Retail banking market investigation

Corporation tax surcharge and bank levy

26 February 2016

This is one of a continuing series of consultative papers published during the course of the investigation. Parties wishing to comment on this paper should send their comments to retailbanking@cma.gsi.gov.uk at the latest by Friday 11 March 2016.

The Competition and Markets Authority has excluded from this published version of the working paper information which the inquiry group considers should be excluded having regard to the three considerations set out in section 244 of the Enterprise Act 2002 (specified information: considerations relevant to disclosure). The omissions are indicated by [✀]. Some numbers have been replaced by a range. These are shown in square brackets.

Contents

Page

Introduction

1. In the July 2015 summer budget, the government announced changes to the tax regime for banks and building societies, effective from January 2016 onwards. A supplementary corporation tax on bank and building societies,[1] known as the bank corporation tax surcharge (CTS), was introduced. The government also announced changes to the bank levy, including a reduction in the headline rate from 0.21% to 0.10% over the next six years.

2. In Section 2 of the Provisional Findings we noted that a number of building societies and smaller banks have expressed significant concerns with the proposed surcharge and said we would consider further the implications of the bank tax regime changes in light of the submissions we received.[2] Separately, the Treasury Select Committee requested that we report our findings on the competition effect of the CTS in advance of the 2016 budget.[3]

3. We have undertaken an assessment of the potential competition impacts of these tax changes. In our Provisional Findings, we found that a combination of features means that there are barriers to entry and expansion in retail banking because of high customer acquisition costs while longer-established banks benefit from a larger existing customer base.[4] These incumbency advantages make it more difficult for new entrants and smaller providers to expand organically, which in turn weakens the constraints that new entrants and smaller banks impose on incumbent banks.

4. As part of this overall assessment of competition in retail banking we have considered whether the combined tax changes lead to differential impacts across firms, and whether the changes could either deter entry or expansion by firms, or indeed lead to exit. Taxation policy is a matter for government and Parliament. We have therefore not sought to evaluate the policy objectives of the bank tax regime changes themselves, although such objectives provide an important context to our assessment of the potential competition impact of the changes. Similarly, we have not sought to consider any wider effects of the tax regime changes beyond any potential competition impacts.

[1] For the remainder of this paper we will refer to both banks and building societies as banks, unless otherwise specified.
[2] Provisional Findings, Section 2, paragraph 2.9.
[3] Letter from Chair of Treasury Select Committee to Alasdair Smith.
[4] Provisional Findings, Section 12.

5. In undertaking our competition assessment, in addition to considering parties' views (including HM Treasury), we have:

(a) sought to quantify the expected financial impacts of the tax changes on banks (using data from banks' public accounts); and

(b) assessed banks' own analysis of the impact of the changes (from internal board papers, strategy documents etc).

6. In the remainder of this paper, we first provide the policy background and a description of the tax changes. We then summarise the submissions from parties and set out in more detail our framework for assessing the competitive effects. Finally, we summarise the findings of our competitive assessment and set out our conclusions.

Background to the tax changes

Introduction of the bank levy

7. The UK government introduced a bank levy in January 2011, which applied to banks (including building societies) operating in the UK.

8. The introduction and design of the levy was motivated by the following published policy objectives:[5]

(a) To ensure that the banking sector makes a fair contribution, reflective of its risks to the financial system and wider UK economy.

(b) To provide an incentive for banks to move away from riskier funding profiles, with the aim of increasing their resilience to liquidity shocks.[6]

9. The levy takes the form of an annual charge on the value of all of the liabilities of the UK banks (including money deposited with the banks) on a global basis, with the following exemptions:

(a) Ordinary deposits covered by the UK's deposit insurance scheme.

(b) Borrowing backed by UK government debts.

[5] HMT (2014), A Bank Levy Banding Approach: Consultation.
[6] Liquidity shocks are circumstances in which the funding for banks is restricted or withdrawn such that it must use assets that are readily convertible into cash (ie liquid assets) in order to repay its depositors and other creditors. Banks can increase their resilience to such shocks either by adopting a more stable funding profile or by holding a larger buffer of liquid assets.

(c) The first £20 billion of any bank's taxable debts.

(d) Long-term debts which are subject to the levy at half the standard rate.

10. The levy is not a tax on bank profits, but rather on the size of the balance sheet, so has to be paid even when a bank does not make any profit.[7]

11. Approximately 25 banks in the UK are subject to the bank levy, including non-retail banks. Barclays, HSBC Group (HSBCG), Lloyds Banking Group (LBG), Nationwide, RBS Group (RBSG) and Santander are currently subject to the levy. Other providers of PCA and SME banking services are currently exempt because their balance sheet liabilities are less than £20 billion.

12. The levy rate was set at 0.05% at its introduction in 2011 and rose to 0.21% by the budget in March 2015. The bank levy raised £2.2 billion in 2013/14.[8]

13. Table 1 below sets out a simulation of the bank levy liability paid by each bank in 2016 before the changes announced to the tax regime for banks in the summer 2015 budget. The simulation is carried out by applying a bank levy rate of 0.21% (ie the prevailing rate of the bank levy before the summer 2015 budget changes) to banks' forecasts of their relevant balance sheet liabilities in 2016. Banks' levy liability as a proportion of forecast 2016 profit is also shown to provide an indication of the materiality of the levy for each bank.

Table 1: Simulation of bank levy liabilities in 2016, before changes announced in the summer 2015 budget

	£m	*%*
Banks	*Bank levy*	*Bank levy liability as percentage of profit*
Six largest banks		
Barclays	[✂]	[✂]
HSBCG*	[✂]	[✂]
LBG	[✂]	[✂]
RBSG†	[✂]	[✂]
Nationwide	[✂]	[✂]
Santander‡	[✂]	[✂]
Total of six largest banks	[✂]	[15–20]

Source: CMA calculations using data provided by banks.
* [✂]
† [✂]
‡ [✂]

14. When considering the bank levy liability as a proportion of UK profit, there is substantial variation between banks in the ratio of the bank levy to profits. We estimate that the bank levy costs the six largest banks on average [15–20]% of their taxable profits. This variation is driven by the exemptions to the levy,

[7] Throughout this paper, unless otherwise specified, profit refers to profit defined for corporation tax purposes.
[8] HMT, Whole of Government Accounts, p83.

reflecting differences in the composition of banks' balance sheets, and is consistent with the policy objective of the bank levy.

15. The levy has resulted in larger banks incurring higher taxation (as a proportion of profit) as compared to smaller institutions, which is driven by the £20 billion threshold exemption. We note however that the bank levy did not as such have a competition objective to favour smaller banks or new entrants.

Summer 2015 budget

16. In the summer budget in July 2015, it was announced that there would be a stepped reduction in the bank levy rate from 0.21% to 0.10% over the next six years, and that from 2021 the levy would only be charged on UK balance sheet liabilities. As the bank levy is charged at the balance sheet date, the new rates affect periods ending after 31 December 2015.

17. The Chancellor also announced a new 'bank corporation tax surcharge' (CTS) – a supplementary tax on banking sector profit of 8% to be levied on the profits of all banks and building societies arising after 1 January 2016. The new tax surcharge will be collected alongside corporation tax, similar to the collection of the bank levy.

18. The CTS will apply to 'total taxable profits' computed for corporation tax purposes, excluding group relief from non-banking companies. Losses arising prior to 2016 are also excluded, which effectively excludes any legacy losses incurred during the financial crisis and start-up losses of new entrant banks. There is a £25 million annual allowance, so participants with profits below that level will not pay the surcharge. HM Treasury estimated that between 60 and 100 banks are potentially within scope of the CTS and above the annual allowance. There is no carry-forward of unused allowances.

19. The summer 2015 budget statement stated that the aim of these changes was to move towards a more internationally competitive and sustainable model for raising revenue from the banking sector, given the very significant improvements in banking sector regulation and underlying profitability since the bank levy was first introduced.[9] It stated that the changes will result in increasing alignment of banks' tax contributions with profitability and capital accumulation, reducing the risk that the tax regime will constrain lending or influence banks' decisions on the location of internationally mobile activities.[10]

[9] HMT, Summer Budget 2015, paragraphs 1.201–1.202, p46.
[10] HMT, Summer Budget 2015, paragraph 1.203, p47.

20. The summer 2015 budget statement stated that by allowing tax receipts to respond naturally to changes in banks' balance sheets and profitability, greater stability will be introduced in the banking taxation regime, allowing banks to incorporate tax into their business plans with greater certainty.[11]

21. In its submission to the CMA, HM Treasury said that it was important to look at the overall bank tax regime and in its view the changes introduced by the summer 2015 budget will ensure a fair, internationally competitive and sustainable mechanism for taxing UK banks in the long term, which is consistent with the UK government's objective to see greater competition within the UK banking sector.[12]

22. In particular, HM Treasury noted that larger banks will remain subject to the bank levy from which smaller banks are exempt due to the £20 billion threshold. HM Treasury submitted that the six largest banks will have an effective additional rate of 10% or more as a percentage of profits (taking the bank levy and the CTS together) compared to a rate of less than 8% for smaller banks and that the effective additional rate for the smallest banks is 0% because of the £25 million CTS annual allowance. HM Treasury also noted other features of the tax regime that benefit smaller banks such as an exemption to the 50% limit on historical losses for losses incurred during a bank's start-up period (ie prior to April 2015) that banks may carry forward to offset their general corporation tax liability.[13]

HM Treasury assessment

23. HM Treasury submitted the following:

   (a) The £25 million annual tax free-allowance significantly reduces the number of banks and building societies subject to the CTS, with around 90% of building societies removed from scope.

   (b) For banks and building societies with profit above the £25 million allowance, the effective tax rate increases gradually.

   (c) The combined effective tax rate under the bank levy and the CTS is considerably higher for the larger banks. Five of the largest banks are subject to an effective rate (ie bank levy and bank surcharge payments as a proportion of profit) of more than 10% or greater as a percentage of

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[11] HMT, Summer Budget 2015, paragraph 1.204, p47.
[12] HMT submission on the taxation of banks.
[13] See further below at paragraph 77 and HMT submission on the taxation of banks.

profits, compared to a rate of significantly less than 8% for many of the smaller banks and building societies).[14]

24. Separately, HM Treasury also provided us with information from banking groups' 2014 annual reports in order to analyse the impact of the changes on individual banking groups.

25. This data can be used to estimate individual banks' tax liabilities before and after the changes to the bank levy rates and introduction of the CTS. Such an approach has the benefit of holding all other factors (such as balance sheet size and profitability) constant in the assessment. This allows any changes in banks' tax liabilities to be directly attributable to the changes to the tax regime. A drawback to this approach, however, is that it will not necessarily capture the potential impact of the changes on banks, such as new entrants, that are likely to expand and increase their profitability over the short to medium term.

26. Being based on 2014 data, such an approach is also likely to overstate the impact of the changes to the tax liability of the six largest banks because it does not take account of the change in the base of the bank levy from global to UK balance sheet liabilities in 2021. This change will benefit banks with significant international exposure. Furthermore, the offsetting impact arising from the phased reduction of the bank levy from 0.21% to 0.10% is not captured in this analysis which is based on the 2016 levy rate.

27. A number of assumptions were also required to remove the profit of any non-regulated entities (which are not subject to the CTS) where it was reported together with banking entity profit within banks' group accounts. Nevertheless, we consider that the data provides a useful cross-check of our own assessment.

28. Our interpretation of this data is that it broadly shows that the six largest banks (ie those that incur the bank levy) experience an increase in their effective tax rate of between 4 and 6 percentage points. Of the other banks analysed, those with profit below the £25 million tax-free threshold do not experience any increase and those with profit above the threshold experience an increase of up to 7 percentage points.

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[14] HMT submission on the taxation of banks.

Parties' views

Bank of Ireland

29. Bank of Ireland told us that, by introducing additional taxes on small banks that were previously outside the scope of the existing bank levy, the changes did not seem consistent with an objective of greater competition. It also said that the changes would slow the repair of capital and returns on equity across the sector and impact on the attractiveness of the UK to the banking sector. It argued that this latter effect could be particularly marked for smaller players and new entrants.

HSBCG

30. [✂]

31. HSBCG considered that the changes would benefit new entrants and small and medium sized banks because of the deduction of the first £20 billion of balance sheet liabilities before application of the levy and the £25 million annual tax surcharge allowance. It argued that the annual allowance would lead to the surcharge having a greater effect on larger banks. Overall, HSBCG considers that it will continue to be placed at a financial disadvantage compared with its UK-focused competitors until 2021.

LBG

32. LBG submitted that the relevant question in a competition assessment of the CTS was not whether it will increase costs for smaller providers or impact on all providers' lending decisions, but rather whether it would lead to a restriction or distortion of competition between banks by having a disproportionate impact on smaller, less well established providers and/or new entrants versus larger, established providers.

33. LBG noted that corporation tax applies almost universally to businesses of varying size across the economy. It argued that since this is not considered to be distortionary there is no reason why an increase in this tax should give rise to competition concerns in the banking sector.

34. LBG highlighted that even following the changes, larger banks, including LBG, would remain subject to the bank levy, whereas banks with liabilities below £20 billion would not. Furthermore, until 2021 the bank levy would continue to be applied to the worldwide balance sheet of UK headquartered banks but only to the UK balance sheet of foreign headquartered banks. Larger banks would also be affected by the tax surcharge.

35. In contrast, while the surcharge would apply to smaller banks for the first time, the effect on new entrants would be mitigated by the surcharge only applying to profits above £25 million.

36. LBG also cited evidence that recent smaller entrants to retail and SME banking are typically earning higher equity returns than more established banks.[15] It attributed this to cost advantages derived from modern IT systems and distribution networks and the absence of legacy costs. LBG argued that this suggests there is no evidence for the hypothesis that an increase in taxation will impact the ability of smaller banks to expand, relative to larger banks.

Nationwide

37. Nationwide submitted that the CTS would have a disproportionate effect on building societies because of the business model they operate, in which profits are either retained to maintain the strength of their balance sheets or re-invested into the development of new products and services.

38. Nationwide also provided an estimate of the financial impact of the CTS which amounted to an increase in its tax liability of approximately £300 million over the next five years.[16]

Secure Trust Bank

39. In its response to the Notice of Possible Remedies, Secure Trust Bank submitted that the size of the CTS tax-free annual allowance should be increased to prevent CTS revenue from smaller institutions being used to offset a reduction in bank levy from the systemically important, larger banks.[17] Similarly, in the post-Provisional Findings roundtable hearing with Secure Trust Bank, Starling Bank, Tesco Bank, Virgin Money and Yorkshire Building Society,[18] Secure Trust Bank stated that smaller institutions that are not subject to the bank levy are effectively subsidising the reduction in the rate of bank levy for the so-called ‘too-big-to-fail’ banks.

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[15] LBG response to Provisional Findings and Remedies Notice, paragraph 5.4.
[16] Nationwide response to Provisional Findings, Appendix 1, paragraph 5.4.
[17] Secure Trust Bank response to Provisional Findings and Notice of Possible remedies, p6.
[18] Transcript of roundtable hearing with Secure Trust Bank, Starling Bank, Tesco Bank, Virgin Money and Yorkshire Building Society, p81, line 23 to p82, line 1.

Starling

40. Starling said [✄].[19]

Tesco Bank

41. Tesco Bank said that the changes to the bank tax regime were unhelpful in the context of expansion insofar as the CTS limited the extent to which it could re-invest profit.[20] It argued that the tax would reduce the ability of new entrants to accumulate capital reserves to support business and market growth, and indirectly impact on profitability and investor appetites.

42. Tesco Bank also told us that the structure of the tax disadvantages banks that have extended into areas outside traditional banking, eg insurance broking or money services. These banks would be less able to compete with non-banking companies such as general insurers in the provision of insurance and related services.

Yorkshire Building Society

43. Yorkshire Building Society said that the CTS would impact mutuals in particular as they tend to use a business model that relies on offering higher savings rates. As such, it argued that a higher rate of taxation would reduce their ability to finance such rates.[21]

Multiparty submission from a group of challenger banks

44. In a multiparty submission in response to the Provisional Findings, a group of challenger banks[22] said that the CTS would compound the impact of existing barriers to expansion such as regulatory capital requirements and the existence of cost of funding advantages, making it even more difficult for smaller banks to expand relative to larger banks.[23]

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[19] [✄]
[20] Transcript of roundtable hearing with Secure Trust Bank, Starling Bank, Tesco Bank, Virgin Money and Yorkshire Building Society, p81, lines 19–22.
[21] Transcript of roundtable hearing with Secure Trust Bank, Starling Bank, Tesco Bank, Virgin Money and Yorkshire Building Society, p82, lines 18–22.
[22] Aldermore, Charter Savings Bank, Close Brothers, Hampden & Co. Bankers, Metro, Secure Trust Bank, One Savings Bank, Shawbrook Bank, Tesco Bank and Paragon Bank.
[23] Letter from group of challenger banks, Response to Provisional Findings, p2.

Framework for assessing the competition impact of the tax regime changes

45. In analysing the potential competition impacts of the tax regime changes, we have not sought to evaluate the objectives of the policy. We have confined our analysis to the retail banks which are included in our inquiry.

46. Our analytical framework is built around an evaluation of the combined incremental impact of the changes to banks' tax liabilities. However, in reaching an overall assessment of the competition impacts, we have considered the context of the existing tax regime for banks. We are also cognisant of the existing barriers to entry that we provisionally found arising from high customer acquisition costs and incumbency advantages arising from having an established base of customers.[24]

47. The CTS is a tax on accounting profit.[25] As such, this is less likely to distort banks' incentives on price and quality than other forms of taxation. Nevertheless, a tax on profits has the potential to distort banks' investment incentives, which could give rise to dynamic impacts on banks' competitive offerings. The introduction of the CTS will, all else equal, increase the tax liability of both existing banks and potential new entrants. This will lead to a reduction in the rate of returns earned, which is expected to reduce the attractiveness of investments in banking compared to the next best alternative investment.

48. With respect to the bank levy, the reduction in the rate of the levy will, all else equal, result in a decrease in the total tax liability for banks which exceed the £20 billion tax free threshold. We would expect banks to pass through some proportion of this reduction into lower prices or improved service quality. The composition of a bank's balance sheet will also determine how large this reduction will be due to the exemptions built into the levy design.[26]

49. In considering the combined effect of the tax changes, we therefore need to consider: (i) the impact of the reduction in banks' returns arising from the CTS; and (ii) the impact and distribution across banks of any offsetting effects from the reduction in the bank levy.

[24] See Section 10, paragraphs 10.261–10.276, and Section 12 of Provisional Findings.
[25] Note that the CTS applies to an accounting rather than economic definition of profit. As such it is theoretically possible that a bank is liable to pay the CTS even though it is not covering its cost of capital (and is therefore not making economic profit).
[26] ie banks with a higher proportion of short-term debt versus retail deposits, government-backed debt and long-term debt will benefit the most form the reduction in the rate of the levy.

50. The proportionate increase in the total tax liability for larger banks (ie those that are subject to the bank levy and the CTS) may be less than that experienced by some smaller banks. We also note that for some banks (depending on the size and composition of their balance sheet) the combined impact on their tax liability may be negative.

51. The combination of the tax changes could result in one (or a combination of) the following outcomes:

(a) **Deterrence of new entry by potential providers** by reducing the attractiveness of investment in banking relative to the next best alternative investment option.

(b) **Deterrence of expansion by existing providers** by reducing providers' profitability and rates of return, leading to dampened incentives and/or ability to raise finance for investment.

(c) **Exit of existing providers** by *materially* reducing providers' profitability and rates of return below investors' required rates of return over a sustained period.

52. Each of these outcomes may lead to a reduction in competition in the relevant markets. Where the tax changes lead to differential changes in the total tax liability across firms, and therefore differential outcomes across firms, there is also the potential for an impact on competition.[27]

53. It is an empirical question as to whether the combination of policy changes results in differential tax liabilities for smaller, compared to larger banks, which we explore below. We also examine below the evidence on the extent to which the tax changes impact banks' ability and/or incentives to enter, expand or exit by reviewing banks' internal papers on the impact of the tax changes.

Quantification of the financial impact

54. We asked the banks to provide internal documents (including management reports, executive/Board papers or strategic plans) which cover the impact of the changes to the tax regime and its potential impact on their business. Where this was not covered by the above material, we also asked each bank

[27] We also note the possibility that the uncertainty associated with changes to the tax regime may have a differential impact on banks, even if the financial implications are similar. This could be the case if there is uncertainty over future levels of taxation and larger banks are better placed to manage this uncertainty. We note, however, that this is a feature in common with all taxes and regulatory interventions. Furthermore, the government has legislated the rates of the bank levy out to 2021 with the specific aim of reducing uncertainty for banks (see HMT, Summer Budget 2015, paragraph 1.204, p46).

to provide its own quantification of the impact of the bank levy and CTS. We have reviewed this evidence to assess:

(a) the financial impact of the tax changes (and how this varies between banks); and

(b) whether and to what extent the tax changes may affect the ability and/or incentives of banks to enter, expand or exit.

55. Table 2 below provides an overview of each bank's estimation of the impact of the changes in the tax regime on their tax liability, where a positive number denotes an increase in the tax liability and a negative number a reduction relative to the expected tax liability before the changes. More detailed information on the evidence provided to us by each bank can be found in Annex A.

56. It is important to note the following caveats in interpreting these estimates:

(a) The definition of UK versus global balance sheet liabilities to be used for the bank levy base in 2021 is not yet known and banks consequently may have used different assumptions for this in their modelling of the impacts.

(b) Banks' estimates will include assumptions about growth in profits and/or changes to the size and composition of balance sheets which will affect the tax base. In the data we have collected from the banks, it is not possible to distinguish between changes to a bank's tax liability arising from forecast changes to the tax base and changes arising from the changes to the tax regime.

(c) Not all banks have estimated the impact of the changes over a consistent time period. This is particularly problematic for those banks that are subject to the bank levy because the reduction in the rate of the levy is stepped over time and the switch from a global to UK liability base, which occurs in 2021.

57. While these caveats limit the comparability of the estimates between banks, we consider that the estimates provide useful information on the size and overall direction of the tax changes.

58. In interpreting the last two columns of Table 2 (ie the combined levy and CTS liability as a percentage of profit for CTS purposes) it is important to note that any reductions in the combined levy and CTS liabilities as a proportion of profit between 2016 and 2021 may be due to an increase in forecast profitability between 2016 and 2021, as well as a reduction in the combined tax liability.

Table 2: Summary of banks' estimates of tax liability changes for 2016 and 2021, relative to the expected tax liability before the changes

Banks	*Change in levy liability (£m)*		*Change in CTS (£m)*		*Combined change (£m)*		*Combined change, % of profit for CTS purposes*		*Combined levy and CTS liability, % of profit for CTS purposes*	
	2016	*2021*	*2016*	*2021*	*2016*	*2021*	*2016*	*2021*	*2016*	*2021*
Six largest banking groups										
Barclays	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
HSBCG	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
LBG †	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
RBSG ‡	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Santander ¥	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Nationwideπ	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Total of six largest banking groups	**–399**	**–1,663**	**1,237**	**1,806**	**838**	**143**	**[0-5%]**	**[0-5]%**	**[20-25%]**	**[10-15%]**
Other established retail banks										
AIBΔ	0	0	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Bank of Ireland	0	0	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Clydesdale **	**	**	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Co-op ##	0	0	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Danske ↑	0	0	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
TSB ◊	0	0	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Total of other established retail banks	**0**	**0**	**18-27**	**38-47**	**18-27**	**38-47**	**6-7%**	**7%**	**6-7%**	**7%**
Smaller banks and recent entrants										
Aldermore□	0	0	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Atom	0	0	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Coventry Building Society ∂	0	0	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Handelsbanken Ā	0	0	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Metro Bank *x*	0 0	0 0	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
One Savings Bank ɣ	0	0	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Paragon Bank ρ	0	0	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Secure Trust Bank	0	0	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Shawbrook Bank ϕ	0	0	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Tesco	0	0	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Yorkshire Building Society ɗ	**0**	**0**	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Total of smaller banks and recent entrants	0	0	**59-69**	**111-123**	**59-69**	**111-123**	**6%**	**7%**	**6%**	**7%**

Source: CMA calculations using data provided by banks.
Notes: [✂]

59. Because the changes in the bank levy impact banks' tax liabilities in a different direction to the introduction of the CTS, it is useful in considering the estimates to distinguish between banks which incur the levy and banks which are exempt from the levy.

Banks that incur the levy and CTS

60. Six retail banks incur the levy. The estimates in Table 2 suggest that initially in 2016 all banks that incur the levy experience a net increase in their tax liability. This is because the introduction of the CTS is not fully offset by the reduction in the rate of the levy. For Barclays and RBSG the additional cost is around £[✂] million, though [✂] around £[✂] million for HSBCG. This contrasts with a [✂] tax liability for LBG of around £[✂] million.

61. The other two banks which incur the levy, Santander and Nationwide, both experience a net increase in their tax liability: Santander expects to pay around £[✂] million more in 2016, with Nationwide paying around £[✂] million more tax. Therefore, in aggregate, we estimate that the six levy paying banks will pay around £840 million more in 2016, with [✂] relating to LBG.

62. By 2021, when the levy only applies to UK liabilities and the full reduction in the rate of the levy has occurred, the direction of the net impact varies between the banks depending on the scope of their international activities. [✂]

63. In aggregate, the tax liability of the six banks which incur the levy will increase by approximately £140 million (relative to the expected tax liability in 2021 before the introduction of the changes).

Banks that are exempt from the levy but are liable for CTS

64. Banks that do not and will not pay the levy will experience no offsetting benefit from the reduction in the levy rate. Where estimates of the CTS were provided by banks, the time horizon was generally three to four years, rather than extending to 2021. In such cases we have produced illustrative estimates of the CTS liability by assuming 10% yearly growth in profit before tax. Furthermore, some banks did not provide accurate forecasts for individual years, rather providing a range of possible outcomes over a period of several years.

65. Overall we estimate that the group of 17 retail banks included in our analysis which are exempt from the levy but liable for the CTS will experience a net increase in tax liability of around £75–£95 million in 2016, potentially increasing to £150–£170 million in 2021. We note that this group of banks

includes both recent entrants as well as established banks with large market shares in the relevant geographic market in which they operate (for example AIB, Bank of Ireland and Danske).

Summary of quantification of financial impact

66. Overall, the estimates of the financial impacts show that most of the banks analysed will experience an increase in tax liabilities as a result of the tax changes. For those banks analysed that are not exempt from the CTS, the combined increase tax liability as a percentage of profit is between [✂] percentage points for most banks. The exceptions to this general result are banks with profitability levels below the £25 million annual threshold and those with high levels of international exposure that are subject to the bank levy.

67. Two of the largest six banks ([✂]) experience a net reduction in tax liability. However, all the six largest banks continue to pay higher effective rates of tax than the smaller banks.

CMA assessment of competitive impact

68. We have considered the potential for any asymmetric impacts of the tax changes that may result in an impact on competition between banks. Examination of the estimates of the direct financial impacts in Table 2, suggests the following:

(a) Banks with large global banking operations relative to their UK banking business will experience a net reduction in tax liability ([✂]). This is strictly related to size only insofar that only banks with balance sheets greater than £20 billion are subject to the levy to begin with.

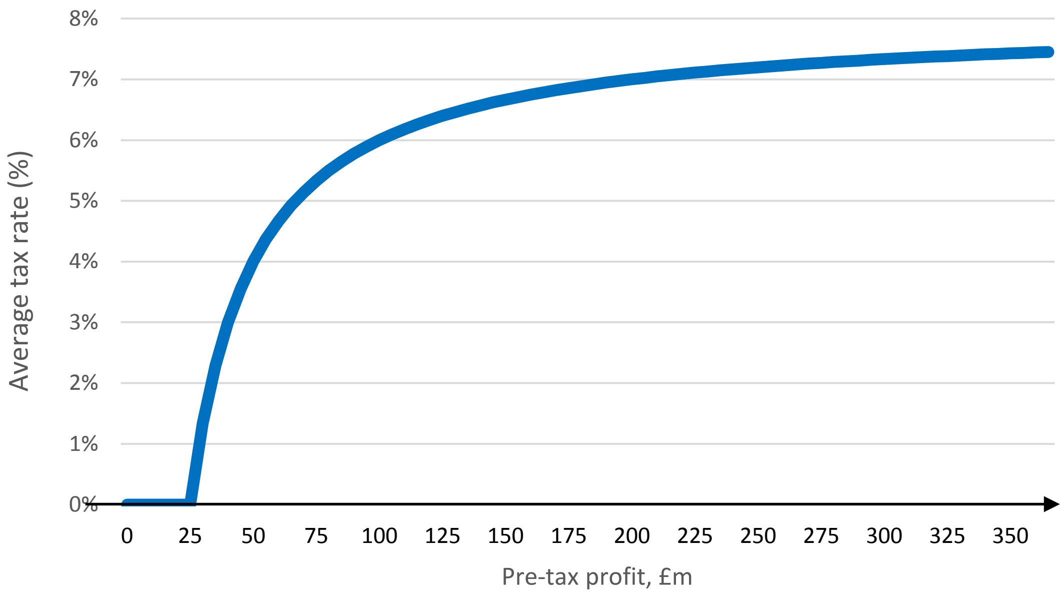
(b) The design of the CTS ensures that banks with profits below the £25 million annual tax-free allowance will not incur the CTS at all. Some banks with low levels of profitability ([✂]) will experience no increase in tax liability or an increase in liability that is small (as a proportion of pre-tax profits). As illustrated in Figure 1, those banks with lower levels of profitability, all else being equal, will have a lower average CTS tax rate.

(c) The remainder of banks for which estimates are available are projected to experience an increase in tax liability equivalent to between 5% and 7% of pre-tax profit by 2021. This includes a mixture of both large and (currently) smaller banks.

(d) The six largest banks (which incur the bank levy) will continue to face higher effective rates of taxation than the other banks analysed.

69. In general, we therefore do not find strong evidence of the changes in banks' tax liabilities differing systematically across large versus smaller bank (or established banks compared to recent entrants).

Figure 1: CTS average tax function



Source: CMA calculations.
Note: Average tax function calculated as the total CTS liability as a percentage of the total CTS profit base.

70. The coverage of the CTS also has the potential to impact how banks compete with both other banks as well as non-banking providers. This arises because the CTS is applied to profit calculated on an entity rather than activity-based definition of retail banking, due to the difficulty in defining activity-based banking:

(a) Banks which undertake non-banking activities in the same entity as banking activities, will be liable for the CTS on all their activities whereas non-banking providers of the same services will not be subject to the CTS. This has the potential to distort competition between these types of providers. This is unlikely to impact new entrants or providers newly expanding into non-banking activities, as they will be able to structure themselves into separate legal entities. We note that any distortive effects may be mitigated, however, since, in accordance with anti-avoidance rules, entities which currently undertake banking and non-banking activities within the same entity may be able to re-structure if they are able to present compelling commercial reasons for doing so.

(b) Non-banking providers that offer services for specific parts of the banking value chain (eg digital wallets or transaction services) will not incur the

CTS. The differential impact of the tax regime may give such providers advantages in the longer term as such providers grow and increase their competitive impact on traditional retail banks. However, the reduction in returns that occurs because of the CTS will also reduce their incentives to expand into deposit holding aspects of the retail banking value chain.

71. Even if the direct financial impact is not distortive, there may be differential effects on banks' entry, expansion and exit decisions. This may be the case if smaller banks are less able to access external sources of finance or have less resources to draw on (in the form of accumulated past profits) than larger banks and are therefore more reliant on profits to finance growth.

72. It is possible that the changes to the tax regime could deter new entry as investors look ahead to the time that expected profits rise above the tax-free threshold and see the rate of return to investment in banking being reduced relative to other investment opportunities. Consistent with this hypothesis, a recent entrant told us that its projected profitability was a key element in justifying the investment case for entering the banking sector. Similarly, another recent entrant ([✂]) told us that the increases in taxation in the banking sector had reduced the attractiveness of investments in banking relative to FinTech start-ups. Furthermore, it told us that it had already noticed a change to this effect in the attitude of potential investors.[28]

73. Some banks have explicitly estimated the impact of the increase in tax liability on their returns. Bank of Ireland estimates that the changes will result in a [✂]. Aldermore [✂].

74. Some banks have told us in general terms that the reduction in returns will have an impact on their investment decisions. [✂] said that it might be necessary to increase product prices in order to ensure that hurdle rates are achieved for future investments. Paragon Group told us that while its subsidiary, Paragon Bank, is not currently subject to the CTS, its future ability to expand could be impacted. This is because capital allocations between its Group entities are based on relative post-tax returns. As such the banking business within the Group could have less capital allocated unless it can pass on the cost of the CTS through higher margins.

75. We have therefore seen some limited evidence that the reduction in returns caused by the tax changes could reduce the ability of banks to finance investments in expansion (or the retention of existing customers).[29] However,

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[28] Transcript of roundtable hearing with Secure Trust Bank, Starling Bank, Tesco Bank, Virgin Money and Yorkshire Building Society, p83, lines 7–14.
[29] Or require them to price less competitively in order to secure this finance.

evidence of a specific impact on banks' business plans and expansion strategy is much more limited:

(a) Secure Trust Bank told us that tax considerations were a factor in its decision to dispose of its Everyday Personal Loans business.

(b) Virgin told us that the CTS may delay, but not prevent, achieving its IPO targets by about a year.

76. We did not receive substantial evidence from banks on the reduction in profitability as a result of the tax changes impacting banks' business plans or competitive strategies (although we note that they may not have yet fully incorporated the impact of the changes into their business plans). Similarly, we have not found any evidence that the changes to the tax regime for banks will result in the exit of existing providers.

77. Banks will be unable to offset losses incurred before January 2016 against their future CTS liability. This may particularly impact recent entrants that have incurred historical start-up losses or smaller banks including mutuals with legacy losses. This can be contrasted with the position under standard corporation tax. While the government introduced restrictions in the 2014 Autumn Statement on the proportion of banks' profits that can be offset by historical losses (ie losses incurred prior to April 2015) a specific carry-forward allowance was included for building societies, and losses incurred during a bank's start-up period (defined as five years from the point it began trading) were exempt from these restrictions on carrying forward losses. Under the CTS, all losses incurred post January 2016 can be offset against the CTS which will benefit newer entrants. However, there is no exemption for new entrants or mutuals to carry forward losses incurred prior to January 2016.

78. With respect to institutions with mutual ownership structures, we note that retained earnings play an important role in financing lending and investment. Smaller building societies are most likely to be affected by a reduction in retained earnings as they may be less able than larger mutuals to access capital funding through new financial instruments (which, for example, have been issued by Nationwide).[30]

Conclusions

79. Taxation policy is a matter for government and Parliament. It is not for us to evaluate the policy objectives of the government in introducing the CTS and the changes to the bank levy. The stated objectives of these policies broadly

[30] Such as Core Capital Deferred Shares.

relate to raising revenue in a more sustainable and fairer way from the banking sector, reflecting the risks the banking system poses to the UK economy. Competition was not an objective of this policy, although HM Treasury submitted to us that the resultant tax regime was consistent with the government's objective to see greater competition in banking.

80. Our aim has been to assess the potential impact on competition of these changes. More specifically, we have assessed whether the combined changes to the bank tax regime lead to differential impacts between retail banks, which could affect competition. Our assessment has been made taking into account our Provisional Findings which concluded that there are barriers to entry and expansion in retail banking because of high customer acquisition costs, while longer-established banks benefit from a larger existing customer base. In addition, our assessment is confined to the impact on competition in retail banking, the subject of this investigation, and does not encompass an assessment of the implications of the bank tax changes for the full range of banks affected by the tax changes.

81. We have examined the impact of the proposed changes on the projected tax liabilities of different banks over the next five years. We have also reviewed banks' internal strategy documents to see whether the changes are having an impact on their incentives or abilities to compete. Some smaller banks stated in general terms that a reduction in their post-tax returns would naturally impact their investment decisions, but we found limited evidence of a specific impact on business plans or expansion strategies. Therefore, there is no strong evidence at this time that the introduction of the CTS combined with the changes to the bank levy will deter entry or expansion or will result in banks exiting. However, the full impact of the tax changes may take time to emerge.

82. The bank levy was targeted on systemically important banks, so smaller banks, including new entrants, were not subject to the levy. This was a consequence of the policy rather than a feature introduced for competition reasons. As a result of the introduction of the CTS and the changes to the bank levy, the tax advantage of smaller banks (including new entrants) over banks that are subject to the bank levy has been reduced.

83. However, the six largest retail banks will continue to pay higher effective rates of tax than smaller banks. In 2016, the bank levy and CTS liability as a proportion of profit for the six largest retail banks averages approximately [20–25]%, compared to approximately 6% for other retail banks. In 2021, when the change to the base of the bank levy from global to UK balance sheet liabilities takes effect, the six largest retail banks will continue to pay approximately [10–15]% compared to approximately 7% for other retail banks.

84. There are aspects of the design of the CTS which may lead to differential effects across retail banks which, while not immediately evident now, might impact on competition between banks in the future:

(a) The £25 million threshold for the CTS has resulted in many smaller banks and most mutuals being exempt from the CTS. The setting of a threshold involves, for a given revenue target, a trade-off between the rate of the tax and the coverage. An increase in the threshold could maintain the previous tax advantage of smaller banks, but would somewhat reduce the revenue raised at the current tax rate.

(b) The tax changes have specific impacts on institutions with mutual ownership structures, for whom retained earnings play an important role in financing lending and investment. Smaller building societies are most likely to be affected as they are less able than larger mutuals to access capital funding through new financial instruments. Again, any further changes which favoured mutuals would have revenue consequences.

(c) Under the CTS, losses arising prior to 1 January 2016 are excluded from the calculation of total taxable profits. Consequently, banks that entered recently are not able to offset start-up losses they incurred prior to January 2016 against the CTS, although they will be able to do so with later start-up losses. Similarly, smaller banks, including mutuals, are unable to offset legacy losses. This contrasts with corporation tax under which, since December 2014, larger banks' ability to offset losses incurred prior to December 2014 has been capped at 50% each year. However, start-up losses incurred in a banks' first five years of trading are not subject to the cap and a further specific allowance has been provided for mutuals, reducing the impact of the measure on new entrants and mutuals.

(d) The CTS applies to banking entities rather than to banking activities. Firms for which banking is only a relatively small part of overall business could be more impacted than others, although this depends on how they are structured. Moreover, firms such as digital wallet providers are not impacted, because they are not regarded as banks for the purposes of the CTS even though they may compete against retail banks for some services. This could give them a competitive advantage over banks subject to the CTS.

85. Consequently, while the tax regime continues to favour smaller banks including new entrants, the overall effect, compared with the pre-2016 position, is that the tax advantages of smaller banks including new entrants have been reduced as a result of the changes to the bank levy and the

introduction of the CTS. Therefore, any effect that these tax advantages had in off-setting the barriers to entry and expansion such banks face are likely to be reduced.

86. We welcome that HM Treasury has confirmed the government's strong commitment to ensuring that the taxation of banks should be consistent with its objective to see greater competition within the UK banking sector. It is in the nature of tax design that specific aspects may need to be adjusted in light of changing circumstances. We therefore endorse the government's commitment to keeping under review the impact on smaller banks and on new entry of the bank tax regime in light of the specific issues we have highlighted above and urge HM Treasury to continue to monitor the impact of its fiscal policies on competition in retail banking more generally.

Annex A: Summary of evidence provided by banks in response to the information request

Barclays

1. The combined effect of the bank levy and tax surcharge is expected to [✂].

£m	*2016*	*Change*	*2021*	*Change*
Levy		[✂]		[✂]
Surcharge	[✂]	[✂]	[✂]	[✂]
Net cost		[✂]		[✂]

HSBCG

2. [✂]

$m	*2016*	*Change*	*2021*	*Change*
Levy	[✂]	[✂]	[✂]	[✂]
Surcharge	[✂]	[✂]	[✂]	[✂]
Net cost		[✂]		[✂]

LBG

3. LBG has projected the effect of the levy and surcharge up to 2018, comparing with the position before the summer 2015 budget changes. The overall effect of the budget changes is a significantly increased tax liability for LBG (with the surcharge increasing by significantly more than the reduction in the levy payable). LBG also commented that recent broker reports have highlighted the adverse effect of the budget changes on UK domestic banks, such as LBG, while also noting that the surcharge applies to all banks (whereas smaller banks are not subject to the levy).

£m	*2016*	*Change*	*2018*	*Change*
Levy	[✂]	[✂]	[✂]	[✂]
Surcharge	[✂]	[✂]	[✂]	[✂]
Net cost		[✂]		[✂]

4. LBG has not estimated the effect of the bank levy and CTS for 2021, as it does not forecast tax liabilities beyond its five year Group performance planning horizon. LBG anticipated, in the circumstances, that the effect in 2021 would be similar to that in 2018. The change in levy coverage to UK liabilities only in 2021 is not expected to have a material impact on LBG, given the UK focus of the Group's business, following the reduction in its non-UK activities over the past few years.

RBSG

5. RBSG's projection is based on [✂].

£m	*2017**	*Change*	*2019*	*Change*
Levy	[✂]	[✂]	[✂]	[✂]
Surcharge	[✂]	[✂]	[✂]	[✂]
Net cost		[✂]		[✂]

*[✂]

Santander

6. Santander estimated that in 2017, a surcharge of £[✂] million would be payable, partly offset by a reduction in bank levy of £[✂] million, leaving the net impact being a cost of £[✂] million. An earlier presentation suggested that in 2016 and 2018 the net cost [✂].

£m	*2017*	*Change*
Levy		[✂]
Surcharge	[✂]	[✂]
Net cost		[✂]

Nationwide

7. Nationwide provided an estimate of the banking levy, with the cost of the levy increasing from £[✂] million in 2016 to £[✂] million in 2020 [✂]. The increase in the tax surcharge in 2019/20 reflects growth in bank profits. Nationwide projected that it would pay approximately £300 million additional tax up to March 2020.

£m	*2016/17*	*Change*	*2019-20*	*Change*
Levy	[✂]	N/A	[✂]	N/A
Surcharge	[✂]	[✂]	[✂]	[✂]

AIB

8. AIB UK estimated the 2016 effect of the CTS to be £[✂] million, [✂].

Bank of Ireland

9. BOI said that changes to allowances for tax losses will lead to cash payment of tax when unutilised tax losses remain. Cost of the tax surcharge over five years is expected to be around £[✂] million with return on equity (RoE) being

reduced by [✂]% by 2020. Ensuring hurdle rates are achieved may impact on product prices.

£m	*2016*	*2021*
Surcharge	[✂]	[✂]

Clydesdale

10. Clydesdale was not able to provide an estimate of the effect of the surcharge. It stated 'Given, amongst other matters, the proposed demerger from National Australia Bank, we do not believe it is appropriate to provide any information on forecast profitability on a tax basis of a single entity within this retail group.'

Danske

11. Danske stated that [✂]

£m	*2016*	*2021*
Surcharge	[✂]	[✂]*

*[✂]

Aldermore

12. [✂]

£m	*2016*	*2021*
Surcharge*	[✂]	[✂]

Co-op

13. The Co-op is currently loss-making [✂].

Handelsbanken

14. Handlesbanken did not provide projections for the impact of the tax surcharge, but its estimate for 2016 was £[✂] million.

Paragon Bank

15. Paragon Bank said it does not expect to exceed the £25 million profit threshold in 2016 and did not provide forward projection to 2021. However, it highlighted that the tax surcharge will have a disproportionate effect on its business through the impact on profitability and capital. Paragon Bank is part

of Paragon Group and as capital allocations between Group entities are based on relative post-tax returns, the banking business could have less capital allocated unless it is able to pass on the cost of the surcharge through higher margins.

Secure Trust Bank

16. Secure Trust Bank estimated that an additional £[✂] million tax will be payable over 2016-21. The impact is expected to create a competitive disadvantage with non-banking companies and reduce lending to SMEs by £[✂] billion over the period.

£m	*2016*	*2021*
Surcharge	[✂]	[✂]

Shawbrook Bank

17. Shawbrook provided a forecast for 2016 based on a consensus from publicly available analysts.

£m	*2016*	*2021*
Surcharge	[✂]	[✂]

Virgin

18. Virgin submitted that the CTS may delay, but not prevent, achieving its IPO targets by about a year, and that between 2016 and 2021 it anticipated an additional £[✂] million in tax to be payable under the CTS.