HM Treasury

A bank levy banding approach:

consultation

March 2014

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Contents

1 Introduction

1.1 This consultation considers the case for a revenue neutral reform of the bank levy, with the aim of increasing the predictability and sustainability of receipts and addressing some potential issues with its existing design.

1.2 The bank levy, a permanent tax on banks' balance sheet equity and liabilities, was introduced by the Government from 1 January 2011 with two core policy objectives:

- to ensure that the banking sector makes a fair contribution, reflective of its risks to the financial system and wider UK economy; and
- to provide an incentive for banks to move away from riskier funding profiles, with the aim of increasing their resilience to liquidity shocks.

1.3 The Government believes that these overarching policy objectives remain appropriate and does not intend to change either the target level of revenue raised through the bank levy or the design of the underlying tax base, which was consulted on as part of a 2013 operational review. The design changes announced at Autumn Statement 2013 in response to this review will be legislated in Finance Bill 2014.

1.4 Instead, this consultation considers a revenue neutral change to the mechanism by which banks are charged under the levy, which would move away from the existing system of headline rates and towards a banding approach. Under this approach, banks would be allocated into different bands according to their chargeable balance sheet equity and liabilities, with each band then corresponding to a pre-set charge paid by all banks within that band.

1.5 The consultation seeks views on the overall concept of banding, including the extent to which it would improve the predictability and sustainability of bank levy receipts and address some of the concerns that have been raised around its existing design. It then considers how a banding model would need to be designed in order to achieve these objectives, presenting illustrative options for how the bands and charges could initially be structured, how the bands and charges could be adjusted moving forward, and how the model's inevitable cliff-edge effects could be addressed.

1.6 Additionally, the consultation sets out the key considerations in using the bank levy to meet the UK's obligations under the EU Bank Recovery and Resolution and Deposit Guarantee Scheme directives and asks whether there could be changes to the bank levy's design that would better enable its costs to be accrued for quarterly reporting purposes.

Timing and engagement

1.7 The consultation will run for a 6 week period, closing on 8 May 2014. If the Government decides to make changes to the bank levy's design in response to this consultation, the intention is to introduce legislation at the Report Stage of Finance Bill 2014, which is expected to take place in early July. The changes would then take effect for chargeable periods beginning on or after 1 January 2015.

1.8 The intention is to hold a number of working groups over the consultation period. Space on these groups will be limited and those that would like to be considered for inclusion should respond using the contact details below. HMT/HMRC officials will also be looking to hold bilateral meetings with banks and organisations to understand the individual impacts of the proposals.

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2 The Banding Approach

Policy context

2.1 The forecast for bank levy receipts was unchanged at Budget 2014, allowing the headline rate to be kept stable for the first fiscal event since the levy's introduction. This reflects more information on the size of the underlying tax base and a better understanding of the factors driving banks' balance sheets, a result of valuable engagement with the sector during last year's operational review.

2.2 Despite this, there remain a number of concerns with the bank levy's existing design that have been raised in recent discussions:

- banks' balance sheets, and thus bank levy receipts, remain highly sensitive to changes in the economic and regulatory environment, particularly those affecting banks' capital and liquidity requirements;
- the frequency of bank levy rate increases in order to meet the Government's revenue target may be creating uncertainty and damaging the perception of UK competitiveness; and
- the marginal cost of the bank levy, which has increased from 0.075 percent to 0.156 percent, may be creating distortions and having undesirable impacts on behaviour. This may include the relocation of certain low-margin activities overseas or to the non-banking sector.

2.3 This consultation therefore considers a possible change to the bank levy's design that may help to address these concerns and make the tax more predictable and sustainable moving forward.

Consultation parameters

2.4 Following the changes announced to the headline rate and tax base at Autumn Statement 2013, the bank levy is forecast to raise £2.9bn a year from 2015-16. The Government recognises that there has been deleveraging and de-risking of banks' balance sheets since the levy's introduction, but considers that £2.9bn is an appropriate revenue target that balances fairness with considerations around UK banking sector competitiveness and lending to the real economy. This also takes account of the benefit that the banking sector has received from reductions to the corporation tax rate since the levy's introduction.

2.5 The underlying basis of the bank levy will remain a bank's chargeable balance sheet equity and liabilities, which is a measure of its systemic importance and the riskiness of its funding profile. This includes the changes announced to the bank levy tax base at Autumn Statement 2013, which are designed to make it simpler, fairer and more aligned with recent regulatory developments.

2.6 The Government acknowledges the ongoing discussions around the framework for resolving global banking groups (i.e. single versus multiple point of entry), but believes that the consolidated balance sheet remains the best representation of a UK domiciled bank's direct and indirect risk to the UK economy. This will not be considered as part of the consultation.

New model

2.7 This consultation instead considers a change to the bank levy charging mechanism, which would move away from a system of headline rates towards a banding approach. Under this model, banks would be allocated into different bands (e.g. Band A, Band B...) based on their balance sheet equity and liabilities. Each band would correspond to a unique and pre-determined charge for the year, paid by every bank falling within it. Higher charges would be attached to bands that encompass the largest and riskiest banks.

2.8 The Government considers that this could provide a more certain and stable model for the bank levy. By reducing the marginal cost of the bank levy to zero at an individual transaction level, the Government also believes that it could weaken some of the undesirable incentives that the bank levy may currently be giving rise to.

2.9 It is accepted that this model would weaken the marginal incentives for banks to stabilise their funding profiles, although the ability of banks to move between bands each year would ensure the overarching policy objective was maintained. While the model would result in banks facing different effective rates of tax, the grouping of banks with similar chargeable equity and liabilities may be considered more reflective of the imprecision in measuring and differentiating risk through banks' balance sheets.

Question 1: Will a banding approach offer a more stable and sustainable basis than the existing bank levy model?

Question 2: Does a banding approach have any drawbacks compared to the current system of rates?

Detailed design – tax base

2.10 The allocation of banks into bands would be based on the existing tax base of chargeable equity and liabilities. However, a number of adjustments would be necessary to maintain the effect of its existing reliefs and provisions.

- **Halving adjustment:** A half bank levy rate currently applies to liabilities with a maturity of greater than one year and non-insured retail deposits, to recognise the relative stability of these forms of funding. To maintain the distinction between short and long-term funding under a banding approach, and the incentives that it creates, it is proposed that a bank's long-term chargeable equity and liabilities would be halved for the purposes of allocating banks into bands. The tax base would therefore become, 'short-term liabilities + 0.5 long-term liabilities (including non-insured retail deposits)'
- **High Quality Liquid Assets:** The bank levy currently allows relief in respect of any assets that qualify for the Prudential Regulation Authority's liquid asset buffer. This acts as an alternative to relieving the funding of these assets, which is fungible and thus difficult to trace. Autumn Statement 2013 announced that, from 2015, banks will receive relief for these assets at the half bank levy rate. To maintain this outcome under a banding approach, it is proposed that these assets would be deducted from a bank's long-term chargeable equity and liabilities before the halving adjustment above.
- **Nil-charge band:** In determining chargeable equity and liabilities under the existing model, banks are entitled to a £20bn allowance, which is applied proportionately across short and long-term liabilities. Instead of an allowance, it is proposed that a banding model would include a bottom band that attracts a nil-charge. This band would be based on banks' adjusted chargeable equity and liabilities (after the halving of long-term liabilities) and would need to be set at a level below £20bn to have the same effect as the existing allowance. Assuming on average that 75 percent of a bank's liabilities were

short-term, the existing £20bn allowance would translate into a £17.5bn nil-charge band.

2.11 The Government welcomes views on this approach and whether any other adjustments are necessary to maintain the effect of the existing tax base. The Government believes that a nil-charge band would provide the simplest mechanism for carving out the smallest and lowest risk banks from the paying population, but also recognises that this has the potential to create winners and losers at the margin.

2.12 For example, it may disadvantage banks that have a greater proportion of short-term liabilities than assumed in the translation of the £20bn allowance into the nil-charge band. An alternative approach would be to maintain a carve out for banks with less than £20bn of chargeable equity and liabilities, prior to the application of the halving adjustment.

Question 3: Are any other adjustments needed to maintain the effect of the existing tax base upon a move to banding?

Question 4: Does a nil-charge band represent the best mechanism for carving out smaller, less risky banks from the bank levy paying population? What is an appropriate level for this band, to reflect the adjustments to the tax base?

Detailed design – band structure

2.13 Given the intention would be to retain the existing tax base under the new model, subject to the adjustments above, the key policy choices are instead around the banding structure. This includes the number of bands, the range of liabilities to which these bands relate and the charge associated with each band.

2.14 There are a number of choices here, leading to a wide range of possible options for how the banding model could be structured. The conditions that a model would have to satisfy to be considered are:

- the ability to raise £2.9bn a year;
- a progressive structure, in which band charges increase in line with chargeable equity and liabilities;
- a clear rationale, which minimises legal risks and is not reliant on the positioning of particular banks; and
- a structure which ensures that the bank levy applies fairly across the population.

2.15 Models would then need to be assessed on their effectiveness at meeting the Government's wider objectives for yield predictability and sustainability, and their ability to overcome the identified risks with a banding approach cited below.

Illustrative models A-C

2.16 It may be possible to design a model which broadly maintains a consistent range of effective tax rates between bands (i.e. the effective tax rate at the top of one band should broadly equate to the effective tax rate at the top of all other bands). This would be achieved by increasing band widths and charges proportionately, from a chosen starting point. The charge for each band would represent the charge that would be due at the midpoint of the band under the existing bank levy rate of 0.156 percent, although this would need to be adjusted (potentially in either direction) to ensure that the £2.9bn revenue target is met.

2.17 The two key variables under these models are: (a) the width and thresholds of the first chargeable band; and (b) the multiplier used to determine the subsequent band widths and thresholds. Some illustrative models are set out below, using different values for these variables.

These models are based on **adjusted equity and liabilities in excess of the £17.5bn nil-charge band**, which is not shown.

Illustrative Model A (10 bands): First chargeable band of £1bn (in excess of £17.5bn nil-charge band) and multiplier of x2.

Band	Lower limit (£bn)	Upper limit (£bn)	Charge (£m)	Effective tax rates (%)
A	0	1	0.8	0.078+
B	1	2	2.3	0.117 - 0.234
C	2	4	4.7	0.117 - 0.234
D	4	8	9.4	0.117 - 0.234
E	8	16	18.7	0.117 - 0.234
F	16	32	37.4	0.117 - 0.234
G	32	64	74.9	0.117 - 0.234
H	64	128	149.8	0.117 - 0.234
I	128	256	299.5	0.117 - 0.234
J	256		599.0	Up to 0.234

Illustrative Model B (16 bands): First chargeable band of £1bn (in excess of £17.5bn nil-charge band) and multiplier of x1.5.

Band	Lower limit (£bn)	Upper limit (£bn)	Charge (£m)	Effective tax rate (%)
A	0	1.0	0.8	0.080+
B	1.0	1.5	2.0	0.130 - 0.195
C	1.5	2.3	3.0	0.129 - 0.198
D	2.3	3.4	4.4	0.131 - 0.193
E	3.4	5.1	6.6	0.130 - 0.195
F	5.1	7.6	9.9	0.130 - 0.194
G	7.6	11.4	14.8	0.130 - 0.195
H	11.4	17.1	22.2	0.130 - 0.195
I	17.1	25.6	33.3	0.130 - 0.195
J	25.6	38.4	49.9	0.130 - 0.195
K	38.4	57.7	75.0	0.130 - 0.195
L	57.7	86.5	112.5	0.130 - 0.195
M	86.5	129.7	168.6	0.130 - 0.195
N	129.7	194.6	253.0	0.130 - 0.195
O	194.6	291.9	379.5	0.130 - 0.195
P	291.9		569.2	Up to 0.195

Illustrative Model C (13 bands): First chargeable band of £4bn (in excess of £17.5bn nil-charge band) and multiplier of x1.5.

Band	Lower limit (£bn)	Upper limit (£bn)	Charge (£m)	Effective tax rate (%)
A	0	4.0	3.1	0.078+
B	4.0	6.0	7.8	0.130 - 0.195
C	6.0	9.0	11.7	0.130 - 0.195
D	9.0	13.5	17.6	0.130 - 0.196
E	13.5	20.3	26.4	0.130 - 0.195
F	20.3	30.4	39.5	0.130 - 0.195
G	30.4	45.6	59.3	0.130 - 0.195
H	45.6	68.3	88.8	0.130 - 0.195
I	68.3	102.5	133.2	0.130 - 0.195
J	102.5	153.8	199.9	0.130 - 0.195
K	153.8	230.7	299.9	0.130 - 0.195
L	230.7	346.0	449.8	0.130 - 0.195
M	346.0		674.7	Up to 0.195

Illustrative models D-E

2.18 It may be considered that the distribution of the bank levy population does not lend itself to the structures outlined above. There may instead be an argument for a clearer distinction between the smallest and largest payers, who may differ in terms of their numbers, relative balance sheet volatility, and sensitivity to the model's cliff-edge effects. This may be particularly true for banks in the lowest bands for whom large step changes in charge may lead to earnings volatility and disincentives for growth. One option to address this would be to narrow bands at the lower end of the model (reverting towards a more continuous structure) and widen bands at the upper end of the model.

2.19 Two illustrative models for achieving this are set out below. In these models, the range of effective tax rates would differ between bands. Banks in the upper bands would have the potential to face higher or lower effective tax rates than banks situated in the same relative position of bands at the bottom end of the model. The inflection point in the second model is only designed to be illustrative, but would need to be set at a level that appropriately differentiates the largest banks.

Illustrative Model D (14 bands): First chargeable band of £1bn (in excess of £17.5bn nil-charge band) and multiplier of x1.075^ (Z), where Z equals band number minus one.

Band	Lower limit (£bn)	Upper limit (£bn)	Charge (£m)	Effective tax rate (%)
A	0	1.0	0.8	0.080+
B	1.0	1.1	1.6	0.149 – 0.164
C	1.1	1.2	1.8	0.150 – 0.163
D	1.2	1.5	2.1	0.140 – 0.176
E	1.5	2.1	2.8	0.134 – 0.187
F	2.1	3.0	4.0	0.133 – 0.189
G	3.0	4.6	5.9	0.129 – 0.198
H	4.6	7.6	9.5	0.125 – 0.207
I	7.6	13.5	16.5	0.122 – 0.217
J	13.5	25.9	30.7	0.119 – 0.228
K	25.9	53.4	61.9	0.116 – 0.239
L	53.4	118.3	133.9	0.113 – 0.251
M	118.3	281.7	312.0	0.111 – 0.264
N	281.7		782.4	Up to 0.278

Illustrative Model E (24 bands): First chargeable band of £1bn (in excess of £17.5bn nil-charge band), with a multiplier of 1.25 up to Band U and a multiplier of 1.75 thereafter.

Band	Lower limit (£bn)	Upper limit (£bn)	Charge (£m)	Effective tax rate (%)
A	0.0	1.0	0.8	0.080+
B	1.0	1.3	1.8	0.138 - 0.180
C	1.3	1.6	2.3	0.144 - 0.177
D	1.6	2.0	2.8	0.140 - 0.175
E	2.0	2.4	3.4	0.142 - 0.170
F	2.4	3.1	4.3	0.139 - 0.179
G	3.1	3.8	5.4	0.142 - 0.174
H	3.8	4.8	6.7	0.140 - 0.176
I	4.8	6.0	8.4	0.140 - 0.175
J	6.0	7.5	10.5	0.140 - 0.175
K	7.5	9.3	13.1	0.141 - 0.175
L	9.3	11.6	16.3	0.141 - 0.175
M	11.6	14.6	20.4	0.140 - 0.176
N	14.6	18.2	25.6	0.141 - 0.175

O	18.2	22.7	31.9	0.141 - 0.175
P	22.7	28.4	39.9	0.140 - 0.176
Q	28.4	35.5	49.8	0.140 - 0.175
R	35.5	44.4	62.3	0.140 - 0.175
S	44.4	55.5	77.9	0.140 - 0.175
T	55.5	69.4	97.4	0.140 - 0.175
U	69.4	86.7	121.8	0.140 - 0.176
V	86.7	151.8	186.0	0.123 - 0.215
W	151.8	265.6	325.6	0.123 - 0.214
X	265.6		569.8	Up to 0.215

2.20 The Government welcomes respondents' assessments of the above models and the appropriate choice of parameters. In particular, the Government is interested in understanding the extent to which the model's strengths and weaknesses are seen to depend on the number and width of bands adopted. These choices are likely to impact on the model's stability, predictability, behavioural incentives and cliff-edge effects.

2.21 As set out in the models above, the Government's intention would be for the top band to be unbounded at the model's introduction.

Question 5: What are the strengths and weaknesses of illustrative models A to E, and the choice of parameters?

Question 6: Are there alternative banding structures that should be considered, subject to the conditions in paragraph 2.14? What is the reason for this?

3 Model Dynamics

3.1 If a banding model was introduced, consideration would need to be given as to how the model would evolve through time. While the movement of banks between bands is inevitable, and key in ensuring the bank levy's behavioural incentives are maintained, it does have the potential to undermine some of the model's cited benefits.

Cliff-edge effects

3.2 A banding model creates the possibility of a small balance sheet adjustment leading to large step changes in a bank's charge and effective tax rate. The behavioural incentives for banks near the threshold of two bands (i.e. those near to a cliff-edge) may therefore be much stronger than intended by the bank levy, potentially distorting commercial decisions and creating undesirable outcomes. This is an issue across all bands within the model, although it is expected to be more prevalent in the lower bands which are narrower and more heavily populated.

3.3 This may not be easy to address through the choice of banding structure, with a trade-off then occurring between the severity of the model's cliff-edge effects and the frequency with which they occur. For example, a model with very gradual increases in band thresholds will contain cliff-edges that are less severe but more frequent, a trend that continues until the model reverts to a continuous structure.

3.4 Instead, there may be a case for introducing provisions that smooth these cliff-edge effects, by introducing higher requirements for banks to move between bands. These provisions could work by:

- requiring a bank to sustain its band movement for two periods before this translates into an increase or decrease in charge; or
- phasing in any increase or decrease in charge as a result of band movement over multiple periods (e.g. 25 percent of difference in year 1, 50 percent in year 2, and full transition in year 3).

3.5 These provisions may help to avoid the fluctuation of banks between bands and weaken the potentially undesirable incentives for banks on a band threshold. However, while they may be appropriate for banks whose balance sheet change is organic, they may fail to accommodate large balance sheet adjustments resulting from mergers and de-mergers. It may well seem unreasonable that a bank reducing the size of its balance sheet by 50 percent, and clearly falling into a new band, does not experience the full and immediate benefit of the reduction in charge.

3.6 To address this concern, the provisions could be limited to movements within say the upper and lower quartiles of a band, where it is less obvious that the movement will be sustained. The Government welcomes views on this and any alternative mechanisms for addressing the cliff-edge issue.

Question 7: Do you think that special provisions are needed to address the model's cliff-edge effects? What problems can you envisage with the implementation of these provisions?

Periodic adjustments

3.7 A key objective of moving to the banding approach would be to increase the stability and predictability of bank levy receipts, thereby reducing the need for frequent rate adjustments that can disrupt individual banks' business planning.

3.8 Nevertheless, receipts under a banding model would still be expected to remain sensitive to changes in the underlying tax base, even if provisions were introduced to contain banks' movement between bands. It is therefore important to consider how the model would be adjusted over time to keep receipts in line with Government targets.

3.9 The simplest way to achieve this would be to review the charges applicable to the bands annually. For example, if receipts were forecast to undershoot the target, the Government could announce a proportionate increase in the charge applicable to all bands. It would be more difficult to offset forecast shortfalls and surpluses by proportionately changing the banding structure. There would appear to be a stronger case for reviewing this structure periodically to take account of any large movements in the tax base and any other issues that it may be giving rise to.

3.10 It might be possible to build automatic adjustments into the model's design. For example, the model's bands could be automatically inflated or deflated each year by a forecasted measure of average or aggregate balance sheet growth. The Government would be interested in views on this approach and the extent to which it is undermined by the fact that banks' balance sheets are subject to different pressures (depending on their business models and home regulator) and thus potentially moving in different directions.

Question 8: How can the model best be adjusted to ensure that the Government's revenue target continues to be met?

4 Other Issues

Double tax treaties

4.1 Those subject to the UK bank levy are typically global banking groups with a presence in multiple countries, some of which have their own bank levy. This can give rise to the double taxation of either the foreign branches and subsidiaries of UK banks, or the UK branches and subsidiaries of foreign banks.

4.2 The UK has specific treaties and agreements in place with France, Germany and the Netherlands to address this issue. The Government does not believe that these treaties and agreements would be undermined by the introduction of a new banding model.

Bank levy calculation

4.3 One of the issues raised by banks in recent discussions is the inability to accrue the costs of the bank levy for quarterly reporting purposes. This means that the full annual cost of the levy may enter a bank's accounts in the final quarter, leading to a large spike in its costs and a potentially inaccurate representation of its quarterly operating profit. While this may primarily be an accounting issue, the Government is willing to consider changes to the bank levy's design, within the parameters of the consultation, which could help to alleviate it.

4.4 The Government does not believe it would be possible to move away from the application of the levy to a bank's closing balance sheet (e.g. towards an average of a bank's quarterly balance sheets). There would be risks to the Exchequer and operational costs to HMRC in using balance sheets that are not audited or verified. There would also be significant administrative issues in requiring banks to calculate their chargeable equity and liabilities at more frequent intervals, a particular issue for banks using the branch allocation methodology that may be reliant on downward flows of information from their parent.

Question 9: Are there changes to the bank levy's design, within the parameters of this consultation, which could help to overcome the barriers to accruing its costs in accounts?

The impact of EU directives

4.5 The Deposit Guarantee Schemes Directive (DGSD) was published by the Commission in July 2010, with the aim of further harmonising the protection offered by national deposit guarantee schemes in all Member States. In June 2012, the Commission also published a proposal for the Bank Recovery and Resolution Directive (BRRD), which aims to provide Member States with a minimum harmonised set of common tools and powers to avert and, if necessary, manage the failure of financial institutions. Political agreement was reached on both the DGSD and BRRD in December 2013.[1]

4.6 As part of these directives, Member States will have to build up an ex-ante resolution fund worth 1 percent of covered deposits (around £10bn) and an ex-ante deposit guarantee scheme

[1] http://register.consilium.europa.eu/content/out?lang=EN&typ=ENTRY&i=SMPL&DOC_ID=ST%2017958%202013%20INIT

fund worth between 0.5-0.8 percent of covered deposits (around £5-8bn). These funds need to be built up over 10 years, through annual risk-adjusted contributions from the banking sector.

4.7 While both directives are still to be finalised, the political agreements on each include permission to meet these obligations through a levy on the banking sector, which meets certain criteria already demonstrated by the UK bank levy. The Government therefore intends to use UK bank levy receipts in meeting the ex-ante fund requirements under BRRD and DGSD, thus avoiding the need for additional levies on the sector (which must be imposed in any Member State that does not have a suitable bank levy). Historical bank levy receipts can also, in accordance with Article 91, be counted towards the UK's BRRD target level.

4.8 There is no requirement to change the bank levy revenue target, which exceeds the combined BRRD and DGSD minimum requirement. With the bank levy only taking the form of a financing stream under this arrangement, there is also no apparent requirement to change the bank levy's existing design or independent policy objective, which are sufficiently based on the criteria in Article 94(7) of the BRRD:

- the risk exposure of the institution, including the importance of its trading activities, its off-balance sheet exposures and its degree of leverage;
- the stability and variety of the institution's sources of funding;
- the financial position of the institution;
- the probability that the institution will enter into resolution;
- the extent to which the institution has previously benefited from State support;
- the complexity of the structure of the institution and the resolvability of the institution;
- the importance of the institution to the stability of the financial system or economy or one or more Member States or of the Union; and
- the fact that the institution is part of an IPS.

4.9 The Government is aware that, in taking this approach, there will not be an exact correspondence between those contributing to the bank levy and those with the potential to benefit directly from the ex-ante funds that it is financing. This may be particularly true for banks with chargeable equity and liabilities below the £20bn allowance or branches of foreign banks that make payments under the levy.[2]

4.10 However, it is the Government's view that any proposed changes to the bank levy's design or scope, which would need to be based on the above criteria in Article 94(7) of the BRRD, should be assessed against its existing policy objective of targeting banks' systemic and funding risk. This position remains subject to the final agreement of the BRRD and DGSD, with decisions around implementation yet to be taken.

[2] All banks, including those below the £20bn allowance, would be required to make ex-post contributions in the event of a resolution that exceeds the amounts available in the ex-ante fund. Furthermore, all banks benefit indirectly from a financing arrangement to the extent that it contributes to financial stability.

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