

Radley &
Associates



The Impact of Tax Changes on Foreign Bank Branches in London

Report to the AFB assessing the impact of
proposed changes to branch capital rules

December 2002

Sponsored by the
Corporation of London

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Executive Summary

- **Foreign branch staff typically provide the UK Treasury with about £80k each**
- **The majority of foreign branches are not very concerned because:**
 - They have double tax treaties,
 - Or they have tax losses in London,
 - Or they are full funded already.
- **Those branches that are affected are mostly smaller and from non-OECD countries**
- **Most foreign branches believe the tax will not affect their staffing plans**
- **Branches that are expected to be strongly affected, are seriously considering reducing their presence in London as a result:**
 - Although not enough to neutralise the gains to the UK treasury
- **In the long term, the tax may drive away or deter small non-OECD banks from setting up in London and reduce the diversity of the market**

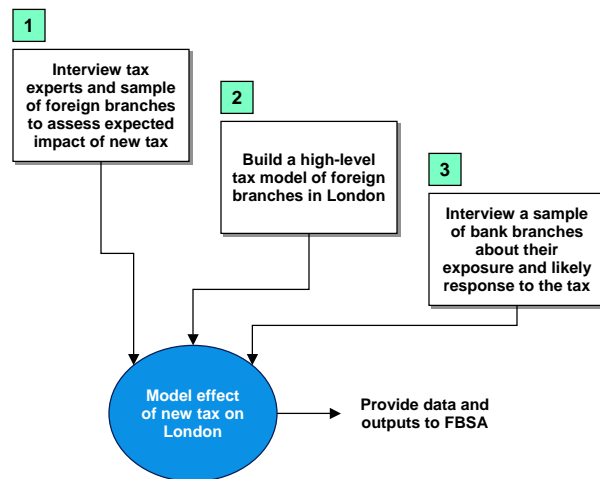
Objectives

- **Identify the likely impact of the proposed new tax treatment on foreign bank branches in London:**
 - On branch level profitability
 - Existing employment levels
 - Future employment plans
- **Provide the FBSA with materials to support their lobbying effort:**
 - Economic arguments
 - Supporting statistics and data

Approach

APPROACH

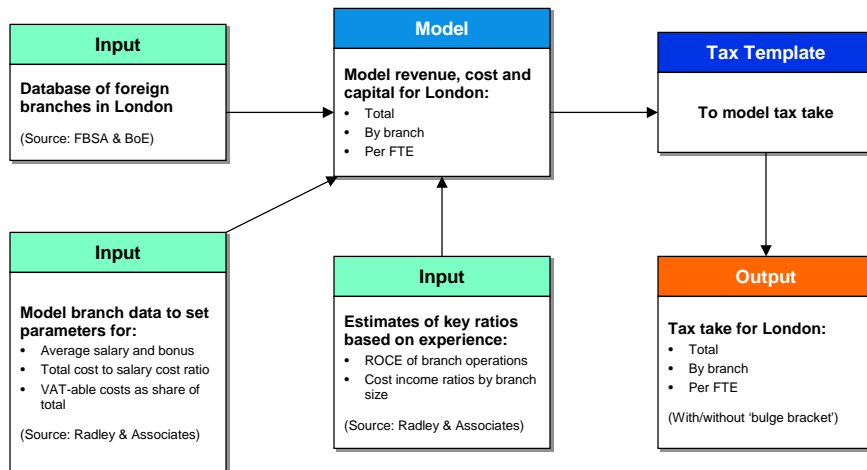
The project has a three stage approach



To develop the tax model, we consulted bank branches and tax accountants

- **Interviewed tax experts to understand tax issue:**
 - KPMG Paul Long (Tax Partner and FBSA tax committee chair)
- **Interviewed example banks to understand the structure and drivers of total UK tax payment:**
 - Nedcorp Frank Le Roux (GM and Financial Controller)
 - Danske Bank Angus MacLennan (GM)
 - DZ Bank Ernst Zeisling (Financial Controller)

We developed a high-level tax model to estimate the total UK tax take generated by foreign bank branches in London



We excluded the top 9 'bulge bracket' foreign banks

Input

Database of foreign branches in London

(Source: FBSA & BoE)

Assumptions

- Excludes 'bulge bracket' banks who have typically a number of legal structures and are adept at minimising exposure to new taxes. Most are not AFB members : **FTEs**

- Morgan Stanley	6,000e
- JP Morgan/Chase	11,000
- Merrill Lynch	6,000e
- Lehman	6,000e
- Citigroup	8,000
- Deutsche Bank	7,150
- UBS/Warburg	6,000
- Goldman Sachs	6,000
- Credit Suisse First Boston	6,000
- 266 other Foreign Banking Institutions
- The data was checked and reconciled with the Bank of England list of institutions licensed to take deposits in June 2002

And used data from a 'model branch' to set key parameters

Input

Model branch⁽¹⁾ data to set parameters for:

- Average salary and bonus
- Total cost to salary cost ratio
- VAT-able costs as share of total

(Source: Radley & Associates)

Assumptions

- Average salary and bonus is £59,460:
 - Average for all staff
- Total branch costs (including rent, depreciation, etc) are 201% of salary costs
- 36% of total branch costs incur VAT at 17.5%

Note 1: the Model branch is a real branch, believed to be typical of London branches

We set Return On Capital and Cost Income Ratios based on geographic region and branch size

Assumptions

ROCE of Branch Operations		Cost Income Ratios	
Region	Typical ROCE	Branch Size	Typical C/I Ratio
North America	20%	Less than 100 FTEs	70%
Africa	10%	100–200 FTEs	60%
Europe	8%	More than 200 FTEs	40%
Middle East/Asia/Far East	8%		
South America	8%		
Australasia	20%		

Input

Estimates of key ratios based on experience:

- ROCE of branch operations
- Cost income ratios by branch size

(Source: Radley & Associates)

We estimated VAT, salary and property taxes and corporation tax

Assumptions

1. VAT of 17.5% on VAT-able expenses, of 36% of total branch expenses
2. Salary taxes (2002):
 - Income tax
 - Employer and employee NICs
 - Average income assumption tends to underestimate tax take
3. Rates:
 - UBR is 19/119 of total property expense
4. Corporation tax:
 - 30% of profits
 - Excludes allowances for solvency capital funding
 - Excludes any other tax reducing factors (e.g. bad debt)

Tax Template

To model tax take

APPROACH

The sample we interviewed is representative of all but the Asia/Far East region

Region	Total Branches ^a	Total Staff	Share of Branches Surveyed	Share of Staff Surveyed
North America and Australasia	25	10,802	24%	12%
Europe	87	24,692	14%	20%
Asia/Far East	55	4,516	—	—
Rest of World	41	3,616	12%	12%
	208	43,626	11%	16%

a. Excludes 9 'bulge bracket' (over 6,000 FTEs) and Rep offices.

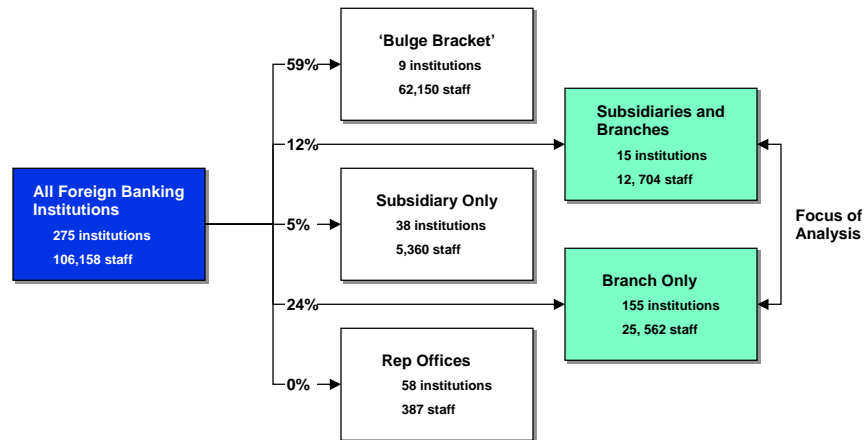
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Tax Model

We focused our analysis on non-‘bulge bracket’ institutions with a London branch



In effect, we assume institutions with subsidiaries and branches book assets in the branch

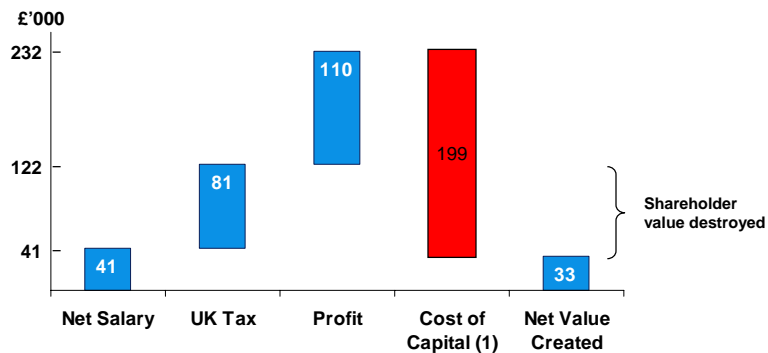
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On average, we estimate each employee provides the UK treasury with £81k and destroys £89k of shareholder value

Value Creation & Distribution per Employee



Net value created per FTE: £33k

(1) We assume a 12% Cost of Equity and that Regulatory Capital is approximately equal to Equity

- Shareholder value (£89k)
- Government £81k
- Employee £41k

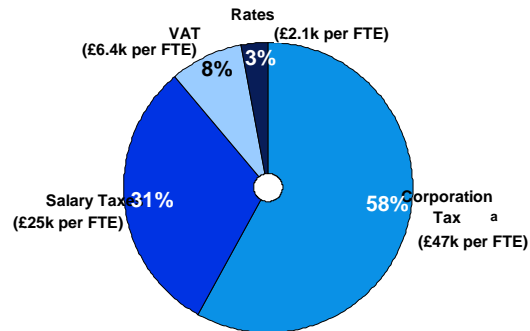
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Corporation tax is the largest element of total UK tax take

Total UK Tax per Employee of Foreign Bank Branches



a. Based on 30% of PBT.

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The proposed tax changes would need to reduce foreign bank employment by 4–8% to neutralise the tax

Treasury Estimate of Extra Revenue from Change in Branch Capital Rules	Estimated Number of Jobs Lost Required to Make Tax Neutral	% of Existing Workforce ⁽¹⁾
£350 million	4,320	4.1%
£650 million	8,023	7.6%

(1) Including Bulge Bracket banks

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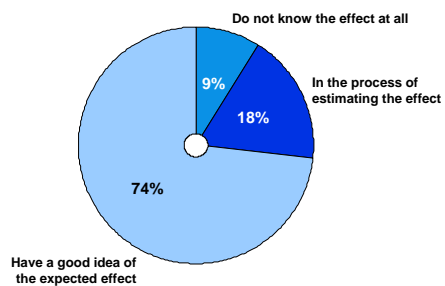
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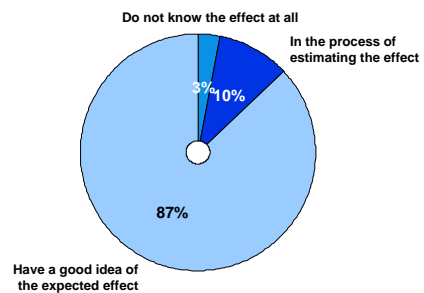
Research Results

Most branches have an idea of the expected impact of the tax

By Number of Branches



By Number of Staff



But those that are uncertain, express strong concerns about the clarity of the proposed new treatment

Comments from the 27% of branches who were uncertain about the impact of the tax:

"But no-one, including the Inland Revenue, can tell me what the actual tax implications will be."

"We don't know how they're going to do it. They haven't told us how to calculate capital. It's an absolute joke. It could be 8%, 10% or 16% capital."

"In many ways, what they are doing is right, but how they are going about it is not clear. We've no idea what it all means."

"We don't know if the Treasury requirements will approximate Economic Capital."

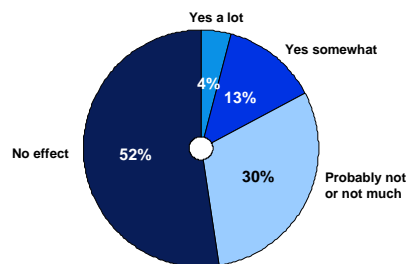
"...until the Treasury publishes how it will work, we don't really have much of an idea."

"We don't have clarity if inter-group loans will be zero-rated for capital purposes."

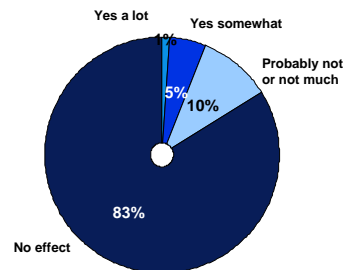
Those expressing uncertainty are generally those most likely to be affected.

Most branches do not feel the new tax will affect them much

*Will the new treatment affect you?
(Branch weighted)*



*Will the new treatment affect you?
(Staff weighted)*



Smaller branches are more affected than large branches.

Those branches affected tend to be non-OECD and smaller

	Share of Branches Affected ^a (%)	Average Size of All Branches (FTEs)	Average Size of Branches Affected (FTEs)
North America ^b Australasia	0%	432	n/a
Europe	17%	283	155
Rest of World	60%	88	62

But these smaller non-OECD branches may be the seed capital of the future.

a. Those answering yes or yes somewhat (see previous page). b. Excluding 'Bulge Bracket'.

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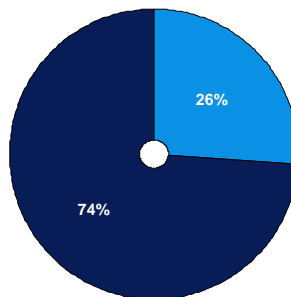
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Most expect to be unaffected because they have double tax treaties or tax losses in London

Unaffected Branches

Branches are unaffected either because they:

- Have double tax treaties (78%)
- Have losses in London (47%)
- Are fully-funded in London (18%)



a. Based on 30% of PBT.

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However, in some cases, even branches with double tax treaties are concerned

Comments from the 78% of branches who have double tax treaties:

"We have a double tax treaty but it doesn't always work out."

"...but [Home Country] will want to hang on to as much tax as possible...it is a poor country."

"...we don't know if [the extra tax] will be allowed by [Home Country] tax authorities...even though we have a double tax treaty."

"...we should be able to offset, but it's just not clear."

"Head Office is OK, but there are some reservations...most of the reaction has been emotional."

"I doubt whether the UK tax authorities will have time to sort it out with every other national tax authority."

Although most believe their tax losses will eventually run out, experience suggests otherwise.

Those branches that fear the new tax think the impact will be significant

Comments from the 26% of branches who fear the tax:

"We estimate the effect will be to increase our tax rate by 10% to 40%."

"We're now paying 31% tax on P&L, it could go up to 51% giving us a ROE of about 6.5% instead of a historical ROE of 10-12%."

"It means double taxation and no-one can run an international business on that basis."

And those branches fearing the new tax, are considering their options

Comments from the 26% of branches who fear the tax:

"If [double tax treaty doesn't work]...high likelihood that this would result in a radical reduction of branch size."

"...it may affect us but we will probably restructure somehow to avoid it."

"We have assets that should be have been booked in [Home Country] so these will be transferred back to HQ."

"We have portfolios from other centres booked in London...but the tax could drive this away—and possibly the jobs."

And those branches fearing the new tax, are considering their options (cont)

Comments from the 26% of branches who fear the tax:

"If the cost is small (say £100k)...but if it is £1 million, it is easier for us to move business out of London."

"We may end up managing bonds here but booking them in Singapore—which would fit nearly into the trend towards globalisation of product group management."

"...we could start moving out the originators, then the back office, then the treasury...over the next 5 years in the worst case, leaving behind a rep office."

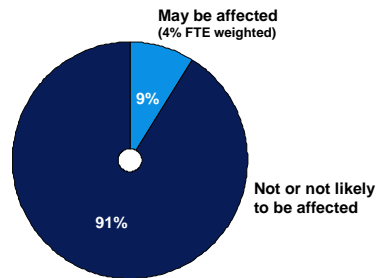
"It is annoying and will not encourage people to set up here in London."

"We may have to manage around it—given the truly global nature of the packages we put together, this should be possible with a bit of imagination."

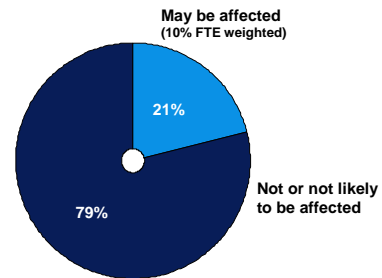
"Dublin is attractive but Isle of Man (and other off-shore centres) doesn't have the infrastructure."

But most banks believe the tax will not affect their employment plans

Branches' staffing plans in the short-medium term



Branches' staffing plans in the long term



We estimate the loss of jobs due to the tax may be upto 1% in the short-medium term and up to 2.4% in the long term.

Conclusions

Some Questions for the Treasury

- **Is it realistic to believe that tax losses are high now and will fall in the future?**
 - As implied by the Treasury estimates that the tax will rise from £350m to £650m?
- **How can the Treasury reassure banks with double tax treaties that all their home office jurisdictions will agree the new treatment without delay?**
- **How can the Treasury minimise the impact on the small, non-OECD banks that may represent a major source of future growth for the City?**
 - E.g. by not imposing the rule on branches from countries without double tax treaties?
- **How can the Treasury square the disproportionate effects of the tax on (e.g.) African banks with the Government's development agenda?**
 - Even though African Banks will contribute less than 1% of the expected revenue?
- **Once finalised, how can the Treasury quickly communicate the details of the proposed treatment to reduce the uncertainty of those banks affected?**