AFME Members’ Briefing Call –
The proposal for enhanced cooperation on a financial transaction tax

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Gerry Cross, Managing Director, Advocacy
Richard Middleton, Managing Director, Tax and Accounting
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
7. Question and answer session
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 members states
   • Must be a last resort
   • Must not undermine common market, restrict trade, or distort comp
   • Must respect rights and competencies of non-participating States
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
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: FTT on the ECOFIN agenda for update and discussion
• 22 May 2013: next Council working group on FTT
Key features of FTT proposal (1)

Applies to financial institutions which include:
• investment firms
• organised markets
• credit institutions
• insurers
• pension funds
• collective investment funds and managers
• SPVs
• other entities whose financial transactions constitute more than 50% of turnover

Financial transactions mean:
• 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 (2)

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

Very limited exemptions
- primary market transactions
- transactions with the EU, ECB, international bodies and central banks of member states
- clearing houses (but counterparties not)
- spot foreign exchange transactions, physical commodities and consumer products
FTT applies to financial transactions involving at least one financial institution established in the FTT zone. Being established in a participating member state means that the institution:

- is authorised by the member state
- is incorporated in the member state
- is resident in the member state
- has a branch in the member state from which the transaction is carried out
- 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
“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:

Existing FTTs in France, Ireland, Italy and UK exempt 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"
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:

<table>
<thead>
<tr>
<th>repo term</th>
<th>0.05%</th>
<th>0.10%</th>
<th>0.15%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1D</td>
<td>72.05%</td>
<td>72.10%</td>
<td>72.15%</td>
</tr>
<tr>
<td>1W</td>
<td>10.34%</td>
<td>10.39%</td>
<td>10.44%</td>
</tr>
<tr>
<td>1M</td>
<td>2.37%</td>
<td>2.42%</td>
<td>2.47%</td>
</tr>
<tr>
<td>3M</td>
<td>0.84%</td>
<td>0.89%</td>
<td>0.94%</td>
</tr>
<tr>
<td>6M</td>
<td>0.45%</td>
<td>0.50%</td>
<td>0.55%</td>
</tr>
<tr>
<td>12M</td>
<td>0.25%</td>
<td>0.30%</td>
<td>0.35%</td>
</tr>
</tbody>
</table>

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
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%
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.
• 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
Proposed tax is unprecedented in extraterritorial reach and will discourage foreign investment in FTT zone

Non-Participating Country financial firms 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 Member States outside the Enhanced Cooperation countries even though it is those companies and governments in the zone that will be most significantly impacted

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
Appendix I: sources


- Oliver Wyman (2012). *Proposed EU Commission financial transaction tax impact analysis on foreign exchange markets*
  http://www.oliverwyman.com/media/Oliver_Wyman_Impact_of_the_Financial_Transaction_Tax_on_FX_markets_FINAL.PDF

- Oxera (2011). *What would be the economic impact of the proposed financial transaction tax on the EU – review of the European Commission’s economic impact assessment*


Appendix I: sources

- AFME (2012). Analysis of Fixed Income Trading Activity
  www.afme.eu/WorkArea/DownloadAsset.aspx?id=6821
- Clifford Chance (2013). Extra-territorial effect of the proposed EU financial transaction tax
  http://www.cliffordchance.com/publicationviews/publications/2013/02/the_european_commissionsfinancialtransactio.html
- London Economics (2013). The impact of a financial transaction tax on corporate and sovereign debt
Appendix I: sources

- ICAP (2013). *The Financial Transaction Tax, an ICAP discussion document* 
  [http://www.icap.com/~media/B5EC97C3015B4A3C8657E057151646CA.ashx](http://www.icap.com/~media/B5EC97C3015B4A3C8657E057151646CA.ashx)
Association For Financial Markets in Europe

Question & answer session
The Association for Financial Markets in Europe advocates stable, competitive and sustainable European financial markets that support economic growth and benefit society.

**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](http://www.afme.eu)