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For chargeable periods ending on or after 1 January 2021, a reduction from a group's equity and liabilities chargeable to the Bank Levy is available for certain loss absorbing instruments.

Broadly, this applies to intra-group instruments issued by an overseas subsidiary in order to meet a loss absorbing capacity or recapitalisation requirement imposed by a regulatory authority, and funded by a chargeable UK sub-group or entity. The regulatory background is discussed in more detail below.

Reductions are streamed and capped to match equivalent instruments issued in the UK sub-group or entity that would otherwise fall within its chargeable equity and liabilities.

The reduction is framed with reference to instruments issued by overseas subsidiaries but can also be understood from the opposite perspective. That is, as a broad summary, the reduction removes from chargeable equity and liabilities an amount relating to certain loss absorbing instruments issued by UK group members in accordance with relevant regulatory requirements, where these would otherwise have fallen within the chargeable equity and liabilities, and where the instruments fund loss absorbing capacity or recapitalisation requirements imposed on overseas subsidiaries by a regulatory authority.

Brief overview of the reduction

The reduction is made at FA11/SCH19/PARA15N(1) Step 3. This means that it falls before the reduction made in respect of high quality liquid assets (para15N(1) Step 4) but after all other exclusions and adjustments made in calculating the Bank Levy (para15N(1) Steps 1-2).

The reduction is calculated by identifying assets of a chargeable UK sub-group or entity that are or that represent qualifying loss absorbing instruments issued by overseas subsidiaries (para 15X(1)). There is more information about what is meant by a qualifying loss absorbing instrument at BKLMXXXXXX Loss absorbing instruments issued by overseas subsidiaries: loss absorbing instruments.

Amounts in respect of these assets are then streamed so that:

- Reductions relating to tier one equity and liabilities of overseas subsidiaries are effectively unavailable (para15X(1)(a)) (discussed at BKLMXXXXXX Loss absorbing instruments issued by overseas subsidiaries: amount of reduction under "3. Cap amount of reduction: tier one instruments", and

- Reductions relating to other loss absorbing instruments issued by overseas subsidiaries are only available against other loss absorbing instruments issued by the UK sub-group or entity, which are not tier one equity and liabilities (para15X(1)(b)).

There is more detail on streaming of assets and liabilities and on the amount of the reduction at BKLMXXXXXX Loss absorbing instruments issued by overseas subsidiaries: amount of reduction.

Background on banks' loss absorbing capacity

Banking entities are required to hold a certain amount of regulatory capital by Basel III. The idea behind regulatory capital is that entities in financial difficulties call upon it to remain in business, which protects customers' interests and avoids disrupting the economy. It acts like a buffer, absorbing losses and preventing the capital position becoming depleted to critical levels.

Basel III includes a requirement that global systemically important banks (G-SIBs) must allow all regulatory capital instruments and certain types of debt liabilities to be written off or converted to equity if a bank is judged to be non-viable. The aim is to move the responsibility for 'bailing out' a bank deemed 'too big to fail' from government and taxpayers to shareholders and creditors.

The Financial Stability Board issued its total loss absorbing capacity (TLAC) standard for G-SIBs in 2015 and this was brought into EU law via the EU Bank Recovery & Resolution Directive (BRRD). Under the BRRD, resolution authorities were given the power to direct all banks, building societies and certain investment firms to comply with a minimum requirement for own funds and eligible liabilities (MREL). This was adopted in the UK in an amendment to the Banking Act 2009 and through the introduction of the Bank Recovery and Resolution (No.2) Order 2014. The resolution authority for UK banks is the Bank of England. The Bank of England published a Statement of Policy in June 2018 setting out its approach to setting a minimum requirement for own funds and eligible liabilities. This included criteria relating to subordination, the holders of such instruments, contractual triggers and mismatching of internal and external MREL.

TLAC sets a global standard for G-SIBs and describes a minimum requirement. In the UK, MREL rules apply to all banks, building societies and large investment firms, and their requirements provide the framework for resolution planning for these institutions.

These standards involve the identification of one or more resolution entities within a group, to which resolution powers will be applied in the event of bank failure. A resolution entity issues external loss absorbing instruments, which help ensure that when a bank fails its own financial resources can be used to absorb losses and recapitalise the business. This allows the bank to continue to provide critical functions without relying on public funds.

Other legal entities in the group issue internal loss absorbing instruments. These internal instruments are issued directly or indirectly to a resolution entity and are designed to be written down or converted to equity to recapitalise the issuer. The effect is that losses are passed up within the group to a resolution entity.

The loss absorbing capacity of the group as a whole is thus supported by external loss absorbing instruments issued by one or more resolution entities, with losses passed to them by other entities in the group through internal loss absorbing instruments.

Precise eligibility criteria for loss absorbing instruments may vary between jurisdictions. However, broadly, these instruments consist of:

- Tier 1 capital: shareholder funds such as ordinary share capital, certain types of reserves, and Additional Tier 1 instruments;
- Tier 2 capital: subordinated debt; and
- Eligible liabilities.

BKLMXXXXXX Loss absorbing instruments issued by overseas subsidiaries: loss absorbing instruments

FA11/SCH19/PARA15V(2), in conjunction with para 15V(4) and SI2020/[XXXX}/REGS2-3, defines loss absorbing instruments so as to include instruments issued in accordance with UK or overseas regulatory requirements for the purpose of maintaining a minimum requirement for own funds and eligible liabilities relating to the recovery and resolution of entities in the banking sector.

The definition applies for the purposes of both

- Identifying loss absorbing instruments issued by overseas subsidiaries, which are the starting point for calculating the reduction in chargeable equity and liabilities at para 15N(1) Step 3, and

- Identifying loss absorbing instruments issued by the UK sub-group or entity, in order to stream and cap the reduction (BKLMXXXXXX Loss absorbing instruments issued by overseas subsidiaries: amount of reduction).

However, some further conditions apply which are specific to each of these two different purposes.

General conditions for loss absorbing instruments

For the purposes of the reduction in chargeable equity and liabilities at para 15N(1) Step 3, an instrument is "loss absorbing" if it satisfies a loss absorbing capacity or recapitalisation requirement (para 15V(2)).

A loss absorbing capacity or recapitalisation requirement is defined at para 15V(4):

- The requirement must be imposed in relation to either tier one capital equity and liabilities or other instruments issued by the entity,

- It must be imposed by an authority in the exercise of its regulatory functions under the law of the United Kingdom or of a country or territory outside the United Kingdom, and

- It must be a "relevant requirement".

"Relevant requirements" (SI 2020/???? Regulation 2)

A relevant requirement will be a requirement set for the purpose of maintaining a minimum requirement for own funds and eligible liabilities relating to the recovery and resolution of entities in the banking sector. The precise conditions depend on whether the requirement was set by the UK regulatory authority or by an overseas regulatory authority.

Where the requirement is set by the UK regulatory authority, the Bank of England, it should be a requirement

- Imposed by a direction under section 3A of the Banking Act 2009, which enables the Bank to direct relevant persons to maintain a minimum requirement for own funds and eligible liabilities (MREL), and

- Imposed for the purpose of complying with the duties set out in Part 9 of the Bank Recovery and Resolution (No. 2) Order 2014, which requires the Bank to set MREL and makes some further specifications with regard to MREL.

Where the requirement is set by an overseas regulatory authority, it should be a requirement imposed under a comparable scheme for a comparable purpose within the overseas country or territory. In these cases, there is no need to determine whether it is precisely equivalent to requirements set in the UK. The legislation is not prescriptive but looks to the existence and purpose of regulatory requirements as they apply to the issuer of the instrument.

Tier one capital equity and liabilities

Tier one capital equity and liabilities for these purposes are the same as for the Bank Levy more broadly, as defined at para 30 with reference to Article 25 of the Capital Requirements Regulation (CRR).

As set out at BKLM221150, for the purposes of the Levy, all entities and groups calculate their tier one capital on the same basis. To achieve this, the CRR is treated as applying to all entities and groups as if the Prudential Regulation Authority (PRA) were their competent authority, to the extent that this is not otherwise the case.

In context of the reduction at para 15N(1) Step 3, this ensures that equity and liabilities of overseas subsidiaries are appropriately streamed and capped. It prevents groups from setting instruments issued by overseas subsidiaries that would be tier one capital under the CRR against other liabilities (not tier one) of a UK entity. (BKLMXXXXXX Loss absorbing instruments issued by overseas subsidiaries: amount of reduction).

Loss absorbing instruments issued by overseas subsidiaries

A loss absorbing instrument issued by an overseas subsidiary can only be taken into account when calculating the reduction at para 15N(1) Step 3 if it meets conditions to be a "qualifying" loss absorbing instrument (para 15W(3), 15X(1)). In practice, this allows the legislation to set further conditions that are specific to loss absorbing instruments issued by overseas subsidiaries.

Para 15W(4)(a) and (5) delineate the overseas subsidiaries in question, by making the following requirements for a "qualifying" loss absorbing instrument:

- The instrument must be issued by a non-UK resident entity,
- That non-UK resident entity must be a subsidiary of a UK resident entity (para 15W(a)),
- The UK-resident entity must be a member of the relevant group (para 15W(5)(a), BKLM241000) (that is, the group covered by the Bank Levy, which will be one of the four types of group specified at FA11/SCH19/PART3), and
- If the relevant group is a relevant non-banking group (para11, BKLM241000), the UK resident entity must also be a UK resident bank or a subsidiary of a UK resident bank (para15W(5)(b), BKLM243000).

In addition, para 15W(4)(b) makes some further requirements for loss absorbing instruments issued by overseas subsidiaries, for them to be "qualifying" loss absorbing instruments:

- The instrument must be held by a UK resident entity,
- The UK resident entity must hold the instrument for the purpose of satisfying a relevant requirement imposed on a member of the relevant group.

These requirements are in addition to the general conditions set out above. They expand the general requirement that loss absorbing instruments satisfy a relevant requirement by looking more specifically to identify the instrument issued by an overseas subsidiary with an instrument held in the UK, and by looking to the purpose for which the UK entity holds the instrument.

Banks' wider regulatory capital requirements can inform whether this test is met. It may be appropriate to look to the requirements of regulators beyond that of the entity's country of residence. An instrument might, for example, be issued by a Hong Kong subsidiary of a UK entity, which is itself a subsidiary of a US parent. In that case, it is possible that regulatory loss absorbing capacity and recapitalisation requirements of all three territories may apply to determine what loss absorbing instruments it is appropriate for the Hong Kong entity to issue and how these are held by the group. The full circumstances should be considered in order to determine what relevant requirements apply.

Loss absorbing instruments issued by UK entities

For the reduction at para 15N(1) Step 3 to be available, the liabilities of the chargeable UK sub-group or entity must include loss absorbing instruments that (para 15W(7)):

- Meet the general conditions discussed above,

- Are not excluded equity and liabilities for the purposes of the Bank Levy, as defined at para 30 with reference to Article 25 of the Capital Requirements Regulation (BKLM331150), and

- Were issued for the purposes of satisfying a relevant requirement imposed on a member of the relevant group.

As with loss absorbing instruments issued by an overseas subsidiary, when considering the purpose for which an instrument was issued, it may be appropriate to look to the requirements of regulators beyond the issuing entity's country of residence. The full circumstances should be considered in order to determine what relevant requirements apply.

The aim of the reduction is to identify and give relief in respect of loss absorbing instruments issued by UK members of the relevant group which fund loss absorbing instruments of overseas subsidiaries, and which might otherwise count towards chargeable equity and liabilities. There is therefore no reduction available in respect of excluded equity and liabilities, which already fall outside the chargeable equity and liabilities of the group.

BKLMXXXXXX Loss absorbing instruments issued by overseas subsidiaries: amount of reduction

The reduction is made at FA11/SCH19/PARA15N(1) Step 3. This means that it falls before the reduction made in respect of high quality liquid assets (para 15N(1) Step 4) but after all other exclusions and adjustments made in calculating the Bank Levy (para 15N(1) Steps 1-2).

The amount of the reduction is calculated as follows:

1. Identify UK assets that are loss absorbing instruments
The group identifies assets held by a UK member of the relevant group that are or represent "qualifying" loss absorbing instruments issued by overseas subsidiaries (para 15W(3), BKLMXXXXXX Loss absorbing instruments issued by overseas subsidiaries: loss absorbing instruments).

"Qualifying" loss absorbing instruments issued by overseas subsidiaries must themselves be held by UK entities. The first part of the calculation should therefore be a straightforward matter of identifying the "qualifying" instruments on the balance sheet(s) of UK member(s) of the relevant group.

A UK member of the relevant group may be (para 15W(6)):

- The chargeable UK sub-group or entity (para 15M),
- Another UK sub-group of the relevant group (para 15B), or
- A chargeable UK resident entity which is a member of the relevant group (para 15M).

Assets of a relevant foreign bank (para 78, BKLM245000) are therefore only included when determining the reduction if the relevant foreign bank is a member of a UK sub-group.

2. Stream assets to separate out tier one instruments
The assets identified at 1. are divided into:

- Para 15X(1)(a) assets, which are or represent qualifying loss absorbing instruments that are tier one capital equity and liabilities, as defined for at para 30 (BKLMXXXXXX Loss absorbing instruments issued by overseas subsidiaries: loss absorbing instruments, BKLM221150), and
- Para 15X(1)(b) assets, which are or represent other qualifying loss absorbing instruments.

3. Cap amount of reduction: tier one instruments

No reduction is available in respect of para 15X(1)(a) assets. Any items against which these might be streamed will have been excluded from chargeable equity and liabilities by para 30.

In the legislation, these assets are streamed and any available reduction is capped against tier one equity and liabilities that are not excluded by para 30, and that remain within the chargeable UK sub-group or entity's equity and liabilities after para 15N(1) Steps 1-2 (para 15X(3), para 15W(7)). However, in practice, there will be no such equity and liabilities, as the definition of tier one equity and liabilities in use for these purposes is the definition at para 30. This means that for the amount of reduction available in respect of para 15(1)(a) assets, there is an effective cap of zero.

4. Cap amount of reduction: other loss absorbing instruments

The amount of the reduction available in respect of para 15X(1)(b) assets is capped with reference to loss absorbing instruments that are not tier one capital equity and liabilities, and that would otherwise be amongst the group's chargeable equity and liabilities (para 15X(4)).

The group must first identify the amount of the chargeable UK sub-group or entity's equity and liabilities, following the adjustments at para 15N(1) Steps 1-2, that is constituted by loss absorbing instruments (para 15V(2), BKLMXXXXXX Loss absorbing instruments issued by overseas subsidiaries: loss absorbing instruments).

They must then remove from this amount any tier one capital equity and liabilities (para 15V(3) BKLMXXXXXX Loss absorbing instruments issued by overseas subsidiaries: loss absorbing instruments).

They must also remove from this amount any liabilities that do not meet the condition at para 15W(7). For more detail on this condition, see BKLMXXXXXX Loss absorbing instruments issued by overseas subsidiaries: loss absorbing instruments.

This cap provides a maximum amount for the reduction. In practice, if the amount of the para 15X(1)(b) assets is lower than the cap, then the amount of the reduction will be the amount of the para 15X(1)(b) assets.

5. Amount of reduction

The reduction will be the lower of

- The cap on the reduction available in respect of para 15X(1)(b) assets, as calculated above, and
- The amount of the para 15X(1)(b) assets.

Example

The following is a simplified example designed to illustrate how the reduction at para 15N(1) Step 3 is calculated. To that purpose, it does not use realistic figures in pounds sterling and ignores most other elements of the Bank Levy.

Simplified example: starting situation
This example looks at a single UK sub-group (para 15B). The equity and liabilities of UK entities in the UK sub-group are:

- 100 equity,
- 100 loss absorbing instruments other than tier one capital equity and liabilities (all of which are long term liabilities), and
- 400 short term liabilities.

The assets of UK entities in the UK sub-group include the following holdings in an overseas subsidiary:

- 50 equity of the overseas subsidiary, and
- 50 loss absorbing instruments other than tier one capital equity and liabilities, issued by the overseas subsidiary.

1. Identify UK assets that are loss absorbing instruments
These are the holdings in the overseas subsidiary, as above:

- 50 equity, and
- 50 loss absorbing instruments other than tier one capital equity and liabilities.

2. Stream assets to separate out tier one instruments
- Para 15X(1)(a) assets (representing tier one capital equity and liabilities of overseas subsidiaries): 50 equity.
- Para 15X(1)(b) assets (representing other qualifying loss absorbing instruments issued by overseas subsidiaries): 50 loss absorbing instruments.

3. Cap amount of reduction: tier one instruments
No reduction is available in respect of para 15X(1)(a) assets.

The equity and liabilities of the UK sub-group include 100 equity. This will be excluded from chargeable equity and liabilities by para 30.

UK equity and liabilities will not include any tier one capital equity and liabilities other than those excluded by para 30. The cap on reductions in respect of para 15X(1)(a) assets must therefore be zero.

4. Cap amount of reduction: other loss absorbing instruments
The amount of loss absorbing instruments that are not tier one capital equity and liabilities, and that would otherwise be amongst the group's chargeable equity and liabilities, is:

- 100 loss absorbing instruments other than tier one capital equity and liabilities.

(This example assumes that there has been no reduction in this amount at para 15N(1) Steps 1-2, so that, prior to Step 3, 100 loss absorbing instruments other than tier one capital equity and liabilities remain within the chargeable equity and liabilities.)

The cap on the amount of the reduction available in respect of para 15X(1)(b) assets (representing other qualifying loss absorbing instruments issued by overseas subsidiaries) is therefore 100. However, this is not the amount of the reduction. It is a cap, or maximum reduction potentially available.

5. Amount of reduction
The group determines which is lower of

- The cap on the reduction available in respect of para 15X(1)(b) assets: this is 100, as calculated above.

- The amount of the para 15X(1)(b) assets (representing other qualifying loss absorbing instruments issued by overseas subsidiaries): this is 50.

The lower amount is 50.

This can be used entirely to reduce liabilities other than short term liabilities, since, following para 15N(1) Steps 1-2, the chargeable equity and liabilities of the UK sub-group still include 100 long term liabilities, in the form of the 100 loss absorbing instruments other than tier one capital equity and liabilities.

At para 15N(1) Step 3, the chargeable equity and liabilities can therefore be reduced by 50 in respect of loss absorbing instruments issued by overseas subsidiaries.

Prevention of double counting

Para 15X(5) prevents the use of para 15N(1) Step 3 to obtain a reduction of chargeable equity and liabilities in respect of the same asset more than once.

No further reduction is available at para 15N(1) Step 3 in respect of an asset of a chargeable UK sub-group or entity that is or represents a qualifying loss absorbing instrument issued by an overseas subsidiary if that asset

- has already been used to calculate a reduction at para 15N(1) Step 3 with regard to another chargeable UK sub-group or entity in the relevant group (para 15X(5)(b)) (that is, it is not possible to obtain a reduction at para 15N(1) Step 3 in respect of the same asset twice), or

- has been used as part of "M's net settlement assets" or "B's net settlement assets" in order to reduce the chargeable equity and liabilities through the netting calculation at either para 15U or para 27D (para 15X(5)(a) and (c)).

The same applies if only part of the asset meets one of the conditions above. No further reduction will be available in respect of that part of the asset.