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By email to: interestdeductions@oecd.org

8 September 2016

Dear Mr. Pross,

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

PricewaterhouseCoopers International Limited on behalf of its network of member firms (PwC) welcomes the opportunity to comment on the OECD's *Public Discussion Draft BEPS Action 4: Approaches to address BEPS Involving Interest in the Banking and Insurance Sectors (the "discussion draft").*

Our comment letter contains four sections:

I. An executive summary setting out our primary comments and recommendations.

II. A more detailed commentary on the principles which we consider relevant to BEPS involving interest in the banking and insurance sectors which we believe support our primary recommendations.

III. Our responses to the questions for consultation contained in the discussion draft.

IV. A detailed analysis of global bank regulation which in our view bolsters our primary recommendation to exempt regulated financial groups from Action 4 and responds to the request that interested parties offer additional comments on the issues raised in the document.

I. Executive Summary

Our principal comments and recommendations may be summarised as follows:

1. The discussion draft acknowledges that there is limited scope for BEPS risks arising in regulated banking and insurance groups due to the limits on leverage imposed through the prudential regulatory regimes which apply to groups operating in these sectors. We agree with this assessment.

2. Applying the fixed ratio rule under Action 4 to banking and insurance groups (or entities within such groups) would impose a significant compliance burden on such groups, may give rise to tension with prudential regulatory policy objectives (e.g., in relation to resolution) and could lead to double taxation. These risks will likely increase to the extent that alternative approaches are adopted by territories in relation to the application of Action 4 to banking and insurance groups. In view of this, we believe it is important that the OECD recommend a preferred single approach for member countries to adopt.

3. Given the limited BEPS risk coupled with significant potential downsides of applying the fixed ratio rule, we believe the preferred approach would be to exclude groups engaged primarily in banking and insurance activities (referred to in this paper as "Regulated Financial Groups") from Action 4 entirely. Further work will need to be performed to determine an appropriate definition of Regulated Financial Group for this purpose although there are precedents elsewhere which may be adopted as a starting point from a banking perspective. We comment on these further below.

4. The discussion draft considers an alternative option being the exclusion of regulated entities from Action 4 with the fixed ratio rule applying to non-regulated entities. We consider this approach would be problematic and could potentially put banking and insurance groups in a worse position than non-banking groups. In view of this, to the extent that an exclusion of banking and insurance groups entirely is not considered optimal, we believe the preferred alternative approaches would be: (a) application of the standard fixed ratio and group ratio rules to banking and insurance groups as a whole (i.e., consistent with other industry sectors), or (b) exclusion from Action 4 of both the regulated entities within a banking or insurance group and those entities conducting activities which are integral to the core banking or insurance business of the groups but which for regulatory or other commercial reasons are conducted in separate legal entities (e.g., group holding companies, group service companies, financing vehicles, etc.).

5. The discussion draft highlights the BEPS risk associated with debt funding being used to finance equity investments which give rise to income which is not taxed or taxed at a preferential rate. We believe it is more appropriate to address such risks through appropriate CFC measures rather than through Action 4.

6. On a more general level, given the fundamental importance of financing and interest in the banking and insurance sectors, it is vital that any approach recommended in relation to Action 4 is consistent with measures taken under other BEPS actions relating to financing activities (e.g., hybrids, CFC, etc.) such that banking and insurance groups have an appropriate level of certainty in relation to the tax treatment of a core element of their business. We believe an exclusion from Action 4 entirely would be the preferred means of achieving this.

7. While the primary focus of this letter is to recommend an exclusion for RFGs, we also recommend regulated banks (and their transactions) within non-banking groups be excluded from Action 4.

II. General comments

Banking and Insurance Groups

We recognize and compliment the OECD in the final report in understanding the need for further analysis in developing rules with respect to debt-equity issues and the deductibility of interest on debt for the banking and insurance sectors.[1]

Our primary recommendation is to exempt from Action 4 banks and insurance companies at a group level since in the current regulatory environment, these RFGs not just individual entities, are subject to a number of regulatory rules that govern and constrain virtually every aspect of their business, including the use of debt.

The discussion draft acknowledges the BEPS risk related to overleverage for banks and insurers is relatively low and our recommendation is consistent with that observation. Prescribing nuanced rules which may be more complicated than the rules in the final Action 4 report for non-regulated entities would seem to contradict the risk analysis. Moreover, it would increase costs and complexity to a sector which is already subject to stringent regulation with respect to its borrowings.

The discussion draft describes, in paragraph 9, the two structures ("risk one" and "risk two") "used by banking and insurance groups which pose the types of BEPS risk intended to be addressed under Action 4. The main BEPS risks involving interest that have been identified include –

1. banks or insurance companies, and entities in a group with a bank or insurance company, using third party or intragroup interest to fund equity investments giving rise to income which is non-taxable or is taxed in a preferential manner;

2. entities in a group with a bank or insurance company incurring excessive third party or intragroup interest expense, which may be set against taxable interest income in the bank or insurance company.

We have two recommendations listed below regarding the two BEPS risks identified in paragraph 9 of the discussion draft.

1. Risk one related to debt funding of certain equity investments should be dealt with via a BEPS Action 3 CFC regime. Most existing CFC regimes already contain a requirement that passive income is included at the parent level. For the banking and insurance industry, the existing CFC regimes, with the requirement for key entrepreneurial risk taking ("KERT") functions to be performed in the CFC jurisdiction (UK model) or that the CFC have employees that perform substantial activities to generate income (U.S. active financing model) are more effective. This solution is preferred in comparison to a rule which would limit the interest expense deduction. The backwards tracing of interest expense may be difficult to isolate, comply with and administer particularly due to the fungibility of money. Moreover, using formula to allocate or any other apportionment type method than a direct

[1] OECD, BEPS Action 4, "Limiting Base Erosion Involving Interest Deductions and Other Financial Payments", Paragraphs 183, 184 and 190.

tracing can result in interest limitations which diverge from economic reality. We recommend that the OECD, and participating BEPS jurisdictions, focus on the preferential income, and if needed amend their CFC regime.

2. Risk two related to groups with bank and non-bank entities is difficult to address, as we do not agree that third party interest expense poses a BEPS risk. When the subjective term “excessive” is added, it presumes someone other than the bank and the third party know the level of debt that is excessive. The rate of interest will be arm’s length between third parties, and the rate of tax of the payor and the payee is not an indication of BEPS, so this concern should simply be dropped. As discussed in further detail in Section IV below, the financial regulators are already performing the function to monitor and limit the regulated financial group’s leverage.

We believe, based upon the two recommendations above, and the current regulatory environment that encompasses the group, not just bank and insurance entities, our primary recommendation is that there should be a group wide exemption for RFGs. Section IIV of our letter explains in detail how global regulation operates using a U.S. bank example (other countries have substantially similar rules pursuant to Basel III) , and why RFGs should be exempt from an additional complex tax regime under Action 4 due to the financial regulatory regimes they operate under.

Groups that Include a Bank or Insurance Company

Rules to address the risks posed for a group that includes other entities with a bank or insurance company will clearly be a challenge to implement, comply with and administer. However, similar to potential BEPS risk two mentioned above, the inclusion in Example 5 whereby all of the debt funding is external, and therefore presumably at arm’s length, we do not believe poses a BEPS risk.

The discussion for these groups centred on how best to apply the EBITDA ratio to a group that includes a bank or insurance company to ensure the net interest income of these entities is not used to reduce or eliminate the effectiveness of the fixed ratio rule for entities operating other types of businesses. While BEPS risks in regulated banks and insurance companies might be mitigated by reliance on the non-tax regulatory regime, as discussed above, the BEPS Action 4 risks in holding non-regulated entities may not be easily mitigated, or they certainly present a higher hurdle. We do believe regulated banks and their transactions should be excluded from BEPS Action 4 even if they are within a non-bank group.

The discussion draft acknowledges that, in the context of the fixed ratio rule, the exclusion of interest income and expense from EBITDA could create significant issues for insurance and banking entities where interest is a key source of income. Somewhat helpfully, the draft suggests that excluding regulatory capital might be a possible approach, on the basis that if the capital had been issued by the regulated entity, it would be either excluded or unlikely to suffer a disallowance.

The discussion draft, at paragraph 67, discusses the practical difficulties of extracting the data necessary to properly produce a group ratio calculation, especially if certain items are excluded, such as regulated entities and regulatory debt funding. However, the paper doesn't address the question of whether it is fundamentally correct to be excluding interest income and expense from the EBITDA calculation where interest forms a central part of 'earnings'. The examples in Annex 3 show how this

would work; however they are hypothetical, and assume significant levels of EBITDA excluding the interest income of the financial services business. It remains to be seen how realistic the examples actually are.

We understand the final October 2015 report did view as a BEPS risk higher levels of third party debt in high tax countries. That said, the Example 5 in the draft Annex 3 did not disclose the tax rates in the borrower and lender jurisdiction, and arguably without this rate differential, and only arm's length third party debt involved, there should be no BEPS Action 4 issue present in Example 5. In addition, going back to the 1998 Harmful Tax Competition report, merely having different tax rates was not an indicia of harmful competition, and we believe that should still be the case.

III. Comments on the Questions For Consultation

The risks to be addressed through interest limitation rules

1. *Are there any categories of BEPS risk involving interest posed by banks or insurance companies, or entities in a group with a bank or insurance company, not identified in the discussion draft which should be focused on as part of this work? If so, what are these risks and how could they be addressed (either through the approaches set out in this discussion draft or otherwise)?*

We do not believe so; the OECD has done a thorough job in identifying potential risks. As discussed in our submission, we believe these risks, specifically those for RFGs, do not require addressing in Action 4.

Banks and insurance companies

2. *Are there any other considerations with respect to the role of interest in banking and insurance which should be taken into account?*

As the OECD has noted, interest income and expense are the result of ordinary course activities for banks, which is why our primary recommendation is that any BEPS Action 4 limits should not apply to interest on debt issued by any member of a RFG.

To the extent that the primary recommendation is not accepted, at a minimum, we would recommend a more nuanced approach should be taken, although this increases tax complexity and costs. As mentioned above, we believe this would not be consistent with the OECD's objectives or risk assessment for this sector. One area of perceived leverage, when there may be no leverage at all due to over collateralization, is in the area of secured financing conducted by banks and securities dealers. It might make more sense to distinguish, and remove the collateralized securities based financing activities of banks and dealers a part of an Action 4 analysis. The GAAP rules generally require a balance sheet gross up of both assets and liabilities, despite the general over-collateralization provided in securities loans and repos.

Removing the collateralized securities based financing would significantly reduce the leverage in both banks and dealers, and avoid interest expense getting caught inadvertently in a BEPS Action 4 crossfire. These transactions, like deposits, including intercompany deposits among affiliates, are ordinary course activity for RFGs. Bank entities and broker-dealers obtain a significant portion of their debt funding through transactions directly with customers, in the form of repos or repo-like

financing transactions rather than deposits. The broker-dealers also rely on longer-term intercompany debt that reflects a portion of the debt issued by the top-tier parent entity in the capital markets. In addition to this longer-term debt, other intercompany debt transactions arise on a daily basis among the broker-dealer subsidiaries, reflecting the need to move cash and assets among them. For regulatory and customer preference reasons, a customer will typically establish a customer relationship with a single broker-dealer entity within a RFG (i.e., the prime broker) for all of its transactions. However, the natural home for the security that is the subject of a customer lending transaction may be in a different jurisdiction as a result of various factors, most importantly, where the market for that security is most liquid. The disconnect between the customer location and the location of the securities being purchased or financed frequently results in the creation of an intercompany debt obligation between two affiliated broker-dealers in different jurisdictions, but under the same global regulatory umbrella. For example, assume a U.S. client of a U.S. broker-dealer wishes to borrow cash against its holdings of gilts, the securities issued by the British government. In order to increase liquidity and for other business needs, the customer enters into a repo transaction under which it sells the gilts to the U.S. broker-dealer, which is its prime broker and with which it has a customer relationship, and agrees to repurchase the gilts at the conclusion of the repo. The group's U.K. broker-dealer can more easily use gilts in its ordinary course of business because the natural market for gilts is located in the United Kingdom (where gilts are issued and traded in the secondary markets). Accordingly, to satisfy the customer's desire to borrow against its gilt position, the U.S. broker-dealer will typically enter into a back-to-back transaction with the U.K. broker-dealer, such as an intercompany repo, to hedge the customer facing repo, and then the U.K. broker-dealer will use the gilts in its ordinary course of business.

Another consideration, absent an exemption for RFGs, would be the removal from an interest deduction limitation for any negative carry associated with the need to maintain high quality liquid assets ("HQLA") in a liquidity buffer. The regulated bank or dealers' cost of funding the HQLA will have a negative impact on the net interest margin, but such a negative carry is driven by a regulatory mandate, not a desire to base erode. A challenge to this approach, and a reason for our primary recommendation, is how to determine the negative carry due to the fungibility of the funding – direct tracing, an allocation or apportionment method? Whether to use an average or blended rate, how to treat currency impacts and derivatives used to hedge currency as well as interest rate and duration risk.

3. Are there other any (any other?) 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.

The discussion draft at paragraphs 18-21 is concerned with different countries regulatory regimes being different in type, different in implementation dates, and also different from the local tax rules. This in inevitable as each jurisdiction seeks to implement what works best for that jurisdiction and for to address the goal of the particular regulator. Our view is there is no Action 4 risk for RFGs emanating from these differences, and that whatever works for the regulator of the home country should be sufficient for the tax authority in that jurisdiction, and that any globally regulated group should also have very limited BEPS Action 4 risk due to the combination of the global / umbrella regulation and the stand alone regulation of subsidiaries. At the very least, the tax authorities should not be at odds

with the rules of another governmental agency. We believe that if the OECD attempts to step in and cherry pick some of the debt and accompanying interest as “good” or “bad” they will inevitably create inconsistencies with the goal of the financial regulator.

We would like to provide more comment and context to the impact of the regulatory capital rules in order for the OECD to get more comfortable with our primary recommendation to exempt RFGs. The regulation and regulatory capital environment has a significant impact on intercompany and downstream funding for banks and insurance groups that would be RFGs, both forcing and restraining the use of debt. For RFGs, the top-tier parent entities (in the U.S. and elsewhere, known as financial holding companies) and each of the banking and broker-dealer subsidiaries are heavily regulated by multiple governmental agencies in order to ensure the country’s financial soundness and protect the depositors, customers and counterparties, as well as the financial system.

The RFG is regulated on a consolidated or umbrella basis, and the banks and broker-dealers are also regulated on a standalone basis. In the current environment, the regulators oversee every aspect of the business of an RFP, including monitoring the debt issued and the loans made. The prudential banking regulations impose regulatory capital requirements, meaning a minimum amount of common equity and certain preferred stock and subordinated debt funding (collectively referred to as regulatory capital) relative to assets, on both a risk-weighted and absolute basis. The regulatory framework also requires limits on leverage, limits on large exposures or risks, and resolution planning, including a capital structure designed to facilitate the orderly resolution of the parent corporation and its material legal entities in the event of future material financial distress or failure.

The regulatory capital rules recognize that debt and leverage are necessary to the operation of a financial services group in its role as a financial intermediary, but place limits on the extent to which a RFG may utilize leverage in order to preserve the safety and soundness of the individual institution and the financial system as a whole (systemic risk). In certain contexts, intercompany debt is encouraged or even required by regulation or supervisory guidance, because it can serve as a tool to enable the RFG’s movement of assets within the group in times of stress. For example, regulators require long-term debt as a component of capital.

The net effect of this regulatory framework is that regulated entities cannot take on excessive intercompany debt and, secondly, that regulatory compliance dominates the planning for the capital structure of a RFG in a way that essentially forecloses tax planning with debt in regulated entities.

In relation to insurance, there are solvency rules (Solvency II) which impose restrictions on the amount of debt which is permitted to count towards regulatory capital requirements. These restrictions exist at the solo and group level. Solvency II applies to European insurers, but similar rules exist or are being developed outside the European Union (“EU”), including for example equivalence requirements. We believe the BEPS risk is low because of the stringent regime in which insurers and other companies in their groups (such as service companies and holding companies) are subject to. The view of rating agencies also places limits commercially on the amount of debt which can be raised by insurance groups. Moreover, it is commonplace for insurers to raise debt at the holding company level and pass this as equity to subsidiaries, an approach which is driven by regulatory constraints. We also note it is accepted in the discussion draft that the BEPS risk within an operating entity is considered to be low, and we believe that the same principle applies where the debt is raised outside the operating entity, which is common practice for insurance groups.

4. Are there other any general issues related to the operation of the authorized OECD approach and the impact on the level of free capital in a permanent establishment of a bank or insurance company that should be taken into account?

In general, it is our experience that tax authorities have limited experience in the practical application of the treatment of free capital for banks and insurance companies. The 2010 *Report on Attribution of Profits to Permanent Establishments* (which outlines how to deal with free capital through a couple of alternatives) does structurally limit the BEPS risk. However, the Authorized OECD Approach (AOA) outlined in the 2010 Report is not overly prescriptive in determining how to mechanically adjust the balance sheet and resulting interest expense after the attribution of capital which can lead to varying interpretation and results. It also gives effect to interbranch transactions which are transactions presumably not of concern to financial regulators, nor sometimes to tax authorities in jurisdiction that have not adopted the AOA. For example, while the U.S. has adopted the AOA, it has done so in only seven of its income tax treaties to date, even for companies who are residents of those 7 countries, it may nonetheless utilize its domestic law for capital attribution. The U.S. domestic laws still provides for a safe harbour of 5% capital and it allocates global interest expense to the PE which is not subject to the arm's length standard. The U.S. presumably allows its domestic rules to be used to attribute capital because the AOA's recommended methods for allocating capital were not prescriptive enough for the U.S. to enforce or administer. This general comment is not targeted at BEPS Action 4, rather pointing out that it may be premature, one way or the other, to determine whether the AOA attribution to free capital has achieved its goals, and that more time to analyse the impact of the 2010 AOA should be provided before altering it, since that project took 15 years or so.

5. Are there any concerns raised by a country not introducing tax rules to deal with excessive interest deductions in banks and/or insurance companies including permanent establishments, if the country has established that no material BEPS risk exists (which may be as a result of the operation of regulatory capital rules)?

Based upon our recommendation and the points in this comment letter, we believe this would be the enlightened jurisdictional approach, the best practice approach.

6. What approaches currently applied by countries would be effective in reducing BEPS risks posed by over-leverage in banks and/or insurance companies including permanent establishments, if a country identifies that such a risk exists? These may be sector specific rules or rules which apply to all sectors.

If a tax authority believes banks or insurance companies are over leveraged, the most effective first point of contact should be their fellow governmental financial regulator. Query what the comparator that the tax authority is comparing a bank to in order to make this "over-leverage" determination? If it is a local, success technology company, the assessment would be accurate yet meaningless, the proverbial apple to an orange comparison. Curiously, if the tax authority compared local banks leverage to the leverage ratio of most central banks, the local banks would likely appear over capitalized.

7. Are there any other practical considerations related to the application of the fixed ratio rule to banks or insurance companies that should be taken into account?

We believe that the fixed ratio bears no relevance to the banking or insurance industry, and its application would do affirmative harm while increasing complexity.

8. Are there any other considerations with respect to the ability of banks and insurance companies to use interest to fund non-taxable income on an equity investment that should be taken into account?

The discussion draft captured the considerations well. We make no additional comment on question 8.

9. What approaches currently applied by countries would be effective in reducing BEPS risks posed by a bank or insurance company using interest to fund non-taxable income on an equity investment? These may be sector specific rules or rules which apply to all sectors.

As mentioned in our general comments, we believe the best practice to deal with this concern would be the application BEPS Action 3, a CFC regime that would include the income earned by the subsidiary in the low tax jurisdiction into the taxable income of the parent jurisdiction, unless there were sufficient substance and people functions in the low tax jurisdiction responsible for the generation of the income.[2] The OECD 1998 Report on Harmful Tax Competition has as its primary recommendation the use of a CFC regime. At the time only 17 of the 30 OECD members had CFC regimes. In our view, this is the most useful tool in the tax tool kit to deal with the BEPS concern of banks or insurance companies using debt to generate tax advantaged income.

The draft put forth options including (1) disallowing the interest expense at the bank parent level used to fund non-taxable income, (2) reducing the income which benefits from a participation exemption or other beneficial tax regime to reflect the value of the interest funding the income, (3) turning off the participation exemption or beneficial regime in certain circumstances, and (4) looking to link up the regulatory capital rules to inform the tax treatment. Each alternative described in the report would add additional complexity to an already overly complex international tax regime. Disallowing the interest expense at the parent level raises the question of how? Direct tracing, some pro-rata test, what to include / exclude from a pro-rata test any source of limitation becomes problematic as discussed above in our recommendation on addressing risk one. We recommend a CFC regime.

10. Are there any other considerations with respect to the ability of banks and insurance companies to use interest to fund non-taxable income on an investment in a permanent establishment that should be taken into account?

We believe any other concerns are addressed in the OECD's *Public Discussion Draft BEPS Action 2: Branch Mismatch Structures*. We make no additional comment on question 10.

11. Where a country introduces targeted rules to address the specific risks identified in the Action 4 Report, are there any implications from applying these rules to banks and insurance companies that would be different from the implications for other types of entity?

Yes, there are several, discussed in our replies to questions 1 to 10, as well as in Section IV of our comment letter. Our primary recommendation is to carve out RFGs.

[2] The UK CFC regime use of KERT principles as the measurement for deferral or the US Subpart F Active Financing regimes are 2 examples of CFC regimes that allow deferral but only when sufficient substance occurs in the (lower taxed) jurisdiction.

Entities in a group with a bank or insurance company

12. Are there any other general issues related to the level of BEPS risk involving interest posed by entities in a group with a bank or insurance company that should be taken into account?

We have no comments on question 12.

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?*

We have no comments on question 13.

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?

We have no comments on question 14.

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?

We have no comments on question 15.

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?

We have no comments on question 16.

17. Do you have any other comments on any of the issues raised by this discussion draft?

If RFGs are not provided a carve-out from Action 4, it is very important, if rules are introduced for insurers or banks, that existing debt is considered. We believe it is important to grandfather existing debt or introduce a period during which restructuring may be undertaken. This is particularly important in the case of third party debt issued by insurers, and there should be no option for a country to opt out of transitional rules.

IV. Reasons for an Exception for Regulated Financial Group

Our primary recommendation is to exempt RFGs from BEPS Action 4 is based on two main arguments: (i) borrowing money has been a vital part of the financial services industry since its

inception and (ii) governments have sought to protect the creditors of financial institutions (such as bank depositors or insurance policy holders) from the risks of borrowing too much money in relation to capital. This recommendation is also consistent with the assessment that the BEPS Action 4 risk is low for this sector. Moreover, there is no compelling reason for tax regulators to overlay additional rules on the existing regulatory processes especially ones that could conflict with another arm of the same government. One of the advantages of this approach would be that it would achieve regulatory capital instrument conformity: amounts that are treated as debt for regulatory purposes would have the same treatment for tax purposes, and likewise for equity instruments.

Whilst much of the philosophy of this section is relevant to insurers, the detail relates to the regulatory regime applicable to banks. As noted above, insurers are also subject to stringent regulatory regimes at individual and group levels, and detailed work would be required to ensure RFGs would be defined appropriately so an exemption would align with the relevant policy objectives.

The definition of a RFG for purposes of the exclusion can start by including "G-SIFIs"[3] as well as any other substantially similar financial institutions. We are happy to continue to work with you to come up with a viable definition, and/or to meet with you to detail our reasoning for this request. The use of interest income and expense of RFGs has accurately been described as being inventory or part of cost of goods sold, and in our view, comparisons to non RFGs are not overly relevant. The definition of an RFG can also look to certain OECD member states existing rules for recognizing the uniqueness of a group with is predominantly a financial services group. The U.S. has a financial services group definition in its foreign tax credit rules provided the group is predominantly engaged, meaning 80% of its income is derived from the active conduct of a financial business. The UK worldwide debt cap rules do not apply to qualifying financial services groups if all, or substantially all of UK trading income, or worldwide trading income of the group is derived from lending, insurance and insurance related activities, and dealing in financial instruments.

Our discussion on bank regulation uses a U.S. based bank with non-U.S. operations as the example to describe the overlapping umbrella effect of global regulation, as well as being subject to multiple domestic regulators.

Bank Regulation

Financial regulators are not focused on tax impacts of debt, but rather on solvency and soundness of the institutions that they regulate. When financial regulators reach a conclusion on the required amount of capital, they are validating an institution's capacity to borrow. There is no industry in which the composition of one's balance sheet is more carefully reviewed and stress-tested than the financial services industry. A business does not choose to be regulated. Rather, it must comply with the complex regulatory regime which comes at a great costs both from actual compliance costs, and opportunity costs. The regulation is nonetheless required based on government policies that are

[3] See the Financial Stability Board 2015 list of 30 global systemically important banks (G-SIBs) at http://www.fsb.org/wp-content/uploads/2015-update-of-list-of-global-systemically-important-banks-G-SIBs.pdf. This could be used as a starting point, there are clearly other banks, and global insurance companies that can, and should be included in a regulated financial group (RFG) excluded from the application of Action 4

intended to protect depositors, policyholders, and the economy as a whole from the possibility of insolvency, default, and the possible domino effect of multiple failures on the economy as a whole.

Regulators want to validate the soundness of institutions both at the consolidated level and at the separate company level (taking into account of both foreign and domestic subsidiaries). Complying with the standards of the applicable regulator is as compelling a business purpose as there can be because, in the end, a non-compliant institution cannot operate, and is either seized by the regulator or merged into a compliant institution pursuant to government order. One could argue that there is always a business purpose for banks to borrow money (within reasonable bounds of scale): money is their inventory. It enables them to enter into revenue-generating transactions, and if they can make more money on those transactions than it costs to borrow, the result is a profit.

The OECD October 2015 final report on Action 4 was on the correct path when pointing out in paragraph 184: *"An important consideration is that the role interest plays in a banking or insurance business is different to that in other sectors. Banks and insurance companies hold financial assets and liabilities as an integral part of their main business activities. In addition financial sector business in most countries are subject to strict regulations which impose restrictions on their capital structures"*. . . .

While paragraph 190 stated that "It is not intended that entities operating in the banking and insurance sectors, or regulated banking or insurance entities within non-financial groups, should be exempted from the best practice approach to tackle base erosion and profit shifting involving interest. Instead, in order to tackle base erosion and profit shifting by groups in all sectors, it is essential that a best practice approach include rules which are capable of addressing risks posed by different entities." Moving from the global or umbrella regulatory discussion, we believe discussing the role of intercompany debt and interest within RFGs would be useful to the OECD as it continues to focus on Action 4.

Intercompany Debt and Interest in the Banking Business

Banking is about financial intermediation – receiving cash from depositors around the world and making it available to other customers. In effect, cash is a bank's inventory, and the interest it pays to obtain that cash is its cost of goods sold. Debt is the means by which cash is transmitted; both from external sources in the form of customer deposits and loans, and within the organization, from one banking subsidiary or branch to another. For a banking organization, the ability to move cash via debt is not merely a matter of convenience, it is essential from a regulatory perspective and for profitability and survival. These transactions create genuine liabilities: they involve fixed sums and creditor claims, rather than a sharing of profits.

Historically, most banking subsidiaries and branches fund themselves primarily through the deposits they take in from customers. They supplement their deposits with longer-term intercompany debt that reflects a portion of the debt raised in the capital markets by the top-tier parent entity. While this represents the basic pattern of debt funding for many banking operations, at any given time there will be a need to move cash from one place to another among the banking entities and branches.

On a daily basis, subsidiaries and branches make hundreds of intercompany deposits in order to manage risk, including liquidity, interest rate exposures and currencies among the various entities.

These transactions are centralized in geographical hubs, with each hub receiving deposits from bank branches and subsidiaries and placing deposits with other bank branches and subsidiaries as necessary. The transactions are largely formulaic, driven by processes designed to optimize worldwide management of risk within the risk governance framework established by the bank's management.

Intercompany Debt and Interest in the Broker-Dealer Business

Similar to banking subsidiaries, a RFG's broker-dealer affiliates obtain a significant portion of their debt funding through transactions directly with customers, but in the form of repos or repo-like financing transactions rather than deposits. The broker-dealers also rely on longer-term intercompany debt that reflects a portion of the debt issued by the top-tier parent entity in the capital markets. In addition to this longer-term debt, other intercompany debt transactions arise on a daily basis among the broker-dealer subsidiaries, reflecting the need to move cash and assets among them. We detailed an example in our reply to question 2 above.

Regulation and its Impact on Intercompany Debt and Interest

Regulated financial groups, starting with the top-tier parent entities (as a financial holding company) and each of their banking and broker-dealer subsidiaries are heavily regulated by multiple governmental agencies in order to ensure the financial soundness of the company, its stakeholders, and the capital markets more broadly. We detailed this more in our response to question 3 above.

Regulatory Constraints on Intercompany Debt – Example in U.S.

U.S. banks are subject to regulation and supervision by a number of bank regulatory agencies. The top-tier parents of large U.S. commercial banks are registered bank holding companies that have elected to be treated as a financial holding company under the Bank Holding Company Act. Accordingly, these banks are regulated and supervised on a consolidated basis by the Federal Reserve Board. National banks are regulated and supervised by the Office of the Comptroller of the Currency ("OCC"). The Federal Deposit Insurance Corporation (the "FDIC") also has examination authority for all banking subsidiaries whose deposits it insures. Overseas branches of U.S. national banks are regulated and supervised by the Federal Reserve Board and OCC and overseas subsidiary banks by the Federal Reserve Board. These overseas branches and subsidiary banks are also regulated and supervised by regulatory authorities in the host countries, as discussed further below. In addition, the Consumer Financial Protection Bureau regulates consumer financial products and services. While most non-U.S. "G-SIFIs" have a primary regulator in their home jurisdiction, and not the multiple regulators as exists in the U.S., the non-U.S. bank largely follow similar regulatory edicts emanating from the BIS in Basel.

The bank regulatory agencies impose many regulatory limitations on the banks, including requirements for banks to maintain reserves against deposits, restrictions on the types and amounts of loans that may be made and the interest that may be charged, and limitations on investments that can be made and services that can be offered. U.S. banks are also subject to regulatory capital requirements issued by the Federal Reserve Board, referred to as the U.S. Basel III rules. These rules

establish an integrated capital adequacy framework, encompassing both risk-based capital ratios and leverage ratios.[4]

In addition, there are restrictions on loans and other transactions between the U.S. subsidiary banks and their non-bank affiliates. Specifically, Section 23A of the Federal Reserve Act prohibits U.S. subsidiary banks from lending more than 10% of their capital and surplus to a single non-bank affiliate, and more than 20% to all affiliates, and requires that most such transactions be on a secured basis. Section 23B of the Federal Reserve Act requires that all such transactions be on arm's length market terms.

U.S. broker-dealers are registered under the Securities Exchange Act of 1934 (the "Exchange Act"). Their primary regulator is the Securities Exchange Commission ("SEC"). They are also members of, and subject to the oversight of, the Financial Industry Regulatory Authority. Certain subsidiaries are also swap dealers and Future Commission Merchants ("FCMs") registered with the Commodity Futures Trading Commission ("CFTC"). These regulated entities are members of, and subject to the oversight of, the National Futures Association. Each of these bodies administers a complex set of rules designed to protect customers and ensure the safety of the U.S. securities and derivatives markets as a whole. SEC-registered broker-dealers must maintain a minimum ratio of net capital to measures of indebtedness specified by regulation (which are measures of the broker-dealer's own indebtedness or, alternatively, customer-related receivables). In addition, as discussed above and below, broker-dealers that are part of large banking organizations are indirectly subject to requirements applicable to their holding company parent, such as consolidated capital requirements that effectively limit their use of leverage, and to resolution planning requirements that drive a need for intercompany debt. To comply with these requirements, SEC-registered broker-dealers must abide by initial, ongoing minimum and excess net capital requirements. Minimum net capital depends on the nature of the SEC-registered broker-dealer's business. There are notification requirements for, and potential restrictions on the timing of, any reduction in excess net capital below certain levels.[5]

Non-U.S. regulators also limit the debt of a bank or broker-dealer. Each non-U.S. subsidiary or branch that conducts banking or dealing operations is subject to the relevant host country bank or broker-dealer regulatory regime and the oversight of that country's regulatory body, in addition to the oversight of the Federal Reserve Board. These host country regulators, and the relevant local laws, have a general objective of ensuring the soundness of that particular entity or branch in order to protect local depositors and customers. While all the regulators have a general interest in ensuring the viability of the group of entities as a whole, each local regulator necessarily monitors the branch or entity for which it bears primary responsibility. As a consequence, each of these branches and entities generally must be able to demonstrate that it is financially strong – by meeting local capital requirements – on a standalone basis.

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[4] *See generally* 12 C.F.R. part 217. The U.S. Basel III rules implement in the United States the framework of capital standards published by the Bank for International Settlements' Basel Committee on Banking Supervision and known as the Basel III capital accord. Basel Committee on Banking Supervision, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* (June 2011 rev.).

[5] FCMs are similarly subject to net capital requirements. Swap dealers that are also banks prudentially regulated by a banking regulator must comply with the capital requirements already applicable to them as banks. While the specific capital requirements for non-bank swap dealers that are not also FCMs have not yet been finalized, these entities will be subject to regulatory capital requirements.

For example, the U.K. subsidiaries are subject to the EU Capital Requirements Directive (2013/36/EU), as transposed into U.K. law, and the Capital Requirements Regulation ((EU) No. 575/2013) (collectively, "CRD IV"), which together represent the EU's implementation of the international Basel III capital accords.[6] A two-step regulatory capital analysis is required to determine the regulatory capital requirements with which a U.K. bank or investment firm must comply. The first step is a formulaic calculation of its minimum capital requirements. The second step involves the bank or firm carrying out the Internal Capital Adequacy Assessment Process (the "ICAAP"). In the ICAAP, the RFG will determine whether its particular risk profile and the level of its exposures mean that it should hold capital beyond the minimum required level. The relevant regulator must then perform a supervisory review of the ICAAP and can require the bank or firm to hold more capital if the regulator believes risks have not been adequately addressed.

We hope this letter provides you with relevant comments and context around the global regulatory regimes for RFGs and provides ample explanation for our recommendations. We look forward to discussing any questions you have on the points we raise above or on other specific matters raised by respondents to the discussion draft.

Yours faithfully,

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[6] While all of the regulatory consequences to banks of the U.K.'s anticipated departure from the EU are not yet known, we do not expect that it will affect the obligation to comply with Basel III.