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Association For Financial Markets in Europe

ASIFMA Briefing Call
The proposal for enhanced cooperation on a financial transaction tax

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Outline

1. Enhanced cooperation procedure
2. Key features of the proposal
3. Application to repo and fixed income markets
4. Impact on corporates and sovereigns
5. Macroeconomic impact
6. Extra-territoriality

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Enhanced Cooperation procedure

1. There is an impasse in the negotiations
2. At least 9 Member States indicate to the Commission that they would like to proceed with enhanced cooperation
3. Decision for authorisation in the Council taken by QMV, consent is also required from the European Parliament
4. Implementation of authorisation: the Commission presents its legislative proposal followed by a normal legislative procedure
5. All 27 Member States can participate in the deliberations but only those who have indicated to participate in the enhanced cooperation procedure have voting rights
6. On 19 April 2013 the UK announced the launch of a legal challenge against enhanced cooperation FTT
7. Conditions for Enhanced Cooperation include:
    - At least 9 member states
    - Must be a last resort
    - Must not undermine common market, restrict trade, or distort competiton
    - Must respect rights and competencies of non-participating Member States

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Background

- September 2011: European Commission presents legislative proposal for EU27 FTT
- June 2012: ECOFIN concludes there is no unanimous agreement possible
- September/October 2012: 11 Member States ask Commission for enhanced cooperation FTT
- October 2012: Commission publishes authorisation proposal
- January 2013: ECOFIN authorises 11 Member States to start the enhanced cooperation procedure for an FTT

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Current developments

- February 2013: Commission publishes legislative proposal for an enhanced cooperation FTT based on its original proposal
- From March 2013: Commission's proposal being discussed at Council working group. Separate meetings among 11 participating countries taking place
- The European Parliament only has a consultative role to play
- 14 May 2013: Council meeting (ECOFIN)
- 22 May 2013: Council working group on FTT

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Key Features of FTT proposal (1)

The proposed FTT would apply to "financial transactions" involving at least one "financial institution" which is "deemed to be established" in a participating Member State.

A financial institution is deemed to be established in a participating Member State if any of the following conditions is fulfilled :

- it is authorised by that member state
- it is incorporated in that member state
- has a branch within that member state, in respect of transactions carried out by the branch
- has a counterparty which is established in the member state
- is party to a transaction in a financial instrument issued in the participating member state (with exception for OTC derivatives)

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Key features of FTT proposal (2)

The definition of financial institutions includes:

- investment firms
- organised markets
- credit institutions
- insurers
- pension funds
- collective investment funds and managers
- certain SPVs
- other entities whose financial transactions constitute more than 50% of turnover

The definition of financial transactions includes:

- purchase and sale of a financial instrument
- repos and stock lending
- conclusion or modification of derivatives
- in the case of group transactions the transfer of the right to dispose of a financial instrument as owner and any equivalent operation implying the transfer of the risk

Key features of FTT proposal (3)

The definition of financial instruments includes:

- shares
- bonds and other securities
- options
- futures
- derivatives
- units in unit trusts and other funds/collective investment schemes

There are some very limited exemptions to FTT:

- primary market transactions
- transactions with the EU, ECB, international bodies and central banks of member states
- clearing houses (but their counterparties are not exempted)
- spot foreign exchange transactions, physical commodities and consumer products

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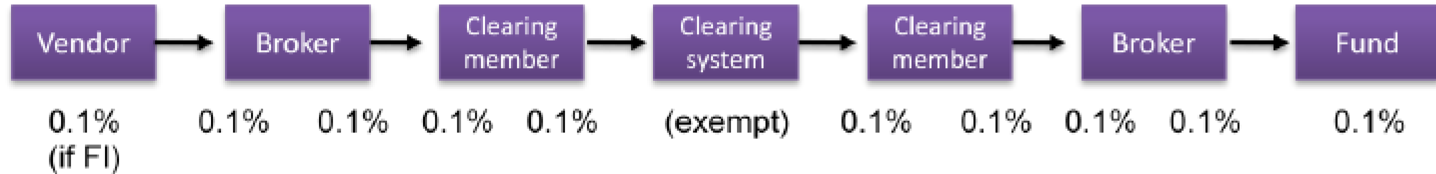
Cascade effect

- "Gross basis" application of tax will lead to a "cascade effect" which massively increases the impact of the tax (Clifford Chance, 2013)
- The sale and purchase of an equity within the FTT zone would be charged at multiple stages of the chain of settlement, for example:



* Clifford Chance (2013)

- Existing FTTs in France, Ireland, Italy and UK have exemptions for intermediaries in order to avoid the negative impact of this cascade effect
- Most taxes operate on a net basis (e.g. VAT, corporation and income taxes). By contrast, the FTT applies on a gross basis and separately to each element of each financial transaction – it "cascades"

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Application to repo markets

- Repo transactions – essentially collateralised lending - are an essential structural component of financial markets

Essential benefits include:

- Supporting
  - Primary debt issuance; and
  - Liquid secondary markets
- Enabling hedging, and collateral/risk management

FTT Cost on Repo:
ICMA report notes that the proposed charge of 0.10% on each side of the transaction (e.g. total of 0.20%) would require significant increases in bid/offer spreads and have an enormous impact on this vital market:

	normal bid/offer spread		
repo term	**0.05%**	**0.10%**	**0.15%**
1D	72.05%	72.10%	72.15%
1W	10.34%	10.39%	10.44%
1M	2.37%	2.42%	2.47%
3M	0.84%	0.89%	0.94%
6M	0.45%	0.50%	0.55%
12M	0.25%	0.30%	0.35%

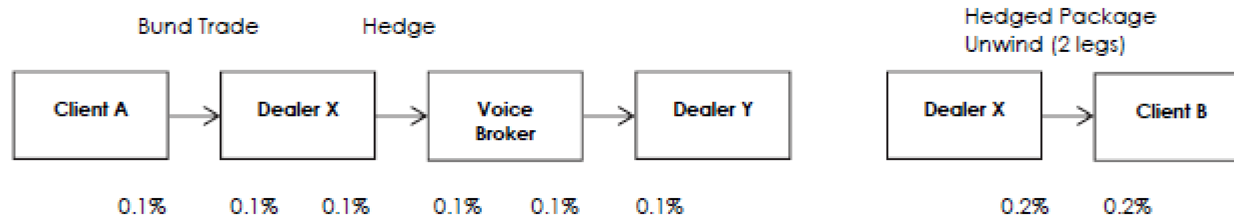
Table 2 --- implied break-even bid/offer spreads that a market-maker would have to charge to recover the FTT and make his normal bid/offer spread on repo-reverse repo matched positions for various terms

Application to fixed income markets

- Client facilitation / Intermediation is essential to functioning of European capital markets. AFME research indicates:
  - 70% Govt Bonds trade < 400 times per month
  - most corporate bond trades are concentrated in the 0-200 trades per month range, with a large number at <20 trades per month (63.8%)

- Intermediation requires a multiplicity of transactions to service clients needs and the cost of functioning of European capital markets will be significantly increased by the FTT

- The fixed-income market structure is based on a quote-driven bilateral system. It is challenging to match buyers and sellers, particularly at the same price and size



* London Economics (2013)

- All of the above transactions are taxable under the current proposals

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Impact on corporates

- Impact on the cost of hedging products will be highly significant. The cost varies by product:
- FX hedging costs will increase by 3-7x on average and by up to 18x for most frequent hedges (Oliver Wyman, 2012)
- FX spot transactions are exempted from the FTT as they would serve to let capital flow across borders in the EU. However, also FX forwards, swaps and options serve this purpose but are not exempt
- When interest rate derivatives are used for hedging, the estimated minimum impact of the FTT cost is at least 5 times. However, ongoing hedging is likely to increase this by an order of magnitude, depending on how the risk is managed
- For cash bond issuance, an estimate of the cost to issuers can be obtained through the London Economics study commissioned by the IRSG:
  - The impact to corporate issuers will depend on the maturity, with a larger impact on shorter dated maturities. For example, corporate bonds with maturity of 8-10 years, the impact of the FTT is estimated at 6.4% per transaction, while for bonds with maturity of 0-2 years, it is estimated at 13.6%

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Impact on sovereigns

- Secondary market activity is necessary for public finances to operate effectively. The FTT proposal does however not seek to safeguard secondary market trading in public debt. This would result in an increased cost of funding and capital burden for governments
- The estimated cost of the FTT on, for example, UK government debt is £3.95 billion based on a gross issuance of £128.08 billion of non-index linked gilts (London Economics, 2013)
- The cost of funds would be proportionately higher for participating Member States

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Economic costs

- Oxera (2011, 2012) concludes that the negative economic impact is likely to be significantly greater than anticipated by the Commission
- Efficient markets theory indicates transaction taxes are borne by end-users. As Oxera (2011) concludes, the burden of the tax will be shared between end-investors and companies
- The OECD (2008) concludes that taxes on financial transactions are one of the most distortive
- Oxera (2011) provides an example of the FTT impact on a retail investment in a fund. The expected return of the fund before the tax is assumed to be 5%, the FTT reduces this to 4.2%

- COM model indicates ratio of GDP loss to revenue raised of between 2:1 and 4:1
- 2:1 ratio => for every €1 revenue raised from FTT €0.80 is lost in other tax revenues
- 4:1 ratio => for every €1 revenue raised from FTT €1.60 is lost in other tax revenues

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Extra-territoriality

- Proposed tax is unprecedented in extraterritorial reach and will discourage foreign investment in FTT zone
- Non-Participating and non-EU financial firms will be subject to the tax:
  - When transacting with a financial institution within the Participating Countries
  - When transacting with a corporate within the Participating Countries
  - When party to a transaction involving an instrument issued within the Participating Countries
- Implies significant impact on non-participating and non-EU financial firms even though it is those companies and governments in the zone that will be most significantly impacted
- And transactions in Asian securities will be caught if either one of the parties is a financial institution deemed to be established in the FTT zone
- As an example, London Economics (2013), has concluded that the cost of funds for governments and corporates both inside and outside the FTT zone will be severely affected because of the taxation of debt securities

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Appendix I: sources

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