AFME Members’ Briefing Call -

Financial Transaction Tax as outlined in the Oliver Wyman report, 'The impact of the EU-11 Financial Transaction Tax on End-users’

16 December 2013
Impact of FTT

Report findings
• Ben Smith, Partner, Oliver Wyman
• Ronan O’Kelly, Principal, Oliver Wyman

Reactions and next steps
• Richard Middleton, Managing Director, Tax, AFME
• Caleb Wright, Head of EMEA Equity strategy and Market Structure, BAML
THE IMPACT OF THE EU-11 FINANCIAL TRANSACTION TAX ON END-USERS

December 2013
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Oliver Wyman was commissioned by AFME to conduct an independent study into the impact of the EU financial transaction tax (FTT) on end-users

**Overview of FTT proposal**

- Originally proposed in 2011, amended in 2013
  - 2011 proposal for EU-wide FTT failed to reach consensus among EU states
  - February 2013 EC proposed revised FTT covering 11 EU member states (“EU-11”)

- Tax on all financial transactions:
  - 1 basis point on derivatives
  - 10 basis points on other instruments (including securities, repos)

- Broad extraterritorial reach and anti-avoidance
  - Residence principle
  - Issuance principle

- Officially planned for introduction in January 2014, though continuing political and legal debate

**Scope of this report**

- Independent assessment on the impact of the FTT on end-users:
  - Corporates
  - Governments
  - Long-term investors (pension funds, asset managers, life insurers)
  - Retail investors

- Focus on core products used by these groups for capital raising, risk management and investing:
  - Equities
  - Corporate bonds
  - Government bonds
  - FX & interest rate derivatives
  - Repos

- This report does not aim to consider the broader macroeconomic costs or benefits of the FTT

1, Belgium, Germany, Estonia, Greece, Spain, France, Italy, Austria, Portugal, Slovenia and Slovakia

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Summary findings
We estimate €30-50BN total annual cost to end-users

Annual impact of the FTT on end-users (€BN)

- Direct taxes paid by end-users (financial institutions)
- Continued need to trade to manage investments and rebalance portfolios

- Cascade effect:
  - Taxes paid by dealers but passed onto end-users via wider bid-ask spreads
  - Tax is many multiples of current spreads so must be passed on

- Liquidity effect:
  - Bid-ask spreads widen further to reflect lower market-wide liquidity
  - Reduced volumes empirically linked to higher bid-ask spreads

Source: Oliver Wyman analysis
Cascade effect: dealer taxes must be passed on

**Dealer revenues vs. market maker taxes on EU-11 issued securities (€BN)**

- End clients face additional costs from the “cascade effect” as **financial intermediaries pass on costs** in facilitating client trades
  - FTT levied on each transaction in the chain
  - A necessary part of risk transfer to facilitate client transactions

- “Cascade effect” taxes cannot be borne by dealers as the **tax is many multiples of current spreads**
  - E.g. 20bps tax on cash equities compares to bid-ask spreads of <5bps for large-cap stocks
  - Dealer taxes on EU-11 securities 3-7x revenues earned on these instruments

- Cost of the “cascade effect” is **significantly larger than direct taxes** paid by end-users

Note: Bank revenues and taxes refer to EU-11 issued securities only (e.g. under the issuance principle). Market-maker taxes shown pre volume declines for comparability to 2012 revenue base. Excludes revenues and taxes on non EU-11 issued securities (e.g. under the residence principle).

Source: Oliver Wyman proprietary data and analysis
Liquidity effect: lower volumes would drive up transaction costs

Observed relationship between bid/ask spreads and traded volume for EU-11 stocks

- Lower trading volumes are associated with higher bid-ask spreads
  - Increased cost of trading drives reduced volumes
  - Lower volumes means higher bid-ask spreads
  - Requires more risk-taking by market-makers, requiring higher spreads to compensate

- The impact of the tax varies across asset classes, reflecting differences in market size and structure
  - **Cash equities**: more liquid, lower impact
  - **Government bonds**: highly liquid, but uncertain given reliance on market-making and linkages to other markets (repos, derivatives)
  - **Corporate bonds**: lower liquidity markets, therefore greater liquidity effect
  - **Derivatives**: moderate impact on spreads, but profound effect on competitive dynamics

\[ y = 146685x^{-0.427} \]

Source: Trading Venues, Thomson Reuters, BofAML analysis, Oliver Wyman analysis
Volume declines: behavioural responses are a key driver of uncertainty

Annual volumes by client type (€BN)
Government bonds example

- Our analysis is based on assumptions about behavioural responses to the FTT, based on:
  - Economic theory and academic studies
  - Detailed data on market volumes and prices
  - Interviews with end-users and market participants

- It is challenging to accurately predict market reactions, so we consider two alternative scenarios:
  - Scenario A uses conservative assumptions of volume declines by counterparty type
  - Scenario B assumes a more radical shift in behaviour and market structure, with breakdown in principal market-making model

- Trade-off between “cascade effect” and “liquidity effect” costs
  - Scenario A has higher “cascade effect” costs but lower liquidity costs
  - Scenario B sharper volume declines not offset by liquidity costs
  - Liquidity costs are not tax receipts; they represent economic inefficiency

Source: ECB, government debt management offices, Oliver Wyman analysis
Costs are realised in three channels

Schematic of FTT cost impacts: annual vs. realised costs

Annual cash flow view

- Taxes paid directly
- Cascade effect
- Liquidity effect

Realised costs view

Securities currently outstanding
- Decline in value today reflecting reduced expected future cash-flows
- One-off impact, primarily on long term investors who hold most securities

New securities issued in the future
- Issuers must pay higher returns to incentivize investors to hold taxable instruments
- On-going annual cost of more expensive financing for corporates and governments

Derivatives hedging
- Increased transaction costs for using derivatives to hedge risks
- On-going annual costs for corporations and long term investors

One-off decline of €260-340BN
4-5% of long-term investor holdings

On-going costs of €20-30BN per annum

On-going costs of €5-15BN per annum

Source: Oliver Wyman analysis
Impact by end-user group

Cost to corporates

- **€8-10BN costs per annum** for EU-11 corporates, 4-5% post-tax profits
- Increased cost of debt and equity financing as investors demand higher returns
  - 10-20 basis points per annum increase in yield on corporate debt
  - 6-8% reduction in market capitalisation of future equity issuance
- **€1-3BN cost of derivatives hedging**; reduced hedging volumes and increased earnings volatility

Cost to governments

- Annual government financing costs to increase by **€15-20BN per annum**
- Sovereign debt yields would increase by **20-30 basis points** per annum
- **Highly uncertain impact** given reliance on market-making and interlinkages to other markets (repos, derivatives, use as collateral)
- Presents **challenges to economics of primary dealer** model

Cost to investors

- **€260-340BN reduction in value of EU-11 securities** held by end-users
- Reflects NPV of higher future transaction costs and lower future cash-flows
- End-users are the main holders of securities, so **bear most of the cost**
- **€5-15BN annual costs of risk management**; necessary for hedging and ALM
- Net effect is reduced returns for savers and investors
Second order impacts

Impact on the banking system

• Banks not considered as end-users in this study but will face material costs from FTT which may be passed onto end-users and increase the cost of lending
  – Increased financing costs in debt and equity markets
  – Increased risk management costs
  – Large holdings of government bonds, as collateral and liquidity buffers (in line with Basel 3 liquidity rules: LCR & NSFR)

Competitive considerations

• OTC derivatives taxes only on “residence principle”, so EU-11 banks taxed on all global derivatives transactions (vs. foreign banks just taxed on EU-11 transactions)
  – EU-11 banks will exit the interdealer market, and become price-takers
  – EU-11 clients will migrate their derivatives business to non EU-11 dealers
  – EU-11 banks will re-price lending products to mitigate this loss; smaller clients to face higher hedging costs given limited access to international capital markets

Impact on monetary policy transmission

• Potential damage to the functioning of monetary policy through the disruption to government bond, repo and interest rate derivative markets
• Repo markets key to the transmission of monetary policy as central banks use repos to inject cash into markets through purchases of fixed-income securities
• FTT would challenge the efficient operation of repo markets and thereby damage effective monetary policy transmission
Closing remarks

- FTT will have a material effect on end-users
  - Increased cost of capital
  - Increased cost of risk management
  - Increased cost of managing investments, and reduced returns

- A number of effects have been underestimated to date, all of which increase end-user costs
  - Extent of cascade effect… and likelihood that this will be passed onto end-users
  - Liquidity costs… the role market-makers play in providing liquidity, and the value of this
  - Interconnectedness of markets… and therefore potential for fundamental market dislocation
  - Impact on asset values… effect may be much greater than 1 year effect

- The impact of the above would be profound for the real-economy
  - Reduced investment
  - Reduced investment income for long-term investors
  - Relocation of corporate treasury centres
  - Increased volatility in financial markets and corporate earnings
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**London**
St Michael’s House
1 George Yard
London EC3V 9DH
United Kingdom

Tel: +44 (0) 20 7743 9300

**Brussels**
3rd Floor
Square de Meeûs 38 -40
1000 Brussels
Belgium

Tel: +32 (0)2 401 8724

www.afme.eu