EXPLANATORY MEMORANDUM TO

THE HYBRID AND OTHER MISMATCHES (FINANCIAL INSTRUMENT: EXCLUSIONS) REGULATIONS 2019

2019 No. 1251

1. Introduction

1.1 This explanatory memorandum has been prepared by Her Majesty's Revenue and Customs (HMRC) on behalf of Her Majesty's Treasury and is laid before the House of Commons by Command of Her Majesty.

1.2 This memorandum contains information for the Select Committee on Statutory Instruments.

2. Purpose of the instrument

2.1 These regulations replace existing legislation exempting regulatory capital issued by banks and insurers from counteraction under the hybrid and other mismatch rules (see 7.4 below). United Kingdom (UK) tax policy allows deductions for the costs of regulatory capital securities which banks and insurers are required to hold to provide stability for those sectors and for the wider UK economy. The existing exemption supports this policy. These regulations ensure the exemption continues to apply and extend it to additional categories of instruments that banks may be required to hold.

3. Matters of special interest to Parliament

Matters of special interest to the Select Committee on Statutory Instruments

3.1 Section 19(4) of the Finance Act 2019 (FA 2019) removed the existing exemption for regulatory capital from counteraction under the hybrid and other mismatches rules and replaced it with a power to make regulations specifying exclusions from the meaning of "financial instrument" which may also be exempted from counteraction. However, section 19(9) FA 2019 provides that the existing exemption continues to have effect until these regulations come into force. These regulations come into force on 29 November 2019 and take effect in relation to payments made on or after 1 January 2019 and quasi-payments (amounts which arise or accrue that give rise to allowable tax deductions) in relation to which the payment period begins on or after that date, in accordance with section 19(8) FA 2019. This ensures that no taxpayers are adversely affected by this change.

Matters relevant to Standing Orders Nos. 83P and 83T of the Standing Orders of the House of Commons relating to Public Business (English Votes for English Laws)

3.2 As these regulations are subject to the negative resolution procedure there are no matters relevant to Standing Orders Nos. 83P and 83T of the Standing Orders of the House of Commons relating to Public Business at this stage.

4. Extent and Territorial Application

4.1 The territorial extent of this instrument is the United Kingdom.

4.2 The territorial application of this instrument is the United Kingdom.

5. European Convention on Human Rights

5.1 As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

6. Legislative Context

6.1 The hybrids and other mismatches legislation contained in Part 6A of the Taxation (International and Other Provisions) Act 2010 (TIOPA 2010) is an anti-avoidance regime that seeks to counteract mismatches in the tax treatment of instruments and structures across jurisdictions. Until it was amended by the Finance Act 2019 on 12 February 2019, section 259N(3)(b) TIOPA 2010 included an exemption for 'anything that is a regulatory capital security for the purposes of the Taxation of Regulatory Capital Securities Regulations 2013 (S.I. 2013/3209) (as amended from time to time)' (the RCS Regulations). The RCS Regulations were amended by the Taxation of Regulatory Capital Securities (Amendment) Regulations 2015 (S.I. 2015/2056) to include certain regulatory capital securities issued by insurers.

6.2 The RCS Regulations provided rules for the taxation of hybrid regulatory capital for banks and insurers. Broadly speaking, those rules provided a tax deduction for the coupon costs of such regulatory capital.

6.3 Article 45 of the Bank Recovery and Resolution Directive (2014/59/EU) (BRRD) contains an obligation for Member States to ensure that certain institutions meet, at all times, a minimum requirement for own funds and eligible liabilities (MREL). The UK implemented the provisions of the BRRD concerning MREL in sections 3A and 3B of the Banking Act 2009 (BA 2009) and in Part 9 of the Bank Recovery and Resolution (No. 2) Order 2014 (S.I. 2014/3348), which came into force on 1 January 2016.

6.4 In June 2018, under section 3B(9) BA 2009, the Bank of England finalised and published its updated policy for exercising its power to direct relevant persons to maintain a MREL under section 3A(4) BA 2009. In order to maintain their MREL, banks are permitted to issue additional types of hybrid capital instruments that were not covered by the RCS Regulations.

6.5 The Bank of England expects to direct banks to meet more stringent MRELs from 1 January 2022. It also expects to set more stringent interim MRELs that will apply to global systemically important banks from 1 January 2019 and to other banks from 1 January 2020.

6.6 Schedule 20 FA 2019 revoked the RCS Regulations with effect from 1 January 2019 and introduced new rules on the taxation of hybrid capital instruments which apply to all sectors, not just banks and insurers.

6.7 These regulations ensure that anything that was a regulatory capital security for the purposes of the RCS Regulations is still exempt from counteraction under the hybrid and other mismatches legislation. These regulations also ensure that other hybrid instruments that banks issue that meet the definition of own funds and eligible liabilities (and are not excluded from the bank's MREL) are also exempt.

6.8 These regulations come into force on 29 November 2019 but have effect in relation to payments made on or after 1 January 2019 and quasi-payments in relation to which the payment period begins on or after that date.

7. Policy background

7.1 The hybrid and other mismatches legislation is an anti-avoidance regime that seeks to counteract mismatches in tax treatment of instruments and structures across jurisdictions. Banks and insurers issue hybrid regulatory capital instruments that include some features which may mean there is a mismatch in tax treatment across jurisdictions.

7.2 Banks and insurers are required to hold regulatory capital so that when they are in financial difficulties they can call upon this capital to remain in business. This protects customers' interests and avoids disrupting the economy. It acts like a buffer, absorbing losses and preventing the capital position becoming depleted to critical levels.

7.3 The more stringent interim MRELs that the Bank of England will set from 1 January 2019 go further than this, requiring global systemically important banks to hold sufficient capital and debt so they can continue to provide critical services when the bank is already failing. Both debt and capital instruments can be written down or converted to shares to absorb losses and recapitalise the bank without recourse to government funds.

7.4 The UK treats these instruments as debt but some countries treat these as equity giving rise to a mismatch in tax treatment. The mismatch arises because the UK will give a tax deduction for payments under such instruments, whilst the overseas jurisdiction will treat the corresponding receipts as non-taxable dividends or distributions. The hybrid and other mismatch rules deal with such mismatches by denying the deduction where the corresponding receipt is untaxed. Without an exemption from the hybrid and other mismatches legislation, banks and insurers issuing these instruments would not get a deduction for the interest they pay on these instruments.

7.5 UK tax policy is to allow deductions for the cost of instruments which are issued to support these regulatory requirements which provide stability for the banking and insurance sectors and for the entire UK economy. The exemption from the hybrid and other mismatches legislation supports this policy by allowing a deduction for interest paid on these instruments.

7.6 These regulations are required to replace the existing exemption for hybrid regulatory capital following the revocation of the RCS Regulations and to extend the exemption to other hybrid regulatory capital and debt instruments that banks may issue to meet their MREL.

8. European Union (Withdrawal) Act/Withdrawal of the United Kingdom from the European Union

8.1 These regulations do not relate to withdrawal from the European Union.

9. Consolidation

9.1 There are no plans to consolidate the legislation.

10. Consultation outcome

10.1 The draft regulations was subject to a short informal consultation, which was considered appropriate as they relate to a minor technical change affecting a small number of businesses in the financial sector. Stakeholders (banks and financial sector

representative bodies) did not indicate that any changes were required to the draft regulations.

11. Guidance

11.1 Banks and insurers have been made aware of these regulations. On 29 October 2018, HMRC published a technical note to provide guidance on the revocation of the RCS regulations and the new rules introduced in Finance Act 2019. Paragraph 3.27 explained that the government intended to use the power now found in section 19 FA 2019 to introduce a new exemption mirroring the existing exemption and extending this to new regulatory instruments issued as a result of MREL requirements.

12. Impact

12.1 The impact on business, charities or voluntary bodies is limited to banks and insurers who have issued hybrid instruments to overseas associates in countries where the interest receipt is not taxed in full. These regulations ensure that the exemption from the hybrid legislation continues to apply to qualifying instruments following the revocation of the RCS Regulations. The small number of businesses impacted by this change will incur insignificant one-off costs of familiarisation with the amendment. There are not expected to be any ongoing costs to those businesses from the amendment.

12.2 There is no, or no significant, impact on the public sector.

12.3 A Tax Information and Impact Note covering this instrument will be published on the website at https://www.gov.uk/government/collections/tax-information-and-impact-notes-tiins.

13. Regulating small business

13.1 These regulations do not apply to activities that are undertaken by small businesses.

14. Monitoring & review

14.1 These regulations will be kept under review through communication with affected taxpayer groups.

14.2 These regulations do not include a statutory review clause. They amend UK tax legislation and therefore fall within the exceptions at section 28(3)(a), Small Business, Enterprise and Employment Act 2015.

15. Contact

15.1 Mark Bryan at HMRC (Telephone: 03000 585607 or email: mark.bryan@hmrc.gov.uk) can be contacted with any queries regarding the instrument.

15.2 Lizzie Arnold, Deputy Director, at HMRC can confirm that this Explanatory Memorandum meets the required standard.

15.3 Jesse Norman MP, Financial Secretary to the Treasury, can confirm that this Explanatory Memorandum meets the required standard.