NEW ZEALAND
BANKERS ASSOCIATION

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Review of the Thin Capitalisation Rules

Deputy Commissioner, Policy and Strategy

Policy Advice Division

Inland Revenue Department

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Dear Struan

Review of the thin capitalisation rules

The New Zealand Bankers' Association (NZBA) is grateful for the opportunity to comment on the Issues Paper, "Review of the thin capitalisation rules" (the issues paper) released in January 2013.

The issues paper, outlines the concern that related party debt is being used to reduce the effective rate of New Zealand tax for foreign owned entities. The paper proposes a number of measures are proposed to address this concern, with the effect of broadening the ambit of the New Zealand thin capitalisation regime.

NZBA wishes to express its concern that these proposals may make New Zealand based securitisation structures unviable.

Securitisation structures are often used as a commercial means of facilitating third-party funding through the use of an independent special purpose vehicle. These structures lower the costs of funding by allowing access to new or differentiated debt markets. To be commercially viable, generally a securitisation vehicle must be independent. This requires it to be tax neutral and bankruptcy remote from the originator. In addition, the recourse of note holders of debt securities issued by the securitisation vehicle must be limited to the underlying assets. In many cases securitisation structures involve the use of complying trusts.

Currently, complying trusts are not listed in section FE 2(1) of the Income Tax Act 2007 (the Act) as an entity that must apply the thin capitalisation regime. As a result, securitisation vehicles are not currently subject to the thin capitalisation rules.

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The issues paper proposes to extend the thin capitalisation regime to complying trusts where 50% or more of the settlements on the trust are made by non-residents or entities that are subject to the New Zealand thin capitalisation rules. This may subject securitisation vehicles to the thin capitalisation rules. NZBA considers this could significantly impact upon the securitisation market, increasing the cost of funding in New Zealand for both businesses and individuals.

Securitisation vehicles are clearly established and managed for commercial reasons. NZBA considers that these vehicles are not the intended target of the thin capitalisation proposals. If the proposals are advanced in their current form, NZBA submits that there should be a specific exclusion for securitisation vehicles from the thin capitalisation regime. This is consistent with the well-established exemption for securitisation vehicles from the Australian thin capitalisation regime.

This submission provides a brief outline of the securitisation market in New Zealand and the potential implications of applying the thin capitalisation regime to securitisation vehicles. It provides strong policy reasons for exempting securitisation vehicles from the thin capitalisation regime, and requests that the Deputy Commissioner advance this proposed exemption.

New Zealand securitisation market

The securitisation market facilitates the provision of cost-efficient finance to both New Zealand businesses and individuals. Securitisation vehicles are an essential means of obtaining funding for many New Zealanders and, as an alternative source of funding to bank debt, they can create competition in the debt market, reducing finance costs.

Securitisation vehicles are a special purpose vehicle (SPV) established for the sole purpose of issuing debt securities to note holders in domestic or offshore capital markets, and using the proceeds to acquire assets, such as receivables, from originators. The SPV has complete legal independence from its originator, using the concept of “bankruptcy-remoteness” to delink the SPV and its assets from the insolvency risk of the originator and other parties to the securitisation structure. This means the credit quality of the assets acquired by the SPV can be evaluated on their own merits, which allows the SPV to effectively transform (securitise) the assets into negotiable securities that can be issued in financial markets.

The bankruptcy-remote status also means that the SPV is not permitted to have employees. Servicing of the assets and administration of the SPV is generally performed by the originator or a suitably qualified third party, which are undertaken on commercial terms and documented under legal agreements with the SPV. It is not possible to materially change the terms of a securitisation structure without the approval of the note holders.

Income from the assets is used to make interest payments, pay fees to service providers and pay the other expenses of the SPV. In the New Zealand market, tax neutrality is often achieved by establishing a complying trust as the SPV, with the requirement that any residual income must be distributed to beneficiaries.

Securitisation structures are well established internationally as a means of lowering the cost of funding. Further, the market accepts that securitisation vehicles are fully funded by debt, issued to New Zealand and overseas investors, without the need to hold any equity. Instead, the originator will subscribe for subordinated debt securities issued by the securitisation vehicle, which provide an initial level of credit protection along with residual income for any losses on the underlying assets. The amount of subordinated debt securities held by the originator is generally governed by the amount of credit protection that is required to achieve the rating on senior debt securities, and will depend on the historical loss and arrears performance of the underlying assets and risks associated with them and the securitisation structure.

Impact of the proposals on securitisation vehicles

Securitisation structures may inadvertently be caught by the proposals for Problem 3 in the issues paper. These proposals apply the thin capitalisation regime to resident trustees if 50% or more of settlements made on the trust are made by:

- a non-resident; or
- a group of non-residents acting together; or
- an entity that is subject to the inbound thin capitalisation rules.

The practical impact of this will be that SPVs would be required to apply the interest apportionment rules outlined in sections FE 6 and FE 7.

As SPVs are effectively fully debt funded to acquire financial arrangement assets, the on-lending concession in section FE 13 should apply to provide some relief from the interest apportionment calculation.

However, there may be circumstances where securitisation structures hold non-New Zealand dollar denominated assets or issue non-New Zealand dollar denominated debt. Where derivatives are used to hedge against foreign exchange exposures or interest rate risk, the on-lending concession provides limited relief from the thin capitalisation regime.

NZBA considers that subjecting securitisation structures to the thin capitalisation regime would severely impact upon the New Zealand securitisation market. Denying interest deductions in the SPV, and therefore impacting its tax neutralilty, could impact on the cash flows available to make payments to note holders and pay the other expenses of the SPV in respect of existing transactions. This could result in the potential downgrading of ratings and/or losses to note holders, ultimately making future securitisations unviable as well as creating solvency issues for current securitisation transactions. This would damage investor confidence in New Zealand debt capital markets, reduce competition by closing securitisation as a potential funding source to New Zealand businesses and, therefore, impact negatively upon the ability of New Zealand businesses and individuals to access finance at competitive rates.

NZBA believes there is strong policy support for a specific exclusion for SPVs used in securitisation structures from the thin capitalisation regime. Should the proposals proceed as drafted, NZBA requests an express exemption for securitisation vehicles from the thin capitalisation regime, to ensure that no securitisation structures are unduly penalised.

Securitisation vehicles are not the intended target

The aim of the thin capitalisation regime is to remove incentives for companies to allocate an excessive proportion of their world-wide interest expense to their New Zealand-sourced income.

Officials are concerned that the thin capitalisation rules are not currently working as intended, with too little tax being paid in New Zealand by foreign owned entities. The proposals primarily focus on private equity investments in New Zealand, where it is believed the thin capitalisation rules are deficient and related party debt is being used to obtain greater tax deductions in New Zealand. The proposals are stated as having been "designed to reduce tax deductions for related party debt that is unduly reducing the effective rate of New Zealand tax, while limiting the effect on other debt."[1]

NZBA believes that the primary aim of the issues paper is to limit the use of complying trusts to obtain related party borrowings on behalf of a foreign owned New Zealand company, where the primary purpose of the structure is avoiding the application of the thin capitalisation rules. Based on this assumption, the use of a complying trust in a securitisation structure is not the target of the proposed changes.

As previously discussed, securitisation structures are necessarily established as bankruptcy remote, which requires complete legal independence from the originator. Once the assets are sold to the SPV, the originator's ongoing involvement is limited to providing services on commercial terms to the SPV and providing credit enhancement to senior investors through investment in the subordinated debt issued by the SPV. The trustee, manager and senior investors in the securitisation structure are typically unrelated and the transactions to establish and manage the SPV are highly regulated, thus ensuring they are undertaken on strictly commercial terms. In addition, the SPV is barred from undertaking any activities beyond those that are necessary to its existence; which includes a restriction on issuing further debt while there is outstanding debt. Finally, the SPV must be tax neutral.

These factors ensure that the note holders financing the SPV are protected from any claims on the originator and there is viable commercial substance to the SPV. This is necessary to give the market confidence that the SPV can be fully debt funded, without the need to hold equity.

[1] Review of the thin capitalisation rules para 1.12, page 2

It follows that an originator could not use a securitisation structure to debt fund the New Zealand operations in the manner envisaged by officials. Rather, securitisation structures arise from a number of purely commercial drivers, including:

- Diversifying funding sources
- Reducing funding costs, through establishing a better credit rating than the originator could achieve in their own right or participating in a debt market the originator could not otherwise access
- Matching funding maturity to asset maturity, and
- Accessing term funding.

Securitisation also allows an originator to limit its own exposure to the risk of poor performance on the underlying assets.

It is NZBA's strong view that securitisation structures are established for purely commercial reasons. The highly regulated and independent nature of the SPV used in the securitisation structure means that it cannot be easily utilised by foreign owned entities to highly gear the New Zealand operations with related party debt, thus limiting the New Zealand taxation of the group. It follows that SPVs are not an intended target of the thin capitalisation proposals.

Australian exemption for securitisation vehicles

Certain "securitised assets" held by "securitisation vehicles" (as defined), and the debt used to fund such assets, were essentially carved out from the Australian thin capitalisation regime when it was introduced in 2001. Australian commentary explains this carve out as follows:

"The zero capital amount provides a carve out of certain assets from the thin capitalisation regime and as a consequence allows full debt funding of those qualifying assets. Assets held by a securitisation vehicle are included in the zero capital amount provided that the definition of securitised asset and securitisation vehicle as set out in section 820-942 are satisfied.

This treatment reflects that securitisation vehicles are tax neutral entities established to pool assets and are generally funded entirely through the issue of debt interests without the need to hold equity."[2]

Recognising that this section may not capture all bona fide securitisation vehicles in practice, further rules were introduced in 2003 (section 820-39), to exempt certain special purpose entities used in securitisation structures from the thin capitalisation rules entirely.

This recognised that the securitisation market is complex and dynamic, and essential for facilitating cost-efficient funding to both commercial borrowers and Australian homeowners.

[2] Taxation Laws Amendment Act (No. 5) 2003: Supplementary Explanatory Memorandum – SEN – Chapter 1 – Thin capitalisation, paras 1.4 and 1.5

To deny securitisation vehicles interest deductions would undermine securitisation structures and, therefore, severely restrict the market's ability to source funding in this way.

Officials sought to ensure that the exemption for securitisation vehicles would not result in such vehicles being used to deliberately subvert the thin capitalisation rules. To do this, officials require each securitisation vehicle to be "an insolvency remote special purpose entity according to the criteria of an internationally recognised rating agency that are applicable to the entity's circumstances".

While the broadened thin capitalisation exemption for securitisation vehicles is currently under review, the aim of the review is to confirm that the exemption for securitisation vehicles is being applied appropriately in practice. It is intended that the exemption for bona fide securitisation vehicles would continue to apply.

Conclusion

The securitisation market is essential for reducing the cost of finance to New Zealand businesses and individuals alike. Subjecting SPVs used for securitisation structures to thin capitalisation restrictions on interest deductions would severely impact upon the ability of New Zealand securitisation structures to access lower cost funding, which would ultimately restrict the amount of low cost funding in the New Zealand market.

NZBA requests that the Deputy Commissioner accept our proposal for a specific exemption for SPVs used in securitisation structures from the thin capitalisation regime.

We trust that the above is helpful in outlining our concerns on this matter and we welcome your consideration. As we appreciate that the securitisation market can be highly complex, we would be happy to meet and discuss the way in which the securitisation market works, to provide officials with a greater appreciation of the potential impact of the proposals.

Yours sincerely

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