HM Revenue
& Customs

HM TREASURY

Re-scope of the Bank Levy – 2021

Summary of Responses
5 December 2016

Contents

1	Executive Summary	3
2	Introduction	5
3	Determination of UK balance sheets	7
4	Subsidiary funding	11
5	Further design issues	16
6	Alternative definitions for UK balance sheets	20
7	High Quality Liquid Assets	25
8	Next steps	27
Annex A	List of stakeholders consulted	28
Annex B	Follow up questions asked of respondents	29

1. Executive Summary

The UK's financial services industry plays a vital role in the UK, European and global economies and the government is committed to making sure the financial sector remains robust, highly competitive and open for business. However, this commitment needs to be balanced against the need for banks and building societies to make an appropriate tax contribution that reflects their unique risks to the financial system and wider UK economy.

The Summer Budget 2015 set out a long-term plan for delivering this balance, one which takes account of developments in regulation and the ongoing recovery in bank profitability.

This included a change in the scope of the bank levy ("the levy", a tax on the balance sheet equity and liabilities of banking and building society groups) from 1 January 2021. From this date groups subject to the levy will be levied solely on their UK balance sheet equity and liabilities.

The plan also included:

- the introduction of a new 8% tax on banking sector profits from 1 January 2016, and
- a phased reduction of the bank levy rate, from a rate of 0.21% in 2015 to 0.1% from 1 January 2021.

These reforms will provide a long-term competitive and sustainable model for taxing the UK banking sector, with a 25% rate of tax on banking sector profits and a 0.1% levy on the balance sheet liabilities of UK banking operations.

It will also introduce greater stability into the banking tax regime by allowing tax receipts to respond naturally to changes in banks' balance sheets and profitability over time.

On 9 December 2015 the government published a consultation setting out objectives for the change in the bank levy's scope from 1 January 2021 and a proposal for delivering these objectives in legislation, highlighting some key issues that need to be addressed in order to achieve this.

This consultation also outlined proposals to amend the definition of High Quality Liquid Assets in line with the new regulatory definitions that were adopted by the Prudential Regulatory Authority in 2015.

Responses to this consultation have provided significant detail on the relative effectiveness and impact of the proposals made by the government on how to implement these changes.

In line with these responses, the government has focused on identifying how these changes to the bank levy can be made in a way that will best deliver the announced policy in the most straightforward manner, while maintaining fairness of application and alignment with regulation.

Key decisions

Following the consultation the government has made the following decisions on how the re-scope of the bank levy will be implemented.

Timing

- The legislation for the bank levy re-scope will be included in Finance Bill 2017-18.
- As announced at Summer Budget 2015 the re-scope will take effect from 1 January 2021.

Subsidiary funding

- Capital issued by UK entities to fund overseas subsidiaries will not be charged to the bank levy.
- To achieve this the government will introduce a relief for loss absorbing capacity issued in the UK in order to fund overseas subsidiaries.
- This will work by allowing groups a deduction from UK liabilities for loss-absorbing instruments that they hold in overseas subsidiaries

Overseas branches

- As well as excluding the liabilities relating to the funding of overseas subsidiaries, the funding of overseas branches of UK banks will also be exempted from the levy.

High Quality Liquid Assets

- The definition of high quality liquid assets has been amended to include all those assets considered “Level 1” high quality liquid assets by the Prudential Regulatory Authority.

Responses to the consultation also highlighted some further design issues which the government will continue to work with the industry in order to resolve. These issues will be addressed when draft legislation is published in 2017.

2. Introduction

Background

2.1 The bank levy ("the levy") is a tax on the balance sheet equity and liabilities of banks and banking groups[1]. It took effect from 1 January 2011, with the legislation included in Schedule 19 Finance Act 2011.

2.2 The purpose of the levy is to ensure that banks make a fair contribution, reflecting the risks they pose to the financial system and the wider UK economy. It was also designed to create appropriate incentives to encourage banks to move away from riskier funding models.

2.3 The levy was designed to reflect these two objectives with the charge applying to:

- the global consolidated balance sheets of UK headquartered 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.

2.4 In order to encourage banks to move away from riskier funding models long term liabilities (those with a maturity date of over 12 months) are charged at the bank levy half rate, whereas short term liabilities (those with a maturity date within 12 months) are charged at the full rate.

2.5 The government announced at Summer Budget 2015 that from 1 January 2021, in line with the evolving regulatory landscape, the bank levy would be re-scoped and banking groups would be levied solely on their UK balance sheet equity and liabilities.

The consultation process

2.6 On 9 December 2015 the government published a consultation setting out objectives for the change and a proposal for delivering these objectives in legislation, highlighting some key issues that need to be addressed in order to achieve this.

2.7 This consultation ran for 12 weeks until 4 March 2016. During this period HMRC and HMT also ran a face to face event which attracted approximately 25 attendees, and undertook a number of bilateral meetings with representative bodies, advisers and banks.

2.8 In response to the consultation several areas were identified which required further investigation. In order to fully understand the issues raised further questions were sent out to parties that had raised these issues in their consultation responses. A copy of these questions can be found at Annex B to this response document.

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[1] The bank levy applies to building society groups and entities in the same way as it applies to banking groups and entities. For ease of reference this document refers simply to banking groups and entities.

High Quality Liquid Assets

2.9 The consultation also covered proposed amendments to the definition of High Quality Liquid Assets following the introduction of new definitions by the Prudential Regulation Authority.

2.10 As outlined in the consultation, changes to this area were made to an earlier timescale and have now been brought into law by secondary legislation. This legislation was laid before parliament on 6 September and has been effective from 1 October 2016.

2.11 A Tax Information and Impact Note was published on 26 May 2016.

https://www.gov.uk/government/publications/bank-levy-amending-the-definition-of-high-quality-liquid-assets-and-high-quality-securities

3. Determination of UK balance sheets

3.1 The proposed change in the scope of the levy means that from 1 January 2021 banks will be levied solely on their UK balance sheet equity and liabilities.

3.2 The meaning of "UK balance sheet equity and liabilities" is fundamental to the reform and something on which the government invited views as part of the consultation.

3.3 One consideration raised by respondents for determining a UK balance sheet was the treatment of UK liabilities that are issued to fund their holdings of investments in overseas subsidiaries. This issue is addressed separately under Subsidiary funding in Chapter 4.

Proposed UK balance sheet outcome

3.4 Chapter 2 of the consultation outlined the government's intention that from 2021 all banking groups will be levied on the balance sheet liabilities of UK based entities and any branches of foreign banks which operate in the UK.

3.5 It set out a proposal to deliver this outcome by amending the existing framework for non-UK headquartered banking groups to deliver a calculation that would result in the levy being applied to the balance sheet liabilities of UK based entities, and on the balance sheets of any branches which operate in the UK.

3.6 The existing bank levy legislation contains provisions to calculate the levy base for foreign banking groups which operate in the UK through subsidiaries and/or branches, which may or may not be in a consolidated UK sub-group. This is achieved by identifying four different categories of equity and liabilities.

> **Type A:** Equity and liabilities of "relevant"[2] UK sub-groups (consolidated UK banking sub-groups).
>
> **Type B:** Equity and liabilities of any UK resident entity in a banking group (unless already included in a relevant UK sub-group), regardless of their trade or activities.
>
> **Type C:** Equity and liabilities of any non-UK resident entity that is held by a UK resident entity (unless already included in a relevant UK sub-group), regardless of their trade or activities.
>
> **Type D:** UK allocated equity and liabilities of a non-UK resident bank (that is not a member of a UK sub-group) with a UK permanent establishment.

3.7 The bank levy is then charged on the sum of Type A to D liabilities, with relevant exclusions, deductions and eliminations for intra-group liabilities and legally enforceable netting agreements.

[2] Broadly, a relevant group consists of a UK parent entity and all entities that are consolidated into its financial statements at the end of a chargeable period.

3.8 The proposed amended methodology was:

Adjusted Type A: Equity and liabilities of relevant UK sub-groups, excluding non-UK resident entities.

Type B: Equity and liabilities of UK resident entities of a banking group (unless already included in a relevant UK sub-group).

Adjusted Type D: UK allocated equity and liabilities of a non-UK resident bank with a UK permanent establishment, even if the bank is a member of a UK banking group or sub-group.

3.9 The consultation sought views on the proposed approach, and included the following questions.

Questions

To what extent do you agree with the government's intended outcomes from the move to a UK balance sheet base?

To what extent do you think these outcomes can be delivered by modifying the existing treatment of foreign banking groups as proposed above?

3.10 The majority of respondents were supportive of the government's intention to move to a UK balance sheet base, although some concerns were raised over whether the proposed approach would deliver this outcome in practice.

3.11 Other than these specific concerns respondents were broadly supportive of the proposed methodology, believing that it should give the right outcome if the further issues outlined in Chapters 4 and 5 of this document could be resolved.

3.12 A few respondents suggested alternative policy proposals for the re-scope. The majority of these were representatives of foreign banking entities operating in the UK through permanent establishments, who expressed a view that the UK activities of non-UK resident entities should not be subject to the bank levy, especially where those entities were covered by a home state resolution fund of some kind.

Government response

3.13 The government believes that the proposed approach of modifying the existing treatment for foreign banking groups will deliver the intended result. This method also has the advantage of building on an understood existing methodology, meaning that both industry and government will be able to rely on previous work undertaken as well as existing knowledge and expertise on the bank levy.

3.14 The inclusion of UK permanent establishments of non-UK based entities was not an issue raised in the consultation document, but given the representations made the government believes that it is appropriate to respond to this point.

3.15 The government believes that including UK permanent establishments of foreign banking entities within the scope of the bank levy remains appropriate and will not be amending this policy.

3.16 The re-scope of the bank levy is refocussing the levy towards a UK territorial application and by definition a territorial application will apply to both entities and permanent establishments that operate within the UK market.

Are there any particular issues that are not addressed by the method proposed above?

3.17 Several respondents raised concerns over the treatment of regulatory capital and whether the government's proposed methodology could lead to a punitive treatment for UK headquartered groups who adopt a single point of entry model.

3.18 Concerns were also raised over the impact of the re-scope on group liquidity management and intragroup trading transactions.

3.19 These areas have been included in Chapter 4 Subsidiary funding and Chapter 5 Further design issues.

What other methods could be used here?

Should banks which prepare consolidated accounts be allowed to elect to calculate their chargeable liabilities on a Type B, rather than Type A basis?

3.20 No respondents outlined any different proposals to the use of Adjusted Type A, Type B and Adjusted Type D liabilities.

3.21 All respondents were in favour of allowing an election between Type A and Type B calculations and no cases were identified where the calculation methods would give rise to a significantly different outcome, provided that the method was used consistently. However many respondents indicated that the relative compliance burdens of the two approaches could vary dramatically depending on the international structure and business model of the bank.

3.22 One respondent also commented that a yearly election would be an unnecessary administrative burden, and allowing banks to elect on a yearly basis may cause some arbitrage risks. They suggested that the elections should instead be indefinite, but only permissible to amend once within a three or five year period.

Government response

3.23 The government will proceed with a calculation method based on Adjusted Type A, Type B and Adjusted Type D liabilities.

3.24 Following the consultation the government agrees that to prepare their calculation, a bank which prepares consolidated accounts for a UK parent entity may elect to calculate their chargeable liabilities on a Type B, rather than Type A basis.

3.25 The government agrees that an indefinite election would be preferable to an annual election and proposes that the election will stand until revoked.

3.26 However in light of the current commercial uncertainties around future structures of both UK and international banking operations, the government does not intend to place any restrictions on how often a group can amend their election at this time. Instead HMRC will keep this under matter under review following implementation.

4. Subsidiary funding

Subsidiary funding

4.1 Under the approach proposed in the consultation, all equity and liabilities of UK entities that relate to a third party (or a group member outside the scope of the levy) would remain within scope of the levy.

4.2 The consultation identified that this could include liabilities of a UK banking entity that are used to raise funding that is then on-lent to their overseas subsidiaries. The government stated that they would consider the case for excluding certain liabilities that a UK entity may issue to fund their capital holdings in overseas subsidiaries.

4.3 The consultation welcomed suggestions for how such an exclusion could be designed.

Questions

To what extent could UK banks be charged on equity and liabilities that relate to the funding of overseas subsidiaries?

4.4 All parties who responded on this area commented that if the bank levy applied to the balance sheet of the UK parent company, and excluded only those liabilities issued directly by overseas subsidiaries, this could result in a material amount of the group funding that relates to overseas subsidiaries remaining within charge.

4.5 Although the liabilities of the overseas subsidiary themselves will be excluded from charge, this approach would not exclude UK liabilities that relate to the central funding of an overseas subsidiary. This would mean that when debt is issued from a UK holding company and then on-lent to an overseas subsidiary the debt raised in the UK would remain chargeable to the bank levy.

4.6 Many respondents commented that this outcome would not be in line with the policy announced at the 2015 Summer Budget.

4.7 Several banks also commented that this approach could create conflicts with regulatory pressures where resolution funding objectives may drive banks to issue loss absorbing capital from the main banking entity or holding company rather than at subsidiary levels.

Do you agree that funding an overseas subsidiary from a UK bank or parent entity has the potential to expose the UK entity to greater risk?

4.8 This question received mixed responses. Most respondents felt that the capitalisation of an overseas subsidiary through a UK parent did not expose the parent to increased risk. In fact a case was made that funding an overseas subsidiary using equity and regulatory capital could even be considered to reduce the exposure of the rest of the group to that subsidiary.

4.9 However others took the view that funding an overseas subsidiary through a UK parent would expose the parent to greater risk, and therefore only liabilities directly attributable to overseas subsidiaries should be excluded from the charge.

What classes of equity and liabilities should be considered for any exclusion?

How could any exclusion be designed and targeted in a way that recognises the fungibility of bank funding?

4.10 This issue was the most complex area considered in the consultation. As well as the questions posed in the initial consultation document a series of follow up questions was later posed to those banks and industry bodies who responded on this issue. A copy of these follow up questions can be found at Annex B to this document.

4.11 The majority of respondents suggested that a deduction should be given against the UK parent's equities and liabilities for capital investment in overseas subsidiaries, allowing this deduction for holdings of equity, additional Tier 1 and other forms of high quality capital instruments.

4.12 One respondent suggested that deductions should be given for all forms of liability on the balance sheet of overseas group subsidiaries that are owed to the UK parent. However, when this suggestion was raised with other stakeholders the wider view from the industry was that it would not be administratively possible to link specific liabilities on the balance sheet of the parent to liabilities on the balance sheet of a subsidiary.

4.13 Several parties also stated that without being able to draw a direct link between liabilities on the balance sheet of the parent and liabilities on the balance sheet of the subsidiary a general exclusion would pose a significant risk of abuse.

4.14 Representations were also made to exclude the total amount of capital funding that the regulator requires the group to issue due to their activities undertaken overseas, whether or not the funding raised from that capital had then been invested in capital of overseas subsidiaries.

Government response

4.15 The government recognises that traceability of funding is inherently difficult within groups, and particularly within large, multinational, banking groups and therefore a direct link between a liability of the UK group and the investment in the subsidiary may either be impossible to identify or administratively complex.

4.16 We therefore intend to give relief for certain assets that UK companies have on their balance sheet in respect of their non-UK subsidiaries, which will provide an indication of capital that has been on-lent.

4.17 There is a risk that this relief could be abused, for example through UK companies providing significant short-term loans to non-UK subsidiaries at year-end.

For that reason the government has decided that the issue of subsidiary funding should be addressed by allowing a deduction against UK equities and liabilities for investments that UK entities hold in loss absorbing instruments issued by their overseas subsidiaries.

4.18 The definition of loss absorbing instruments will need to reflect any regulatory changes but is expected to be based on the global standards for instruments eligible as Total Loss Absorbing Capacity[3], as implemented in the UK through Minimum Requirement for own funds and Eligible Liabilities[4].

4.19 This deduction will only be given where the UK entity has invested in loss absorbing instruments issued by an overseas members of the group.

Global apportionment

4.20 Some consultation responses suggested the adoption of an apportionment basis for calculating UK liabilities rather than an exclusion or relief for investments in subsidiaries.

4.21 This would involve establishing a group or sub-group's chargeable equities and liabilities on a global basis, and then allocating a proportion of those liabilities to the UK on the basis of the UK's proportional share of the group's assets.

Government response

4.22 Although the government did consider this approach the proposal raised some significant concerns over how this method would work where activities undertaken in the UK operations had a materially different risk profile from activities undertaken by overseas subsidiaries.

4.23 The government concluded that allowing a deduction for loss absorbing capital instruments issued by overseas subsidiaries would be a better way to deliver the proposed policy.

[3] http://www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf
[4] http://www.bankofengland.co.uk/publications/Pages/news/2016/082.aspx

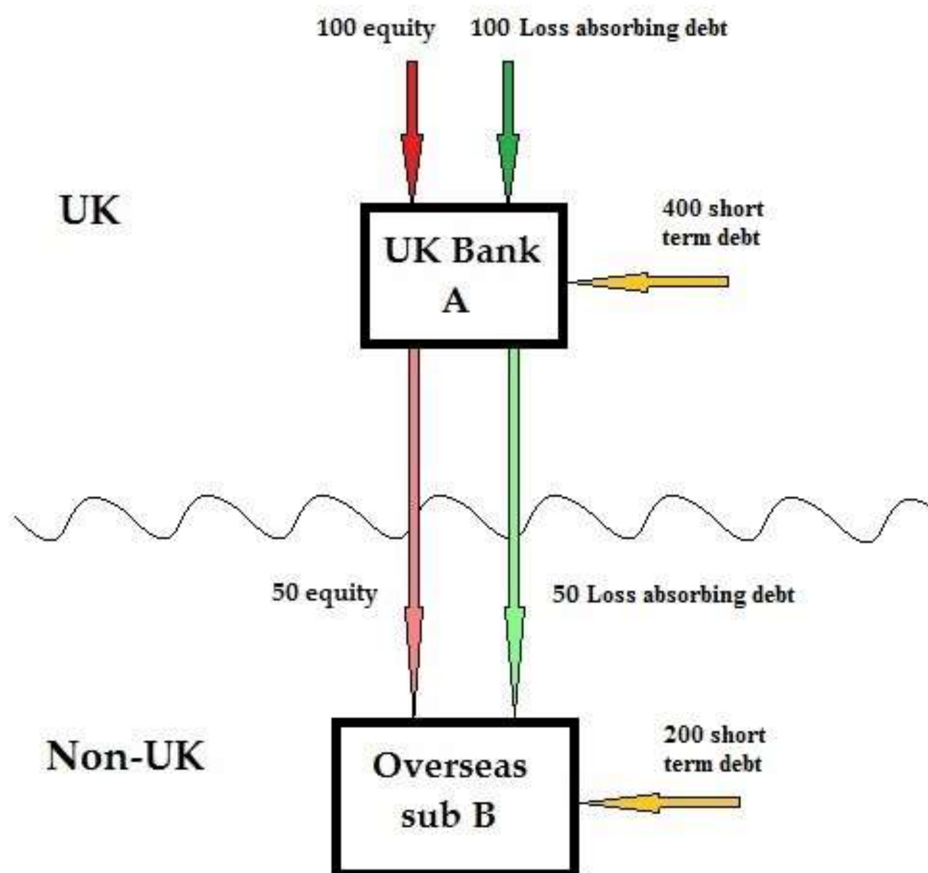
How will this work?

4.24 The deduction will be given against the chargeable liabilities of the parent entity in a similar manner to the deduction for high quality liquid assets.

4.25 Deductions for holding different classes of instrument will be matched against the same type of instrument issued by the parent entity.

4.26 As loss absorbing capital is a long term liability this will mean that the deduction for investment in overseas subsidiaries will be at the half rate.

4.27 This is demonstrated below:



Current basis

The bank levy is charged on the full consolidated balance sheet of the group:

Total liabilities = 800	100 equity is excluded from charge as T1
Chargeable liabilities = 700	Including 100 loss absorbing debt (long term) and 600 other debt (short term)

Post re-scope

The bank levy is charged on the consolidated balance sheet of the UK group. However equity and loss absorbing debt held in overseas subsidiaries are deducted from the equity and loss absorbing debt issued by the UK parent:

Total UK liabilities = 600	Less 50 equity and 50 loss absorbing debt issued by overseas sub
UK allocated liabilities = 500	UK allocated liabilities less 50 equity (100 total - 50 invested in overseas sub)
Chargeable liabilities = 450	Including 50 loss absorbing debt (long term) and 400 other debt (short term)

Equity

4.28 Investments in equity of overseas subsidiaries will be deducted from the equity of the UK parent when calculating the bank levy computation.

Debt

4.29 Investments in loss absorbing debt of overseas subsidiaries will be deducted from the loss absorbing debt of the UK parent when calculating the bank levy computation.

Interaction with Tier 1 exclusion

4.30 Tier 1 capital (both Common Equity Tier 1 and Additional Tier 1) is excluded from charge for the bank levy. However the amount of Tier 1 that may be excluded is calculated *after* regulatory deductions, such as investments in financial subsidiaries.

4.31 Following the re-scope the exclusion for Tier 1 capital issued will continue to be given after deductions (including any deduction for Tier 1 investments in overseas subsidiaries) and a separate deduction will be given for holdings of loss absorbing capital instruments issued by overseas subsidiaries (including Tier 1).

Interaction with HQLA deduction

4.32 In some cases a UK entity may issue loss absorbing capital, but not then invest the funds raised in loss absorbing capital issued by overseas subsidiaries.

4.33 However in these cases any “excess” funding that the UK regulator mandates must be raised, but the overseas regulator does not then mandate be invested in the subsidiary, could be held in the form of high quality liquid assets.

4.34 A deduction would then be given for the holding of these high quality liquid assets in accordance with the current rules. As both the deductions for high quality liquid assets and investment in loss absorbing capital of overseas subsidiaries are active at the half rate of the bank levy, this should give the same outcome.

5. Further design issues

Treatment of Tier 1 capital

5.1 The bank levy legislation currently excludes Tier 1 capital from the bank levy charge in order to reflect the stability and loss absorbency of this form of funding.

5.2 The exclusion for Tier 1 applies to both Common Equity Tier 1 and Additional Tier 1 and is calculated after regulatory deductions; this means that the amount of the exclusion is calculated after a deduction for Tier 1 investments in financial subsidiaries.

5.3 As part of the consultation the government sought views on whether using the current definition of Tier 1 capital post-deduction for investments in subsidiaries remains appropriate upon the move to a UK balance sheet tax base.

5.4 In particular the government wanted to explore whether this issue would be best addressed through an amendment to the definition of Tier 1 capital, or whether this should be dealt with as part of the wider issues around subsidiary funding.

Questions

Are there any specific considerations around the treatment of Tier 1 that differ from those that arise from other forms of subsidiary funding?

5.5 All respondents felt strongly that the outcome of the re-scope should not result in additional amounts of Tier 1 capital issued by UK entities being brought into charge.

5.6 However most respondents also commented that if the issue of subsidiary funding could be suitably addressed this would also resolve the Tier 1 issue and responses were split on whether exclusion of Tier 1 or deduction for overseas investments should take primacy for deduction.

Government response

5.7 No responses to this consultation have identified any issues that are specific to Tier 1 capital rather than applicable to all subsidiary funding. For that reason no specific amendments will be made to the Tier 1 rules.

5.8 The government view is that allowing a deduction for investment in both high quality debt and equity issued by overseas subsidiaries will result in a simpler and more consistent approach than would be achieved by amending the rules for Tier 1 exclusions.

5.9 This means that although UK groups will no longer be able to exclude Tier 1 capital that they have invested in their overseas subsidiaries, they will instead receive a deduction for their holdings of high quality capital issued by those subsidiaries, including Tier 1 instruments.

Netting

5.10 The current rules include provisions which allow certain liabilities to be excluded from the bank levy charge when they are subject to a legally enforceable netting agreement.

5.11 For foreign banking groups, the provisions are restricted to entities that fall within the bank levy's scope. For example, under the current rules the liabilities of a UK banking entity cannot be netted against the assets of a non-UK resident banking entity, unless this entity falls within a UK sub-group (and is chargeable to the bank levy).

5.12 The consultation proposed that following the re-scope the netting provisions for all banks' groups should be aligned with this treatment from 2021 and invited views on this proposal.

Questions

Do you agree with the government's proposed approach for netting?

5.13 Most respondents agreed with the government's proposed approach and many commented that this was an area where they were keen to avoid any fundamental changes.

5.14 However one concern was raised regarding the fact that under the current rules a UK liability that is subject to a netting agreement with a non-UK asset (and so does not pose a funding risk in the UK) does not benefit from the netting rules.

5.15 It was questioned whether maintaining this approach would be appropriate in the future given that the liability is netted at global level and the funding risk has been netted out of the UK.

Government response

5.16 The government acknowledges that the existing approach for netting may continue to charge liabilities that do not pose a funding risk to the UK entity.

5.17 However many assets are netted across the group as a whole, and this means that the assets can be netted against liabilities of many group entities, not just those in the UK. Because of this any proposed amendment would need to be able to identify the residual netted position of the UK chargeable entities on a standalone basis, even though the netting agreements may well be group wide.

5.18 The government agrees that the netting rules need to be reviewed in respect of cases where liabilities are netted against assets held by entities outside the UK and commits to keep working with industry to ensure that the draft legislation best reflects the policy in this area.

Further Issues

Are there any particular issues that are not addressed by the method proposed above?

5.19 Chapter 2 of the consultation asked for input on whether there were any additional issues that were not addressed by the government's proposed method of using Amended type A, type B and Amended type D liabilities to calculate the bank levy charge from 2021.

5.20 Several respondents raised concerns over the impact of the re-scope on group liquidity management and intragroup trading transactions.

Liquidity Management

5.21 The concerns raised around group liquidity management arise from the requirements for banks to manage the availability of sufficient financial resources to enable a group to meet the demands of customers and their own payment obligations as they fall due.

5.22 One of the most common ways of managing group liquidity is for subsidiary entities to place excess funds (surplus liquidity) over and above anticipated outflows on deposit with the main regulated banking entity.

5.23 Under the current proposal where intragroup deposits are placed with a UK banking entity by overseas subsidiaries these liabilities will be brought within charge, potentially creating an incentive to strand surplus liquidity overseas.

<u>Government response</u>

5.24 The government does recognise that bringing intragroup liquidity pooling into charge may result in some outcomes that initially appear counterintuitive. It also recognises that this issue may have a disproportionate impact on UK headquartered banks as liquidity pooling is commonly undertaken in a bank's home jurisdiction.

5.25 However it has not been possible to identify a manner of differentiating between intragroup deposits that are held centrally for liquidity purposes, rather than other forms of deposits that are held with the main banking entity by another member of the group.

5.26 Intragroup liquidity pooling is by nature a short term liability (often overnight) and to exclude this type of liability from the scope of the levy would cause significant conflicts with wider bank levy policy.

5.27 In addition, without being able to explicitly target liabilities that relate to liquidity pooling rather than funding or intragroup lending, an exclusion for intragroup deposits would cause significant conflicts with existing rules, creating incentives to raise short term funding using overseas entities and then place it on deposit in the UK.

5.28 Despite the initial concerns raised, the government is not convinced that charging liquidity pooling does create a conflict with bank levy policy, and also is doubtful whether there is a practical manner in which any such exclusion could be drafted.

Intragroup trading

5.29 The concerns raised around intragroup trading focussed on the treatment of intragroup transaction levels and balances, which may take the form of settlement balances, stock loans, repos or intercompany payables.

5.30 Much of the banking industry operates on a centre of excellence or expertise model. This means that when a client based outside the UK wants to acquire UK assets, rather than the foreign part of the banking group obtaining the assets directly the UK part of the bank will act as a conduit, connecting the non-UK part (and its client) with the UK marketplace.

5.31 The function of the UK bank as a conduit for these transactions gives rise to intragroup liabilities which eliminate on group consolidation, but will fall within the scope of the bank levy if only the UK entity's balance sheet is considered. This is the way the treatment currently applies to foreign banks who use the UK as a point of access to European markets.

5.32 Respondents questioned whether it was within the proposed policy to charge these balances where the liabilities related to trading activity undertaken outside of the UK.

Government response

5.33 The issue of intragroup trading balances has been raised in the past by foreign banking groups. The government position has been that as these activities do give rise to liabilities for the UK entities it is correct to include those liabilities within the scope of the bank levy.

5.34 Although the government view is still that transactions that give rise to liabilities for the UK entities should be included within the scope of the bank levy, it acknowledges that the presence of the liability on the balance sheet of an entity does not necessarily mean that the full risk of that liability is born by that entity.

5.35 However even where the market risk of the liability is faced by a non-UK associate the UK entity will still remain subject to the counterparty risk.

5.36 The government proposes to continue to work with industry on this issue to see if it is possible to identify where risk is located within the transaction chain.

6. Alternative definitions for UK balance sheets

6.1 In Chapter 4 of the consultation the government acknowledged two alternative proposals for the UK balance sheet definition that had been proposed by the banking industry since the re-scope of the bank levy had been announced, and asked the following question.

Question

To what extent to you think there are alternative approaches to defining UK balance sheet equity and liabilities that address the government's concerns in this Chapter?

Branch treatment

6.2 The policy rationale for the re-scope of the levy was based on the reduction in the risks posed to the UK economy by independently capitalised and host state supervised overseas entities that do not operate in the UK market.

6.3 In the consultation document the government questioned whether this rationale could apply in respect of the treatment of overseas branches of UK banks. It noted that in the case of a branch operating outside the UK, risks such as credit and funding risks could not be readily divorced from the overall risks faced by the entity.

6.4 The government therefore did not propose any exclusion for the liabilities of a UK bank that related to the funding of its overseas branches.

6.5 The government also noted that an exclusion for branches could introduce considerable further complexity in requiring UK liabilities to be apportioned to overseas branches if it was necessary to reverse the existing branch allocation methodology.

6.6 Several respondents noted that the inclusion of both UK branches of overseas banking entities, and overseas branches of UK entities within the scope of the bank levy seemed inconsistent with the move to a UK territorial basis for the charge.

6.7 Others raised the point that as well as increases in regulatory supervision and capitalisation requirements imposed on subsidiaries by host states, many host states now also required assurances of funding and liquidity adequacy for permanent establishments as well.

6.8 Representations were made by both banks and industry bodies that this approach could lead to differential treatment of banks operating overseas through branches as opposed to subsidiaries, and could create market distortion by making it more expensive for UK banks to do business in overseas markets than their competitors.

6.9 In addition, despite initial concerns the majority of banking groups that operate overseas branch networks from the UK expressed an opinion that the calculation of an apportionment of overseas branch liabilities would not necessarily add significant complexity to the calculations.

6.10 Some respondents also commented that it may be possible to allow banks to elect to exclude liabilities that relate to the funding of overseas branches, meaning that banks with only small establishments overseas would not then face any additional complexity at all.

6.11 A case was also made that as all UK entities are subject to the same regulatory regime and hence would have common rules for capital funding requirements, a branch allocation methodology could potentially be simpler to apply for UK banking entities than for UK permanent establishments of foreign banks.

Government response

6.12 The government has considered the responses on this area in detail and undertaken additional work into the consideration of host state regulatory oversight of branches.

6.13 The government recognises the concerns raised by the industry over the different treatment of permanent establishments of UK banks and foreign entities competing in overseas markets and acknowledges that this impact does need to be reconsidered following the announced policy to re-scope the bank levy to a UK territorial basis.

6.14 It also acknowledges that initial concerns over the potential complexity of branch exclusion may have overestimated the compliance burden.

Following the consultation the government confirms that liabilities relating to the funding of a UK bank's overseas branch will also be exempted from charge to the bank levy.

How will this work?

6.15 Based on the responses received to the consultation the government believes that a reverse apportionment method would be the preferred approach.

6.16 This would involve a calculation similar to the existing apportionment method for inbound branches to identify the UK allocated and non-UK allocated assets and use of this proportion to establish the proportion of the entity's liabilities that will be subject to the bank levy charge.

6.17 Use of the branch exclusion will not be mandatory for UK banks with small overseas branches.

6.18 The existing rules for determining the chargeable equity and liabilities of a UK branch follows a number of steps that are set out in paragraph 24 of Schedule 19. The calculation of UK allocated equities and liabilities are outlined in steps 1 to 4.

Step 1
Determine the amount ("A") of the bank's assets as at the end of the chargeable period (subject to adjustments for netting).

Step 2
Determine the amount ("B") of the assets, as at the end of the chargeable period, which the permanent establishment would have were it a distinct and separate enterprise which carries on a trade in the United Kingdom:

(a) engaged in the same or similar activities under the same or similar conditions, and

(b) dealt wholly independently with the relevant foreign bank.

The proportion which B is of A is "X%".

Step 3
Determine the amount ("C") of the bank's total chargeable equity and liabilities.

Step 4
The amount of the UK allocated equity and liabilities is X% of C.

6.19 A fundamental aspect of the current branch allocation method is the "separate enterprise principle" where the relevant provisions of sections 21 to 28 of CTA 2009 are to be applied as they would be applied in determining profits attributable to the permanent establishment for corporation tax purposes.

6.20 The reverse apportionment approach for branches would operate in a similar manner, calculating a proportion of assets that relate to overseas branch activity and excluding the same proportion of liabilities from the charge.

Banking company application

6.21 The consultation acknowledged proposals put forward by the banking sector to confine the bank levy charge to the balance sheets of companies/branches that are classified as banks for the purposes of the surcharge on banking companies[5].

6.22 It was highlighted in the consultation that the government had significant reservations about this approach and believed that applying this to a balance sheet based tax as opposed to a profits based tax (such as the CT surcharge) was less justifiable from a policy perspective, as well as resulting in a narrower tax base.

6.23 The government particularly highlighted the following concerns:

a) It would represent a departure from a policy rationale based on funding and liquidity risk, which is generally managed and assessed at a group-level.

b) It would have a much greater impact on the size of the tax base, reducing yield from domestic banking groups as well as international banking groups with non-UK resident companies held from the UK.

c) It would introduce additional complexity and risk banks being affected differently depending on where their non-banking companies are located within the group e.g. whether they are held by a banking company or held directly from a non-banking holding company.

d) It could create undesirable incentives for banks to relocate both external funding and capital intensive activities outside of regulated banking companies.

6.24 Overall, the government believed that this approach was less justifiable from a policy perspective, as well as resulting in a narrower tax base.

6.25 Many respondents expressed a view that this approach should be reconsidered by the government.

6.26 Others viewed such a change as adding unnecessary uncertainty to both the size of the tax base and complexity in the application of the levy to different group structures. They also agreed that such a change may create undesirable structuring incentives that would run counter to regulatory objectives.

6.27 Respondents in favour of reconsidering a banking company application believed that this approach would reduce complexity and administrative burdens, whereas others believed that it may increase complexity and administrative burdens, particularly in relation to holding companies.

6.28 Those that responded to the possibility of creating structuring incentives that would run counter to regulatory objectives commented that even if such incentives were created, regulatory restrictions should limit the impact of any reaction.

[5] http://www.legislation.gov.uk/ukpga/2015/33/schedule/3/enacted

6.29 Many respondents also disputed whether narrowing the application to banking companies only would have a significant effect on the tax base with several banks providing evidence that the impact on the tax base would be minimal.

Government response

6.30 Given the level of responses requesting that this proposal be reconsidered, the government has reviewed all the material in detail and considered whether the data provided addresses the policy concerns outlined in the consultation.

6.31 However, despite industry appetite for this proposal, and detailed engagement with some proponents of this approach, the government remains of the view that a banking company application is not justifiable from a policy perspective when considering a balance sheet based tax.

6.32 Of particular relevance is the issue of creating structuring incentives that would run counter to regulatory objectives.

6.33 From the outset, the bank levy has been designed to encourage less risky forms of funding and raise revenue in a way that does not create incentives that are misaligned with regulatory objectives.

6.34 A change that creates incentives that will need to be managed by the application of regulatory constraints would not be in line with this policy.

6.35 Following the responses received the government acknowledges that in practice a banking company application may have a limited impact on the tax base for most banking groups. However this will not be the case for all groups, and would depend heavily on the structure of the group.

6.36 The government view is that an approach where the tax base would vary so much depending on the group structure may not only cause conflicts with regulatory objectives, but would also run counter to the policy objective of ensuring that all banks make a fair contribution to the exchequer.

6.37 For these reasons the government does not believe that a banking company application would address the previously outlined policy concerns and will not be amending the application of the bank levy in this manner.

7. High Quality Liquid Assets

7.1 In calculating chargeable equities and liabilities for bank levy purposes, banks are entitled to claim a deduction for high quality liquid assets ("HQLA") that they hold on their balance sheets. Broadly, these are assets which the regulator mandates banks to hold for liquidity purposes.

7.2 The definition of HQLA within the bank levy legislation is linked to assets eligible for inclusion within a firm's liquid asset buffer as determined by the Prudential Regulation Authority ("PRA").

7.3 From 1 October 2015, the PRA withdrew the previous definition of HQLA defined in section 12.7 of the Prudential sourcebook for Banks, Building Societies and Investment Firms (known as the BIPRU 12 definition) and moved to new liquidity requirements as set out in European law under EU Regulation 575/2013, as supplemented by Commission Regulation 2015/61 (known as the CRD IV Liquidity Coverage Ratio).

7.4 In order to deliver a legislative response which is consistent with regulation and upholds the policy objective for providing HQLA relief the government consulted on the following two options for amending the bank levy definition of HQLA.

Option 1: Limiting relief to Level 1 assets, subject to a possible restriction

Option 2: Allowing relief for a bank's minimum CRD IV liquidity buffer requirement

Questions

The government welcomes views on the options for updating the definition of high quality liquid assets.

7.5 Responses were received from a greater number of stakeholders on this area of the consultation than any other.

7.6 The vast majority of respondents favoured option 1, indicating that this would be a far simpler calculation to undertake and would better reflect the actual funding costs of holding high quality liquid assets.

7.7 However representations were made from all parties that applying a restriction to the deduction did not appear in line with the bank levy policy not to make the holding of assets that are held for regulatory objectives uneconomic.

7.8 Several UK headquartered banks commented that in order for option 2 to deliver the policy objective it would need to include the bank's pillar II liquidity requirements. As these are determined by the home regulator of the bank they may then need to be hypothecated for foreign banks branched into the UK.

The government also sought input on the following areas.

How each of these options will apply for the UK branches of non EEA banks?

How each of these options will apply for the non-EEA subsidiaries of UK headquartered banking groups?

Both of these types of entity currently undertake BIPRU 12 based HQLA calculations specifically for bank levy calculations.

7.9 Responses from UK branches of non-EEA banks strongly favoured option 1. Several members of this group indicated that, although they were not in favour of a restriction, this would still be preferable to option 2.

7.10 Representations were also received from some members of this group suggesting that the definition should be linked to whatever assets qualified as Level 1 under the definitions used by the home regulator of the entity.

Is the impact of the work needed to be undertaken by non-EEA based banking entities expected to change significantly with a move to CRD IV calculations?

Is this impact expected to differ significantly between the options outlined above?

7.11 The majority of non-EEA based banking entities did not believe that option 1 (either with or without a restriction) would have a significant impact on the work that needs to be undertaken.

7.12 However the impact of option 2 was expected to be significantly higher. Not only would this involve complex calculations that would need to be undertaken only for the purpose of one aspect of the bank levy computations, many banks did not believe that they would be in a position to undertake the calculations at all as they did not have access to the necessary data.

Government Response

7.13 Based on the responses to this consultation the government does not believe that option 2 would be viable in practice.

7.14 The government also agrees that imposing a restriction would not maintain the policy of ensuring that the imposition of the bank levy does not make the holding of these assets uneconomic.

7.15 The government has reviewed the suggestion that was made by non-EEA banks to link the definition of HQLA to the definition of level 1 assets used by the domestic regulator. However it does not believe that it would be appropriate to reference standards or practices used by a foreign regulatory agency within the UK bank levy legislation.

Following this consultation the government decided to proceed on the basis of option 1 with no restriction and has already legislated to put this into effect.

8. Next steps

Legislation: Re-scope of the bank levy

8.1 The government will publish draft legislation to implement the re-scope of the bank levy in 2017.

8.2 This legislation will be included in Finance Bill 2017-18 and will be active from 1 January 2021.

8.3 In this document the government has committed to undertake further work with the industry on both the application of netting and the treatment of intra-group trading transactions.

8.4 This work will commence immediately and will be reflected in the draft legislation published next year.

High quality liquid assets

8.5 As outlined in the consultation, changes to this area were made to an earlier timescale and have now brought into law by secondary legislation.

https://www.gov.uk/government/publications/bank-levy-amending-the-definition-of-high-quality-liquid-assets-and-high-quality-securities

8.6 The final legislation was laid before parliament on the 6 September and has been effective from the 1 October 2016.

http://www.legislation.gov.uk/uksi/2016/874/made

8.7 Guidance on applying the new definition has also been included in the HMRC Bank Levy guidance manual at BKLM361000 and BKLM36200.

Annex A: List of stakeholders consulted

Association for Financial Markets in Europe
Association of Foreign Banks
Bank of America Merrill Lynch
Bank of China
Bank of Ireland
Bank of New York Mellon
Barclays Bank
BNP Paribas
The British Bankers Association
Citi Group
Commerzbank
Confederation of British Industry
Crédit Agricole
Deloitte
EY
Goldman Sachs
HSBC
Investec
JP Morgan
Lloyds Banking Group
Mitsubishi Bank
Mizuho
Nomura
Northern Trust
PWC
Royal Bank of Canada
Royal Bank of Scotland
Standard Chartered Bank
State Street
UBS

Annex B: Follow up questions asked of respondents

Bank levy re-scope: areas for further discussion

Subsidiary funding

Background

- The bank levy re-scope consultation considered the case for excluding UK balance sheet liabilities that relate to the funding of overseas subsidiaries.
- It was noted that there would be significant difficulties in identifying which liabilities related to the funding of overseas subsidiaries for the purpose of an exclusion, given the fungible nature of group funding.
- It was instead proposed that in calculating chargeable UK liabilities, relief be given for particular interests that UK companies have in their non-UK subsidiaries.

What are these interests?

- The consultation document proposed that relief for subsidiary funding should be limited to regulatory capital, recognising the regulatory and resolution pressures for groups to issue this centrally.
- In line with this, many responses suggested that the relief for subsidiary funding be confined to instruments that qualify for the banking groups' total loss absorbing capacity (TLAC).
- If this approach was taken, we would like to understand whether there is a universally applicable definition of TLAC that could be adopted here that takes account of the fact that:

  (a) different jurisdictions may implement TLAC requirements in different ways; and

  (b) some banks may not be global systemically important banks (G-SIBs), and thus not subject to TLAC requirements.

How would the relief work?

- It is proposed that the relief would work as follows:

  a) Calculate UK balance sheet equity/AT1
  b) Calculate remaining UK balance sheet liabilities, split into short and long-term.
  c) Deduct the value of UK companies' shareholdings and AT1 holdings in non-UK subsidiaries from (a).
  d) Deduct the value of UK companies' TLAC-debt holdings in non-UK subsidiaries from long-term liabilities in (b).

- We consider that this methodology is consistent with using a post-deduction basis for calculating CET1 deduction, as demonstrated by Example 1 in the annex.

Key considerations

- This model means that there would be a bank levy cost to the group if debt is issued by a UK company in order to fund an equity investment in an overseas subsidiary.
- However, there would be a corresponding bank levy benefit to the group where equity and/or retained earnings are used by a UK company in order to fund a TLAC-debt investment in an overseas subsidiary.
- These results seem consistent with regulatory incentives, but we would welcome views on this.

- The model focuses on TLAC-eligible capital.
- Some banks have raised concerns that there could be other chargeable liabilities of UK entities that relate to the overseas activities of UK headquartered groups, including unsecured funding such as general inter-company lending and intra-group repos and derivatives.
- We would like to explore these concerns in more detail to understand how the issue of unsecured funding differs between UK and non-UK banking groups for bank levy purposes. And why would the current rules for intra-group liabilities of non-UK headquartered banks not work for UK headquartered banks?
- We would also like to consider in more detail how the current netting rules for foreign banking groups (as currently apply at para 18 of Sch. 19 FA 2011) would apply to exclude intra-group repo and derivative liabilities of UK groups, and in what situations they may not.

<u>Consolidation of UK balance sheets</u>

- Some responses to the consultation suggested simplifying the bank levy calculation by reducing the number of entities within consideration, with particular reference to smaller entities that have minimal chargeable liabilities.
- One of the suggestions was to extend the "de-minimis" rule for UK subsidiaries of foreign banking groups at para 17(18) of Sch. 19 FA 2011.
- This rule allows UK subsidiaries with balance sheets of below £50m to be disregarded in calculating a foreign banking group's chargeable liabilities, albeit with a cap on the cumulative balance sheet liabilities that can be excluded of £200m a year.
- If we were to extend this approach, how effective would it be in reducing the administrative burden on UK banking groups?

- To what extent is the £200m cap the limiting factor to more companies qualifying for this exemption? What would be the impact on the amount of bank levy charge of increasing this cap?

- Additionally, if a group starts from consolidated rather than individual accounts then this approach would require the "deconsolidation" of additional UK entities.
- We would be interested in how this approach would impact these groups, and in any demonstration of how this would be a simplification if it requires a group to de-consolidate?

Apportionment

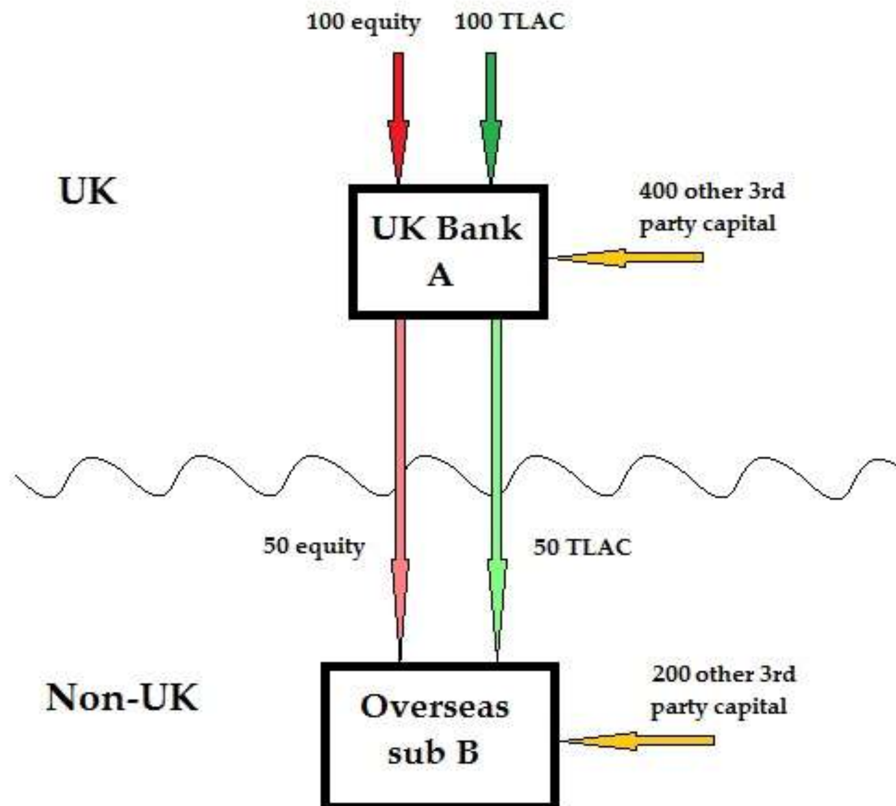
- Some consultation responses suggested the adoption of an apportionment basis for calculating UK liabilities.
- This would involve establishing a group or sub-group's chargeable equities and liabilities on a global basis, and then allocating a proportion of those liabilities to the UK on the basis of the UK's proportional share of the group's assets.

- We have a number of questions on this proposal:

  a) To what extent could this approach be applied to UK parented sub-groups of non-UK headquartered banks as well as UK headquartered banks?
  b) To what extent could differences between the risk/nature of a group's international operations mean that the UK is under/over allocated chargeable liabilities under this approach?
  c) To what extent could this be addressed through the use of a risk-weighted asset basis for apportioning liabilities? To what extent could this be distorted by companies that are within the bank levy group but not within regulatory consolidation?
  d) How would you propose that netting is considered under this approach? Would netting be taken into account before or after the apportionment of liabilities?

Annex: Subsidiary Funding Examples

Example 1



Current basis

The bank levy is charged on the full consolidated balance sheet of the group:

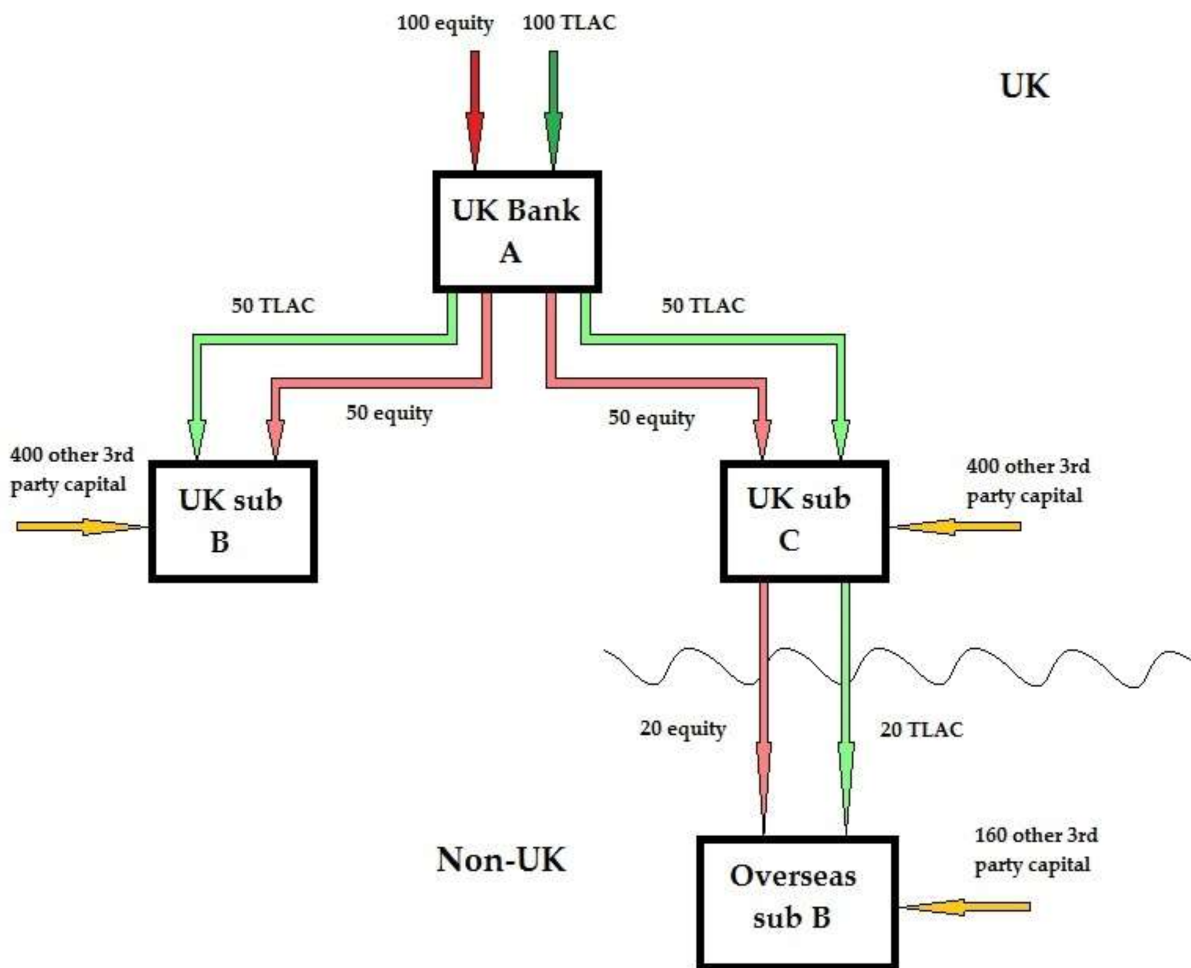
Total liabilities = 800	Including 100 equity
Chargeable liabilities = 700	Including 100 TLAC (long term)

Post re-scope

The bank levy is charged on the consolidated balance sheet of the UK group. However equity and TLAC held in overseas subsidiaries are deducted from the UK equity and TLAC:

Total liabilities of UK group = 600	Including 50 equity and 50 TLAC in overseas sub
UK allocated liabilities = 500	Including 50 equity (100 total – 50 invested in overseas sub)
Chargeable liabilities = 450	Including 50 TLAC (100 total - 50 invested in overseas sub)

Example 2



Current basis

The bank levy is charged on the full consolidated balance sheet of the group:

Total liabilities = 1160	Including 100 equity
Chargeable liabilities = 1060	Including 100 TLAC (long term)

Post re-scope

The bank levy is charged on the consolidated balance sheet of the UK group. However equity and TLAC held in overseas subsidiaries are deducted from the UK equity and TLAC:

Total liabilities of UK group = 1000	Including 20 equity and 20 TLAC in overseas sub
UK allocated liabilities = 960	Including 80 equity (100 total – 20 invested in overseas sub)
Chargeable liabilities = 880	Including 80 TLAC (100 total - 20 invested in overseas sub)