

HM Revenue & Customs discussion paper: the tax treatment of regulatory capital instruments

This document is for discussion purposes only

Introduction

The Basel Committee on Banking Supervision has proposed regulatory reforms focused on:

- enhancing the quality and quantity of bank capital
- addressing pro-cyclicality
- introducing a leverage ratio,
- ensuring that banks are adequately capitalised against their counterparty credit risk;
- liquidity management

The committee has proposed the creation of new capital instruments to support these reforms however a number of features of these instruments make their tax treatment uncertain under existing tax and accounting rules.

Basel III will begin to be implemented in the European Union (EU) from 1 January 2013 so any changes to tax rules that the Government deems necessary will need to be made in Finance Bill 2012. In line with the Government's 'New Approach to Policy-making' notice to this effect was given in Budget 2011. As part of this policy making process the Government has asked HM Revenue & Customs (HMRC) to identify specific tax issues arising from the Basel III proposals through an open informal discussion with industry with the aim of identifying any legislative changes to the tax rules that might be needed.

The Government is committed to the full implementation of Basel III and is also awaiting the final recommendations of the Independent Commission on Banking, which made provisional recommendations on additional loss absorbency measures in its interim report.

Background

'Basel III: A global regulatory framework for more resilient banks and banking systems' published in December 2010 set out the Basel committee's proposals. Basel III changes the focus of regulatory capital requirements from total capital (that is tier 1 plus tier 2) to core tier 1, while leaving additional requirements for additional tier 1, and tier 2 (both revised in form). The effect is that this will require banks to start increasing their tier 1 (common equity (core tier 1) and additional tier 1 capital) and either replacing or issuing new tier 2 capital so that a proportion of their additional tier 1 and tier 2 capital transforms into core tier 1 at a trigger point. This will lead to the creation of a number of new types of capital instrument that convert to equity at a pre-defined trigger point (these are detailed in the next section).

The Basel proposals will be implemented in the EU through changes to the Capital Requirements Directive (CRD 4). The European Commission issued a consultation document (see below) on 26 February 2010 on proposed changes **inter alia** to the definition of capital in CRD 4.

[The European Commission consultation document dated 26 February 2010 \(Opens new window\)](#)

[Basel III: A global regulatory framework for more resilient banks and banking systems](#)

Following this consultation legislative proposals are expected to be published by the European Commission in the coming months and will then be subject to negotiation amongst member states. So it is expected that Basel III will be implemented in the EU and elsewhere progressively between 2013 and 2019 in line with the Basel timetable and the statement by the G20 leaders following the Seoul Summit in November 2010.

The Basel proposals will give rise to a significant increase in the quantum and quality of tier 1 capital generally in the form of ordinary share capital and reserves which provide the greatest loss absorbency. For example under Basel III it is proposed that deferred tax assets whose recognition depends on the realisation of profits in the future should be largely removed¹ from tier 1 capital and the reduction made good from another source.

The tax treatment of these new instruments will be an important competitiveness issue for banks across the EU and beyond. In the midst of this changing regulatory landscape many banks and building societies are refinancing or considering future refinancing and they wish to do so in a way that is likely to conform to the expected future capital requirements.

Tax will be an important consideration in the type and range of instruments that develop to meet the new regulatory requirements; however, a number of the required regulatory features of these instruments make the tax treatment under the present tax rules uncertain in a number of respects. In particular, while issuers of existing innovative tier 1 and tier 2 instruments in the form of debt generally enjoy tax deductions for any coupons paid to investors, instruments reflecting the loss absorbency requirement may not be tax deductible under current rules.

The New Capital Instruments

Additional tier 1

The proposals will remove certain existing innovative tier 1 instruments from qualifying as tier 1 capital and replace them with additional going concern capital (AGCC). Basel III proposes that these instruments must be truly perpetual with no step up or call provisions.

¹ To be not greater than 10 per cent of the banks' common equity component, and restricted to deferred tax assets arising from timing differences (thus excluding those arising from carry forward of losses).

So they must:

- be perpetual
- permit a call option only for the issuer
- carry fully discretionary and non cumulative dividends/coupons

Tier 2

The objective of tier 2 capital will be to provide loss absorption on a gone-concern basis. This will require the issuance of capital that will convert from tier 2 to core tier 1 on a trigger event.

Conversion and trigger events

To ensure that these instruments meet the minimum requirements to ensure loss absorbency at the point of non-viability the terms and conditions of all non-common tier 1 and tier 2 instruments issued must have a provision that requires such instruments, at the option of the relevant authority, to either be written off or converted into common equity upon the occurrence of the trigger event.

This will give rise to the issuance of certain instruments other than ordinary share capital, namely contingent convertible capital instruments (CoCos) - where a bond type instrument converts from tier 2 debt (or potential additional tier 1 if accounted for as debt although the probability of such instruments may not be high - see next section) into ordinary share capital (core tier 1) on the occurrence of certain trigger events - for example a bank's percentage of core tier 1 capital falling below a certain level.

Further to this, the issue of 'bail-in' is being discussed internationally. Under a 'contractual bail-in', banks would issue debt that would either convert to equity or write down at a trigger point close to, or at the point of, non-viability (PON).

This PON proposal contains an important caveat. If a nation's statutory resolution regime contains features/powers which allow these contractual outcomes to be delivered via statutory outcomes then the PON contractual clause may not be required

Such a 'statutory bail in' would give the resolution authorities an explicit statutory power to impose 'haircut's on creditors as part of a resolution. These issues are still being discussed internationally and no decisions have been taken. They are not, therefore, part of the Basel III framework but raise similar issues with respect of the potential tax treatment of these instruments.

The Accounting treatment

The accounting rules for classification of such capital instruments are complex and subject to change as part of the work to converge International Financial Reporting Standards (IFRS) and US Generally Accepted Accounting Principles (GAAP). Thus it is difficult at this stage to give certainty on the likely accounting treatment of such instruments.

Under Basel III common equity tier 1 capital is subject to 14 detailed criteria which should ensure these are the most subordinated interests in the bank, for maximum loss absorbency. One of these criteria is that common equity tier 1 must be

accounted for as equity under the relevant accounting standards. This precludes any such instruments being treated as debt for accounting purposes.

Additional tier 1 capital will in general be accounted for as equity, in a manner consistent with common equity tier 1.

As noted above the current Basel III proposals stipulate that additional tier 1 capital must:

- be perpetual
- permit a call option only for the issuer, and
- carry fully discretionary and non cumulative dividends/coupons.

It is difficult to see how any form of liability treatment would be possible under the current rules applicable under IFRS within these parameters. If additional tier 1 capital instruments do achieve liability classification for accounting purposes, Basel III proposals require the instruments to contain loss absorbency features (permanent write down or conversion into common equity).

HMRC would welcome recipients views on the degree to which some form of liability accounting may be possible for additional tier 1 instruments. It is assumed that if some degree of liability classification is possible, the accounting classification of additional tier 1 instruments could include:

- equity instruments
- compound instruments (containing equity and liability components)
- one of the above plus one or more embedded derivatives

Tier 2 capital will often be accounted for as a financial liability. As noted above the objective of tier 2 is to provide loss absorption on a gone-concern basis.

Additional tier 1 capital and tier 2 capital accounted for as a financial liability (either wholly or in part) could give rise to different permutations of financial instrument including the following:

- Financial liability in its entirety: any loss absorption features (for example write down) may give rise to changes in expected cash flows under the effective interest rate (EIR) calculation, or derecognition of the financial liability. Either of these would be expected to give rise to a credit to the income statement.
- Financial liability plus equity (compound instrument): such treatment may apply if the 'fixed for fixed' criteria of International Accounting Standards (IAS) 32 applies to a conversion feature in the instrument. Upon conversion the carrying value of the liability would be reclassified to equity.
- Financial liability plus embedded derivative: a write down feature or conversion feature which does not qualify as equity (for example conversion into a variable number of equity instruments) may require separate recognition as a derivative. Gains or losses may be recognised on the derivative if a loss absorption trigger event becomes probable.

For financial liabilities measured at amortised cost, any coupon payments will be used as part of the calculation of the finance expense recognised in the income statement, using the EIR calculation. The accounting for such instruments can be complex however. The correct accounting under the current rules will thus depend upon the specific terms of a particular instrument.

However, the current accounting requirements may change within the next two years as part of the work towards convergence of IFRS and US GAAP. While the equity/liability classification project is currently on hold, work is expected to resume on this area once the current International Accounting Standards Board/Financial Accounting Standards Board priority projects are finalised.

Even minor changes could have a significant impact upon the classification of instruments which are at the boundaries of equity/liability classification (which may include some additional tier 1 capital instruments).

In view of this uncertainty, it may be difficult in the short term (at least the next 12 months) to give any certainty over the future accounting treatment of possible additional tier 1 capital instruments. Therefore the degree to which the tax treatment of such regulatory capital instruments should depend (at least in part) upon either the accounting classification or measurement of such instruments needs to be considered as part of these discussions.

Specific tax issues

There are many complex tax rules dealing with financial products which will all need to be considered but in broad terms the main areas of concern which HMRC would like to discuss are:

a) The impact under various rules the conversion or write down features of the CoCo and bail-in instruments may have upon the tax deductibility of interest costs and the re-characterisation of the interest as a distribution which under current tax rules is not tax deductible

For example:

- Do the convertible or write down features of some of these new capital instruments impact the deductibility of interest?
- How will the re-characterisation as a distribution under Chapter 2 Part 23 of Corporation Tax Act 2010 be treated on the basis of:
 - profit dependency (non-cumulation features)
 - non-commercial return on 'principal secured' (write-down features)
 - equity notes (in relation to AGCC raised intra-group).

b) The Stamp Duty and Stamp Duty Reserve Tax (SDRT) treatment, for example, in relation to the applicability of the Stamp Duty loan capital exemption. In particular how will the provisions of section 79 of Finance Act 1986 apply?

c) The loan relationship rules may create tax charges on the debtor in relation to write-downs.

For example:

- There could be a tax charge on the debtor upon the occurrence of a trigger event, in particular in relation to write-downs.
- Embedded derivatives in instruments may give rise to potentially taxable income statement volatility when some form of conversion or write down becomes probable. For example using the alternative accounting treatments set out above, under the current tax legislation a credit would be brought into account either as a profit on a related transaction of a loan relationship or of the embedded derivative.

- This is also true for wholly equity accounted instruments (section 321 of Corporation Tax Act 2009 - the credit recognised in equity represents a profit on a related transaction of a loan relationship).
- Will new perpetual additional tier 1 instruments be loan relationships - will they constitute a 'money debt'?

d) Under Basel III any given level of business activity will require additional capital to cover credit and liquidity risk. This will give rise to transfer pricing issues as the 'capital function' increases in importance relative to 'people function' in attributing profits for the purpose of taxing permanent establishments².

Also currently innovative tier 1 meets some of the criteria for being within the scope of the arbitrage rules - how will these rules apply to these new instruments?

e) Particular issues may arise out of investors choosing to raise capital on shariah-compliant terms by structuring instruments under the alternative finance rules.

f) Sector-specific issues will arise, for example specific issues arise for non-joint stock companies, building societies and industrial and provident societies and with regard to investors in these instruments.

Data to support any potential impact assessment

As set out above there are significant issues to be taken fully into account in designing a loss absorbent capital structure for banks.

The headline data sets that would best inform any HMRC analysis and therefore subsequently advice to Ministers broadly split into the following questions:

- How much?
- When?
- Who buys?
- What do they buy?
- At what cost?

As such HMRC would be grateful for recipients' views on the following:

A: Overall capital requirements:

- A1 What might the overall capital ratio of banks look like by 2019? Will these ratios be in excess of those minimum requirements indicated by Basel III due to market pressure?
- A2 Following on from A1, projected capital ratio - what is its profile likely to be?
- A3 Do people feel that there will be (i) market pressure that will ensure that the full Basel 3 capital requirements are implemented by January 2013, or (ii) a more phased introduction by January 2019 as set out in the Basel timetable?

² Compensation to capital can be calculated by multiplying a measure of the amount of capital by a target return on capital; so a consequence of Basel III is that the likely overall increase in the required compensation to capital will shift the distribution of the value chain from compensation to 'people functions' in favour of the 'capital function'.

B: Capital-based questions

- B1 If capital ratios are anticipated to be greater than that required by Basel III, in which tier(s) would the additional capital be held: Common equity tier 1, additional tier 1 or countercyclical buffer?
- B2 **CoCos** - how much is each institution expected to hold of this buffer instrument - expressed as a percentage of 'total capital' indicated in A1?
- B3 **CoCos** - what is the expected yield on these buffer instruments both current and projected?
- B4 **Cocos** - do people anticipate loss absorption features taking the form of write down, conversion into ordinary shares, or conversion into other equity instruments
- B5 **Bail-in-bonds** - what will be the tax characteristics of bail in bonds instruments?
- B6 What percentage will be denominated in non sterling currencies?

HMRC welcomes comment on the points raised in this note, and any other areas of concern that respondents may wish to raise, and proposes that these form the basis of an open discussion at the meeting on the 18 May 2011.

Thank you in advance for taking the time to contribute to this process.

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