



Bank Levy Review 2013

Consultation document

Publication date: 4 July 2013

Closing date for comments: 26 September 2013

Subject of this consultation:	A review of the operational efficiency of the bank levy.
Scope of this consultation:	This consultation reviews the design of the bank levy to ensure it is operating efficiently. The overarching objectives of raising £2½ billion per annum and encouraging banks to move to safer and more stable funding remain unchanged and will not form part of the consultation.
Who should read this:	The UK banking and building society sectors, their representatives and advisors.
Duration:	4 July 2013 to 26 September 2013
Lead official:	Anthony Fawcett HMRC Policy and Technical Adviser (Financial Products and Services Team) CTISA.
How to respond or enquire about this consultation:	<p>Responses can be sent by email to: anthony.c.fawcett@hmrc.gsi.gov.uk or samantha.brown@hmrc.gsi.gov.uk, or by post to:</p> <p>Anthony Fawcett HM Revenue & Customs Room 3C/06 100 Parliament Street London SW1A 2BQ</p> <p>Enquiries can be made via email as above or please telephone; Anthony Fawcett on 020 7147 0654 or Samantha Brown on 020 7147 0180.</p>
Additional ways to be involved:	HMRC will welcome discussions with interested parties, and will be establishing working groups as a forum for dialogue with stakeholders. In addition, HMRC will hold an open event on Monday 5 August 2013; details of this can be found in Chapter 12.
After the consultation:	The proposals will be reviewed in light of the responses. The Government will publish its summary of responses to the consultation by the end of 2013 along with any draft legislation that may be proposed for inclusion in Finance Bill 2014.
Getting to this stage:	The bank levy was introduced by Schedule 19 of the Finance Act 2011, with effect from 1 January 2011.
Previous engagement:	<p>Prior to introduction of the bank levy, the Government carried out a consultation about the design and implementation of the levy in summer 2010 and published a consultation response in October 2010.</p> <p>From the outset, the Government has set out that it would review the design of the levy in 2013 to ensure that it is operating efficiently. Early in 2013, officials from HMRC and HM Treasury held informal consultation with a number of banks, tax advisers and representative bodies to discuss the key issues to be addressed in this consultation.</p>

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1. Introduction

Background

1.1 The bank levy (“the levy”) was announced in the June 2010 Budget. It took effect from 1 January 2011, and the relevant legislation is included in Schedule 19 Finance Act 2011.

1.2 In the same June 2010 Budget, as part of its approach to improving the tax policy making process, the Government set out an intention to evaluate the effectiveness of tax reforms to ensure they are meeting their objectives. Consistent with this, the Government announced, when it introduced the levy, that it would review the design of the levy in 2013 to ensure it is operating efficiently. This consultation sets out the parameters of the review, and the specific issues on which the Government is consulting.

Policy Context

1.3 Excessive risk taking in the banking sector was a significant contributory factor in the recent financial crisis. The levy is part of the wider financial regulatory reforms introduced by the Government aimed at increasing the resilience of the financial sector.

1.4 The purpose of the bank levy is to ensure that banks make a fair contribution, reflecting the risks they pose to the financial system and the wider economy. From the outset, the Government has stated that it expects the levy to raise at least £2½ billion each year. This is an appropriate contribution in light of the possible costs related to systemic risk, that balances fairness with the competitiveness of the UK banking sector, and there are no plans to revisit this.

1.5 As a result the review will be cost neutral and, once the design issues covered in this consultation are finalised, the Government will consider whether further adjustment of the levy rates is required to ensure the £2½ billion target is achieved.

1.6 The levy is also designed to create appropriate incentives to contain systemic risk and encourage banks to move away from riskier funding models. Problems with risky funding led to serious liquidity problems that played a key role in the financial crisis, including causing the failure of some institutions and requiring resolution action in certain cases, the direct and indirect costs of which have been significant. The crisis demonstrated the central role that liquidity shocks can play in triggering and propagating systemic banking crises.

1.7 The Government believes these objectives remain appropriate, and therefore does not plan to revisit these as part of this review. The Government reiterates its position that it does not propose to establish a separate resolution fund and notes that mechanisms are available, if necessary, to provide financing in connection with bank resolutions.

Structure of the Bank Levy

1.8 The design of the bank levy reflects the objectives agreed at the June 2010 European Council meeting and is based broadly on the proposal in the 2010 International Monetary Fund Report to the G20, *A Fair and Substantial Contribution by the Financial Sector*, for a broad balance sheet charge.

1.9 The bank levy applies to:

- the global consolidated balance sheets of UK banking groups and building societies;
- the aggregated UK subsidiary and branch balance sheets of foreign banks and banking groups operating in the UK and their subsidiaries; and
- the balance sheets of UK banks and UK branches of foreign banks in non-banking groups.

1.10 To ensure that the levy is proportionate, it includes an allowance so that the first £20 billion of chargeable equity and liabilities are not taxed. This balances the probability that a firm would pose a systemic risk, which is correlated with size, against the relative burden imposed in order to gather additional revenue at the margin.

1.11 The bank levy applies to banks' balance sheets. It is based upon the total chargeable equity and liabilities as reported in the relevant balance sheets. In determining the chargeable equity and liabilities, there are exclusions in respect of a number of items, including Tier 1 capital, and deposits covered by depositor protection schemes. There is also a deduction for High Quality Liquid Assets, ("HQLA"), which are required for regulatory purposes. Liabilities funding HQLA are likely to form part of the levy base and the deduction removes any disincentive for banks to hold these assets.

1.12 Given the objectives of the levy, the Government believes that these overarching structural features remain appropriate, and therefore is not considering any fundamental changes to these core design aspects.

Review Scope

1.13 Feedback received to date indicates that the bank levy is largely operating as intended and is fulfilling its policy objectives. Banks have confirmed that the levy encourages safer funding and complements regulation effectively. These features will continue to be reviewed from time to time, for example, having regard to European and international initiatives.

1.14 This review is therefore focused on the following areas.

- The operation and compliance aspects of the levy and whether there are changes that can be made to simplify and reduce compliance costs.

- Ensuring the legislation can be applied fairly (given its twin objectives) to the bank levy population, which contains banks that have numerous differences in activities, location, structure and systems.
- Within the broad design framework, the operation of specific design features, and whether there is merit in making changes to these that would better align the levy with its objectives – particularly with regard to targeting riskier funding. Any changes here would have the potential to adjust the current levy burden faced by individual institutions.
- Ensuring that the bank levy remains aligned with the current regulatory regime and that proposed changes to the regulatory rules are taken into account in the bank levy design.
- Improving the understanding of revenues, taking into consideration the factors that drive balance sheets.

1.15 The majority of banks submitted their first returns in respect of the levy (relating to 2011) in late 2012 / early 2013. Following this, officials from HMRC and HM Treasury met with a number of banks and their representative bodies to discuss their experiences of the levy. These meetings helped to build a picture of the areas where there was scope for possible improvements in the operation and design of the levy.

1.16 The next 9 chapters explore these issues in further detail, and set out the specific questions on which the Government is inviting responses.

1.17 If the Government concludes that changes are merited following this consultation, these will need to be given effect through legislative change in a future finance bill. Any specific legislative changes planned for Finance Bill 2014 would be consulted on as part of the Government's normal tax policy making process, with draft clauses published later this year.

1.18 As noted above, the review will be cost neutral. The Government will consider whether, as a result of any legislative changes, further adjustment of the levy rates is required to ensure the £2½ billion target is achieved.

2. Protected Deposits

Current Treatment

2.1 Protected deposits are excluded from the levy charge by paragraph 29, Schedule 19 of the Finance Act 2011. For these purposes, protected deposits include:

- deposits that are protected by the Financial Services Compensation Scheme (“FSCS”), or
- deposits protected by an overseas deposit protection scheme, which is comparable to the FSCS, or
- deposits protected by an explicit government guarantee.

2.2 The exempt amount of scheme deposits, in the case of the FSCS and comparable overseas schemes, is the higher of:

- the amount of the deposit insured,
- the amount of the deposit by reference to which the premium or fee in respect of the scheme is computed, and
- the amount of the deposit by reference to another amount, not exceeding 100 per cent of the relevant scheme deposits.

2.3 The exempt amount where deposits are covered by an explicit government guarantee is the guaranteed amount; usually this is 100 per cent of the amount deposited.

Policy Rationale

2.4 This exclusion has two policy objectives. It is intended to identify and remove from charge deposits which are likely to remain available to the bank in a time of stress (i.e. a stable source of funding). These are often referred to as “sticky deposits”. The exclusion in Schedule 19 was also designed to prevent a double imposition where a deposit protection fee is charged by the FSCS or a comparable overseas scheme.

2.5 From a policy perspective identifying and defining which deposits are sticky can be challenging because the concept is, to some extent, subjective. The Government is satisfied that the current definition which identifies deposits covered by either the FSCS or a comparable overseas deposit protection scheme and relies on the definition of deposit within Regulation 5 of the Regulated Activities Order 2001, is an acceptable measure of sticky deposits. However, this consultation seeks views on whether a change to the definition should be considered in order to address potential compliance burdens.

Operational Experience

2.6 During discussions held earlier this year, a number of issues were raised by banks in relation to the exclusion for protected deposits.

2.7 Some banks have explained that identifying the correct amount of protected deposits can be challenging and in some cases burdensome. In order to identify these deposits, banks must possess information about the relevant guarantee or deposit protection scheme. In the case of a deposit protection scheme, this information must be sufficient to ascertain whether it is comparable to the FSCS, how the scheme fee is charged and the amount of any cap or limit on protection.

2.8 HMRC has included a White List in the Bank Levy Manual,¹ which helps banks identify deposit protection schemes that are comparable to the FSCS. This list itself does not provide all the necessary details of scheme fees or caps on the amount protected, so that a bank is still required to undertake further due diligence to establish the position. It is unclear how much the list aids banks with large and diverse overseas deposits bases. We would welcome views on this.

2.9 Some overseas schemes operate in unusual ways which result in anomalies when the bank levy rules are applied. For example, banks can exclude 100 per cent of their US deposits because of the way the US FDIC fee is calculated. In contrast, the Swiss deposit protection scheme caps protection at 6 billion CHF but grants preferred creditor status to depositors and applies strict liquid asset requirements on deposit takers. As a result, Swiss deposit takers find their level of protected Swiss deposits is capped, although one might argue that the scheme, when viewed as a whole, offers protection equivalent to the FDIC.

Areas for Discussion

2.10 There may be scope to amend and potentially simplify the protected deposits rules to minimise the administrative burden on banks and harmonise their application across the various overseas schemes. Respondents' views are sought on the extent of any compliance or administrative burdens, how simplification could be achieved and whether it will mitigate the identified burdens. A number of options are set out below but the Government would nonetheless be interested to hear alternative suggestions.

2.11 One potential way in which legislative simplification might be achieved is by changing the definition of excluded deposit to encompass a broader concept of sticky deposit. For instance, the exclusion could be extended to cover all retail deposits.

2.12 This option would remove the requirement for banks to retain and update information about each applicable deposit protection scheme; however there are some possible drawbacks. There is considerable doubt about whether all retail deposits really are sticky, particularly in the case of large deposits by companies or wealthy individuals. So it could be argued that it might be better to target a subset of retail deposits that excludes such depositors. Additionally, the 2010 consultation identified difficulties in finding a definition of retail deposits which can be applied across the bank levy population without itself presenting an excessive compliance burden. Whilst this challenge remains, the Government would be interested in exploring any regulatory developments which may provide a better starting point for identifying retail or sticky deposits.

¹ The White List can be found at BKLM331115.

2.13 Alternatively it might be preferable to retain a sticky deposits proxy based on deposits that are covered by UK or overseas deposit protection schemes or guarantees, but to remove the link between the excluded amount and the scheme fee. The amount of excluded deposits in this case would be the qualifying scheme deposits up to the protection limit.

2.14 This option reflects the fact that, in many cases, especially where schemes are not pre-funded, the fee has very little to do with the deposits on which it is charged. Such a change would remove considerable complexity from the calculation of protected deposits and would go some way to removing the inequities that are currently present. However, banks would continue to require information about the coverage and caps applicable to a wide variety of overseas schemes.

Questions

Q2.1 Which definition most accurately reflects the concept of “sticky deposits”?

- All retail deposits.
- All smaller retail deposits below a certain fixed amount, say £50,000.
- All deposits protected by a deposit protection scheme – up to the scheme limit.

Q2.2 The Government is aware that banks may have built systems to comply with the current protected deposits rules and we would like to ensure that we do not make changes that may make these systems redundant. With that in mind, would any of the proxies for sticky deposits at Q2.1 above cause significant compliance burdens?

Q2.3 If respondents consider that retail deposits (or a proportion thereof) most accurately reflect the concept of stickiness, is it possible to arrive at a definition of “retail deposits” that would be readily applicable to all banks?

Q2.4 If sticky deposits continue to be defined by reference to deposit protection schemes, would removing the link to the scheme fee significantly reduce compliance burdens?

3. Netting

Policy Rationale

3.1 During the initial design and consultation phase of the bank levy the Government considered how best to determine the level of derivative contract liabilities that should be chargeable under the levy. In particular, the Government was aware that in many instances derivative liabilities would be netted with derivative assets and that in fact there was a general presumption that such netting arrangements were effective in reducing the funding risk of the bank and also the exposure of the counterparty to the bank on insolvency. To reflect this, netting provisions were introduced into the levy design.

3.2 Determining exactly how netting would be incorporated into the levy posed a number of issues. The accounting approach taken under UK GAAP and IFRS is markedly different to that taken under US GAAP, leading to very different amounts of netting being reflected on balance sheets prepared under the different standards. Choosing one accounting approach over the other as the basis of our netting rules would therefore have created compliance issues for at least one group of levy payers.

3.3 In addition, the original consultation in 2010 exposed the fact that there are other types of assets and liabilities which may be subject to a legally enforceable right of set off, for example loans and credit balances. The Government therefore decided that bank levy netting would be extended to include all liabilities covered by a valid netting agreement in addition to derivative liabilities and the bank levy would employ netting principles similar to those used under the Basel II Accord.

Current Treatment

3.4 The netting rules are contained within Schedule 19 of the Finance Act 2011 at:

- paragraph 16 for UK banking groups and building society groups,
- paragraph 18 for foreign banking groups,
- paragraph 20 for relevant non-banking groups,
- paragraph 22 for UK banks and building societies that are not members of groups, and
- paragraph 25 for relevant foreign banks.

3.5 Broadly the levy rules recognise netting that takes place under certain specified circumstances (see 3.6 below) and permits liabilities that are recognised on a balance sheet of any relevant member to be reduced as far as possible (but not below zero) by netting off any asset balances that are recognised on the balance sheet of any relevant member. The remaining net balance is the figure to be taken into consideration when calculating the chargeable equity and liabilities.

3.6 The specific circumstances in which netting is allowed arise where the liabilities and assets that are recognised on the balance sheets are:

- with the same counterparty (or member of the counterparty's group),
- covered by the same netting agreement,
- where the counterparty is either a third party or a group company whose liabilities are not subject to the bank levy.

3.7 For netting to be recognised for levy purposes, a netting agreement must be legally effective and enforceable. It must grant the parties the right, where a netting event occurs (i.e. termination of arrangements as a result of the bankruptcy or insolvency of one of the parties), to offset any amounts owed against any amounts due. Such that, there is one single net sum either due to or payable by the group member to settle all liabilities and assets covered by the agreement.

3.8 The netting rules were amended in December 2011 to ensure that they applied to “short selling” and situations where shares or securities are posted as collateral against liabilities. Without these changes, the netting rules would not have applied as originally intended.

Operational Experience

3.9 Generally the netting provisions have worked well. The principles on which the provisions are based have provided a framework that is applicable across all of the banks within the levy population, allowing banks to exclude gross liabilities that can be netted with assets under a legally effective and enforceable netting agreement.

3.10 However, HMRC has received a number of queries about transactions which appear to reduce risk in a similar way to netting arrangements, although they do not fall within the levy netting rules as they do not meet one or more of the legislative principles. Sometimes known as “common law” netting, these transactions frequently lack a legally effective and enforceable agreement, or may introduce a third party into the arrangements (over and above the group members of both counterparties).

3.11 For instance, “Failed Sale”² transactions may create a similar result to netting in the event of insolvency but they do not fall within the current netting provisions. Although an asset and liability are recognised on the balance sheet for accounting purposes, these cannot be covered by a legally effective netting agreement because, in reality, a sale for cash does not create an ongoing liability / legal obligation.

3.12 HMRC is also aware of some transactions such as tripartite or client clearing arrangements (see chapter 9 for proposals relating to client clearing) which introduce into the equation another party, over and above the bank and the original counterparty. Again whilst the effect of these arrangements may be risk reducing, they are not generally accommodated by the bank levy’s established netting principles.

3.13 As a result, there are certain situations in which it is not possible to bring a transaction inside the scope of the current netting rules. However, some banks have already expressed concern that it will become uneconomic to carry out certain

² Failed sale transactions involve an asset sale for cash accompanied by other contracts/clauses, which mean that for accounting purposes the sold asset continues to be recognised on the seller’s balance sheet and a liability is recognised for the proceeds.

commercial activities if these non-netted liabilities remain chargeable to the full levy rate.

Areas for Discussion

3.14 The Government understands the above concerns. However, extending the netting rules further risks damaging the principles on which they were founded. Widening the rules to accommodate these common law netting transactions would mean running the risk of also permitting netting for other arrangements that are not genuinely risk reducing and would introduce additional complexity to one of the most difficult areas within the levy.

3.15 Banks have also made us aware of a number of areas where they believe netting can create practical difficulties. For instance, where banks manage collateral on a macro basis they have found it difficult to trace netted fungible securities. Other banks have been unable to identify the maturity split of derivatives via their current reporting systems. They have therefore found proportional netting, and charging non-netted derivatives at the correct rate, challenging.

3.16 Banks' concerns about compliance burdens and the economics of certain non-nettable transactions need to be set against a backdrop of the very limited scope that exists for extending the netting rules without damaging the sound principles on which they are based. Any changes to the scope of the current rules would also add further complexity. Instead, the Government can see merit in discussing alternative approaches to netting and we would like to explore a number of options.

3.17 One option would be to remove the netting provisions from the levy entirely and instead apply a significantly lower rate to all derivative liabilities to recognise the fact that they are frequently netted with derivative assets.

3.18 Under such a system, the lower rate of charge would apply only to derivative contract liabilities, which make up the majority of liabilities currently taken out of charge by netting. We are aware that repo liabilities and deposits also feature heavily in existing netting arrangements. However, exclusions are already provided for protected deposits and sovereign repo liabilities, recognising their lower risk status. We are also aware that banks are now being urged to consider their gross position when risk assessing their repo books and that net exposure may not be the only or indeed best indicator of risk.

3.19 This proposal may arguably partially diminish the extent to which the levy recognises the risk reducing benefits of netting. It would also inevitably lead to changes to individual banks' levy payments. However, such a change would avoid the need for long and complex debates on the application of the netting principles to an ever increasing variety of transactions, which would be time consuming and costly for all involved and may ultimately require resolution at Tribunal. It would also ensure that similar transactions are treated consistently across all banks. The lower rate applicable to derivatives would mitigate the impact of the levy on low margin transactions, which cannot currently qualify for netting treatment.

3.20 An alternative option would be to consider treating all derivative contract liabilities as short term for the purposes of the levy. This option would remove a certain amount of complexity from the netting rules including the requirement to proportionally net short and long term liabilities and the identification of the maturity split of non-netted derivatives. However, this approach would not reduce the administrative burdens associated with applying the netting principles to discrete transactions, and could add to pressure on the viability of lower margin transactions.

3.21 A further option would be to leave the netting rules as they are. This option would retain the status quo and ensure that systems put in place by the banks to comply with the current legislation would not be made redundant. However, it may require additional work on the part of some banks to put in place systems or processes to make complying with requirements such as proportional netting and identifying the maturity split of non-netted liabilities an easier, more automated, process. It also fails to address the uncertainties surrounding common law netting arrangements and would not offer simplification or a reduction in compliance burdens in this area.

Questions

- Q3.1** Would removing the netting rules and moving to a system that charges derivative contract liabilities at a lower rate lead to a simpler, fairer and less burdensome regime?
- Q3.2** If not, would short term treatment of all derivative contract liabilities, for the purposes of the bank levy, simplify the netting provisions?
- Q3.3** With the expectation that all banks will have, or will put in place, systems and processes that can cope with the more intricate elements of the netting rules, should they remain unchanged?
- Q3.4** How could “common law” netting agreements which genuinely reduce risk be included in the bank levy rules, without damaging the sound principles on which they are based?

4. Allocation of liabilities to UK branches of foreign banks

Policy Rationale

4.1 Foreign banking groups carry on banking activities in the UK through subsidiaries and permanent establishments (branches) of foreign banks. A consistent approach is taken to UK branches of foreign banks and subsidiaries, both are included within the scope of the levy. This reflects the risk that UK branches may pose to the wider UK economy and ensures that foreign banking groups do not receive a competitive advantage over domestic groups.

Current treatment

4.2 Unlike subsidiaries, a branch's assets and liabilities are simply part of the assets and liabilities of the foreign bank. A method is therefore required to determine how much of the foreign bank's equities and liabilities should be brought within the bank levy charge.

4.3 The method is set out within paragraphs 24 – 27 of Schedule 19 of Finance Act 2011. Broadly the steps to determine the foreign bank's UK allocated liabilities are as follows:

- **Step 1** – Determine the amount of assets held by the foreign bank at the end of the chargeable period to give an amount 'A'.
- **Step 2** – Determine the amount of assets held by the UK branch of the foreign bank to give an amount 'B'.

Calculate the proportion of the foreign bank's assets that are held by the UK branch to give 'X per cent', that is calculate the proportion that B is of A.

- **Step 3** – Determine the amount of chargeable equity and liabilities held by the foreign bank to give an amount 'C'.
- **Step 4** – The amount of chargeable equity and liabilities to be allocated to the UK branch is X per cent of C.
- **Steps 5 and 6** – These steps determine the proportion of the chargeable equity and liabilities that are to be treated as long term (chargeable to the bank levy at half rate) and those liabilities that are short term liabilities (charged at the full bank levy rate).

4.4 The starting point for steps 1 - 3 is always the amounts that are recognised in the foreign bank's accounts under IAS or UK GAAP or, where the foreign bank prepares accounts using a different accounting standard, the amounts that would have been recognised under IAS or UK GAAP.

4.5 Branch allocation methodology was discussed extensively during the original consultation and it was concluded that this particular methodology presented two key benefits:

- i) Allocation of chargeable equity and liabilities based on the ratio of branch assets as a proportion of total entity assets ensures that the genuine economic activities of the UK branch are reflected. It also ensures that the levy charge is based on the funding profile of the foreign bank, of which the UK branch is a part. This funding profile would drive the bank's actions in relation to its UK branch in a crisis.
- ii) Asset attribution at step 2 follows an OECD approved method that is already used as part of the process of determining the Capital Attribution Tax Adjustment (CATA) for Corporation Tax (CT) purposes. The expectation was that this would reduce the administrative burden and provide a robust methodology.

Operational experience

4.6 Recent discussions with foreign banks have shown that the branch allocation methodology has been adopted reasonably well, providing a coherent set of rules for allocating liabilities to branches without introducing significant compliance burdens. This is welcome news given the challenges faced in identifying a suitable method and the paucity of workable options available.

4.7 However, these discussions have also highlighted some challenges for banks who apply the branch allocation methodology. Step 1 requires determination of the amount of assets held by the foreign bank. Obtaining details of the foreign bank's solo balance sheet has presented difficulties for some US banks, where accounts are drawn up and reporting is carried out on a consolidated basis. This should equally be an issue for corporation tax purposes. HMRC would therefore be interested in exploring which difficulties with this approach are unique to the levy.

4.8 More generally, the levy requires UK branches and tax departments to obtain detailed and complex financial data from the foreign bank of which they are a part. This requires information to flow in the opposite direction to the way it does for normal reporting purposes, which has caused some compliance issues.

Areas for Discussion

4.9 The levy attempts to be neutral in its approach to branches and subsidiaries. The funding profile of a foreign bank is proportionately applied to its UK branch to reflect the fact that the branch is part of a larger legal entity and will be supported by capital etc held in that entity. From our discussions with banks we are aware that this approach has some advantages and some disadvantages. Some banks have stated that this approach in some circumstances indirectly favours branches. Where UK branches are part of a foreign bank with significant protected deposits they will benefit from a proportion of those excluded liabilities even though their own activities may be limited to investment banking. However, the clear advantage of this approach is that it

recognises that it is the funding profile of the overall entity, of which the branch is only a part, which gives rise to funding risks. We would like to consider further whether the method of allocation reflects the risk that UK branches pose to the UK economy and whether it is possible to more accurately reflect this risk without losing the benefits of the overall approach.

4.10 We would like to discuss whether access to information will become easier as groups grow more familiar with carrying out the bank levy computation. If this issue is unlikely to improve with time we would like to explore whether there are any viable options for reducing compliance burdens in this area.

4.11 Using CATA for bank levy purposes means that CATA has grown in significance as a compliance risk. As banking is a fast moving industry it is likely that regular audits of this area will become more commonplace. The Government is keen to minimise burdens arising from additional compliance activity but does not see a viable alternative to CATA at the present time. We invite discussion of workable suggestions for minimising compliance burdens whilst retaining CATA and ensuring that appropriate levels of assurance can be provided that the liabilities attributed fully reflect the appropriate risk profile of the branch.

4.12 At present the levy only applies to the UK branches of foreign banks, it does not apply to the UK branches of entities that are not banks but which are nevertheless part of a foreign banking group. In this respect the bank levy treatment for branches and subsidiaries is inconsistent as non banking subsidiaries of foreign banking groups are included. We would be interested to hear views on this and to understand to what extent this may be a problem.

Questions

- Q4.1** Does the current methodology produce an advantageous result for UK branches of foreign banks? If so, what measures could be introduced to ensure fairness?
- Q4.2** Do the information gathering issues that arise from the branch allocation method lead to unreasonable compliance burdens?
- Q4.3** If so, how do respondents suggest that this aspect of the methodology could be improved?
- Q4.4** Basing the bank levy upon the initial part of the CATA adjustment will lead to increased compliance activity in this area. Do banks feel that this will lead to excessive administrative burdens?
- Q4.5** Are there ways in which the branch allocation method could be simplified so that it reduces administrative and compliance burdens, but still meets the policy aims?
- Q4.6** Should UK branches of non-banking entities that form part of a foreign banking group also be included within the levy?

5. High Quality Liquid Assets (HQLA)

Current Treatment

5.1 After removing excluded liabilities and netted liabilities from chargeable equity and liabilities, a deduction is permitted for any assets that are capable of qualifying for the Prudential Regulation Authority's ("PRA") liquid assets buffer. However, this deduction may not reduce total chargeable equity and liabilities below nil.

Policy Rationale

5.2 Responses to the July 2010 bank levy consultation noted that liabilities incurred in order to fund banks' liquidity buffers would be charged to the levy. The margin on assets within the buffer is small and it was feared that without some form of relief, the bank levy charge could make it uneconomic for banks to hold these assets, undermining an important regulatory objective. As the funding of these assets was derived from fungible sources it was not possible to identify the particular liabilities funding these assets. The deduction for High Quality Liquid Assets ("HQLA") was therefore included in the levy design.

Operational Experience

5.3 Directly mirroring the regulatory definition of HQLA has provided a clear and straightforward definition for the purposes of the levy deduction.

5.4 However, a number of banks have told us that for the purpose of their own internal stress testing scenarios they include within their buffers assets which are outside of the regulatory definition. The banks believe these assets to be of equal quality and liquidity to those included in the PRA's buffer.

Areas for Discussion

5.5 We would like to understand more about these assets and what the rationale would be for moving beyond those assets included in the buffer by the PRA. Respondents should note that whilst the Government accepts that it is generally desirable to encourage banks to maintain high levels of liquidity, it is important to recognise that the policy behind the current deduction is to align with the specific regulatory requirement.

5.6 We would also be interested to consider whether a better approach would be to exclude from charge the liabilities that fund the assets held in the regulatory liquid assets buffer. This would meet the policy approach but the fungible nature of funding may introduce unwanted additional compliance burdens (which was the reason for not taking this approach in the first place).

Questions

- Q5.1** Do the current HQLA rules target the correct base of assets that banks hold for liquidity purposes?
- Q5.2** Will changes in the regulatory world cause difficulties with the current HQLA deduction method?
- Q5.3** Would excluding the funding supporting assets held within the regulatory liquid asset buffer be a better approach and what compliance burdens would such an approach bring?

6. Regulatory Capital

Current Treatment

6.1 The bank levy excludes all Tier 1 capital from charge. Tier 2 capital is recognised by being subject to the half-rate for longer maturities (over 1 year).

Policy Rationale

6.2 The levy excludes all Tier 1 capital from charge in order not to discourage capital accumulation. This exclusion is based on the broad balance sheet levy recommended by the International Monetary Fund in their report to the G20 and complements the wider regulatory reform agenda, including moves to strengthen capital requirements.

Area for Discussion

6.3 In its October 2010 Consultation Response Document, the Government committed to keeping this exemption under review in light of regulatory developments, and in particular the outcome of the Basel III consultation on contingent capital.

6.4 At Budget 2013, the Government announced that, following the conclusion of the Capital Requirements Directive IV, it will issue secondary legislation to confirm and ensure that the banks' Additional Tier One debt capital instruments, both already in issue and yet to be issued, will be deductible for the purposes of a bank in computing profits for corporation tax.

6.5 The combination of levy and corporation tax rules mean that within Tier 1 capital, Additional Tier 1 debt instruments receive a more favourable tax treatment than common equity. Some, including the Parliamentary Commission on Banking Standards³, have raised concerns that this tax treatment creates a disincentive for banks to hold capital in the most loss absorbent form.

6.6 Reform of the corporation tax rules is not within the scope of this review. However, as common equity is widely recognised and proven to be the most loss absorbing form of capital, there could be merit in recognising this in the levy rules, by amending the current exclusion for all Tier 1 capital and instead limiting it to Common Equity Tier 1.

Questions

Q6.1 Should the Tier One exclusion be restricted to just Common Equity Tier 1?

Q6.2 If the answer to Q6.1 is no, please explain why not.

³ Parliamentary Commission on Banking Standards final report – 'Changing banking for good'

7. Non-Funding Liabilities

Current Treatment

7.1 Respondents to the July 2010 bank levy consultation highlighted a number of liabilities unconnected with funding which the Government excluded from the scope of the levy. These non-funding liabilities included: client monies; corporation tax liabilities; deferred tax liabilities; defined benefit retirement obligations and provisions for the levy itself.

Area for Discussion

7.2 HMRC has been made aware of a number of other non-funding liabilities which should potentially be removed from the scope of the bank levy. Whilst the Government is opposed to adding unnecessary complexity to the levy, we recognise there is a strong argument that liabilities owed to HMRC should be excluded from charge, to prevent a double imposition. Such liabilities would include those in respect of Value Added Tax ("VAT"), Pay as You Earn ("PAYE") and the Tax Deduction Scheme for Interest ("TDSI").

7.3 As noted in Chapter 1, the Government remains committed to the existing annual revenue target for the bank levy, and therefore a reduction in the tax base resulting from additional exclusions would imply, all other things being equal, an offsetting increase in the levy rate.

Questions

- Q7.1** Would an exclusion for liabilities owed to HMRC in respect of VAT, PAYE and TDSI lead to unreasonable compliance burdens?
- Q7.2** Should the Government consider excluding any further liabilities on the basis that they do not represent funding?

8. Deposits from Authorised Persons

Current Treatment and Policy Rationale

8.1 Deposits not excluded as “protected” are generally treated as long term liabilities, chargeable at the half rate. However, this rule does not apply to deposits from an authorised person for the purposes of FISMA 2000 or an entity that would be an authorised person if it was UK resident. Deposits from authorised persons are therefore treated as either short or long term depending on their contractual maturity.

8.2 Deposits from authorised persons do not receive deemed long term treatment because deposits from financial traders are generally considered to be less “sticky”⁴ than other types of deposit.

Area for discussion

8.3 HMRC has been made aware that a number of banks have had difficulty identifying the maturity of these deposits. An alternative to the current approach would be to treat all deposits from authorised person as short term liabilities. As well as potential simplification benefits, this would also reflect the generally transient nature of these deposits.

Questions

- Q8.1** Would treating all deposits from authorised persons as short term simplify the bank levy calculation?

⁴ For further information about “sticky” deposits see chapter 2 above.

9. Other Issues

Collateral Upgrades and Liquidity Swaps

9.1 The Financial Services Authority (“FSA”) - and later the Prudential Regulation Authority (“PRA”) - has defined collateral upgrade transactions, a broad term which includes liquidity swaps, as collateralised borrowing transactions where there is a material difference in the quality of the assets exchanged.

9.2 The FSA carried out a consultation on liquidity swaps in 2011 and issued guidance on collateral upgrade transactions (including liquidity swaps) in February 2012. In short, the Regulator *“see[s] a role for these transactions on a sensible scale, provided the risks are properly identified and managed by both parties.”*⁵. The PRA formally adopted this guidance when it came into existence on 1 April 2013.

Interaction of collateral upgrades with Bank Levy

9.3 This consultation will explore the relationship between collateral upgrades and the levy. The levy contains certain provisions which may interact with collateral upgrades.

9.4 Paragraphs 31 and 32, Schedule 19 of the Finance Act 2011 exclude liabilities arising from sovereign repo and sovereign stock lending transactions. Collateral upgrades usually contain one or more of these transactions (when high quality collateral is sold or lent onwards by the bank).

9.5 Paragraphs 15, 17 and 19 contain deductions for High Quality Liquid Assets (“HQLA”) in respect of the levy calculations of UK banks, building societies and banking groups, foreign banking groups and relevant non-banking groups, respectively. Whilst high quality assets acquired by virtue of a collateral upgrade are usually held off-balance sheet, the levy allows a deduction in respect of these assets where they form the collateral underlying an advance of cash and would otherwise qualify as HQLA.

9.6 The Government would like to understand whether collateral upgrades genuinely improve the liquidity of a bank and therefore whether they complement the levy’s policy intention of encouraging banks to move towards safer funding models. If necessary, we would like to identify hallmarks that could be used to make the legislation better reflect the policy.

9.7 We are aware that liquidity swaps are used as a genuine commercial source of cheap finance for many banks, and indeed Funding for Lending and some asset protection schemes use very similar techniques to provide funding for the banks. We are mindful not to make changes that would negatively affect desirable commercial activity.

⁵ Prudential Regulation Authority, Supervisory Statement LSS2/13

9.8 There are a number of areas that we would particularly like to focus on: quality, linked transactions and maturity.

Quality

9.9 Whilst theoretically a HQLA deduction is not due where assets are exchanged for assets without any cash transfer; we understand that exchanges are frequently backed on both sides by cash, bringing the transactions within the scope of the deduction.

9.10 We would like to understand more about the commercial impact of transactions where assets are temporarily exchanged for assets of a materially better quality via, for example, a swap, stock lend or repo.

Link between Transactions

9.11 The levy rules permit both an exclusion and deduction in respect of the same high quality asset. Where X lends cash to Y under a repo collateralised by a qualifying high quality asset, X may claim a HQLA deduction in respect of its financial asset (the repo debtor). Equally Y may exclude its repo liability because it is backed by a high quality asset. This result appears counterintuitive. We would like to investigate whether the same asset can, in reality, improve the liquidity of one party whilst securing the liabilities of another.

Maturity

9.12 The levy rules contain no restrictions as to the length of time that an entity must be contractually entitled to hold an asset. We would like to understand whether this is the correct position. Can a high quality asset acquired under a short term (say overnight) reverse repo genuinely improve the borrower's liquidity?

Client Clearing

Policy

9.13 As part of the regulatory reform agenda, there is a drive to introduce central clearing of derivatives via regulated central counterparties ("CCPs"). The benefits of central clearing include enhanced asset protection and mitigated counterparty risk, as well as improved market transparency.

9.14 Mandatory central clearing of certain products will be implemented in the EU via the European Markets Infrastructure Regulations ("EMIR") and in the US, via the Dodd-Frank Act.

9.15 We understand that regulators are encouraging banks to act as clearing members, facing the CCP and facilitating the counterparty's transaction. Some banks have raised concerns that, due to the very small margins on these transactions, the levy may make this activity uneconomic.

Area for Discussion

9.16 The levy is intended to align with and complement regulation wherever possible. Therefore, we would welcome further discussion with parties affected by central clearing to develop our understanding of how central clearing will interact with the levy.

9.17 In particular we would like to explore the feasibility of bringing central clearing within the scope of the client money exclusion.

Other Design Issues

9.18 The levy contains a number of reliefs and incentives for what are considered to be low risk funding and a lower rate for longer term liabilities to reflect the stability of the banks' funding profile. Previous chapters have set out specific issues where we believe there is merit in re-examining the operation of the levy. In several cases, a key concern is to ensure the levy is designed in a way that best meets its objectives i.e. around targeting riskier funding while remaining operable and proportionate.

9.19 In addition to the specific issues identified in this document, we would welcome any comments or suggestions on other areas where the incentives and reliefs within the bank levy could be refined to better reflect the risks that banks pose.

9.20 It is also important to ensure that the levy continues to work efficiently in the longer term. As such we would encourage banks and other stakeholders to discuss with us any proposed future changes in the economic, regulatory and accounting worlds that may affect the levy. In particular, we would like participants to consider the regulatory and accountancy definitions that the levy uses and to advise of any areas where these may be subject to change.

Questions

- Q9.1** Do temporary exchanges of assets of unequal quality genuinely improve the liquidity of the party receiving the higher quality asset?
- Q9.2** Can the same asset, in reality, improve the liquidity of one party whilst securing the liabilities of another?
- Q9.3** Should short term reverse repo or swap transactions receive the same treatment as longer ones, and if not at what point in time should the position change?
- Q9.4** Will central clearing be implemented materially differently in the EU and the US, if so please give details of the differences?

- Q9.5** Would bringing central clearing within the scope of the client monies deduction lead to unreasonable compliance burdens?
- Q9.6** In addition to the areas already set out, could any of the other incentives and reliefs within the bank levy be amended to better reflect the risks that banks pose?
- Q9.7** Are there any regulatory or accounting changes on the horizon that may require definitions within the bank levy to be revised?

10. Revenue Drivers

10.1 The original forecasts for bank levy revenues were developed with information provided by banks about their expected levy liabilities. However, since the bank levy was introduced, receipts have been smaller than originally anticipated, and in both 2011 and 2012 have been below the £2½ billion target. In response, the Government has made several increases to the rate of bank levy charged to ensure that the levy raises at least £2½ billion each year.

10.2 Forecasting challenges are, to some extent, inherent in the introduction of a new tax, such as the bank levy. Nevertheless, the Government has been consistently clear that the levy has a revenue target, and is committed to setting the bank levy at the rate necessary to achieve this. Improving the information we have on revenue drivers could therefore help improve forecast accuracy. This should in turn reduce the size and frequency of any further rate adjustments needed to meet the current revenue target.

10.3 To help understand the picture in greater detail, the Government would like to explore any other factors which may be driving banks' charges under the levy. In particular the Government would like to understand which of the following factors is playing the most significant part in reducing banks' exposure to the bank levy and how these may play out in the near future:

- changes to banks' balance sheets,
- regulatory factors,
- economic factors, and
- the effect of the incentives within the bank levy.

Question

Q10.1 What factors will be important in shaping banks' balance sheets over the next few years and how might these impact upon levy payments?

11. Summary of Consultation Questions

This document contains a number of specific questions, and these are summarised below. However, as noted earlier, respondents should not feel necessarily constrained to restrict their comments to those specific points; more general thoughts on the issues raised are also welcome.

Chapter 2 Protected Deposits

Q2.1 Which definition most accurately reflects the concept of “sticky deposits”?

- All retail deposits.
- All smaller retail deposits below a certain fixed amount, say £50,000.
- All deposits protected by a deposit protection – up to the scheme limit.

Q2.2 The Government is aware that banks may have built systems to comply with the current protected deposits rules and we would like to ensure that we do not make changes that may make these systems redundant. With that in mind, would any of the proxies for sticky deposits at Q2.1 above cause significant compliance burdens?

Q2.3 If respondents consider that retail deposits (or a proportion thereof) most accurately reflect the concept of stickiness, is it possible to arrive at a definition of “retail deposits” that would be readily applicable to all banks?

Q2.4 If sticky deposits continue to be defined by reference to deposit protection schemes, would removing the link to the scheme fee significantly reduce compliance burdens?

Chapter 3 Netting

Q3.1 Would removing the netting rules and moving to a system that charges derivative contract liabilities at a lower rate lead to a simpler, fairer and less burdensome regime?

Q3.2 If not, would short term treatment of all derivative contract liabilities, for the purposes of the bank levy, simplify the netting provisions?

Q3.3 With the expectation that all banks will have, or will put in place, systems and processes that can cope with the more intricate elements of the netting rules, should they remain unchanged?

Q3.4 How could “common law” netting agreements which genuinely reduce risk be included in the bank levy rules, without damaging the sound principles on which they are based?

Chapter 4 Allocation of liabilities to UK branches of foreign banks

- Q4.1** Does the current methodology produce an advantageous result for UK branches of foreign banks? If so, what measures could be introduced to ensure fairness?
- Q4.2** Do the information gathering issues that arise from the branch allocation method lead to unreasonable compliance burdens?
- Q4.3** If so how do respondents suggest that this aspect of the methodology could be improved?
- Q4.4** Basing the bank levy upon the initial part of the CATA adjustment will lead to increased compliance activity in this area. Do banks feel that this will lead to excessive administrative burdens?
- Q4.5** Are there ways in which the branch allocation method could be simplified so that it reduces administrative and compliance burdens, but still meets the policy aims?
- Q4.6** Should UK branches of non-banking entities that form part of a foreign banking group also be included within the levy?

Chapter 5 High Quality Liquid Assets

- Q5.1** Do the current HQLA rules target the correct base of assets that banks hold for liquidity purposes?
- Q5.2** Will changes in the regulatory world cause difficulties with the current HQLA deduction method?
- Q5.3** Would excluding the funding supporting assets held within the regulatory liquid asset buffer be a better approach and what compliance burdens would such an approach bring?

Chapter 6 Regulatory Capital

- Q6.1** Should the Tier One exclusion be restricted to just Common Equity Tier 1?
- Q6.2** If the answer to Q6.1 is no, please explain why not.

Chapter 7 Non-Funding Liabilities

- Q7.1** Would an exclusion for liabilities owed to HMRC in respect of VAT, PAYE and TDSI lead to unreasonable compliance burdens?
- Q7.2** Should the Government consider excluding any further liabilities on the basis that they do not represent funding?

Chapter 8 Deposits from Authorised Persons

- Q8.1** Would treating all deposits from authorised persons as short term simplify the bank levy calculation?

Chapter 9 Other Issues

- Q9.1** Do temporary exchanges of assets of unequal quality genuinely improve the liquidity of the party receiving the higher quality asset?
- Q9.2** Can the same asset, in reality, improve the liquidity of one party whilst securing the liabilities of another?
- Q9.3** Should short term reverse repo or swap transactions receive the same treatment as longer ones, and if not at what point in time should the position change?
- Q9.4** Will central clearing be implemented materially differently in the EU and the US, if so please give details of the differences?
- Q9.5** Would bringing central clearing within the scope of the client monies deduction lead to unreasonable compliance burdens?
- Q9.6** In addition to the areas already set out, could any of the other incentives and reliefs within the bank levy be amended to better reflect the risks that banks pose?
- Q9.7** Are there any regulatory or accounting changes on the horizon that may require definitions within the bank levy to be revised?

Chapter 10 Revenue Drivers

- Q10.1** What factors will be important in shaping banks' balance sheets over the next few years and how might these impact upon levy payments?

12. The Consultation Process: How to respond

This consultation is being conducted in line with the Tax Consultation Framework. There are 5 stages to tax policy development:

- Stage 1 Setting out objectives and identifying options.
- Stage 2 Determining the best option and developing a framework for implementation including detailed policy design.
- Stage 3 Drafting legislation to effect the proposed change.
- Stage 4 Implementing and monitoring the change.
- Stage 5 Reviewing and evaluating the change.

This consultation is taking place during stages 1 and 2 of the process. Some chapters of this document seek views on how the bank levy legislation is performing in practice. Other chapters set out options, or in some cases, a proposed way forward. This consultation seeks views on the policy design within the framework of these options and proposals.

Further Consultation

Open meeting

To complement this document, the Government will hold an open meeting. This will take place in London on 5 August 2013 and will last around 2.5 hours. The purpose will be to introduce the consultation and give an opportunity for participants to make high level comment.

Space will be limited and there is controlled access to the building. Therefore, for reasons of practicality and security, if you wish to attend this meeting, you must notify Samantha Brown by email at:

Samantha.brown@hmrc.gsi.gov.uk

This will also ensure that you can be notified of the arrangements and any changes. You are asked to give notification as early as possible; if it is necessary to limit numbers attending, this will be done on a first come, first served basis, and multiple applications from individual organisations may have to be limited.

Working group

HMRC will be establishing three working groups to act as a forum for detailed discussion of protected deposits, netting and the other remaining issues arising from the consultation. These groups are expected to meet once per group during the

consultation period. To ensure that these groups are effective and broadly representative, membership will be limited. If you would like to be considered for inclusion in this group, you should contact Samantha Brown by email, briefly explaining your interest.

How to respond

A summary of the questions in this consultation is included at chapter 11.

Responses should be sent by 26 September 2013, by e-mail to anthony.c.fawcett@hmrc.gsi.gov.uk or samantha.brown@hmrc.gsi.gov.uk or by post to:

Anthony Fawcett
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SW1A 2BQ

Telephone enquiries 020 7147 0654 or 020 7147 0180

Paper copies of this document or copies in Welsh and alternative formats (large print, audio and Braille) may be obtained free of charge from the above address. This document can also be accessed from [HMRC Inside Government](#). All responses will be acknowledged, but it will not be possible to give substantive replies to individual representations.

When responding please say if you are a business, individual or representative body. In the case of representative bodies please provide information on the number and nature of people you represent.

Confidentiality

Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 ("FOIA"), the Data Protection Act 1998 ("DPA") and the Environmental Information Regulations 2004.

If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals with, amongst other things, obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HM Revenue and Customs ("HMRC").

HMRC will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

Consultation Principles

This consultation is being run in accordance with the Government's Consultation Principles.

The Consultation Principles are available on the Cabinet Office website: <http://www.cabinetoffice.gov.uk/resource-library/consultation-principles-guidance>

If you have any comments or complaints about the consultation process please contact:

Amy Burgess, Consultation Coordinator, Budget Team, HM Revenue & Customs, 100 Parliament Street, London, SW1A 2BQ.

Email: hmrc-consultation.co-ordinator@hmrc.gsi.gov.uk

Please do not send responses to the consultation to this address.