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cutting through complexity

Bank Levy Consultation Document

The bank levy consultation document issued by HMRC on 4 July contains discussion of some controversial issues. Responses to the consultation document are due by 26th September, and an HMRC open meeting on Monday 5 August gave more flavour of HMRC's objectives and also confirmed that there would be working groups (though probably no more than a single meeting) on netting, protected deposits and probably other issues. The aim is to publish both the consultation response and draft legislation in November.

The bank levy remains, as at inception, a zero sum game, so changes which benefit some banks will have to be paid for either by another specific group or by an uplift in the rate of bank levy. Deep into the consultation document (at 10.1) is the acknowledgment that bank levy has raised less than the initial target £2.5 billion in both years of operation. HMRC also acknowledged at the open meeting that the target annual yield has now increased to £2.9 billion as a result of CT rate reductions. It seems likely that an objective of the consultation is to assess the pros and cons of changing the tax base rather than increasing the rate of levy again.

The main issues addressed by the condoc are as follows:

Protected deposits

The issue here is how to reconcile HMRC's policy objectives in terms of sticky deposits with a manageable compliance burden. This is an area which has caused some compliance uncertainty and difficulty in practice, including in relation to the "comparability" test in the legislation at the moment, and also because of the different way in which scheme fees/protection caps are calculated. The publication of the White List has helped with, but not resolved these issues The consultation document proposes as alternatives the following:

- Exclude all retail deposits (would remove some of anomalies but no clear definition of "retail" plus HMRC appears concerned whether all of these are really "sticky")
- Continue with a definition based on a link to UK/overseas deposit schemes but remove link between scheme fee and amount excluded (this is a particular issue in any case where the FDIC US schemes is involved)
- Put in a cash limit (£50,000 is the suggested figure)

This involves some contentious issues particularly as banks have invested in systems to support a workable approach under the current regime.

Netting

Many banking groups have reassessed their approach to netting for both bank levy and other purposes and there is little sense of appetite for significant disruption to the current rules. However, there are circumstances (HMRC cite failed sale and client clearing) where either netting agreements present problems or there are practical difficulties with the operation of netting for fungible securities or maturity splits for derivatives) where banks have sought a more pragmatic approach or greater flexibility than the current very rigid criteria allow.

Options HMRC is considering – other than simply living with the status quo – are:

- Removing netting rules – and lowering the rate of charge on derivatives
- Removing the need to split derivatives between short and long term liabilities by treating them all as short term

It is difficult to see that there would be many winners from this proposal except as regards compliance (and possibly low margin transactions), and HMRC has not committed itself to any specific rate of charge on derivatives. As they acknowledge, repos are a major area for netting and would not benefit from the reduced rate.

Allocation of liabilities to UK branches of foreign banks

HMRC indicates that concerns have been raised that use of the CATA model favours UK branches of foreign banks (because branches with limited/no deposits get the benefit of an apportionment of protected deposits from head office). Concerns have also been raised about the compliance burdens arising from access to and analysis of parent financial statements being required.

In this area HMRC have focused principally on questions and issues rather than specific proposals but it is clear that there will be scrutiny of the CATA approach. A specific question is asked about inclusion of branch banks which are branches of non-bank entities.

High Quality Liquid Assets ("HQLA")

- HMRC's view seems to be that the use of regulatory definitions for this purpose has been a good approach: however, consideration is give to whether there are additional assets which should be included – specifically, whether it would be workable (or impose an undue compliance burden) to exclude liabilities which fund assets excluded from the bank levy rather than having a deduction for the assets. The latter point was discussed in the original consultation and concluded to be unworkable so there seems little merit in reconsidering this.

Regulatory Capital

- At the moment, all Tier 1 capital is excluded. HMRC acknowledges that the exclusion could be extended to include Tier 2 capital as well – or restricted to Common Equity – linking this to the proposed changes to introduce a deduction for coupons on AT 1 instruments.
  - It appears that HMRC's default setting is to restrict the exclusion to common equity
  - This may be regarded as undermining the tax changes in respect of AT 1 and Tier 2, particularly as AT 1 changes can be regarded as substituting economically for the ability to get tax deductions for innovative tier 1 capital.

Non-funding liabilities

- HMRC acknowledge that including liabilities owed to HMRC in respect of VAT, PAYE and TDSI is a form of double taxation, and appear open to representations that these should be excluded, subject to the compliance being workable.

Deposits from Authorised Persons

- HMRC notes that there has been some difficulty identifying the maturity of deposits from Authorised Persons. As with derivative maturities for netting, it proposes to resolve this by treating them as short term.

Collateral Upgrades and Liquidity Swaps

- HMRC notes that where High Quality Liquid Assets are acquired as part of a collateral upgrade they will generally be held off balance sheet, but will be deductible. It appears as if the position for both collateral upgrades (i.e. whether these should remain deductible) and the position for other funding models which improve liquidity are subject to further consideration. Specifically, HMRC appears sceptical about leaving in place rules which allow a collateralised repo to deliver a net bank levy benefit (because the economic lender under a collateralised repo can claim a HQLA deduction for the securities it holds under the repo, but the economic borrower does not need to include the repo liability because it is backed by HQLA).

Client Clearing

- HMRC have noted the impact of EMIR and Dodd Frank on the central clearing of transactions and economic impact of the levy. On this, HMRC seem open to representations as to the scope for excluding transactions along the lines of exclusions for client money.

There are a number of areas in which the consultation document suggests HMRC are looking for guidance from banks based on practical experience or undersatnding, particularly in the context of interaction with regulatory definitions and the practicalities around compliance. Banks will no doubt want to bear this in mind when submitting representations, as well as the impact of the proposals which are likely to be unwelcome around netting, protected deposits, and high quality liquid assets.

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