permanent tsb

Response to Public Consultation

To: Department of Finance

From: Permanent TSB

Date: 07 July 2016

Re: Public Consultation – Levy on Financial Institutions

Purpose:

The purpose of this note is to respond to the questions raised by the Minister for Finance and the Department of Finance in the public consultation regarding the calculation of the levy on Financial Institutions ("the bank levy").

Background:

Under current legislation, the bank levy applies to Irish and EU approved banks (operating in Ireland through a branch) who are currently carrying on a trade in Ireland and who were within the ambit of the DIRT legislation as it applied in 2011. The current bank levy is based on a fixed percentage of 35% of the DIRT liability paid by banks in 2011 (excluding banks with DIRT payments of less than €100,000 in 2011).

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

Yes, for the following reasons which are discussed in further detail below:

- Current calculation penalises banks with a particular funding mix;
- Stated rationale of the levy versus methodology applied in calculating the levy are incongruous;
- Current calculation bears no reflection of current economic activity.

DIRT applies to interest paid by banks and building societies on Irish deposits held by Irish resident individuals. Therefore, wholesale banking activities or banks not engaged in taking deposits in Ireland from Irish residents will escape any liability under the proposed levy calculation methodology. Also, banks which are largely funded with wholesale/ institutional funding are advantaged. This results in a

[1] Credit Institutions whose ultimate parent entity is resident in Ireland or which have a significant (>20%) level of business with Irish households and non-financial corporations in terms of their overall resident business activity,

disproportionate percentage of the banking levy being paid by Irish retail banks with a significant Irish resident deposit base.

On introduction, the Minister for Finance stated that the levy "reflects the significant role played by the banking sector in the crisis". Under the current format, the bank levy is based on the level of Irish retail deposits held by banks. However, it was not the level of deposits held by the banks which led to the crisis: rather it was caused by rapid and wide scale credit expansion and the level of lending linked to over reliance on wholesale funding. While we appreciate that a calculation based on a historic DIRT liability provides certainty, it is inconsistent with the Minister's stated rationale and inequitable in its allocation.

For completeness, we have set out below details of the bank levy paid by financial institutions in 2015 as a percentage of 2015 gross interest income and total assets, which shows that the quantum of levy paid by PTSB is proportionally higher than other Financial Institutions. This results in a distortion as banks without a retail focus have a competitive advantage.

Furthermore, a levy which is calculated based on a historical, static measure is not a reflection of current economic activity or impact. It is therefore our view that there is a need to review the methodology for calculating the Financial Institutions Levy.

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

No. While we welcome the date change, we disagree with the proposed approach for the reasons noted below.

The proposed approach suggests using the same methodology as is currently in place but changing the base year from 2011 to 2015. While this addresses the issue of changes to the market participants since 2011, it does nothing to address the potential distortion in the market and bears no relationship to the stated rationale for the levy. We therefore strongly disagree with this proposed approach for the following reasons:

- The bank levy is applied as a tax which has no corresponding link to profitability. The same quantum of levy applies regardless of profit levels within an institution. This point is particularly relevant given the Financial Institution Sector's return to profitability in recent times. In this regard, we note the following quote from the OECD 2001, Tax Policy Studies paper *"... the distribution of taxation's impact across the population raises issues of equity, or fairness, which must be given substantial weight even if it entails costs in terms of economic efficiency* "[3];
- The proposed approach has no consideration for the relative size (or risk profile) of each institution in balance sheet or profitability terms. Banks with a smaller market share may pay a disproportionate percentage of the bank levy. This will not change under the proposed approach;
- As already stated herein, banks which are predominantly funded with wholesale/ institutional funding are advantaged under the current methodology;

[2] The numbers, as included in this table, have been obtained from the 2015 Annual Report of the relevant Financial Institution.

[3] Source: OECD 2001, Tax Policy Studies No. 6, Tax and the Economy: A Comparative Assessment of OECD Countries, p17.

- The proposed approach does not reflect the current economic activity or impact of the relevant Financial Institution.

The consultation paper suggests that the "*new formulation would be maintained until 2021*". We have inferred that this may mean no change to the 2015 base year in the future. In our view, this needs to be reconsidered. This is inequitable, unfair and is potentially inconsistent with EU law as new entrants or banks without a retail focus in the base year are at a significant competitive advantage. This inconsistency was demonstrated in how the existing levy was applied (or not applied) to market participants. There should be a mechanism in place such that new entrants to the market fall within the remit of the levy or are otherwise not treated differently.

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

Please see above.

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

In our view, the basis of the calculation in Ireland is anti-competitive in comparison to other EU countries. Banks engaged in corporate banking or wholesale banking will effectively be excluded from the bank levy and banks with large volumes of deposits from non-residents will have very low, if any, liability. It is our view that the levy should be expanded to ensure that banks are subject to a levy which is equitable and which is based on a measure of relative size and commensurate with risk profile. For completeness, we have included below a high level overview of the bank levy methodology which is in place in some EU countries.

Most EU countries have a bank levy in place. In a number of countries, it is combined with the level of consistency provided for under the Bank Resolution and Recovery Directive ("BRRD").

For some jurisdictions the levy has been in place a number of years[4] and, while the method of calculation varies, for the majority of countries the calculation is based on a specific formula which is derived from the bank's balance sheet with specific elements being exempt (i.e. covered deposits). Certain jurisdictions apply a factor depending on the riskiness of the entity.

In the UK, the levy is based on the total liabilities of banks (i.e. both short and long term liabilities with no distinction between banks with different funding mixes). The levy applies where relevant aggregate liabilities (exclusions include Tier 1 capital, insured retail deposits, repos secured on sovereign debts and policyholder liabilities of retail insurance businesses within banking groups) exceed £20 billion. The rate which is applied to the liabilities in calculating the bank levy has changed over the last few years but is lower (50% lower) for long term liabilities than for short term liabilities. Changes are being introduced to the UK levy such that the levy will reduce over the next six years and stop applying to worldwide assets from 2021. However, a new 8 per cent surcharge on bank profits is being introduced from 2016.

In France, the current bank levy is based on own funds required to comply with coverage ratio obligations for the preceding calendar year. It applies to a wide range of companies such as credit institutions, investment companies, members of a clearing house, payment institutions and regulated financial companies.

In Spain, the levy is based on total liabilities excluding own funds and guaranteed deposits. The contribution is adjusted by a factor depending on the riskiness of the institution.

---

[4] Austria – January 2011; Belgium – 2012; Cyprus – 2011; France – 2011; Germany – 2011; Netherlands – 2012; Portugal – 2011; UK - 2011

Potential alternative model

Currently, the bank levy applies to Irish and EU authorised banks operating in Ireland through a branch or building society. The levy should continue to apply to all such credit institutions. However, current legislation restricts the levy to those banks that were within the scope of Irish DIRT in 2011(or as proposed: 2015). It is our view that this restriction should be removed from current legislation and that relevant banks in this context should include all banks within the CBI Domestic Market Group including Credit Unions and An Post. On this basis, we have a number of suggestions for the calculation of the bank levy:

- Levy based on total level of liabilities held by the relevant banks (including Credit Unions and An Post). This data is easily obtained and measurable and reflects the relative size of each institution. This is also the approach which is adopted in other jurisdictions.

- Levy based on total liabilities (excluding covered deposits and capital/own funds). This is consistent with the theoretical methodology proposed in the BRRD. We would also suggest a surcharge be included for those banks whose former bank assets continue to be managed by NAMA to be consistent with the originally stated rationale for the levy.

  We note the statement made in the consultation that *"importing a formula calibrated around the make-up of the balance sheet ... would be overly interventionist"*. We disagree with this statement and are of the opinion that a levy based on this methodology provides the best balance between equitability, consistency with the stated rationale for the initial introduction of the bank levy and adherence to the core principles outlined in the consultation paper (i.e. simplicity, impartiality, certainty for the payee and ease of collection). It is acknowledged that a levy based on total liabilities could, to some degree, affect certainty for the taxpayer when compared to the proposed methodology however this could be partly alleviated by using a static base year in calculations for a period of time. In any case, we are of the opinion that the benefits of this methodology outweigh this potential downside.

- Levy based on profitability and tapered down for profits below a certain level of ROE. However, levy based solely on profits could result in significant fluctuations year on year if profits are re-measured annually. Sharp fluctuations will arise for release of provisions or significant risk events occurring. To reduce the impact of the fluctuations a hybrid calculation based on total liabilities (excluding covered deposits and capital/own funds) plus a surcharge for normalised operating profit could be considered.

- Levy based on operating profit and tapered down for non-supranormal Gross Interest Income or Net Interest Income.

- Levy based on the level of non-retail business. This would help to emphasise the support of the DoF for the retail banking market and assist in ultimately reducing the cost of banking for Irish consumers.

Is there any further comment you wish to make?

We welcome the consultation process and the appetite to change the current basis of calculation of the levy. As noted, while a change of the base year to 2015 reflects changes to the market participants since 2011 and takes account of reduced interest rates, it still results in significant potential distortions in terms of participation in the levy and bears no relationship to the originally stated rationale for introducing the levy.

On balance, we believe it is important that the methodology adopted should reflect the rationale for a levy, namely that it should be economically fair, clear, consistent and minimise any distortion of competition. We believe this is best achieved using a straightforward measure of relative total liabilities of the banks (excluding covered deposits and capital/own funds) for which information is readily available.

The extension of the bank levy is stated to run to 2021 and, in our view, it is also important that its cessation at that time is confirmed now to provide certainty to the investor market. This confirmation should be incorporated in the methodology proposed.

Conclusion

In summary, Permanent TSB welcomes the consultation on the Bank Levy, but does not agree with the proposed calculation methodology as, in our view, it is neither proportionate nor fair, having regard to the stated purpose of the Levy.