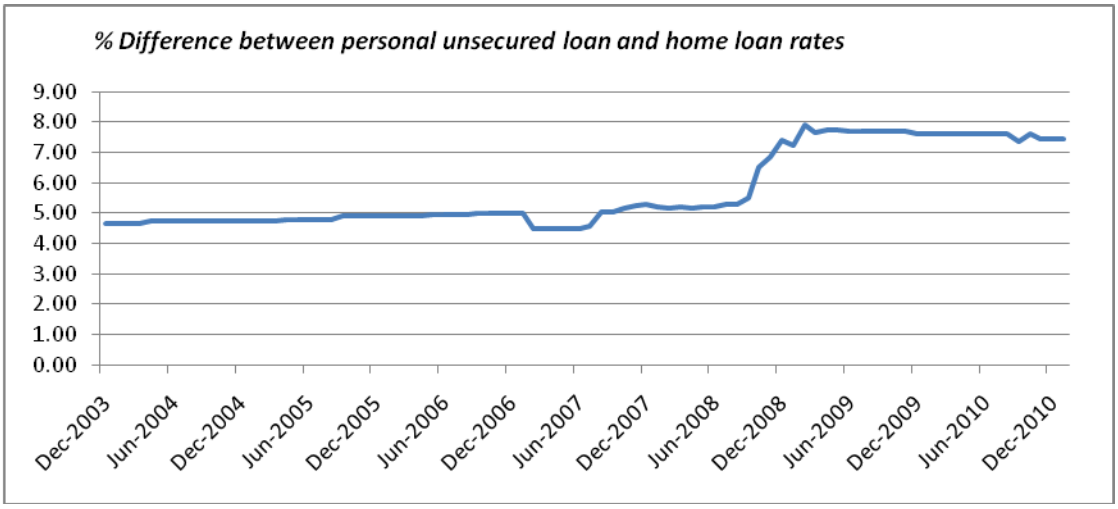
Notwithstanding these factors and the proposed higher benchmark interest rate, TLAB 5 projects even higher tax revenue than the Budget 2008 announcement.

Table 2: Comparison of Revenue Projection Overlap Years

Additional Tax Revenue $ million	2010-11	2011-12
TLAB 5	30	40
2008 Budget	20	25

The increased differential between the personal loan rate and the home loan rate since the GFC has been a bonus to tax revenue. As figure 3 shows, the differential between the pre-2008 Budget benchmark interest rate and the home loan interest rate has expanded by 2.5 percentage points relative to its previous average. Thus, an increase of **250 basis** points above the home loan rate is required to preserve the relationship announced in the May 2008 Budget. Against this backdrop, the proposed 100 basis point increase is clearly too low.

Figure 3: Interest Rate Differentials



In summary, while we acknowledge the unanticipated benefit to tax revenue from the expanded differential between the proposed and the previous benchmark rates, we cannot reconcile the tax revenue forecasts with the sharp decline in business reported by members and as evidenced in the available statistics (see figure 1).

8. Recommendation

Having regard to the matters described above, AFMA recommends that the benchmark rate should be amended to be the mid-point of the indicator rates for standard variable rate housing loans and personal unsecured variable rate loans, as published in the Reserve Bank of Australia's Bulletin. We think this approach would provide a stable and workable solution that protects tax revenue and enable investors to go about their business under reasonable tax rules – for the first time in more than a decade.

We would further note that a benchmark interest rate at anything less than the margin loan interest rate is not credible and would not significantly address the inequity and harm to investors consequent to the 2008 Budget announcement.

Appendix

Annual Applicable Tax Deduction Rules for Capital Protected Borrowings at the Time of Issue over the Period 1999 to 2011

	Year investment made:	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
1	Full deduction (Pre-Firth case)	✓												
2	Part IVA applies	✓												
3	Limited deductibility 1 (average of unsecured loan and credit card rates)		✓											
4	Limited deductibility 2 (lower of unsecured loan rate or 80/85% of interest)			✓	✓									
5	CGT Black hole	✓												
6	Full deduction (Post-Firth case)					✓								
7	Transition rule (03-07) - matrix 85% deductible						✓	✓	✓	✓				
8	Unsecured personal loan rate										✓			
9	Standard variable home loan rate											✓		
10	Standard variable home loan rate +100bps												✓	✓

Note: The TLAB 5 changes to the benchmark interest rate will apply retrospectively from the Budget 2008.

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