5 April 2023

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Dear Committee Members,

Treasury Laws Amendment (2023 Measures No. 1) Bill 2023 – Franked distributions funded by capital raisings

The Australian Banking Association (**ABA**) welcomes the opportunity to comment on the *Treasury Laws Amendment (2023 Measures No. 1) Bill 2023* (the **Bill**) and the Explanatory Memorandum. In this submission, we address amendments to the *Income Tax Assessment Act 1997* under Schedule 5 of the Bill.

The ABA accepts the public policy position that capital raisings should not be undertaken for the sole purpose of funding the distribution of franking credits.

However, the current scope of this Bill creates some uncertainty whether certain capital raisings could be deemed unfrankable despite those capital raisings not being intended to fund any dividend or distribution. The ABA believes that legislative certainty and clarity is of paramount importance for banks when looking to raise capital to ensure that market-standard capital management actions are not inadvertently caught by the Bill. The ABA submits that it is not the intent of this Bill to introduce uncertainties on capital raisings and seeks to ensure that the Bill supports the existing sound capital management and Prudential Standards. Any additional uncertainty that impacts capital raising activities of banks should be minimised through clarifications to the Bill and Explanatory Memorandum.

Banks are subject to a wide range of capital and liquidity requirements under the Australian Prudential Regulation Authority's (**APRA**) prudential standards. These standards include requirements to hold minimum levels of capital and liquidity. When managing a bank's capital requirements, a bank will consider, among other things, their current funding profile, expected future capital needs and prudential requirements, alongside domestic and international market conditions and available windows for raising capital. APRA prescribes minimum capital levels and buffers to be held by banks, and banks must actively manage their total capital (which comprises common equity Tier 1, Additional Tier 1 capital, and Tier 2 capital). While a capital raising (which can include non-share equity) can occur near the time of a franked dividend or distribution payment, it should not be assumed that the two events are connected.

An example that highlights the relationship between a bank's capital raising needs and its dividends or distributions is a letter APRA wrote to banks on Tuesday 15 December 2020, which stated,

> *"APRA expects banks and insurers to continue to moderate dividend payout ratios, and consider the use of dividend reinvestment plans (DRPs) and/or other capital management initiatives to offset the impact on capital from distributions."*[1]

It is clear that APRA intended (and intends) for banks to use dividend reinvestment plans and other capital raising activities to support their capital position whilst separately continuing to pay franked dividends or distributions.

For clarity, ABA members do not use capital raisings[2] for the purpose of distributing franking credits. Capital raisings and the decision to pay a dividend or distribution are separate commercial decisions that serve separate commercial and prudential purposes. Banks determine the amount to be distributed based on the Net Profit after Tax and market expectations and in accordance with their approach to capital management.

[1] Full letter enclosed for reference.
[2] Including raising either common equity or Additional Tier 1 equity.

In the Annexure below, the ABA sets out recommendations for changes that will enable the public policy outcome sought and ensure that banks' capital and liquidity management practices are unaffected by the Bill. In short, the recommendations are:

1. Clarification of indirect and partial funding so to avoid an unnecessarily broad scope.
2. Ensuring the consideration of established practice.
3. Clarification of the impact on Dividend Reinvestment Plans.

The ABA strongly encourages the Committee to consider the recommendations contained within the Annexure in light of the concerns we have raised in this letter.

If the Committee would like to discuss further, please do not hesitate to contact Mitchell Frater-Baird at Mitchell.Frater-Baird@ausbanking.org.au.

Signoff

Head of Economic Policy

About the ABA

The Australian Banking Association advocates for a strong, competitive and innovative banking industry that delivers excellent and equitable outcomes for customers. We promote and encourage policies that improve banking services for all Australians, through advocacy, research, policy expertise and thought leadership.

Australian Banking Association

Annexure

1. The Bill creates uncertainty for a bank's ability to manage its capital consistently with its prudential requirements

Substantial part of the relevant distributions

In sections 207-159(1)(c)(i) and (ii), the phrase "*or part of the relevant distribution*" is vague as the scope of *part* is unclear. The current wording could be interpreted broadly, to include merely incidental or coincidental purposes or effects of capital raisings.

The ABA recommends that the phrase "*or part of the relevant distribution*" be replaced with the phrase "*or a **substantial part** of the relevant distribution*". This change reduces uncertainty for banks as well as increasing confidence and clarity in complying with the provisions of this Bill because it would require a consideration of the whole distribution. The introduction of *substantial* will not significantly limit the Bill's ability to *prevent a distribution being franked where capital is raised for the purpose of inappropriately distributing franking credits outside of the entity's regular pattern of distributions*.

Clarifying the scope of '*indirectly fund*'

In section 207-159(1)(c)(i), the wording "…*the direct or indirect funding*…" creates uncertainty as to the scope of '*indirect funding*'. The current wording would allow for a very broad interpretation of '*indirect funding*' and this uncertainty has the potential to create the circumstances where a broad interpretation could link very separate capital raisings and dividends or distributions. Banks need certainty as to what (if any) actions are needed to fall within this provision.

The ABA recommends that the Committee consider amending the Explanatory Memorandum to restrict the scope of '*indirect funding*' to ensure that funds raised, which contribute to the general pool of funds available to the bank, are not considered as funds raised for the purpose of making a dividend or distribution.

APRA regulatory requirement to be a specific consideration

In section 207-159(2) the ABA recommends the insertion of an additional specific consideration, being "*(f) any impact of regulatory requirements*".

This change will limit the extent to which this Bill creates constraints or incentives regarding capital raisings that are inconsistent with the requirements of prudential regulations or non-operating holding companies (NOHC) authority under the Banking Act 1959.

The introduction of an additional specific consideration of relevant regulatory requirements will not limit the objective of the Bill. Rather, this change will provide certainty to banks that *the operation of the provisions will not conflict with sound capital management in accordance with APRA's* regulatory requirements.

2. The Bill creates ambiguity with respect to the acceptability of the consideration of established practice

Established Practice

Subsections 207-159(1)(a)(i) and (ii) of the Bill require that, when determining whether or not a 'relevant distribution' is funded by a capital raising, the past regular practice of an entity should be taken into consideration. Further, section 207-159(3) states that this consideration of the past regular practice of an entity should not be undertaken should the distribution be deemed as a distribution funded by a capital raising under any other subsection under section 207-159(1).

Subsections 207-159(1)(a)(i) and (ii) allow entities to refer to past practice when determining the compliance of future practice and this creates certainty for entities in their compliance with the Bill. For regulators and banks the value of subsections 207-159(1)(a)(i) and (ii) is the ability to reference legitimate past practice, that would not be deemed compliant under the Bill, when determining future compliance.

Section 207-159(3) removes this ability to refer to past practice unless that past practice complies with the other provisions of section 207-159(1). In the ABA's view this removes any purpose for Section 207-159 (1)(a)(i) and (ii). Past distributions should be considered regardless of whether those distributions would have complied with section 207-159(1).

As stated above, the ABA understands that its members do not use capital raisings (of either common equity or Additional Tier 1 capital) to fund distributions. The ABA seeks to ensure that there are no limits to the consideration of established practice when applying the provisions of this Bill. Therefore, the ABA recommends that section 207-159(3) be removed from the Bill so that both regulators and banks are not constrained when considering the established practice of paying distributions. The removal of section 207-159(3) would not impact the effectiveness of Section 207-159(1), distributions that do not comply with these provisions will still be deemed unfrankable.

Established Practice Example

Due to a range of external factors, including at the direction of APRA, banks may occasionally not make distributions, distribute lesser amounts, or make distributions less frequently. This occurred during the COVID pandemic where banks deferred or cancelled their dividends.

Example 5.4 refers to an APRA regulated body that makes a distribution after raising capital. It is stated that *"The company regularly pays such dividends and has a longstanding practice of paying such distributions to its members generally every six months."* This example concludes that "*The measure does not apply as the company has a longstanding established practice of paying such dividends to its members*". The example makes clear the importance of "*longstanding established practice*" in determining if the measures apply.

In the ABA's view a banks' decision to not make or reduce certain dividends or distributions should not impact on the consideration of a banks "*longstanding established practice*". Banks should be free to cease or alter their dividends or distributions, when necessary, without concern that it will impact on their "*long standing established practice*" and potentially mean that the measures of this Bill apply.

The ABA seeks clarity in example 5.4 along the lines of "...*has a longstanding practice of paying such distributions to its members generally every six months, **despite not making distributions for a period due to Prudential constraints**".*

Types of Distributions

The ABA understands that for the purposes of this Bill 'distributions' will include all distributions or dividends made through a wide range of instruments, including share equity and non-share equity. For clarity, the ABA suggests that an interpretive provision be inserted to the effect of: *"In this section, references to a distribution include each and all of the individual distributions made by an entity pursuant to the same particular resolution or other authorising action of the entity."*

3. The current scope of the Bill creates some uncertainty as to the use of DPRs and UDRPs for bank prudential capital management purposes

Dividend Reinvestment Plans (DRPs) and fully or partially Underwritten Dividend Reinvestment Plans (UDRPs) are important and market-standard methods in which banks raise capital to meet their capital management requirements for the purposes of APRA's prudential standards. Banks do not use DRPs and UDRPs for the principal purpose or effect of funding distributions.

In order to clarify the impact of the Bill, Example 5.2 should be amended to include a statement that one or more UDRPs should not result in the application of the provisions. This could be done by including a sentence in the example clarifying that Example 5.2 is only illustrative of a special dividend and not of DRPs (including UDRPs) that occur in respect of dividends that fall within the established practice of dividend or distribution.

Further, as the example in 5.2 relates to UDRPs, the lack of an explicit example for DRPs leads to uncertainty as to the applicability of Example 5.2 to DRPs. Banks will only declare dividends when they have sufficient liquid assets (including cash) to pay the dividend and do not require additional funding from an issue of shares to fund the dividend payment and are subject to regulatory restrictions on the payment of dividends.

The additional shares issued via the DRP or UDRP help banks to manage capital requirements (e.g., to improve a bank's Common Equity Tier 1 regulatory capital ratio to meet its target operating capital level). The DRP or UDRP is also a convenient way for shareholders to increase their holding of a bank's shares without incurring transaction costs.

Example 5.2 implies that banks should not use DRPs or UDRPs if there is a risk that the dividend will not materially change the company's financial position.

Specifically addressing the three reasons provided as to why the principal effect and purpose tests are satisfied by DRPs and UDRPs, the ABA responds as follows:

1. Under DRPs, shareholders can voluntarily choose to use their dividend to acquire additional shares in the company instead of receiving a cash payment. As such a Bank cannot control whether a DRP offsets a dividend payment such that the company's financial position is not materially changed. If a bank allows a shareholder to participate in a DRP it cannot control the level of capital raised. The bank cannot not be said to have funded the distribution with an unknown amount of future capital raised.
2. UDRPs provide banks with certainty when using DRPs to raise capital. The purpose of a UDRP is to guarantee the amount raised, allow all shareholders to participate in the equity raising and share the risk of shareholder participation with the underwriter.
3. By their nature DRPs and UDRPs must be temporally close to a distribution. Shareholders can elect to participate in the DRP shortly after the record date for the dividend and DRP Shares will be issued at the same time as the payment of the cash dividend.

Given the role of DRPs and UDRPs in a bank's capital management and only an incidental link between the capital raised and the dividend amount, the ABA requests that the Bill be amended to clarify that DRPs and UDRPs do not automatically have the principal effect and purpose of funding their related dividend. The ABA strongly requests that Example 5.2 be supplemented by including clear examples or case studies of *"evidence that the capital raising was for a purpose other than to fund the special dividend"*. These examples or case studies should include capital raisings done for the principal effect and purpose of prudential capital management and capital raisings via DRPs including UDRPs for general corporate purposes or acquisitions.

These clarifications would not impact DRPs and UDRPs undertaken by a bank with the express purpose of raising the capital required for the relevant distribution. Such DRPs and UDRPs would remain unfrankable under the Bill.