KBC BANK IRELAND

Levy on Financial Institutions

Public Consultation

KBC Bank Ireland

July 2016

Public Consultation – Levy on Financial Institutions

Introduction

KBC Bank Ireland (KBCI) welcomes the opportunity to respond as part of the public consultation on the Levy on Financial Institutions (Levy) which was issued by the Department of Finance, dated 9 June 2016. KBCI herewith contributes to the consultation process as a corporate body.

The introduction of the Levy by the Finance (No. 2) Act 2013 was considered a temporary measure and we are disappointed that the Levy will now be extended for an additional five years. KBCI continues to contribute to economic recovery by recruiting c. 150 employees per year, increasing its footprint in the Irish market and offering an expanded and competitively priced product range to Irish consumers. The purpose of this paper is to set out KBCI's responses to the consultation questions, whereby it is outlined that the proposed methodology of calculating this Levy results in a disproportionate allocation of the Levy to a limited number of financial institutions and in particular to KBCI. Using the updated DIRT-based methodology for its calculation, we estimate that KBCI would be required to contribute between circa 8% of the total Levy, which is disproportionate to our deposit market share. KBCI believes that there is a lack of alignment between the requirement and rationale for the Levy and the allocation of its burden. Therefore we have included a proposal for an amendment to the methodology for consideration.

Consultation Paper Response:

Do you agree that there is a need to review the methodology for calculating the Financial Institutions Levy?

Yes, KBCI strongly agrees that there is a need to review the methodology for calculating the Financial Institutions Levy as currently proposed for the period (2017-2021).

Do you agree with the proposed approach recommended by the Department of Finance?

No, KBCI does not agree with the proposed approach recommended by the Department of Finance, for the following reasons:

1. **Limited application of the Levy:**

   The stated purpose of the Levy is to enable "*the financial services sector to contribute to the Irish economic recovery"*. However, the DIRT-based approach as proposed results in the application of the Levy being restricted to a limited number of deposit taking institutions. If the stated purpose of the Levy is interpreted narrowly and is restricted to enabling the domestic financial services sector to contribute to the Irish economic recovery, we note that the Central Bank of Ireland currently report that 22 credit institutions and credit unions form the Domestic Market Group (defined as institutions which have a significant level of retail business with Irish households and non-financial corporates and exclude the more internationally focused banks).

   Currently in excess of 96% of the Levy for the period 2014 – 2016 is collected from only five financial institutions and the allocation mechanism as such is unrepresentative of the financial services sector in Ireland and does not fulfil the stated purpose of the Levy. We would argue that if the current DIRT-based methodology was to remain, then the scope of financial service providers contributing to the Levy should be broadened to include all members of the Domestic Market Group, including credit unions.

2. **Equitable allocation of the Levy**

The Levy meets the definition of a tax and therefore the key principles of the operation of any tax should be considered. We note that the Department of Finance in its consultation paper refers to some of the core principles of any tax, - *"In assessing the various options for calculating the levy, adherence to the core principles of simplicity, impartiality, certainty for the payee and ease of collection was foremost in the Department's considerations"*.

However, the consultation paper does not reference one of the core principles of any good tax, the fairness or equity of the tax. Equity has two main elements, horizontal equity and vertical equity. Horizontal equity means that taxpayers in similar circumstances should bear a similar tax burden. Vertical equity means that taxpayers in better circumstances should bear a larger portion of the tax burden. In the context of the Levy and its stated purpose, the use of the equity principle (both vertical and horizontal) would result in entities in the financial services sector contributing to the Levy based on their relative size as a proportion of the overall financial services sector in Ireland, i.e. pay a fair and proportionate share of the tax. As outlined previously, given that circa 96% of the Levy is currently collected from five institutions, this is not the case and the current methodology does not consider proportionality. Therefore the proposed approach does not appear to satisfy the principle of equity.

If, in order to protect the annual yield of €150 million to the Exchequer, the rate applicable to DIRT payments in 2015 rises to circa 55%, then KBCI will, based on our estimate, be required to contribute circa 8% of the total Levy. It is appropriate to consider whether the proportion of the Levy payable by KBCI is proportionate to the size of KBCI in terms of the Irish financial services sector. On any measure and over any timeframe KBCI could not be considered to circa 8% of the Irish financial services deposit market and therefore it would be inequitable for KBCI to be required to contribute circa 8% of the total Levy.

3. **Impact on Pricing Strategies**

The application of the Levy may impact the pricing strategy of those institutions that are subject to it, in a number of ways. Firstly, institutions that pay the Levy will have to consider the additional cost of the Levy when determining their pricing strategies. As such, this may result in an adverse impact on customers, as prices may not be as competitive as those of institutions that are not subject to the Levy.

Secondly, the Levy is based on DIRT payments in 2015 as a base year. However, this may result in a negative impact on those banks which paid higher interest to their customers in 2015. Furthermore, given the consideration of the Levy in pricing strategies, the application of the Levy may impact the rate of interest that banks pay customers in the future, in anticipation of the Levy evolving in future years.

The proposed calculation method could appear interventionist, notwithstanding that this is not the intention of the Levy. The considerations above could influence funding methodologies of financial institutions, whereby Irish banks may target less stable forms of funding, such as corporate, non-resident or interbank funds, and in this way minimise their quantum of the Levy. Domestic retail funding is considered by regulators, investors and rating agencies as the most stable form of funding. Irish banks should be incentivised to target this type of funding rather than penalised in the form of a Levy charge based on it. The Levy focuses on just one form of funding within the funding mix rather than the total stock of funding and as such, could appear to be interventionist in its targeted focus on domestic retail funding.

4. **Barrier to Entry:**

The DIRT-based deposit levy could also be considered to be a competitive barrier to entry, in that it favours incumbent financial institutions with significant domestic retail current account funding bases (which carry a zero interest rate) over new entrants to the market. In order to attract customers from the incumbent financial institutions, new entrants to the market have to pay competitive deposit rates. The Levy under the proposed methodology is allocated as a function of both the volume of retail funding and the rate of interest paid and therefore the rate of interest paid has an impact on the quantum of the Levy payable. As a result, the proposed allocation

of the Levy impacts on the ability of new entrants to compete in respect of attracting domestic retail funding.

Therefore, the Levy payable should not be dependent on the rate of interest paid on funding or the rate of interest charged on lending in order to avoid impacting the ability of financial institutions to compete with each other on pricing.

If not, what alternative model would you suggest, bearing in mind that it would have to protect the annual yield of €150million to the Exchequer?

A significant number of other EU countries have introduced a form of bank Levy in the past number of years. The basis on which such levies are allocated is proportionate either on the amount of liabilities of the institution (adjusted for a variety of items) or the asset base of the institution. We note that the Department of Finance have stated that the approaches adopted in other EU countries are overly interventionist, particularly in the context of the current prescriptive environment around funding models of financial institutions. In our opinion, the proposed DIRT-based model also has implications in respect of the funding models of financial institutions, as outlined above. The Levy is only payable in respect of a certain category of deposits (predominantly domestic interest-bearing retail deposits) and is thus dependent on the rate of interest paid in respect of this category of deposits. This methodology could be considered interventionist as it increases the cost of domestic retail deposit funding vis-á-vis other forms of funding. Under the proposed DIRT-based methodology the more interest a credit institution paid to retail customers (due to paying higher deposit interest rates), the higher the Levy the institution is required to pay. Under the proposed DIRT-based methodology, the Levy incentivizes a reduction in interest rates on retail deposits, an increase of overseas deposits, corporate and institutional deposits, funding from the ECB/CBI, securitisations and other money market funding operations.

The CBI/ECB applies levies on financial institutions and has in recent years developed a number of methodologies for apportioning such levies to financial institutions. We would favour an approach whereby the Levy is based on balance sheet size. For the implementation of this approach there are a number of alternatives available to the Department of Finance, such as:

- Total Liabilities less Tier 1 capital
- Total Liabilities to Irish residents (less Tier 1 capital)

Furthermore, we would advocate that the base is not static and should be representative of the balance sheet of the institution as time progresses. The base should change on a rolling basis each year to facilitate changes in the market and to ensure the allocation of the Levy is representative of the financial services sector. Changing the base every year would assume that new entrants are captured as well as the changing nature and size of the balance sheet for existing institutions.

As at 31 March 2016 there are 58 credit institutions resident in Ireland[1] based on the Central Bank of Ireland's Money and Business statistics. The Money and Business statistics are compiled in respect of business written out of all within-the-State offices of both credit institutions authorised to carry on banking business in Ireland under Irish legislation and credit institutions authorised in other EEA Member States operating in Ireland on a branch basis. It could be considered that this is the best approximation of the financial services sector in Ireland operating through credit institutions with a presence in Ireland.

We would suggest that alternative methods, such as those above, would satisfy the requirements set out by the Department of Finance of simplicity, impartiality, certainty for the payee and ease of collection, while also respecting the principle of equity.

Should the Department of Finance reject a new methodology such as those outlined above, we would advocate that the scope of the current methodology be expanded, given that it currently excludes the majority of institutions included in the Domestic Market Group from contributing.

Are there any additional factors you believe should be taken on board in any evaluation of the existing formula?

The Department of Finance consultation paper in respect of the Levy to apply for the period 2017 to 2021, states that the intention is to collect €150 million annually. It further states that due to the fact that the amount of DIRT collected in 2015 was lower than the amount of DIRT collected in 2011, the rate applied to DIRT payments would need to rise. We understand that the amount of DIRT collected in 2015 was c. €300m which would necessitate a rise in the rate to at least 50%. This increase exacerbates the requirement to revise the current methodology for allocation.

[1] http://www.centralbank.ie/polstats/stats/cmab/pages/money%20and%20banking.aspx

Is there any further comment you wish to make?

N/A – all information for consideration is included above.

Conclusion

We do not agree with the proposed approach for allocation of the Levy for a number of reasons, namely (i) the application of the Levy is limited to a small number of deposit taking financial institutions within the Domestic Market Group; (ii) there is an apparent lack of consideration of equity as a key principle of the operation of any tax; (iii) the methodology will possibly have a negative impact on pricing and funding strategies of financial institutions which will ultimately impact the customer and (iv) the DIRT-based methodology favours incumbent financial institutions with significant domestic retail current account funding bases over new entrants to the market.

As such, we have suggested and would favour an alternative methodology which focusses more on total liabilities as a basis for calculating the Levy and a dynamic base for calculation. Should the Department of Finance wish to continue with the DIRT-based approach, then we feel that it is imperative to consider a revision of the scope of institutions required to contribute to the Levy.