



Bank Levy – Amendment of Netting Agreements

Technical Note

Dated: 25 November 2011

Introduction

An amendment is proposed to broaden the netting provisions within the bank levy to ensure that they cover the full range of commercial transactions that are included within netting arrangements. Where all other netting conditions are met the changes will mean that shares and securities posted as collateral and shares and securities that are sold short can be included.

The amendment is called '[The Finance Act 2011 \(Bank Levy: Amendment of Netting Agreements Provisions\) Order 2011](#)' (the Order) and is made under the affirmative process which means that the Order is subject to Parliamentary debate before it can be made.

Background

The bank levy applies to UK banks, building societies, banking and building society groups and to foreign banks, banking groups and banking sub groups in non banking groups where the bank or group has banking interests in the UK.

The bank levy is charged upon the entity or group's chargeable equity and liabilities for a chargeable period.

Bank entities and banking groups often undertake financial transactions with counterparties where the bank and counterparty enter into bilateral or multilateral netting agreements covering those transactions. These allow a member or different members of the same banking group to enter into a net settlement agreement with the same counterparties should either party become bankrupt or insolvent. If such a netting event occurs all of the liabilities and assets of the entities that are covered by the netting agreement will be settled net; that is settled by a single payment. Where such arrangements are legally effective and enforceable the remaining net balance of any such liabilities is the figure to be taken into consideration when calculating chargeable equity and liabilities.

The issue

The arrangements covered by netting agreements often include very complex financial transactions. Since Finance Act 2011 received Royal Assent HM Revenue and Customs have become aware of some transactions that are included within netting agreements that are not catered for in the netting provisions in Schedule 19 to the Finance Act 2011, in particular where the netting includes 'short selling' and situations where shares or securities are posted as collateral against liabilities.

The solution

Given the complexity of the types of arrangements that could be covered by netting agreements the Government made an amendment to Schedule 19 at the Report Stage of Finance Bill 2011 to introduce a power to allow HM Treasury to amend the netting provisions by way of secondary legislation to cater for situations that came to light subsequently that were not covered by the legislation as drafted but which were within the policy objectives of the netting provisions.

To ensure the netting rules apply as intended, an Order is being made under this power to amend Schedule 19 to cover these additional situations.

The amendment is contained within The Finance Act 2011 (Bank Levy: Amendment of Netting Agreement Provisions) 2011 and it makes amendments to paragraphs 16, 18, 20, 22 and 25 of Schedule 19.

The Order removes the requirement for the assets of the counterparty to correspond directly to the liability that the entity or the member of group has. Instead it is replaced by a requirement that the entity or group member recognises as assets amounts due from the counterparty. This means that shares or securities that the entity or member of the group posts as collateral (where the shares or securities are recognised on the entity's balance sheet and are included under a netting agreement) or which are sold short can be taken into account for netting regardless of their accounting treatment in the hands of the counterparty.

The Order also simplifies the netting provisions as the amendments mean that reverse repo transactions will now be covered without requiring specific provisions. This allows paragraph 16(3), 18(11), 20(11), 22(3) and 25(4), which specifically deal with these transactions, to be removed.

The changes to the netting rules will be effective for all chargeable periods ending on or after 1 January 2011. This ensures that the netting rules will work as intended from the date of the introduction of the Bank Levy.

Example

In order to cover a short sale 'M' enters into a stock lending transaction with a third party counterparty 'N', where M posts collateral with N in the form of debt securities in respect of its obligations under the stock loan.

In this scenario the accounting treatment in respect of the stock loan will be that M would recognise a liability (representing M's obligation to N to return the securities borrowed under the stock loan). Whereas N

would continue to recognise the securities lent to M under the stock loan as an asset on its balance sheet.

In terms of the collateral posted, M would continue to reflect the securities transferred to N as an asset on its balance sheet (this represents M's right to receive redelivery of the securities given as collateral to N under the agreement). Providing N continues to hold the securities provided as collateral it would reflect nothing on its balance sheet. If N disposed of the securities provided as collateral it would reflect a liability in respect of its obligation to return to M these shares.

Under the netting rules as drafted in Schedule 19 the stock loan would not be capable of meeting the terms within the netting provisions as these required the counterparty to hold assets that correspond to the entity or group member's liabilities. As the counterparty's asset is the actual securities lent under the stock loan, it is arguable that this asset does not correspond to the entity or group member's obligation to return the securities.

The securities provided as collateral are also similarly affected under the netting provisions as currently included in Schedule 19, as the entity or group member's asset (the securities posted as collateral) will not result in a liability in the counterparty's balance sheet (if the securities are retained) or where the securities are disposed of the liability (the requirement to redeliver the securities) will not correspond to the entity or group member's asset.

The amendment removes the 'corresponding to' requirement and this allows the netting provisions to include both stock lending and shares or securities where they are posted as collateral.

Points of contact

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