ICAEW REPRESENTATION 68/14

A bank levy banding approach: consultation

ICAEW welcomes the opportunity to comment on the *A bank levy banding approach: consultation* (link) published by HM Treasury on 27 March 2014.

This response of 8 May 2014 has been prepared on behalf of ICAEW by the Financial Services Faculty with input from the Tax Faculty. As a leading centre for thought leadership on financial services, the Financial Services Faculty brings together different interests and is responsible for representations on behalf of ICAEW on governance, regulation, risk management, auditing and reporting issues facing the financial services sector. The Faculty draws on the expertise of its members and more than 25,000 ICAEW members involved in financial services.

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MAJOR POINTS

1. We note that the bank levy has two purposes, firstly, to encourage de-risking of banks and secondly to ensure banks make sufficient contribution to public receipts. It appears that de-risking has become decoupled from the purpose of the levy, as if this is a goal, we would naturally expect the levy to decrease as the riskiness of banks' balance sheets reduced, not remain the same. We support the bank levy as a de-risking incentive, but do not consider if it is used simply as a mechanism for raising additional public funding, it will not be an effective way of limiting any implicit public guarantee of the banking system.

2. We think the bank levy could be operationally improved by allowing quarterly accruals rather than the current one day triggering position. This is discussed further in paragraphs 15 and 16 below, and we encourage HMT to explore the possibilities in this regard.

RESPONSES TO SPECIFIC QUESTIONS

Q1: Will a banding approach offer a more stable and sustainable basis than the existing bank levy model?

3. We do not think a banding approach will create a more sustainable or stable basis for the levy. It would lead to punitive marginal rates of tax at the boundaries between the bands which will encourage distortive behaviour. The banding approach also makes the proposed new model significantly more complicated. Because of the effects of this, it may make the amount of levy less predictable for individual banks, meaning that the amount of revenue generated is less stable.

4. Furthermore, as the levy is calculated based upon the year-end balance sheets, it may create an incentive for banks to reduce their balance sheets on the day the calculation is made to reduce the levy they pay. The banding approach significantly increases this incentive. Our suggestion for a quarterly basis of calculation may reduce the incentives for window-dressing around period ends. We would not support an approach based upon average balances, however, as it would be significantly more complex and administratively burdensome.

Q2: Does a banding approach have any drawbacks compared to the current system of rates?

5. A banding approach would need to be updated as the structure and size of the industry as it changes. Structuring the levy in this way may also lead to the impression of fixing revenue requirements rather than incentivising de-risking behaviour as the main goal of the levy. As noted above, the difference between bands may affect behaviour in a negative way.

Q3: Are any other adjustments needed to maintain the effect of the existing tax base upon a move to banding?

6. As noted in 'major points' above, we do not believe the de-risking objective of the bank levy should become entirely subservient to the revenue raising objective. The key justification for having a levy specific to the banking sector is that there is an implicit public guarantee of bank deposits. The extent of this guarantee varies according to both the riskiness of individual banks and the banking system as a whole. As such, the size of the levy, and amount of revenue raised, should reduce as banks' reduce the riskiness of their activities and vice-versa. This creates both an incentive for banks to reduce their riskiness and a charge against them for risky activities that attract an implicit public guarantee.

7. The proposals and implementation of the levy rather confirm the fact that the overriding aim of the levy is a raise a fixed revenue target. This undermines the relationship between the total size of the levy and the riskiness of the banking system (and size of the implicit guarantee). Without this relationship, it is more difficult to justify having a levy or tax that is applicable to only one industry sector.

Q4: Does a nil-charge band represent the best mechanism for carving out smaller, less risky banks from the bank levy paying population? What is an appropriate level for this band, to reflect the adjustments to the tax base?

8. We believe a nil-charge band would be an appropriate way to carve out smaller, less risky banks from the levy paying population.

9. Research by KPMG shows that the five largest banks contributed 73% of bank levy receipts in 2013 so should a nil-rate band be adopted at the lowest level is unlikely to materially change the overall amount collected.

Q5: What are the strengths and weaknesses of illustrative models A – E, and the choice of parameters?

10. ICAEW does not propose to comment on the detailed workings of the model.

Q6: Are there alternative banding structures that should be considered, subject to the conditions in paragraph 2.14? What is the reason for this?

11. ICAEW does not propose to comment on the detailed workings of the model.

12. A more useful metric may be one more directly linked to risk than the size of the adjusted balance sheet, such as the regulatory capital requirement. We do however acknowledge that this number is not currently subject to audit or assurance, and have raised concerns that these numbers are not as reliable as they should be, given that different banks internal models can generate significantly different risk-weighted asset measurements on the same hypothetical model portfolios of assets.

Q7: Do you think that special provisions are needed to address the model's cliff edge-effects? What problems can you envisage with the implementation of these provisions?

13. A cliff-edge system can distort behaviour in a similar way to the current marginal transaction calculation, and the extent to which banks would have power to manipulate their true position to fall into a different band would need careful consideration.

Q8: How can the model best be adjusted to ensure that the Government's revenue target continues to be met?

14. ICAEW do not propose to comment on the detailed workings of the model.

15. As noted in 'major points' above, we do not believe the de-risking objective of the bank levy should become entirely subservient to the revenue raising objective. If this is to become the main objective of the levy then this should be overtly stated.

Q9: Are there changes to the bank levy's design, within the parameters of this consultation, which could help overcome the barriers to accruing its costs in accounts?

16. A proportionate approach could be taken allowing banks to accrue based on quarterly balance sheet position with any necessary adjustment made when the closing balance sheet number is known. If HMRC is able to estimate receipts and potential shortfalls in the tax take, then it should follow logically that banks should be able to accrue on a reasonable basis by establishing a liability quarterly. Periodic calculations would also decrease incentives to manipulate the position within a banded approach (gaining a saving from a lower marginal rate of tax at the top of a band as opposed to the bottom of the next highest band for example).

17. For example, a bank may make its accrual on the following basis:

	Q1	Q2	Q3	Q4
Expected levy for the full year based on Q end balance.	100	120	140	120
To accrue in relevant Q	25	35	45	15
Equivalent to	25%	50%	75%	100%
Total accrual	25	60	105	120
Basis	25% of expected total payment to represent 1Q activity	50% of expected total payment to represent 2Qs activity, less amount already accrued in Q1	75% of expected total payment to represent 3Qs activity, less total accrual in Q2	Marginal amount needed to bring to full year levy.

18. However, in order for it to be possible to accrue quarterly under IAS 37 and IFRIC 21, it must be the case that a liability is established each quarter, and hence the recognition and measurement of the ultimate annual liability needs to be split.

19. If this is not the case, such that the levy for each quarter up to the year end is potentially avoidable, it will not be possible for banks to accrue the proportionate charge. This would therefore require a change to the legislation such that a bank would become liable for the charge each quarter.

20. The government may decide that this is most easily achieved by requiring the levy to be paid within a certain period of each quarter date. The alternative is to allow it to remain outstanding until the final calculation at the year-end: although the government hence takes the credit risk were the bank to cease trading, that would arguably leave the government in no worse a position than it is in now in such circumstances.

21. The government would nevertheless need to decide what would happen if a bank were to cease trading as a bank before its year end. In our view it would be necessary for the quarterly levies due or paid to date for the year to be non-refundable and hence unavoidable if quarterly accrual is to be achieved. However, the government may wish to leave itself as an unsecured creditor in such circumstances.