Capel, Michael

Sent: Tuesday, 12 October 2010 7:14 PM
To: Murphy, Jim
Cc: Lonsdale, John; Douglas, Justin; Anderson, John; Preston, Kate; Capel, Michael
Subject: RE: FCS Charging Options [~~SEC-IN-CONFIDENCE~~]
Attachments: 101012 FCS as a Revenue Source.docx

Dear Jim,

As discussed with Justin, here is a revised paper on potential banking sector charges. It sets out the rationales for different fee options and their bases. [s22]

The paper refers to an attachment regarding the merits of a tax linked to the FCS – this would be a revised version of the FCS charging paper, a draft of which you saw on Friday.

Regards,

Matt

Matthew Burston
Analyst

Financial System Division
The Treasury, Langton Crescent, Parkes ACT 2600
phone: (02) 6263 2810
email: [s22]

From: Burston, Matthew
Sent: Friday, 8 October 2010 6:41 PM
To: Murphy, Jim
Cc: Lonsdale, John; Douglas, Justin; Capel, Michael
Subject: RE: FCS Charging Options [~~SEC-IN-CONFIDENCE~~]

Dear Jim,

Please find **attached** a revised paper on imposing a charge as part of the Financial Claims Scheme, in clean and track changes versions.

[s22]

Regards,

Matt

Matthew Burston
Analyst

Financial System Division
The Treasury, Langton Crescent, Parkes ACT 2600
phone: (02) 6263 2810
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From: Lonsdale, John
Sent: Thursday, 7 October 2010 8:13 PM
To: Henry, Ken; Murphy, Jim; Ray, Nigel
Cc: Douglas, Justin; Burston, Matthew; Capel, Michael; Woods, David; Maloney, Matthew
Subject: FCS Charging Options ~~[SEC-IN-CONFIDENCE]~~

Ken/Jim/Nigel

The attached paper discusses issues related to imposing a charge as part of the Financial Claims Scheme and has been a joint effort between FSD, BPD and TAD. It concludes that the approach could raise considerable revenue but it is not without sensitivities.

It is very much work in progress and if we went down this route there would be a number of design elements that we would need to work through. The revenue numbers are indicative only and are based on eligible deposits [s47] We are working up additional revenue estimates on a broader base (total liabilities) and some cameos on the impact on a big bank, 2nd tier and a credit union. Finally, it very much concentrates on the FCS and does not consider broader tax based options that could be applied to the financial sector

John

POTENTIAL TO RAISE REVENUE FROM THE AUSTRALIAN BANKING SYSTEM

It is sometimes argued that since the large Australian banks benefit from implicit government guarantees against the risk of collapse, they should pay a return to the community to reflect this. Australia's framework for resolving a distressed financial institution provides a broad range of mechanisms. These include monitoring processes, directions powers, appointment of a statutory manager, facilitating private sector solutions (such as recapitalisations, restructurings and takeovers), public sector support (such as liquidity support, guarantees and capital injections) and, if an institution is allowed to fail, a mechanism to assist depositors (the FCS).

Since the FCS is just one (small) part of a broader, integrated framework, it is important to have regard to the other elements of the framework when considering how any FCS levying arrangements might be changed to generate general purpose revenue. If justified on the basis of pre-funding expected payouts, an FCS levy would likely raise only marginal revenue. However, this does not mean that a broader financial sector tax should not be considered, or cannot be justified on other grounds. In contrast, it can be argued that there is a strong case for charging the banking sector for the implied systemic guarantee provided by the public sector, especially the public sector's role in providing a liquidity backstop to the financial system.

Challenges using the FCS as the rationale for taxing the financial sector

s47

Another issue is that the expected revenue from an actuarially appropriate fee would be negligible. The main benefit to depositors from the FCS is that it provides early access to funds. In most situations, it could be expected that funds paid out via the FCS would be subsequently recovered via the liquidation process. Reasons for this include the need for ADIs to hold prudential buffers, so that APRA should be able to intervene before an institution's liabilities exceed its assets.

Even if an institution's liabilities exceed its assets, the FCS is still likely to recover its costs via the liquidation since the FCS has priority ranking in the liquidation and covered deposits are equivalent to only one-quarter of system-wide bank liabilities s47. While covered deposits typically represent a higher proportion of assets for smaller ADIs, the point remains that an ADI would still need to incur very substantial losses before the FCS would experience a shortfall.

s47 If there was a larger pre-funded FCS levy, it would be unlikely to be recognised as proportionate to the expected costs and would, therefore, be likely to be classified as a tax.

Another sensitivity with using the FCS as the rationale for a bank tax is that the obvious tax base would be protected deposits, which would increase the cost to banks of raising deposit funds and discourage banks from increasing the proportion of their funding raised via deposits. This is counter to other reforms currently underway that are designed to address the over-reliance of Australian banks on wholesale funding, rather than deposits, and which are therefore aimed at encouraging banks to raise a higher proportion of their funding via deposits.

s22

An alternative rationale for taxing the financial system

As noted above, there may be good reasons for taxing the banking sector apart from the FCS. Internationally, a number of countries are currently considering taxes on their banking sectors, although the rationales are highly divergent. For example, the UK introduced a tax on bankers' bonuses to combat perceptions of excessive remuneration, and Sweden has implemented a tax on non-deposit liabilities to create a bailout fund equal to 2½% of its GDP. Other European governments are considering bank taxes as a means of financing climate change programs or overseas aid. The benefit that large European and American banks received from being bailed out is often cited as the rationale for such taxes. Further details on international tax proposals are set out in Table 1.

s22

s22

Some other options

s22

An alternative is to tax banks simply based on their size. Such approaches are being examined in a number of overseas countries, where there is a desire to reduce the size of major banks, and therefore their systemic importance. However, the marginal impact of a levy is unlikely to change whether a financial institution would be systemically important if it encountered difficulties. Possible approaches would be a tax based on total assets (similar to the existing APRA levies on ADIs), a tax on total liabilities, or a tax on wholesale funding (that is, assets minus equity and deposits).

Another possible rationale for taxing banks in Australia are that they are perceived as making excessive profits. In this case, a tax based on excess rents would be most appropriate. A simpler variation on this would be to increase the rate of company tax (either with or without a corresponding increase in imputation credits) on firms operating in the banking sector.

[1] This does not take account of possible second-round effects on company tax.

Table 1: International Positions on Taxes and Levies on the Banking Sector

Country/Organisation	*Position/Developments on Taxes and Levies on the Banking Sector*
Austria	Austria has announced plans for a resolution fund (a 'bank solidarity tax'). The government estimates the tax will raise €500 million annually if Austrian banks are required to pay a 0.07 per cent tax on their total business year assets. More specific details are yet to be worked out, but Chancellor Werner Faymann stated in February 2010 that the tax could come into effect either in 2011 or 2012.
Canada	Opposed to any form of taxes and levies on the banking industry.
European Commission	The EC is considering an EU wide network of *ex-ante* levies on banks and investment funds to build up a network of resolution funds. There is ongoing debate about the use of such a fund. On 7 October 2010, the EU announced a two pronged approach to taxation – one would be at the EU level, a Financial Activities Tax (FAT); and one would be at the global level – a financial transaction tax (FTT). A FAT would target the profits and remuneration of financial institutions rather than the individual actors in transactions (which is what the FTT does). The EC anticipates that the revenues generated from this measure could be up to €25 billion per annum at a tax rate of 5%. The funds would most probably be used to facilitate orderly resolution of institutions but not as insurance against failure or to bail out financial institutions. The EC will present these proposals to the EU Finance Minister at the ECONFIN Council meeting on 19 October, then to the EU Heads of State and Government at the EC meeting at the end of October. The EU will take its global approach to the G20 Leaders in November to influence the take up of a global FTT. The EC will develop policy initiatives in 2011 after an in-depth Impact Assessment Study for these proposals beginning in late 2010.
France	France announced plans for a bank levy in June 2010. Scheduled to be introduced from 2011, the government anticipates that this tax will generate €504 million in 2011, €555 million in 2012 and €810 million in 2013. The tax will be imposed on about 20 institutions, including banks, credit institutions and credit companies. The levy will not apply to hedge funds. It will be imposed on both French banks and foreign banks operating in France. It will also be deductable from corporate taxation. The use of the revenues is targeted to reducing France's public deficit. France is

	also a supporter of the FTT.
Germany	Germany has announced plans for an ex-ante bank levy, the proceeds of which will go into a resolution fund More specific details are yet to be worked out. Germany aims to raise €1.2 billion from the levy. The levy will extend to hedge funds. Germany is also a supporter of the FTT.
Japan	s22
Sweden	Sweden introduced a resolution fund through an ex-ante levy on banks in 2008. This levy applies to domestically incorporated banks and their foreign branches. The levy is set at a rate of 0.036 per cent and will be applied to the uninsured liabilities of financial institutions. The size of the resolution fund is approximately 2.5 per cent of GDP. The fund is used for capital injections, loans and guarantees (temporarily) and deposit insurance (proposed) after 2011.
United Kingdom	The UK government announced in its June 2010 budget plans for a levy on bank liabilities to come into effect from 1 January 2011. The UK government is scheduled to consult with the banking industry in the second half of 2010 to work out the details of the levy. The government has stated that the bank levy will apply to the consolidated balance sheets of UK banks; the subsidiary and branch sheets of foreign banks operating in the UK; and the balance sheets of UK banks in non-banking groups. Banks will be required to pay the levy when their relevant aggregate liabilities amount to £20 billion or more. Tier one capital, insured retail deposits, repos secured on sovereign debt, and policy holder liabilities of retail insurance businesses within banking groups will be excluded from the total liabilities calculation. This bank levy is non-deductible for corporate taxation and will be set at an introductory rate of 0.04 per cent in 2011, increasing to 0.07 subsequently. The UK levy is expected on average to raise around £2 billion annually. These amounts will not be incorporated into a fund for bailing out financial institutions in the future but will be remitted to consolidated revenue. s22
United States	The US Dodd Frank legislation implements an ex-post levy on banks to recoup the costs of previous bailouts. The Act does not intend that any future bailouts will be paid for by taxpayer funds. The US does not favour a FTT, and also

	does not favour the FAT proposed by the IMF in its final report to the G20 in June 2010.
International Monetary Fund	The IMF recommends a combination of a 'Financial Stability Contribution' (FSC) (an *ex ante* levy on institutions that would form a fund to cover the cost of future support for the sector – but not for bail outs) and a 'Financial Activity Tax' (FAT) (a tax on the sum of profits and remuneration of institutions to be paid into general revenue). It believes that both of these options have the best potential to provide incentives for institutions to reduce or limit their systemic importance and excessive risk taking, when compared to the other alternatives it considered – *ex post* levies and a financial transaction tax (FTT). The FSC and FAT have the potential to address the adverse externalities created by the financial sector (that is, creation of ***institutions that are too systemically important to fail***, and excessive risk taking) in the ways below. By designing the FSC to directly account for systemic risk by applying it to all institutions but the fee for individual institutions being dependent on its contribution to systemic risk. By designing the FAT as a tax on rents of the financial sector (that is, applied to high profits and high remuneration levels). This would have a corrective effect on adverse externalities created by the financial sector, and the burden would be less likely to fall on consumers than an FTT.