afme/

22nd November 2010

Aidan Reilly
HMRC
100 Parliament Street
London SW1A 2BQ

Dear Aidan

Comments on the bank levy: draft legislation

We welcome the opportunity to comment on the draft legislation. We should also like to thank you for the way in which the consultation is being conducted and, in particular, the opportunities for dialogue during the consultation period.

We have previously provided comment on design of the levy (our letter of 5 October 2010) and we are pleased to note that a number of the design principles have been reflected in the draft legislation.

It is critical to our members that the legislation is of the highest quality, and accordingly in the Appendix to this letter we raise a number of technical drafting points. In addition to ensuring that the legislation is of the highest quality it is very important that it should be applied in a manner which, so far as possible, makes use of information that is already being gathered for other purposes (such as preparation of the accounts, regulatory returns or tax returns). Accordingly we also comment on particular areas where we consider that guidance is required. In many cases, we believe that it will be sufficient that the guidance reflects the discussions that have taken place during the consultation period. We understand that the intention is to publish draft guidance on 9 December 2010 and that there will be an opportunity to comment on that guidance. We very much welcome that opportunity and believe that clear guidance will be critical to achieving a workable introduction of the levy. We also understand that the anti avoidance paragraphs are being reconsidered, and we will be pleased to comment on the next draft.

Some of the broader aspects of the bank levy are still of concern. In particular, we would refer back to our previous letter in which we raised a number of issues. We remain unsure how to reconcile the statement regarding collection of £2.5 bn each year with the natural reduction of the yield as funding profiles change. The degree of co-ordination with other jurisdictions and the possible imposition of multiple taxation remain matters of concern. In order to provide certainty, it is important that the issues are resolved, whether bilaterally or through discussions at ECOFIN or the European Council.

We continue to be concerned about the potential impact of the levy on competitiveness of undertaking business in UK markets. In particular, we consider that the levy is likely to act as a disincentive to new entrants as they consider whether they should come to the UK. We would urge that the competitiveness position be closely monitored.

We trust that this letter is helpful and we would be pleased to engage in further discussions on any of the points raised.

Yours sincerely,

Richard Middleton
Managing Director, Tax and VAT

Appendix

Our comments on the draft legislation are set out below. References to paragraphs are to those in the draft legislation.

1. Liquid assets, repos and reverse repos

In calculating "chargeable equity and liabilities", there is a reduction for "relevant high quality liquid assets" (paragraphs 20,22,24,26,32).

We understand that the intention of the reduction is to give relief for assets which are eligible for inclusion in the liquid assets buffer under FSA rules.

The definition of high quality liquid assets is designed to reflect this intention.

Paragraph 55 states that
" "high quality liquid asset" means an asset within section BIPRU 12.7.2 (1) to (4) of the FSA Handbook."

Section 12.7.2R states
"For the purpose of satisfying BIPRU 12.2.8R, a firm to which this section applies may only include in its liquid assets buffer:

(1) high quality debt securities issued by a government or central bank; [1]
(2) securities issued by a designated multilateral development bank;
(3) reserves in the form of sight deposits with a central bank of the kind specified in BIPRU12.7.5R and BIPRU12.7.6R; and
(4) in the case of a simplified ILAS BIPRU firm only, investments in a designated money market fund."

It is important to note that firms can only count securities which are unencumbered.
Section 12.7.9R states
"for the purposes of BIPRU 12.7.2R (1) and (2), a firm must only count securities:

(1) which are unencumbered;
(2) to which it has legal title; and
(3) which that firm realises on a regular basis."

[1] The term "high quality debt securities" in section 12.7.2R (1) is defined by sections 12.7.3R and 12.7.4R. These sections limit the definition by reference to the jurisdiction and credit rating of the issuers.

Section 12.7.10G states
"The FSA regards as encumbered any asset which the firm in question has provided as collateral. Therefore, where assets have been used as collateral in this way (for example in a repo), they should not be included in the firm's liquid assets buffer."

The reduction for relevant high quality liquid assets therefore does not provide a reduction where the assets have been used as collateral.

Moreover, there appears to be no provision aimed at the liability side of the balance sheet that would exclude the corresponding liability (ie the funding) in calculating chargeable equity and liabilities (unless somehow the netting rules were to apply).

It would therefore seem that, as drafted, there is no mechanism for relief for high quality liquid repo funding (ie repo funding of securities which, but for Section 12.7.9R, would be eligible for inclusion in the liquid assets buffer).

We understand from our recent meeting that HMRC's intention is to exclude high quality liquid repo funding from the levy base and to make appropriate amendments to the draft legislation. We welcome this clarification.

We noted at the meeting that we would also like to conclude our thinking on the case of stock loan funding. We would confirm that stock loan agreements and repo agreements are essentially equivalent from a risk standpoint, and that members use both types of documentation.

We believe that stock loan funding of high quality liquid assets is non-risky funding in the same way as repo funding of such assets. Accordingly we consider that high quality liquid stock loan funding should be excluded from the levy base. We would be pleased to provide examples of the use of high quality liquid stock loan funding should that be helpful.

There are various possible ways in which relief for non-risky funding could be achieved. One approach would be to define such funding to be an excluded liability. The new paragraph could be inserted between paragraphs 35 and 36.

Reverse repos

During our discussion, there was some uncertainty about the correct measure of the high quality liquid asset reduction for reverse repos. There was some debate as to whether the reduction should be for the market value of the securities (being the amount that would be reflected on the FSA 048 return at line 6 column A) or for the amount of the receivable recognised in the firm's financial statements.

Having considered the matter, we believe that in order to align with the regulatory measure of liquidity, the appropriate measure for the reduction in the bank levy

base would be the amount that would be eligible for inclusion in the liquid assets buffer. We would recommend that this point be addressed in guidance.

Other points

There are other points that may be useful to cover in guidance. We understand that the intention is to give relief for assets which are *eligible* for inclusion in the liquid assets buffer under FSA rules, rather than assets which are *required* to be so included.

Whilst we believe that this is the effect of the legislation, the point is not explicitly covered, and guidance would therefore be helpful.

On a more technical point, we note that paragraph 55 refers to particular subsections of BIPRU 12.7, and this has led to questions as to how to import other subsections of BIPRU 12.7. Whilst we believe that the legislation has the intended effect, it may be appropriate to add some commentary in the guidance. For example, it could be emphasised that the definitions in subsection 12.7.2 (1) to (4) need to be read in the context of BIPRU 12.7 as a whole.

2. Starting point for calculation of chargeable equity and liabilities

We understand that the starting point for the calculation of chargeable equity and liabilities is intended to be the equity and liabilities recognised in the relevant balance sheet.

Accordingly, where amounts are not recognised on the balance sheet, but are merely disclosed in the financial statements, then such amounts should not be included.

To ensure that this is clear, we would recommend that paragraphs referring to "amounts disclosed" in financial statements are reviewed.

For example, paragraph 20 (4) states that

"For the purposes of this paragraph and paragraph 21 the relevant group's assets, equity and liabilities are to be determined by reference to –

(a) The amounts disclosed in the group's consolidated financial statements….."

We also note that the amount of equity and liabilities recognised in the relevant balance sheet may be net amounts (ie after netting against assets). We understand that it is the net amounts that form the starting point for the calculation and that there is no intention that firms should be required to gross up these net amounts.
We would recommend that the drafting be clarified in this regard.

The present definition of liabilities in paragraph 19 refers across to international accounting standards. In those standards the term "liability" has a legal meaning and is not restricted to liabilities which are recognised in the balance sheet. One approach to clarifying the starting point would therefore be to amend paragraph 19.

3. Netting Provisions

The netting provisions in paragraphs 21,23,25,27,30(7) generally follow the principles-based approach that had been advocated, ie to allow an adjustment where the counterparty risk is reduced.

We understand that the intention is to provide for multi-lateral netting as well as bi-lateral netting. We would recommend that the relevant paragraphs be reviewed, and that, where necessary, amendments be made to ensure that the legislation has the intended effect.

We noted in section 2 that the starting point for the calculation of chargeable equity and liabilities may itself be a net amount. Accordingly, for some groups it may be that there will be no adjustment under the netting provisions. On the other hand, for groups that may have a relatively restrictive form of netting in their financial statements, the netting provisions should enable them to make an adjustment in line with the principles-based approach.

4. Long term liabilities

Long term liabilities are defined in paragraphs 60 to 62.

Paragraph 60 states that

(1) Liabilities are "long term" to the extent that -

(a) as at the end of the chargeable period, the liabilities are not required, and cannot be required, to be repaid or otherwise met during the 12 month period starting with the last day of the chargeable period and

(b) in the case of liabilities of one member of the relevant group to another member of the relevant group, an officer of Revenue and Customs is satisfied that the following condition [i.e. the condition in paragraph 60(2)] is also met in relation to the liabilities.

(2) The condition is that, as at the end of the chargeable period, the liabilities are funded by the relevant group through –
(a) equity,
(b) excluded liabilities to persons who are not members of the relevant group, or

(c) liabilities to such persons which are not required, and cannot be required, to be repaid or otherwise met during the 12 month period starting with the last day of the chargeable period."

We understand that in considering paragraphs 60(1)(a) and 60(2)(c), the determination is made by reference to circumstances existing at the balance sheet date. It would be helpful to include a statement to this effect in the legislation or in guidance.

We understand that in relation to paragraphs 60(1)(b) and 60(2)(a) and (b), HMRC's expectation is that firms should provide appropriate evidence to show that the condition in paragraphs 60(2)(a) and (b) is satisfied. Where the FSA has accepted a loan as tier 2, we understand that HMRC would be unlikely to require additional evidence. At the same time, it would be open to the firm to provide alternative evidence to demonstrate that the conditions are met.

We would also note that long term debt would be expected to carry a long term rate, and to be regarded as long term by the lender.

Thus in practice we would hope that the determination of a liability as long term should not be problematic.

If there are cases which are more difficult to classify, we consider that the method set out in the technical note (ie to prorate the liability between short term and long term by applying the same proportion that the group's short-term funding bears to its total external funding) might be a practical approach. We understand that this method is to be included in guidance, and it may also be appropriate to include a "just and reasonable" clause in the legislation so as to provide a reference point for that guidance.

5. <u>UK branches</u>

The need for the legislation to be implemented in a practical way is probably most acute in the case of branches.

(i) Companies not using IAS or UK GAAP

There has been particular concern regarding the operation of paragraph 29(2) which states that

"For the purposes of this paragraph and paragraphs 30 to 32 assets, equity and liabilities of a relevant foreign bank of the permanent establishment through which it carries on a trade in the UK on to be determined by reference to –

(a) the amounts disclosed in the bank's financial statement for the chargeable period as prepared under international accounting standards or UK GAAP, or

(b) if no such financial statements are prepared, the amounts which would have been so disclosed had such financial statements been prepared –
   (i) under international accounting standards, or
   (ii) under UK GAAP if that is what the bank prepares its financial statements under."

Many foreign banks do not prepare financial statements under IAS or UK GAAP, and it is considered that such banks should be able to apply their own GAAP where either the differences would not be material, or where the differences are consistent with the principles for calculating the levy base. In particular, where the netting under local GAAP is consistent with the principles-based approach to netting, it is considered that foreign banks should not be required to re-compute their assets and liabilities under IAS or UK GAAP.

We understand that HMRC recognises that this is an important practical matter and that HMRC is working with the accounting firms to understand the main differences between IAS and the major GAAPs.

We would recommend that the point be covered in some detail in guidance, in order to provide the reassurance that a practical approach to implementation will be taken.

(ii) Disregarding intracompany assets and liabilities

It has always been the government's stated intention to follow the CATA approach for the purposes of measuring the assets of UK branches of foreign companies. It is a clearly established principle of the CATA procedures that amounts due from other parts of the same company are disregarded when assessing the assets of the hypothetical separate enterprise.

We are concerned that the legislative machinery proposed in paragraph 31 may not have the expected and intended effect. Paragraph 31(2) provides that the permanent establishment will have the assets which it would have under the separate enterprise hypothesis. Sub-paragraph 3 overlays the effects of sections 21 to 28 CTA 2009. Whilst we know that HMRC disregard intracompany assets when measuring the risk weighted assets of the permanent establishment in order to determine the capital that the separate banking enterprise might require, we do not consider that sections 21 to 28 CTA 2009 allow intracompany assets to be disregarded for all purposes relevant to computing the profits attributable to the permanent establishment for corporation tax purposes. For instance if a permanent establishment lent money at interest to another part of the same company, the interest income on that loan **would** form part of the permanent establishment's taxable profits.

This is a critical point for branches of foreign banks. We would appreciate your giving it careful consideration and your confirmation that the legislation will apply as intended.

(iii) Netting and measuring a branch's share of company assets

The principle adopted in the draft legislation is to measure the assets of the branch as a proportion of the assets of the company of which it forms part after permitted netting. This seems to us to be a sensible approach. However, netting is not permitted in respect of balances due between companies within scope of the levy. This does not matter in general because liabilities due to such companies can be excluded from the charge. It does, though, matter when it comes to determining the branch share of assets. Including amounts due to the branch from UK affiliates that are covered by netting agreements, such as derivative assets, at their gross levels is quite inconsistent with the basic measurement principle. It inflates the branch share, meaning that more of the company's other liabilities are attributed to the branch for levy purposes. We urge you to correct this anomaly in the draft legislation.

(iv) Guidance by example

More generally, we consider that it would be useful for the guidance to include some illustrative examples of calculations for UK branches, and in particular the way in which adjustments for netting are to be calculated. Different methods have been suggested during the review process, eg whether netting should be at entity level or branch level, and it would be helpful if firms could be given some degree of flexibility in determining which of the methods is most appropriate (as long as the basis adopted by a firm is consistently applied).

6. <u>Joint ventures</u>

We consider that the intention and effect of paragraph 44 and 45 on joint ventures is not entirely clear.

We understand from discussion that there are various circumstances which these paragraphs are directed, and it would be very helpful if worked examples could be included in guidance.

7. <u>Anti-avoidance</u>

We consider that the anti-avoidance provision is more widely drafted than had been intended. We understand that a revised draft is to be made available for comment in advance of the publication of final draft legislation, and we welcome the opportunity to comment on the revised draft.

8. Double taxation relief

The draft legislation at paragraphs 52 to 54 provides a framework for double taxation relief. The effectiveness of that framework will depend, to some degree, on double taxation agreements. We understand that discussions are progressing with other countries in this respect.

We would appreciate the opportunity to comment on the draft legislation once there is more clarity as to how the double taxation arrangements may be drafted.

9. Operation of the £50m/£200m condition

We consider that it may be worth including a brief comment in guidance as to how the de-minimis condition should be operated.