International Banking Federation

5th Floor, One Angel Court
30 Throgmorton Street
London EC2R 7HJ
tel: + 44 (0)7725 350 259
web: www.ibfed.org

Intra-group Funding by Global Banks – Tax Policy Paper – 30 January 2018

1. Summary

- Global Banks conduct significant intra-group lending. This typically occurs between:
    - branches of the same legal entity (e.g. from head office to offshore branch); and
    - separate legal entities (e.g. from the Bank in one jurisdiction to a subsidiary in another).
- Global Banks must adhere to arm's length principles when conducting such intra-group lending. Inherently, there needs to be flexibility to determine the arm's length price. The Revenue Authorities should accept a number of different alternative approaches, including using external issuances or pricing from an internal mechanism (such as a yield curve).

2. Background

Global Banks

Because of the nature of their business, banks need a substantial amount of funding to operate. Global Banks borrow money from a number of sources (including global debt markets and retail deposits) and lend money at a margin to earn a profit.

Global Banks operate in a number of jurisdictions, typically through a branch network or subsidiaries. The form is often dependent on the local regulations, laws and commercial factors. Regulators exercise stringent oversight over the amount and nature of the debt that a financial services business can incur, where that debt may be located, and the debt's permitted terms.

Global Banks generally fund their operations through the use of a pool of funds. Funding derived from a number of sources is pooled, and used by the Bank for its daily operations. There is normally no ability to trace the funding to a particular source. Global Banks use the cash from the pool before external funding is sourced.

Banks will generally prefer to fund their offshore business internally, because it provides greater flexibility and ensures profit remains within the Group (rather than paying unnecessary margins externally).

Tax Transfer Pricing

Banks are required to adopt an arm's length pricing in respect to such intra-group funding. This will ensure that they do not breach tax transfer pricing laws.

3. Pricing Intra-group Loans for Banks

Tax Transfer Pricing requires that the price of intra-group funding should be on similar terms to those that would have been entered into by independent parties.

There is not one prescriptive method, but rather there needs to be inherent flexibility. This is confirmed by OECD commentary that states:

"In practice, banks will use a variety of methods to set the prices of internal —interest dealings. One method might be to price the internal —interest dealing using a comparable market inter-bank rate to reward the function of borrowing and lending money, and separately reward any additional treasury functions by a service fee or by adding a margin to this rate. … It should be stressed that the method used is irrelevant as

long as an arm's length reward is given to the treasury function, and internal —interest dealings are priced within an arm's length range …."[1]

Other relevant excerpts supporting this position from an OECD / jurisdictional perspective is contained at Appendix 1.

In determining the interest rate paid for intra-group funding, it is important to take into account:

- the terms and conditions of the loans (e.g. loan tenor, seniority, fixed/floating, collateral position, derivatives/guarantees etc.);
- the credit or default risk of the borrower (rating of borrower); and
- the interest rates offered by other lenders in comparable circumstances.

There is sometimes a lack of available comparable information, in which case interpretation/interpolation is required.

Generally loans that are less than 3 months are priced off a benchmark rate (e.g. LIBOR, BBSW, BKBM etc.). Loans greater than 3 month are priced off a benchmark rate with a Term Premium (TP) or a Liquidity Premium.

4. Alternatives for arm's length pricing

To determine arm's length pricing for intra-group lending greater than 3 months, there are a number of viable alternatives. Two that are available to Global Banks are discussed below.

i. Use of external issuances

Banks can adopt the same pricing for an internal loan by reference to comparable external debt issuances or bilateral loans. To use this alternative, it is important that key factors are comparable - including term, ranking, credit risk and tenure.

Limitations of only using external issuances are:

- Contemporaneity - the external issuances/loans used as a comparison must be at the same time as the intra-group loan, otherwise market conditions could change creating pricing discrepancies;
- Lack of directly comparable data (issuances/loans) – particularly if funding is longer term (e.g. 10 year loan).

The use of external issuances may often require adjustments to be made to ensure true comparable with arm's length pricing.

ii. Use of internal mechanism – such as pricing off a curve

Global Banks build yield/TP curves (or also referred to as FTP or Funds Transfer Pricing curves), which are used to price internal and external loans.

The market derived TP curves effectively aim to measure the margin above a chosen benchmark (e.g. 3 month LIBOR) at which to price a loan. The curves are derived from undertaking a standard analytical process in a selected currency such as USD and are updated frequently to reflect market conditions. Estimates are obtained from external dealers of the margins across a portfolio of wholesale funding tenors in a range of markets at a particular point in time. These dealer quotes are from external independent parties.

Typically, the information from the dealers is then aggregated, and the averages are plotted on a curve. Banks use these curves to inform pricing of not only external trades but internal lending also.

The use of curves based on dealer quotes is standard market practice and has been the subject of extensive review and approval by the banking regulators.

These TP curves provide a proxy for the pricing loans of varied terms, and a more complete data set based on a range of market observations. They reflect current market conditions, and are generated from information provided by external independent third parties.

[1] Paragraph 169 [page99] of 2010 OECD Report on the Attribution of Profits to Permanent Establishments.

Appendix 1 - Observations from an OECD / jurisdictional perspective

OECD

For the OECD commentary, at paragraph 169 [page99] of 2010 OECD Report on the Attribution of Profits to Permanent Establishments, it specifically states that:

"169. In practice, banks will use a variety of methods to set the prices of internal —interest dealings. One method might be to price the internal —interest dealing using a comparable market inter-bank rate to reward the function of borrowing and lending money, and separately reward any additional treasury functions by a service fee or by adding a margin to this rate. *This internal —interest rate is likely to be computed on a fully debt-funded basis. As noted in Section D-1(iv) above, an adjustment will have to be made to reflect the —free capital attributed to the PE and, as noted in Section D-1(iii)(b), an adjustment may also have to be made to reflect any higher interest rate items, such as subordinated debt, that are not appropriately reflected in the interest rate comparable. It is also possible that some internal —interest dealings will be directly traced and priced accordingly, for example, in respect of agency or conduit transactions (see Section D-2(iii)).* ***It should be stressed that the method used is irrelevant as long as an arm's length reward is given to the treasury function, and internal —interest dealings are priced within an arm's length range that appropriately reflects the hypothesised capital structure of the PE,*** *including any —free‖ capital."*

Para 1.13 of the OECD Transfer Pricing Guidelines 2017

"1.13 Both tax administrations and taxpayers often have difficulty in obtaining adequate information to apply the arm's length principle. ***Because the arm's length principle usually requires taxpayers and tax administrations to evaluate uncontrolled transactions and the business activities of independent enterprises, and to compare these with the transactions and activities of associated enterprises, it can demand a substantial amount of data. The information that is accessible may be incomplete and difficult to interpret;*** *other information, if it exists, may be difficult to obtain for reasons of its geographical location or that of the parties from whom it may have to be acquired. In addition, it may not be possible to obtain information from independent enterprises because of confidentiality concerns. In other cases information about an independent enterprise which could be relevant may simply not exist, or there may be no comparable independent enterprises, e.g. if that industry has reached a high level of vertical integration. It is important not to lose sight of the objective to find a reasonable estimate of an arm's length outcome based on reliable information. It should also be recalled at this point that transfer pricing is not an exact science but does require the exercise of judgment on the part of both the tax administration and taxpayer."*

Australia

The Australian Taxation Office (ATO) has issued a draft practical compliance guideline to taxpayers to assist taxpayers to risk assess their intra-group lending in the context of the recent *Chevron* case. This guidance largely focuses on multinational corporates and not Banks. It is understood that the ATO and APRA (the prudential capital regulator), have previously accepted the approach of Banks using market-derived curves to price their funding on an external and internal basis.

Refer to para 47 of ATO Taxation Ruling TR 2010/7:

"47. In the absence of such direct comparables data, publicly available data as to market interest rates applicable to rated borrowers can be used in producing a reliable measure of the arm's length consideration, provided the rate used takes account of all relevant facts and circumstances, including whether the borrower has the ability to raise that amount of debt funding from an unrelated third party. TR 92/11 contemplates the use of an appropriate market reference rate (for example, London Inter Bank Offered Rate (LIBOR), Singapore Inter Bank Offered Rate (SIBOR), or the Bank Bill Swap Rate (BBSW))[40] plus an appropriate margin (if any) reflecting the borrower's credit standing as a means of estimating an arm's length interest rate for an associated enterprise loan."

https://www.ato.gov.au/law/view/document?DocID=TXR/TR20107/NAT/ATO/00001

New Zealand

The Internal Revenue in NZ has expressed concern in relation to the use of dealer quotes to derive arm's length pricing. This approach is not consistent with other tax authorities e.g. Australia.

http://www.ird.govt.nz/transfer-pricing/practice/transfer-pricing-practice-financing-costs.html

United Kingdom

In accepting the use of market available information the UK Tax Authority (HMRC) and banking regulators acknowledge that Banks may adopt different approaches to deriving a benchmark funding curve reflective of differences in business models. There are clearance procedures to enable tax payers to obtain certainty with respect to their particular circumstances.

United States

The US arm's length standard provides limited guidance however acknowledges that the use of indirect comparable evidence in deriving the price can arise.

France

Under French transfer pricing regulation, no specific guidance is given on the determination of interest rate for banks.