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OECD Centre for Tax Policy and Administration
Email: cfa@oecd.org

OECD Public Consultation - Tax Challenges Arising from Digitisation – Pillar 1

Dear Sir/Madam

We refer to our previous submissions in relation to the OECD's Pillar 1 Blueprint[1] and Public Consultation Document[2]. We refer specifically to our submission to the OECD dated 11 November 2019 and our meetings with you on 9 October 2019 and 11 March 2021.

We understand that work is ongoing on Pillar 1 and it is with this in mind that we take the opportunity to provide additional comments for consideration. The purpose of this letter is to address recent comments and proposals put forward in the US which may impact the Pillar 1 rules,

We would be happy to meet with you as part of your consultation process should the need arise.

1. Summary

The exclusion for financial services detailed in the Pillar 1 Blueprint is welcomed and supported by the IBFed. We remain strongly of the view that there needs to be such an exclusion for financial services, for the reasons set out in our previous submissions to the OECD on Pillar 1.

We disagree with a broad revenue or profit margin metric that seeks to include large corporates into the scope of Pillar 1, as that would imply that the specific features of banks that have explicitly been acknowledged in the current OECD Pillar 1 Blueprint would no longer be taken into account. As we have previously put forward in our discussions with you, the relevant calculation of profit margin for banks differs significantly from other industries because of the nature of the banking business. If this approach is being contemplated, however, an alternative calculation or metric would be required to encompass these industry differences.

[1] https://www.oecd.org/tax/beps/tax-challenges-arising-from-digitalisation-report-on-pillar-two-blueprint-abb4c3d1-en.htm
[2] http://www.oecd.org/tax/beps/public-consultation-document-reports-on-pillar-one-and-pillar-two-blueprints-october-2020.pdf

2. US proposals

The US administration has set out a new tax agenda, and we refer to its recent paper "The Made In America Tax Plan"[3], issued by the US Department of the Treasury, supporting documents and related discussion that has resulted.

Whilst we welcome an approach that is both simple and effective for applying Pillar 1, we disagree with a new approach that would appear to remove the exclusion for banks set out in the Blueprint. We have set out extensively in various submissions to you the principles which support regulated banks being excluded from the scope of Pillar 1. The US administration is proposing various changes to the corporate tax rules and base as outlined in their Tax Plan. However, it is the proposed change in approach to Pillar 1 that we would like to focus on. It is our understanding that the US administration has proposed Pillar 1 rules that would:

- Scope in the largest and most profitable Multinational Enterprise (MNE) groups, regardless of industry or business model;
- Limit the number of MNE groups in scope;
- Target MNE groups that benefit from global markets, but focus less on those corporates previously the focus of Pillar 1 (including automated digital and consumer facing companies); and
- Adopt a quantitative screening criteria based on both revenues and profit margins.

3. Preliminary Response to the US proposal on Pillar 1

We acknowledge the significant efforts and investment that member countries, industry and taxpayers have made in contributing to the current Pillar 1 framework. We continue to advocate strongly for the exclusion of banks, that banks should not be within the scope of Pillar 1 due to their taxable, physical presence in places where they operate regulated businesses.

There is some uncertainty around what the US proposals mean for the existing framework and for the proposed exclusion of financial services from the OECD Pillar 1 Blueprint. We look forward to further information on the direction of the Pillar 1 work as it becomes available.

As you would appreciate, banks operate at scale and can generate sizeable *gross* revenues. Prima facie, this could result in many large banks falling within the scope of a revenue threshold. However, looking at singular metrics such as revenue can be very misleading because of the extremely high capital costs associated with running regulated banks compared with other industries (such as technology and consumer goods companies).

In our view, it would be discriminatory to apply a broad based profit margin approach across all industries (inclusive of banks) without reference to the underlying nature of the business of each industry and the inputs into determining comparable profit margin metrics. Where there is any re-think in relation to Pillar 1, however, we request an opportunity to provide input. Below we have restated some information on why profitability metrics such as profit margin are not feasible from a banking perspective.

[3] https://home.treasury.gov/system/files/136/MadeInAmericaTaxPlan_Report.pdf

4. Measuring profitability of banks

As we have highlighted to you previously, banks do not earn abnormal profits in comparison to other industries. It is important to recognise that profit comparisons and measures applied between different industries are not always informative. Due to the highly leveraged nature of banking and the core business activity of deriving a net interest margin, certain measures used to determine operating profit margin produce very different results for financial services than, for example, for consumer goods and manufacturing industries.

Operating profit margin (operating income/revenue) is not an appropriate basis for comparing banks with other industries because:

i. Interest expense, which is effectively cost of goods sold for banks, is not included in the definition of operating income; and
ii. Banks report trading revenue net of trading costs and interest revenue net of interest expense as meaningful profitability measures for their stakeholders.

These fundamental differences would artificially distort bank operating margins by increasing the numerator and decreasing the denominator in the calculation. In addition, measures of profitability based only on income statement ratios do not reflect the significant and disparate costs a bank incurs holding capital.

Banking requires significant amounts of regulatory capital to be held compared to other industries. The economies of scale differ greatly between industries, and it is difficult for banks to achieve 'scale without mass'. For example, for each additional loan asset, a bank is required to hold additional capital and liquid assets relative to the risk of the asset. As a result, comparative measures can be less informative between industries than across the same industry.

5. Alternative comparative measures

Alternatively, Return on assets (ROA)[4] or Return on equity (ROE)[5] measures are more useful indicators of profitability compared to operating profit margin.

When comparing ROA and ROE across industries, these metrics for banks (on both the retail and institutional side) are generally less than other industries. In addition to ROA and ROE, other measures of comparison such as book value to market value may be informative.

Globally, ROA highlights the difference between banks and big technology companies. Big technology companies have ROAs that are a multiple of banking ROAs. For example, many banks have an ROA of less than 1% and many large technology companies have an ROA closer to 20%.

Globally, the ROE for banks is approximately 9% (McKinsey, 2017). We note that globally, banking ROE is trending down as prudential/regulatory capital requirements increase, and banks are required to hold more capital and more liquid assets, reducing their relative profitability.

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[4] net income/total assets
[5] net income/shareholders' equity

Comparatively, large technology companies have significantly higher observed ROE (in excess of 20 – 30%).

For further information on this point, we refer you to Appendix D of our letter dated 11 November 2019 which details a matrix with profitability of banks by jurisdiction.

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Should you have any questions or require additional input please contact us.

Yours sincerely,

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