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Briefing Paper

The Bank Levy

Financial stability is an archetypical Public Good, in the sense used by economists that consumption by one person does not reduce the amount available for consumption by others. Consideration of who should pay for achieving financial stability and how much stability we want is a Public Policy issue. There is a 'Dutch Dyke Problem' involved. Like flooding in the Netherlands, it is simply too costly to completely eliminate the possibility of financial crises. Completely eliminating financial instability might well require eliminating bank lending, and also equity financing, entirely; with negative consequences for economic wellbeing and growth.

The recent financial crisis demonstrates that depositors, bondholders, and even shareholders of big banks, were underwritten by taxpayers well above and beyond any contributions the banks were making to deposit insurance, and wider investment protection schemes, and the fees charged for their regulation and supervision. A report by the IMF for the G-20 countries in June 2010 argued that a 'Financial Stability Contribution' should be made by big banks to compensate taxpayers for the insurance they provide to the funders of big banks. The government promptly introduced a 'Bank Levy' on the liabilities of the big banks net of their insured deposits, equity capital, etc. Its aim is to require banks to make a contribution to their, hitherto largely free, insurance by the taxpaying public and to encourage them to hold safer, more 'liquid', liabilities and more equity capital. In this vein, exemption could also be considered for issuance of good ('Contingent-Convertible' and 'Covered') bonds. The banks can claim, as a business expense against Corporation Tax on their profits, 'interest' paid on the bonds they issue. The November 2010 Mirrlees Review of the UK tax system recommended that this exemption should be retained, but the principle of tax neutrality required it to be extended to the dividend payment costs associated with equity financing. In contrast, the IMF Report preferred eliminating tax deductibility of interest in order to achieve neutrality with equity issuance and remove the bias towards ‘leveraging’ by banks. The UK Bank Levy is not to be accumulated in a bail-out fund because the government needs the revenue and feels that the existence of such a fund might encourage excessive risk taking (‘moral hazard’). Any (normally idle) fund could not anyway be large enough to eliminate the need for taxpayer support in another major crisis. There is thus a case for an additional, retrospective, tax on the banks that manage their risks badly during a crisis; a sort of ‘polluter pays’ tax, as applied to BP in the US after last year’s deep sea oil well disaster. The problem is that the weakest banks couldn’t pay such a tax immediately after the crisis and would be better using post crisis profits to rebuild their capital bases. The government should, however, restrict their ability to pay dividends and bonuses whilst they re-build their regulatory capital ratios, and might also consider preventing losses incurred during the crisis being set against profits for a suitable pay-back period.

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