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European Commission public consultation:
Taxation of the financial sector

A response by the Association for Financial Markets in Europe

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Response to the European Commission public consultation on taxation of the financial sector

AFME welcomes the opportunity to contribute to the European Commission's public consultation on the taxation of the financial sector. Appropriately, the crisis has led to international discussion and initiatives concerning the regulatory regime and, more recently, the taxation of the sector has moved up the agenda.

Taxation of financial services

1. Historically, taxation of financial services has been similar to taxation of other important sectors of the economy, such as manufacturing. All sectors have the following taxes in common:

   (i) Taxes on business profits;
   (ii) Taxes on remuneration of employees, either payable by the employer (e.g., employer's social security) or payable by the employee but collected by the employer on behalf of the government (e.g., payroll taxes);
   (iii) Value-added taxes on supplies of goods or services (often collected by business on behalf of the government).

2. There were, however, some differences (which still remain) between the sectors:

   (i) In relation to VAT, it was decided as a policy matter that supplies of certain financial services should be exempted; while customers do not pay VAT on such supplies, financial institutions are not able to recover all the input VAT they pay to suppliers, and therefore have higher VAT costs than companies in other sectors;
   (ii) The financial sector makes a significant contribution to the operation of tax systems through its responsibilities for reporting and collection of other taxes, such as taxes on dividend income, interest income and capital gains;
   (iii) Financial institutions make contributions to deposit guarantee schemes and investor compensation schemes to ensure that eligible depositors and eligible investors are covered up to a maximum limit in the event that a deposit-taking institution or investment firm is unable to make payment.

Fiscal policy

3. As Europe takes steps to tackle both the short term challenges posed by high and rising deficits and levels of debt, and the longer term fiscal challenges posed by issues such as ageing populations, there will be debate on the different courses of action including the balance between cuts in expenditure and increases in taxes.

4. Inherent in the Commission's consultation paper is the question of whether the provision of financial services should face its own, specific taxation regime, or simply be treated in the same way as any other corporate activity, taxed under a general regime.

5. The consultation is taking place against the backdrop of several significant new taxes already being introduced by individual Member States. Following the crisis and the IMF report to the G-20 in June 2010, several Member States have introduced levies on certain financial institutions. Such levies are intended to constitute a fair and substantial contribution for the risks posed by the financial sector to the rest of the economy. Some Member States are using levies for general revenues; others are using levies for resolution funds.

6. To address the question of whether financial services should face its own specific taxation regime we believe that it is important to be clear from the outset about the policy objectives of any specific form of taxation for financial services.

7. Our understanding is that the policy objectives of any specific tax regime for financial services would be as follows:

    (i) to raise revenues
    (ii) to change behaviours so as to increase the stability of the financial system

8. In relation to objective (i) we note and concur with the Commission's assessment that it is important first to determine whether financial services are undertaxed *and* what the impact of any additional taxes would be, before consideration of how any revenues should be allocated or used. We believe that a study should be undertaken to establish the total tax contribution (including all taxes and levies noted above) of financial services across the EU. The study should have a broad perimeter, covering all providers of financial services. This would help to inform any decision as to whether to introduce any additional tax and if so, how to calibrate the tax. We believe that a study could be completed in a reasonably short timescale on the assumption that national tax authorities in the Member States would be prepared to provide the relevant data (though we appreciate that thought would need to be given to an appropriate common format for data collection and analysis).

9. In relation to objective (ii) we believe that the ongoing regulatory reforms are critical. The financial crisis has led to multiple reviews of systemic risk in the global financial system and agreement on new standards as governments and regulators seek to mitigate such risks in order to achieve financial stability. The optimal way forward is to develop sensible reforms that reduce systemic risk and the need for government intervention when failures occur. Such reforms encompass: sound

governance and risk management practices in financial firms; robust and appropriately calibrated capital, liquidity and leverage regimes that reduce the risk of failure; effective supervision designed to identify risks early and avert institutional and systemic risk; market practices that prevent risks from building up unseen; and appropriate resolution regimes that reduce the impact of any failures.

10. We believe that regulation should be the primary tool to achieve greater stability of the financial system, and that it is important that regulatory reforms now being implemented are not undermined by any tax measures. In particular, to the extent that the incidence of any tax falls on providers of financial services, the effect on capital, and lending, should be carefully considered.

11. Given the current patchwork of taxes across the EU, we believe that it would be helpful for the European Commission to press for the co-ordination of the measures which have already been taken by Member States, and to seek to influence Member States contemplating new tax measures. The objective is to work towards a system whereby income, activities or balance sheet can only be taxed in one Member State, thereby eliminating the risk of double taxation.

12. Our responses to the detailed questions are set out below. It may be helpful to point out that we have responded at some length to the opening questions in the sections on FTT, FAT, and levies, and that our responses to later questions in those sections should be read subject to those earlier comments. We have also repeated some of the arguments where they are relevant to more than one question.

Q1 – do you consider it justifiable that the revenue side of fiscal consolidation efforts of Member States are targeting the financial sector?

A1 – no, because…

Financial institutions are subject to broadly the same taxes as other sectors. The main difference relates to VAT, where financial institutions have higher VAT costs than companies in other sectors, because financial institutions are not able to recover all the input VAT they pay to suppliers.

Accordingly, financial institutions generally make a higher contribution to tax revenues than companies in other sectors (for the same level of profits).

Following the IMF report to the G-20, several Member States have introduced levies on certain financial institutions. Such levies are intended to constitute a fair and substantial contribution for the risks posed by the financial sector to the rest of the economy.

In considering any additional fiscal measures targeting the financial sector, Member States would need to be very careful to ensure that such measures do not have a negative impact on the economic recovery.

Q2 – do you find it problematic that Member States introduce patchwork national measures without coordination?

A2 – yes, because…

Whilst acknowledging that Member States have sovereignty over introduction of new taxes, we consider that patchwork national measures can lead to situations where different Member States seek to tax the same income, activities or balance sheet, thereby leading to a risk of double taxation of the same income, activities or balance sheet.

We believe that it would be helpful for the European Commission to focus on the co-ordination of the measures which have already been taken by Member States, and to seek to influence Member States in their future tax policies to work towards a system whereby income, activities or balance sheet can only be taxed in one Member State, thereby eliminating the risk of double taxation.

Q3 – do you consider that shortcomings in the governance or behaviour of financial markets or financial institutions were one of the major reasons for the financial and economic crisis?

A3 – other.

The financial crisis has led to multiple reviews of systemic risk in the global financial system as governments and regulators seek to mitigate such risks in order to achieve sustainable financial stability.

The optimal way forward is to develop sensible reforms that reduce systemic risk and the need for government intervention when failures occur. Such reforms encompass: sound governance and risk management practices in financial firms; robust and appropriately calibrated capital, liquidity and leverage regimes that reduce the risk of failure; effective supervision designed to identify risks early and avert institutional and systemic risk; market practices that prevent risks from building up unseen; and appropriate resolution regimes that reduce the impact of any failures.

Q4 – which sectors and activities within the financial sector had most to do with the crisis?

A4 – other.

The financial crisis has led to multiple reviews of systemic risk in the global financial system as governments and regulators seek to mitigate such risks in order to achieve sustainable financial stability.

The optimal way forward is to develop sensible reforms that reduce systemic risk and the need for government intervention when failures occur. Such reforms encompass: sound governance and risk management practices in financial firms; robust and appropriately calibrated capital, liquidity and leverage regimes that reduce the risk of failure; effective supervision designed to identify risks early and avert institutional and systemic risk; market practices that prevent risks from building up unseen; and appropriate resolution regimes that reduce the impact of any failures.

Q5 – do you consider that shortcomings in the governance or behaviour of financial markets or financial institutions to be an EU-wide problem?

A5 – yes, it affected most EU Member States.

The financial crisis affected Members States differently, depending in part on the importance of the financial sector to their economy. Most of the Member States were affected in some way by the crisis.

Q6 – do you consider the financial sector in the EU to be under-taxed (eg because of VAT exemption, exemption from thin capitalisation rules, higher economic rent, ie excess profits) or overtaxed (eg because of special additional taxes already implemented) with respect to other sectors of economic activity?

A6 – it is not undertaxed compared to other sectors.

Financial institutions are subject to broadly the same taxes as other sectors. The main difference relates to VAT, where it was decided as a policy matter that supplies of certain financial services should be exempted. While customers do not pay VAT on such supplies, financial institutions are not able to recover all the input VAT they pay to suppliers and therefore have higher VAT costs than companies in other sectors.

Accordingly, financial institutions generally make a higher contribution to tax revenues than companies in other sectors (for the same level of profits) and consumers pay a lower level of tax on financial services than they pay on supplies from other sectors.

Following the IMF report to G-20 in June 2010, several Member States have introduced levies on certain financial institutions. Such levies are intended to collect a fair and substantial contribution for the risks posed by the financial sector to the rest of the economy. The contribution of the sector to government revenues is already demonstrably substantial in most Member States. In assessing any proposal for additional taxes, we would urge governments to take full account of the overall tax contribution from the sector. It should also be noted that financial institutions already make substantial contributions to deposit guarantee schemes and investor compensation schemes to ensure that eligible depositors and eligible investors are covered up to a maximum limit in the event that a deposit-taking institution or investment firm is unable to make payment. While these contributions do not generally constitute taxes as such, they should be recognised as significant financial contributions which mitigate the risks posed by the sector to the wider economy.

The IMF report noted that a narrow perimeter for levies would single out specific institutions and create incentives for systemic risk to migrate, and could worsen moral hazard by suggesting that such institutions are less likely to fail than other institutions. The report suggested that the levy should be imposed on all financial institutions. Notwithstanding this suggestion, several Member States have used a narrow perimeter. We consider that financial institutions within this narrow perimeter are therefore likely to be over-taxed relative to financial institutions outside the perimeter.

In addition, the lack of coordination between national levies is presenting significant risk of double taxation.

Whilst financial institutions themselves generally make a higher contribution to tax revenues than companies in other sectors (for the same level of profits), there remains the question of the effect of the current VAT policy on Government revenues.

There are two aspects to consider.

Firstly, where exempt supplies are made directly to the end consumer, Governments do not collect VAT on those supplies; instead Governments collect attributable VAT paid by the supplier.

Secondly, where exempt supplies are made to a taxable business, and used in the production of taxable goods and services, Governments collect VAT on those taxable goods and services, and also collect attributable VAT paid by the supplier of exempt services. In this case, to the extent that the cost of this attributable VAT is passed on by the taxable business to the end consumer, Governments will also collect VAT on that extra cost.

Accordingly, the overall effect will depend on the balance between the two categories and the amount of attributable VAT in each category.

It has been suggested that the overall effect is that the policy leads to less VAT being collected than would otherwise be the case. The point was raised at the Brussels Tax Forum by Professor Huizinga and it was acknowledged that additional factors (such as the cascading effect through the supply chain) were not reflected in the estimates and would need to be considered to give a more accurate analysis. We also understand that Member States may have empirical data on the effect of VAT exemptions (for example, data may be available in relation to cases where VAT exemptions have been removed). We would suggest that all relevant data should be considered in order to arrive at a conclusion as to whether less VAT or more VAT is collected as a result of the current VAT policy. We consider that such data may also be relevant to the Commission's work in relation to the Green Paper on the Future of VAT, and we would suggest that the Commission should coordinate the two initiatives in order to determine whether changes to the VAT system are considered appropriate.

Q7 – which sectors and/or activities within the financial sector do you think are most under/over-taxed?

A7 – other.

Financial institutions are subject to broadly the same taxes as other sectors. The main difference relates to VAT, where it was decided as a policy matter that supplies of certain financial services should be exempted. While customers do not pay VAT on such supplies, financial institutions are not able to recover all the input VAT they pay to suppliers and therefore have higher VAT costs than companies in other sectors.

Accordingly, financial institutions would generally make a higher contribution to tax revenues than companies in other sectors (for the same level of profits).

Following the IMF report to G-20 in June 2010, several Member States have introduced levies on certain financial institutions.

The IMF report noted that a narrow perimeter would single out specific institutions and create incentives for systemic risk to migrate, and could worsen moral hazard by suggesting that such institutions are less likely to fail than other institutions. The report suggested that the levy should be imposed on all financial institutions. Notwithstanding this suggestion, several Member States have used a narrow perimeter. We consider that financial institutions within this narrow perimeter are therefore likely to be over-taxed relative to financial institutions outside the perimeter.

Q8 – what do you think of tax measures, versus regulatory measures and levies (connected to the financing of funds to ensure the proper resolution of financial institutions)?

A8 – taxes would extract cash flow from the financial sector and reduce the ability to increase loss absorbing equity as foreseen by regulatory reforms.

A8 – other.

We consider that regulation should be the primary tool to achieve greater stability of the financial system. If tax measures are introduced, these should be complementary to regulation. In particular, to the extent that the incidence of any tax falls on the sector, the effect on capital and lending should be carefully considered.

Our submission to the Commission on the Crisis Management consultation includes comments on financing arrangements for resolution. A general theme which runs through our submission is that in the event of a bank failure, the liability of a resolution fund financed by the industry should be no more than it would have been in the event of a liquidation.

Q9 – do you consider that an FTT or FAT could lead to cumulative social and economic effects in combination with any of the ongoing regulatory reforms in the financial sector, including the banking levy (see COM 2010(310) final)?

A9 – yes, because…

We consider that the cumulative effects of the regulatory reforms and levies on the economy as a whole should be taken into account, and that implementation of these reforms should be carefully calibrated in order to avoid restricting economic growth. To the extent that any additional taxes fall on the financial sector, this will reduce capital and will thus reduce the capacity of the sector to finance the economy. To the extent that any additional taxes fall on the customer, this will reduce consumption and will therefore restrict economic growth. The relocation incentives should also be carefully considered, particularly if any additional taxes are proposed at the EU level.

We have commented specifically on the FTT in our responses to Q10 to Q21, and on the FAT in our responses to Q22 to Q37.

Financial Transactions Tax (questions 10 to 21)

Q10 – at what level do you think the FTT will be most effective?

A10 – the FTT will not be effective at any level because…

Our understanding is that the primary objectives of additional taxes on the financial sector are as follows:

(i) to raise revenues

(ii) to change behaviours so as to increase the stability of the financial system.

We therefore consider the effectiveness of the FTT relative to these two objectives.

In relation to objective (i), Member States have had different experiences, and it is appropriate to consider the various cases.

In the case of Sweden, transaction taxes caused migration of trading to London, with the effect that the taxes did not raise the expected revenues, and the taxes were subsequently abolished. The report "Financial transaction taxes: the international experience and the lessons for Canada" (prepared for the government of Canada) considers this case in some detail. It states that "with the 1986 announcement that the equity tax would double, 60% of the trading volume of the 11 most actively traded Swedish share classes, accounting for one half of all Swedish equity trading, moved to London. Foreign investors reacted to the tax by moving their trading offshore, while domestic investors reacted by reducing the number of their equity trades. Even though the tax on fixed-income securities was much lower than that on equities, the impact on market trading was much more dramatic. During the first week of the tax, the volume of bond trading fell by 85%. Once the taxes were eliminated, trading volumes returned."

There are other cases in which a transaction tax still exists. This is the case with the UK's stamp duty, but it is important to recognise that this includes special arrangements for financial markets. The UK government has always recognised that it is beneficial to companies in the wider economy that intermediaries should offer to buy and sell their securities. Intermediaries are therefore exempted where they provide this service.

The UK government has also progressively reduced the rate of the tax, with a view to eventually abolishing it. It might be thought that reducing the rate of the tax, and eventually abolishing it, might lead to lower revenues for the government. The report "Stamp duty: its impact and the benefits of its

abolition" (Oxera; May 2007) considered this matter. In summary, the findings were that the likely effects of abolishing the tax would be as follows: reduction in the cost of capital for listed companies in the wider economy, an increase in GDP, and higher revenues from other taxes, so that, overall, the government would raise more revenues by abolishing the tax.

We note also the analysis in the IMF report to the G-20 published in June 2010, which states that "while an FTT would have the greatest impact on short term, low margin trading, it would also increase the cost of capital for all firms issuing taxed securities, since investors would require higher returns to compensate them for reduced liquidity. This increase would be greater for issuers of more frequently traded securities, such as large corporations, since expected costs of trading activity would be capitalised into security prices. Some studies find that these effects are quite large, and hence could have a significant adverse impact on long-term economic growth".

In summary, we believe that the empirical evidence shows that where new transaction taxes are introduced, there is a significant risk of relocation (and hence the desired revenues are not raised), that the analysis in the Oxera report indicates that where old transaction taxes remain, the overall effect is that the government would raise more revenues by abolishing them, and that the analysis in the IMF report indicates potentially significant adverse impact on economic growth. For these reasons, we consider that objective (i) would not be met by transaction taxes.

In relation to objective (ii), there has been a suggestion that a tax should be applied to certain types of trading such as high frequency equity trading.

Some initial studies have been carried out on the impact of this type of trading.

We note for instance the recent report "High Frequency Trading: the application of advanced trading technology in the European marketplace" (Netherlands Authority for the Financial Markets; November 2010). The report concludes that "high frequency trading strategies that add liquidity and assist the process of price formation make a positive contribution to reducing fragmentation [across trading platforms], and … on balance have a positive function in the market". We would acknowledge, though, that the report states that additional independent empirical research would be desirable.

We are also not aware of evidence that a transactions tax applied to a wider set of transactions would increase the stability of the financial system.

We note, in addition, the analysis in the IMF report to the G-20 published in June 2010, which states that "if the aim is to discourage particular short-term transactions, regulation or targeted taxes are more effective".

Based on these considerations, we consider that objective (ii) would not be met through introduction of a transaction tax.

Q11 – do you think that a broad-based financial transaction tax is a viable instrument?

A11 – no, because in the case of an FTT implemented at EU level only, the transactions will simply move outside the EU, hurting EU competitiveness.

A11 – other.

Subject to our response to Q10, we would offer the following comments.

We are concerned that an FTT implemented at EU level would lead to significant relocation, and that an FTT implemented at global level would reduce liquidity, increase the cost of capital to companies in the wider economy, and introduce frictions and distortions into the economy as a whole.

Q12 – what do you consider as an appropriate connecting factor for the place of levying of the tax?

A12 – other.

Subject to our response to Q10, we would offer the following comments.

We consider that there are substantial difficulties with defining a connecting factor which is free from relocation or collection issues.

Q13 – do you think that the value set for the underlying is (in general) a correct tax base for derivatives?

A13 – other.

Subject to our response to Q10, we would offer the following comments.

We consider that there are substantial difficulties in defining a tax base for derivatives. If it is the leverage aspect of derivatives which policy-makers wish to address, then regulation should be the primary tool.

Q14 – do you consider that there would be a risk of financial engineering around the broad or narrow-based FTT that would undermine the objectives of the measure?

A14 – yes, there is such a risk to the narrow-based FTT.

A14 – yes, there is such a risk to the broad-based FTT.

Subject to our response to Q10, we would offer the following comments.

We consider that there are significant relocation and reengineering risks associated with both the narrow-based and the broad-based forms of FTT, particularly if implemented at EU level.

Q15 – what do you think of the FTT designed as a cumulative tax (ie every subsequent sale is taxed at the full amount of the transaction without any deduction of previously paid FTT?

A15 – it is not justified, because this will hinder the liquidity of the markets.

Subject to our response to Q10, we would offer the following comments.

We consider that designing FTT as a cumulative tax (ie every subsequent scale is taxed at the full amount of the transaction, without any deduction of previously paid FTT) is likely to hinder the liquidity of the markets, leading to higher volatility and higher costs of capital for companies in the economy as a whole.

Q16 – would there be a need for specific exemption of certain transactions from the FTT or an exemption threshold?

A16 – yes, the FTT must exempt the following transactions.

Subject to our response to Q10, we would offer the following comments.

One immediate requirement is that any FTT should exempt all transactions which provide liquidity to the markets, in particular transactions undertaken by intermediaries (whether acting as agent or principal) between buyers and sellers. Policy cases for other exemptions would also have to be assessed in the context of specific proposals for FTTs, following a detailed evaluation of the economic consequences of the taxes and of how the burden would fall on different parties.

Q17 – do you think FTT rates should be differentiated depending on the types of product traded?

A17 – other.

Subject to our response to Q10, we would offer the following comments.

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We consider that it would be important to carry out a thorough impact assessment for each type of product traded, taking into account who would bear the tax and the likelihood of migration of activity into different locations or into different transaction forms.

Q18 – do you think that the incidence of the tax will fall on the financial sector, or will it be shifted to customers?

A18 – other.

Subject to our response to Q10, we would offer the following comments.

The incidence of taxes is often difficult to establish, and is dependent on the competitive environment for the relevant product or service. As such, market economics will determine who bears the cost.

Nonetheless, we consider it evident that customers, as buyers or sellers in financial transactions, would inevitably bear part of the burden.

The Oxera study concludes that in the UK, stamp duty constitutes a significant cost to individuals, households and pensioners.

Q19 – what do you think of the administrative costs related to the broad-based FTT?

A19 – they will be comparatively high, because…

Subject to our response to Q10, we would offer the following comments.

We would anticipate that the administrative costs of either form of FTT would be high. Use of centralised clearing systems would facilitate collection of the tax, though we would expect that there would be an incentive to relocate transactions away from such systems, thereby reducing collection and undermining regulatory reforms.

Q20 – what do you think of the effect on employment from broad-based FTT? Do you think that it would be the same for a narrow-based FTT?

A20 – in case the FTT is not globally implemented, qualified workforce will benefit [in] companies/branches in non-taxing countries.

Subject to our response to Q10, we would offer the following comments.

We consider that an FTT would increase the cost of capital for companies in the economy as a whole, and unless implemented at global level would lead to relocation incentives, to the benefit of countries outside the EU.

Q21 – what do you think of the effect on small and medium enterprises (SMEs) from broad-based FTT?

A21 – it will have an overall negative effect on SMEs, because…

Small and medium enterprises (SMEs) are a vital part of the economy and are significant users of financial services.

Subject to our response to Q10, we would offer the following comments.

We consider that a FTT, as with other taxes, would have an overall negative effect on SMEs, as the higher costs of capital for companies would to some extent be passed on to SMEs.

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Financial Activities Tax (questions 22 to 37)

Q22 – at what level do you think the FAT will be most effective?

A22 – the FAT will not be effective at any level, because…

Our understanding is that the primary objectives of additional taxes on the financial sector are as follows:

(i) to raise revenues

(ii) to change behaviours so as to increase the stability of the financial system.

We have considered whether the FAT would be effective in achieving these objectives.

Addition method FAT

The consultation paper states that the addition method FAT is designed to compensate for the VAT exemption of the financial sector.

Our understanding is that the proposal for an addition method FAT is thereby based on the premise that VAT exemption of financial services leads to lower tax revenues for Governments.

We have considered the premise in our response to Q6, and would suggest that further research is needed to establish whether the premise is correct. We would suggest that the research would have two parts. First, to assess the VAT consequences based on particular assumptions as to how prices would adjust (i.e., assuming that the same transactions would occur, at adjusted prices). Second, to assess to what extent the transactions would not take place at all (it has been stated in previous research that the size of the financial sector would reduce, which presumably means that some transactions would not occur).

If the premise is not correct, then this would call into question the basis for additional tax.

If the premise is correct, then it is necessary to analyse whether the addition method FAT would indeed compensate.

We would suggest that further research is needed on this question as well. As above, the research would have two parts. First, to assess the revenues based on particular assumptions as to how prices would adjust (i.e., assuming that the same transactions would occur, at adjusted prices). Second, to assess to what extent the transactions would not take place at all. In assessing these questions, it would be important to take into account the geographic scope of a FAT. If it were applied at EU level, we consider that this would likely lead to a reduction of business taking place in the EU. It should be noted that the

reduction of business in the EU would not simply derive from firms moving activities outside the EU or deciding not to make new investment in the EU. It would also derive from the fact that, for some products and services, non-EU firms not subject to a FAT would be able to offer keener pricing to EU resident customers, and so would win business at the expense of EU firms.

We would also note in relation to objective (ii) that it does not seem clear that the addition-method FAT would be effective in changing behaviours so as to increase the stability of the financial system.

Rent-taxing FAT and risk-taxing FAT

The rent-taxing FAT is based on economic rents, and data from the Bank for International Settlements indicates that the return on capital in the financial sector is not significantly different from that in other sectors. If that is correct, then the tax would not raise significant revenues.

The consultation paper states that the risk-taxing FAT is very similar to the rent-taxing FAT. The tax base for the risk-taxing FAT would be lower than for the rent-taxing FAT. Accordingly, it would seem even less likely that a risk-taxing FAT would raise significant revenues.

We note also that both the rent taxing FAT and the risk-taxing FAT are defined by reference to a measure of profits. It is not clear how well this correlates with the objective of reducing risk. For example, different institutions competing in the same market and exposed to the same risks may make substantially different returns, as a function of the quality of their risk management processes. In such a case, the institution which has the highest quality risk management would already contribute more taxes. It would not seem appropriate to impose an additional charge for high quality risk management or other good commercial stewardship. Taxing profits is thus a blunt tool for discouraging untoward risk taking.

We would suggest that the more appropriate way of addressing risk is by way of regulation. The capital, liquidity and leverage requirements under Basel III and the forthcoming EU Capital Requirements measures are specifically targeted at risk, and in effect they also act as a tax in the sense that they increase the costs of doing business.

Q23 – what is your opinion of the industry scope of the FAT?

A23 – it must encompass the financial sector defined broadly in order to keep the level playing field and prevent a substitution effect.

Subject to our responses to Q6 and Q22, we would offer the following comments.

If the tax is intended to compensate for VAT exemption of financial services then we would assume that all supplies of financial services which are exempt from VAT would be in scope, and that all other supplies would be out

of scope. We consider that this is important to maintain a level playing field between EU-based providers of exempt financial services and to prevent a substitution effect, and to maintain a level playing field between providers of all other supplies. We consider that the design of the tax as set out in the consultation paper does not properly reflect these considerations, and we believe that this undermines the stated basis for the tax.

Q24 – which form of FAT do you consider most appropriate?

A24 – other.

Subject to our responses to Q6 and Q22, we would offer the following comments.

We consider that whilst the addition-method FAT might raise additional tax, there would be a downside risk to consumption, economic growth and competitiveness of the EU. We consider that further research on this downside risk should be undertaken.

The rent-taxing FAT is based on economic rents, and, as already noted, data from the Bank for International Settlements indicates that the return on capital in the financial sector is not significantly different from that in other sectors. If that is correct, then the tax would not raise significant revenues.

The consultation paper states that the risk-taxing FAT is very similar to the rent-taxing FAT. The tax base for the risk-taxing FAT would be lower than for the rent-taxing FAT. Accordingly, it would seem even less likely that a risk-taxing FAT would raise significant revenues.

We note also that both the rent-taxing FAT and the risk-taxing FAT are defined by reference to a measure of profits. It is not clear how well this correlates with the objective of reducing risk. For example, different institutions competing in the same market and exposed to the same risks may make substantially different returns, as a function of the quality of their risk management processes. As noted previously, it would not seem appropriate to impose an additional charge for high quality risk management.

We would suggest that the more appropriate way of addressing risk is by way of regulation. The capital, liquidity and leverage requirements under Basel III and the forthcoming EU Capital Requirements measures are specifically targeted at risk, and in effect they also act as a tax in the sense that they increase the costs of doing business.

Q25 – what are the major difficulties with the three forms of FAT?

A25 – the three forms of FAT have the following difficulties.

In addition to our responses to Q6 and Q22 and Q32, we would offer the following comments.

Addition method FAT

- There is a downside risk of increase in price of financial services for consumers, lower consumption, and lower economic growth. Moreover, if the FAT was introduced at EU level, we consider that this would likely have an adverse affect on the competitiveness of the EU, leading to a reduction of activities taking place in the EU, thereby leading to a reduction in economic growth.
- If the tax is intended to compensate for VAT exemption of financial services then we would assume that all supplies of financial services which are exempt from VAT would be in scope, and that all other supplies would be out of scope. We consider that this is important to maintain a level playing field between EU-based providers of exempt financial services and to prevent a substitution effect, and to maintain a level playing field between providers of all other supplies. We consider that the design of the tax as set out in the consultation paper does not properly reflect these considerations, and we believe that this undermines the stated basis for the tax.

Rent-taxing FAT and risk-taxing FAT

- Data from the Bank for International Settlements indicates no significant rents, which would imply limited potential for revenue raising.
- Different institutions competing in the same market and exposed to the same risks may make substantially different returns, as a function of the quality of their risk management processes. In such a case, the institution which has the highest quality risk management would already contribute more taxes. It would not seem appropriate to impose an additional charge for high quality risk management.

Q26 – what do you consider the most appropriate starting point for the addition method FAT?

A26 – other.

Subject to our responses to Q6 and Q22, we would offer the following comments.

- We have noted in our response to Q23 that if the tax is intended to compensate for VAT exemption of financial services then we would assume that all supplies of financial services which are exempt from VAT would be in scope, and that all other supplies would be out of scope. We consider that this is important to maintain a level playing field between EU-based providers of exempt financial services and to prevent a substitution effect, and to maintain a level playing field between providers of all other supplies. We consider that the design of the tax as set out in the consultation paper does not properly reflect these considerations, and we believe that this undermines the stated basis for the tax.

Q27 – what do you consider the most appropriate starting point for rent-taxing and risk-taxing FAT?

A27 – other.

Subject to our responses to Q6 and Q22, we would offer the following comments.

We have noted that data from the Bank for International Settlements indicates that the return on capital in the financial sector is not significantly different from that in other sectors. If that is correct, then the tax would not raise significant revenues.

We note also that both the rent-taxing FAT and the risk-taxing FAT are defined by reference to a measure of profits. It is not clear how well this correlates with the objective of reducing risk. For example, different institutions competing in the same market and exposed to the same risks may make substantially different returns, as a function of the quality of their risk management processes. In such a case, the institution which has the highest quality risk management would already contribute more taxes. It would not seem appropriate to impose an additional charge for high quality risk management.

We would suggest that the appropriate way of addressing risk is by way of regulation. Specifically, the capital, liquidity and leverage requirements under Basel III and the forthcoming EU Capital Requirements measures are targeted at risk, and in effect act as a tax in the sense that they increase the costs of doing business.

Q28 – do you consider individual or consolidated statements as more appropriate?

A28 – other.

Subject to our responses to Q6 and Q22, we would offer the following comments.

Addition method FAT

We have noted in our response to Q23 that if the tax is intended to compensate for VAT exemption of financial services then we would assume that all supplies of financial services which are exempt from VAT would be in scope, and that all other supplies would be out of scope. We consider that the tax would then be charged on individual entities.

If the entities in question formed a group, there should be an administrative provision enabling one member of the group to be nominated as the collecting agent.

Rent-taxing and risk-taxing FAT

We have noted in our response to Q27 that it would not seem appropriate to impose an additional charge on institutions with high quality risk management processes. The appropriate way of addressing risk is by regulation, where there are capital, liquidity and leverage requirements at individual entity and group level.

Q29 – would there be a need for specific exemption of certain profit/remuneration from a FAT?

A29 – other.

Subject to our responses to Q6 and Q22, we would offer the following comments.

Addition method FAT

We have noted in our response to Q23 that if the tax is intended to compensate for the VAT exemption of financial services, then we would assume that all supplies of financial services which are exempt from VAT should be in scope, and that all other supplies would be out of scope. We consider that this is important to maintain a level playing field between EU-based providers of exempt financial services and to prevent a substitution effect, and to maintain a level playing field between providers of all other supplies.

Rent-taxing and risk-taxing FAT

We have noted in our response to Q27 our concerns regarding the rent-taxing FAT and risk-taking FAT. We consider that the appropriate way of addressing risk is by regulation. For example, the capital, liquidity and leverage requirements under Basel III and the forthcoming EU Capital Requirements measures are targeted at risk, and in effect operate as a tax by increasing the cost of doing business.

Q30 – the state of the head office or group headquarters may tax on the basis of consolidated statements and the state of the branches or group members may also tax those. What do you consider as a suitable solution?

A30 – other.

Subject to our responses to Q6 and Q22, we would offer the following comments.

We consider that activities should be charged to tax in one state only.

There should be clear rules defining taxing rights and the amounts on which tax should be charged.

We note also that there are differences in the way that Member States treat cross-border branch to head office transactions from a VAT perspective, and it would be necessary in the case of an addition method FAT to consider these differences in arriving at an appropriate solution.

Q31 – due to the way the tax base in a FAT is derived (their accounting treatment and/or the subsequent adjustment), do you consider that one or more of the following items will be unduly disadvantaged/favoured?

A31 – certain activities will be disadvantaged, because…

Subject to our responses to Q6 and Q22, we would offer the following comments.

If the tax is intended to compensate for VAT exemption of financial services, then we would expect that activities that are currently exempt would become more expensive. The effect may depend to some degree on the range of activities carried out by a particular institution and the way in which the FAT is co-ordinated with the VAT system.

Q32 – would the addition method FAT need to be aligned with the current VAT system to avoid the cascading effect from the interaction between the two?

A32 – other.

Subject to our responses to Q6 and Q22, we would offer the following comments.

We have noted in our response to Q23 that if the tax is intended to compensate for VAT exemption of financial services then we would assume that all supplies of financial services which are exempt from VAT would be in scope, and that all other supplies would be out of scope. We consider that this is important to maintain a level playing field between EU-based providers of exempt financial services and to prevent a substitution effect, and to maintain a level playing field between providers of all other supplies.

We consider that the addition method FAT would need to be aligned with the current VAT system to avoid a series of different taxes on the same activities, and that the rate of FAT would in any event need to be lower to reflect the lack of a credit. We consider that the alignment should take account of the irrecoverable VAT currently incurred by suppliers of exempt financial services. We have noted at Q25 that we consider that the design of the tax as set out in the consultation paper does not properly reflect such considerations, and we believe that this undermines the stated basis for the tax. The interaction of the FAT and VAT is, in our view, an additional reason why it would be appropriate to base the tax on cash flows rather than profits. If the tax were based on profits, it would be necessary to develop a methodology for allocating profits to different categories of supplies; we are concerned that this would introduce a high degree of subjectivity and uncertainty and would significantly add compliance costs, at the same time, thereby reducing the efficiency of the single market.
We consider that the addition method FAT would also need to be aligned with the current system of substitute taxes on certain financial services, such as insurance premium taxes.

Q33 – could a FAT rate well below the current standard VAT rate reduce distortions that might arise from missing interaction between VAT and addition method FAT?

A33 – other.

Subject to our responses to Q6 and Q22, we would offer the following comments.

Our understanding of Q33 is that it is asking about distortions that might arise if there was no interaction between VAT and the addition method FAT.

All other things being equal, we consider that such distortions would be positively correlated with the FAT rate.

We consider that the more important question (which we have considered in more detail in our response to Q22) is whether the introduction of a FAT would raise or reduce revenues.

Q34 – do you think that the incidence of the tax will fall on the financial sector, or will it be shifted to customers?

A34 – other.

Subject to our responses to Q6 and Q22, we would offer the following comments.

The incidence of taxes is often difficult to establish, and dependent on the competitive environment between providers of financial services. The burden will be shared between shareholders, employees, customers and suppliers.

The burden will also be felt in the wider economy to the extent that activities reduce or migrate outside the EU.

Q35 – what do you think of the administrative costs related to the FAT?

A35 – they will be comparatively high, because…

Subject to our responses to Q6 and Q22, we would offer the following comments.

We consider that the administrative costs related to the FAT would depend heavily on the design of the tax.

Addition method FAT

We consider that if the tax is designed to compensate for VAT exemption of financial services, then it should be based on cash flows and aligned with the VAT system. In such a case, there would be some additional cost and it would be sensible to design in such a way as to take advantage of synergies with VAT systems.

Rent-taxing and risk-taxing FAT

We have noted in our response to Q27 our concerns regarding the rent-taxing FAT and risk-taxing FAT. We consider that the administrative costs related to such taxes are likely to be significant, because there is a high degree of subjectivity and uncertainty.

Q36 – what do you think of the effect on employment from the FAT?

A36 - qualified workforce will benefit [in] companies/branches in non-taxing countries.

Subject to our responses to Q6 and Q22, we would offer the following comments.

We consider that the FAT would be a risk to economic growth, and hence likely to have an adverse effect on employment across all sectors (on the basis that all sectors are users of financial services).

We consider that the FAT, if applied at EU level, would be likely to have an adverse effect on the competitiveness of the EU, to the benefit of companies/branches in non-taxing countries.

Q37 – what do you think of the effect on small and medium enterprises (SMEs) from FAT?

A37 – it will have an overall negative effect [on] SMEs, because…

Small and medium enterprises (SMEs) are a vital part of the economy and are significant users of financial services.

Subject to our responses to Q6 and Q22, we would offer the following comments.

We consider that a FAT, as with other taxes, would have an overall negative effect on SMEs. The overall negative effect would arise due to higher prices, lower consumption, lower economic growth and an adverse effect on competitiveness if the tax is applied at EU level.

Levies (questions 38 to 57)

Q38 – at what level do you think the levy will be most effective?

A38 – other.

Our understanding is that levies have two main objectives

(i) To raise revenues, either for general purposes or for financing a resolution fund

(ii) To change behaviours so as to increase the stability of the financial system.

We will consider the effectiveness of levies by reference to these two objectives.

Interaction with regulation

We consider that regulation should be the primary tool for reducing risk in the financial system.

Nevertheless, several Member States have introduced national levies.

Where national levies are introduced, it is important that they are complementary to regulation.

To give a concrete example, where regulators require an increase in holdings of liquid assets, firms may borrow in order to meet this requirement. In such as case, an effect will be to increase both the asset side and the liabilities side of the balance sheet. To ensure that the levy complements regulation, it would be important to exempt the increase from the levy.

Relocation incentives

We consider that relocation incentives may be significant, depending on the design and scope of the national levies. There may be incentives for various different kinds of relocation. We comment on these incentives on the assumption that national levies are introduced in the major financial centres in the EU but not in all the major financial centres outside the EU.

Incentives relating to new business

Institutions making decisions on business location will take into account the regulatory and tax environment.

There is a clear risk that institutions may decide to invest outside the EU if the regulatory and tax environment in the EU makes the EU uncompetitive.

Investment outside the EU could take the form of starting new activities outside the EU, or setting up companies outside the EU or both. We would acknowledge that it is not easy to measure this type of relocation effect, because it may not be apparent whether the EU was even considered as a

location for investment. It is therefore important to develop some kind of method for monitoring the extent to which new business is being diverted outside the EU.

Incentives relating to existing business

Institutions will take into account the regulatory and tax environment when considering how best to carry out their existing business.

Relocation could take the form of moving people from the EU to non-EU countries, or reorganising the group structure (for example to eliminate European holding companies).

This type of relocation may be somewhat easier to identify.

Q39 – what is your opinion of the industry scope of the levy?

A39 – it must encompass the financial sector defined broadly in order to keep the level playing field and prevent a substitution effect.

The IMF report to the G-20 stated that a narrow perimeter would single out specific institutions and create incentives for systemic risk to migrate, and could worsen moral hazard by suggesting that such institutions are less likely to fail than other institutions. The report suggested that the levy should therefore be imposed on all financial institutions.

We would agree that where national levies are introduced, the scope should be broad in order to keep the level playing field and prevent a substitution effect.

We note that there are other systemically important sectors, outside the scope of the IMF report, where similar considerations could apply in future.

Q40 – what is your perception of the risk exposure for the financial sector?

A40 – other.

The risk exposure for the financial sector is being addressed through many changes to the regulatory framework. In particular, there are changes to capital requirements (based on assets) and to liquidity and leverage ratios (based on assets and liabilities)

There are also changes to the crisis management framework, designed to ensure that all firms are resolvable and that the taxpayer should not ultimately bear the costs of resolution.

These changes reduce the probability of individual institutions failing. They also reduce the likely size of the loss in the event of a failure.

The changes to the regulatory framework will therefore reduce the risk exposure for the financial sector and for the rest of the economy.

We therefore consider that it is important that any national levies should be designed to take account of this reduction, and not merely the reduction in risk of any particular institution.

Q41 – therefore, which form of levy do you consider most appropriate?

A41 – other.

We have noted at Q38 that regulation should be the primary tool for reducing risk in the financial system; the additional capital, liquidity and leverage requirements will effectively act as a tax in the sense that they will increase the costs of doing business.

Subject to that, we offer the following comments on different types of levy.

Asset-based levies would seem to overlap to a significant extent with asset-based capital requirements.

Liabilities-based levies would seem to overlap to a significant extent with liabilities-based capital requirements.

A potential advantage of the liabilities-based levy is that the levy base may be more stable. For example, if assets are written down, then it may be that the eligible liabilities remain the same; in the simplest case, assets and equity would fall by equal amounts and the eligible liabilities would not change.

Q42 – what are the major difficulties with the two forms of levy?

A42 – an asset-based levy has the following difficulties.

A42 – a liabilities-based levy has the following difficulties.

We have noted at Q41 that both forms of levy are to some extent duplicative with regulatory requirements and that the asset-based levy may be less stable than the liabilities-based levy.

In addition, the lack of coordination between national levies is presenting significant risk of double taxation.

Q43 – what do you consider the most appropriate starting point for the asset-based levy?

A43 – the balance sheet assets side amended with…

If a levy is based on assets, we consider that the most appropriate starting point would be the asset side of the balance sheet.

Amendments may be required in order to maintain a level playing field between Member States.

Q44 - what do you consider the most appropriate starting point for the liabilities-based levy?

A44 – the balance sheet liabilities side amended with…

If a levy is based on liabilities, we consider that the most appropriate starting point would be the liabilities side of the balance sheet.

Amendments may be required in order to maintain a level playing field between Member States.

Q45 – would there be a need for specific exemption of certain assets/liabilities?

A45 – the asset-based levy must exempt the following assets…

A45 – the liabilities-based levy must exempt the following liabilities…

In the case of an assets-based levy, the assets should be risk-weighted. In the case of a liabilities levy, certain types of funding should be exempted, including equity, deposits (up to the amounts covered under a compensation scheme) and funding which is collateralised by high quality liquid assets.

In each case, the idea is to ensure that a levy complements the wider regulatory framework.

Q46 – would there be a need for a threshold (ie the levy is based only on financial institutions with large balance sheets) or allowance (ie for all financial institutions there would be a "tax-free" allowance for a certain amount of assets/liabilities) from the levy?

A46 – there is no need for a threshold or allowance.

In principle, there is no need for a threshold or an allowance from a levy. In practice, high compliance costs may indicate that some level of threshold is a practical approach.

Q47 – do you consider individual or consolidated statements as more appropriate?

A47 – cannot decide.

We consider that taxing rights first need to be defined in order to consider the question of whether individual or consolidated statements are more appropriate.

There are various different approaches to defining taxing rights, presenting different risks of double taxation.

The effect on EU competitiveness should also be considered. For example, depending on the design details, the use of consolidated statements could lead to an adverse competitive effect on EU-headed groups and on groups with intermediate holding companies in the EU.

Q48 - the state of the head office or group headquarters may tax on the basis of consolidated statements and the state of the branches or group members may also tax those. What do you consider as a suitable solution?

A48 – cannot decide.

We consider that activities should be charged to tax in one state only.

We consider that there should be clear rules defining taxing rights and the amounts on which tax should be charged.

Q49 – what would be the solution for attribution of assets/liabilities to bank branches (not subsidiaries)?

A49 – other.

We consider that taxing rights first need to be defined in order to consider whether any attribution of assets/liabilities to branches is required.

In case the definition of taxing rights does require attribution of assets/liabilities, we would note that there are various possible methods of attribution.

In the case of an asset-based levy, we consider that the authorised OECD approach to asset attribution would be an appropriate starting point.

In the case of a liabilities-based levy, one approach would be to prorate the liabilities of the head office by reference to the fraction defined as attributed branch assets divided by total assets.

We consider that the authorised OECD approach to asset attribution would be an appropriate measure for determining the fraction. Having calculated branch liabilities by this method, we consider that it would be necessary to exempt certain liabilities in order to ensure a level playing field between branches and subsidiaries (assuming that certain types of liabilities of subsidiaries are exempted).

Q50 – since some Member States have already implemented such levies, which are different in their features, what do you think the interaction should be with those levies?

A50 – all individual levies/taxes based on the balance sheet must be repealed.

Question 50 introduces the concept of an EU-wide levy. Our understanding, though, is that this means a levy which is implemented as a *national levy* in each Member State, and which is *used for national purposes*.

Some Member States have already introduced national levies, based on the IMF recommendation for a fair and substantial contribution. Those Member States that have taken the lead in following the IMF recommendation should not be required to introduce further levies. Alternatively, if an EU-wide levy is determined to be appropriate, the national levies already introduced would need to be repealed.

We would also note that the financial sectors in different parts of the EU are at different stages of development. We therefore consider that it would be

very challenging to deliver an EU-wide levy that would adequately reflect the widely differing economies within the EU.

Q51 - due to the way the tax base in a levy is derived (their accounting treatment and/or the subsequent adjustment), do you consider that one or more of the following items will be unduly disadvantaged/favoured?

A51 – certain activities will be disadvantaged, because…

In this question, we assume that the levy is designed so as incentivise less risky assets and/or less risky funding structure.

Investments

Lower risk investments will be favoured.

Financing means

Longer term, stable financing means will be favoured.

Activities

The geographic scope of the levies may incentivise relocation of activities (as discussed in more detail at Q38).

Q52 – some authors argue that overnight secured credit (through repos mainly) necessitates special treatment of those types of funding because of the cheap, but unstable funding leading to systemic risk. Do you agree to such argument and if so, what treatment do you suggest?

A52 – no, because…

We consider that the risks related to secured borrowing are substantially less than the risks posed by unsecured borrowing. By definition, the lender in secured credit is protected by assets provided by the borrower. The funding is cheap because of the existence of the security.

The lender's risk is mitigated, very often by possession of highly rated government securities. We therefore question whether such borrowing does give rise to significant systemic risks; those that suggest that it does need to make their case.

The question of the tenor of the borrowing is different: clearly financial institutions cannot rely excessively on short term borrowings and must manage their liquidity risks carefully. That is a matter of the utmost priority for the management of financial institutions and for regulators. It is therefore rightly the subject of regulatory controls.

In considering that the impact of repo funding, and more generally the treatment of collateralised funding, recognition should be given to the quality of the underlying collateral. Suppose for example that the collateral consists of high quality liquid assets. Suppose that these are funded by overnight repo, and that on the following day the repo counterparty require the return of the

funds. The borrowers could either return the funds from existing resources, or borrow from another lender or sell the collateral (noting the premise that the collateral is highly liquid). Accordingly the risk of the borrower not being in a position to return the funds would be low (and as noted above, the consequences to the lender of default by the borrower are mitigated by the collateral).

Suppose on the other hand that the collateral consists of assets other than high quality liquid assets. The repo counterparty would be expected to require a significant level of overcollateralization (above what would be needed with high quality liquid assets) and this would be calibrated to compensate for the greater liquidity risk.

It may therefore be appropriate to base the treatment of repo funding (and other forms of economically equivalent collateralised funding, such as stock loan funding) on the quality of the underlying collateral, as a way of reflecting liquidity risk.

In any event, is important that the tax regime does not undermine the regulatory regime.

Q53 – would there be a necessity for the harmonisation of certain accounting concepts (eg creation of provisions/reserves, netting of derivatives and other related positions) and to what extent?

A53 – no, because…

For ease of calculation of the levy, it is desirable though *not* essential that the accounting treatment is consistent across Member States. We do however consider that it is important that national levies are calculated on a consistent basis in order to eliminate double taxation.

We also consider that national levies should reflect the risks to which institutions are exposed. So for example if an institution has reduced its exposure to a counterparty by means of an enforceable netting agreement, then the levy should reflect the economic exposure (ie the reduced amount).

Q54 – do you think that the incidence of the levy will fall on the financial sector, or will it be shifted to customers?

A54 – other.

The incidence of taxes is often difficult to establish, and dependent on the competitive environment for the relevant product or service.

Q55 – what do you think of the administrative costs related to the levy?

A55 – other.

The administrative costs related to the levy will depend significantly on the ability to use data which is already collected for other purposes (eg accounting, regulatory). The costs will also depend on the geographic scope of the levy.

Q56 – what do you think of the effect on employment from the levy?

A56 – qualified workforce will benefit [in] companies/branches in non-taxing countries.

To the extent that the levy falls on the financial sector, there will be less capital available for lending, and this is likely to negatively affect economic growth and employment across all sectors.

To the extent that the levy is borne by customers, this will make financial services more expensive, in turn leading to lower consumption and lower economic growth.

We consider that there will be a significant benefit to companies/branches in non-taxing countries.

Q57 – what do you think of the effect of small and medium enterprises (SMEs) from the levy?

A57 – it will have an overall negative effect on SMEs, because…

Small and medium enterprises (SMEs) are a vital part of the economy and are significant users of financial services. We consider that a levy, as with other taxes, would have an overall negative effect on SMEs.