Financial Transaction Tax
An ICAP discussion document

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Headline Summary

- 11 countries have provisionally agreed to introduce a tax on financial transactions with the stated objective of raising public finances and reducing risk taking. We are concerned, however, that unintended consequences of the FTT could have a negative effect on the real economy and financial stability, and increase the cost of government borrowing. It also runs counter to EU Treaty freedoms. This analysis sets out some of the potential impacts we anticipate may arise from the introduction of the FTT as proposed.

- The FTT will damage the mainstream economies of those countries in the FTT zone to the relative benefit of those markets and economies outside the zone. We anticipate that the more pronounced effect will be migration of markets rather than net global reduction.

- Government borrowing costs would increase, in particular for those who are members of the FTT zone. Businesses, especially those in the FTT zone, would find it more expensive to secure finance.

- Systemic risk could increase as the FTT runs counter to G20 objectives and obligations under the European Market Infrastructure Regulation by disincentivising central clearing.

- Treating overseas branches of FTT-zone firms less favourably than those operating through subsidiaries is not compatible with the freedom of establishment required under the EU Treaty (Article 19 TFEU).

- The proposed FTT would also restrict the freedom of movement of capital (Article 63 TFEU).

- Economic activity located in the UK is likely to be among the largest generators of FTT revenue but the UK Government will not receive any revenue as it will be paid to FTT zone tax authorities.

Overview of the FTT proposal

- 11 EU member states (together the "FTT Zone") have requested an FTT be introduced . The FTT zone comprises, Austria, Belgium, Estonia, France, Germany, Greece, Portugal, Spain, Italy, Slovakia and Slovenia.

- The proposal is broad in terms of the transactions and the entities that would be in scope. The FTT will apply to:

  - **Financial institutions in the FTT zone;**

  - **Financial institutions <u>outside the FTT zone</u>** if the transaction:

    - involves a counterparty that is headquartered in the FTT zone (this also includes overseas branches of firms headquartered in the FTT zone); or
    - involves an FTT-zone branch of an overseas-headquartered firm; or
    - involves an instrument that has been issued in the FTT zone; or
    - is cleared by a CCP based in the FTT-zone.

  - **Corporates in the FTT zone** with "significant treasury activities".

- Exemptions are envisaged for spot FX and physically settled commodities. However all other financial instruments are in scope for transactions that are defined as follows:

  - **Purchase or sale of a financial instrument**, including repos and securities lending;

  - **Material modification of a contract** (which extends to contracts entered into prior to 1 Jan 2014);

  - **Transfer of risk** (not just transfer of legal ownership).

Potential Impact

- **<u>Detrimental impact on economic growth in the FTT zone</u>: the FTT will significantly increase funding costs for Governments and corporates in the FTT-zone, and to a lesser extent those outside the FTT zone, with consequences for the real economy.**

  - The proposal includes an exemption for Debt Management Offices (i.e. the issuers of public debt) and for primary issuance more broadly.

  - It is widely accepted that secondary market activity is necessary for public finances to operate effectively. However the proposal does not seek to safeguard secondary market trading in public debt. This would result in an increased cost of funding and capital burden for Governments. Bank of America Merrill Lynch* estimates the FTT will result in an increased annual interest cost of €6.5 – €8.5bn for Germany, Italy and France in the first year.

  - The FTT would result in some banks choosing to no longer continue as primary dealers; introduce a higher liquidity premia on the issuance; and lead to a widening of bid/offer spreads. It could also “parochialise” the public debt markets of those within the FTT-zone.

  - Corporates based in the FTT-zone will find it more expensive to issue debt and equity; and it will also be more expensive for them to modify their risk exposure. This impact will be particularly acute for those companies that are reliant on relationships with their local banks. There will be an increase in funding costs, in particular for short dated funds.

  - Although the FTT will incentivise a move towards loan finance (as this will not be taxed) corporates will find it more expensive to secure a bank loan as the FTT will reduce banks’ funding via the tax on repo.

* Source: *Financial Transaction Tax - toll or roadblock?, Bank of America Merrill Lynch, 19 March 2013*

Potential Impact

- **<u>Overall increase in systemic risk</u>: without further exemptions, the FTT runs counter to G20 objectives by disincentivising secured lending and central clearing.**
  - Under the proposal, transfers of collateral are defined as a “transaction” and subject to FTT. This will incentivise unsecured lending, with further consequences for the market from 2015 when uncleared derivatives transactions must be collateralised (both initial and variation margin).
  - Repo is also within scope and the FTT would have a major effect in raising banks’ short-term funding costs. This would almost certainly be largely transmitted to the private sector with consequential negative effects on investment, employment and output.
  - If the FTT attaches to central bank money market operations it will increase the pressure on the circulation of cash with direct consequences for the real economy.
  - The FTT effectively imposes a tax on the posting of initial and variation margin, thereby increasing the cost of mandatory clearing. Although the proposal provides an exemption for central clearing counterparties (CCPs), the exemption only extends to the CCP leg of the transaction and does not extend to the clearing member or to clients of clearing members.

Potential Impact

- **Operational impact: Firms globally will need to undertake major systems change and potentially incur costs relating to the collection of the tax.**
  - There is currently no FTT collection mechanism in place. The proposal therefore appears to rely on firms (including firms outside the FTT zone) to act as collection agents. This would require significant systems change and investment, even for firms whose Governments would in no way benefit from the revenues that were raised.
  - The so-called "Residence Principle" is a new concept. Firms' systems are not currently configured to identify counterparties in the way that has been proposed. To identify a chargeable transaction will therefore require systems change globally.
  - There is perhaps a parallel to be drawn with the US FATCA regime, which is arguably simpler in operation (in that it is predominantly a reporting requirement, whereas FTT will require reporting and collection and payment of cash tax). The cost of FATCA implementation has been estimated to be in the hundreds of millions of dollars.
  - The systems change that would be required means operationally it will not be possible for many firms to be compliant by the intended implementation date of 1 January 2014.

Potential Impact on the UK

- **The UK will generate the largest FTT revenue but its contribution to the EU budget will not be reduced.**
  - If the FTT is to constitute an own resource for the EU budget then FTT-zone Member States will see their contributions reduce accordingly. As the majority of the tax revenue raised will be from economic activity taking place in the UK, this means it is better for FTT-zone members to have the UK out of the FTT than in.
  - For example, in the case of a transaction involving a counterparty based in France and a counterparty based in Germany, the revenue raised would be shared equally between France and Germany. However, in the case of a transaction involving a counterparty based in France and a counterparty based in the UK, <u>all</u> FTT revenue would go to the French tax authorities. The UK-based counterparty would also incur costs relating to collection and payment of that revenue.
- **A significant % of wholesale markets activity in London would be within scope of the FTT.**
  - In most asset classes, we believe the principal impact will be via the Residence Principle; however, in corporate and sovereign bonds the impact is exacerbated by the Issuance Principle.
  - A significant proportion of wholesale market trading in UK gilts involves FTT-zone counterparties (some GEMMS would appear to be captured by the Residence Principle). If secondary market trading in public debt remains within scope, UK borrowing costs would likely increase because the FTT would insert itself between the bid and offer, thereby widening spreads.
  - Some banks may choose to discontinue their market making activity in public debt as the FTT impacts their ability to hedge, thereby increasing the risk and cost of their continuing to act primary dealers. For FTT-zone primary dealers, an alternative may be to create subsidiaries (rather than branches) outside the FTT zone.

Potential Impact on the UK

- **There is potential for UK equities to be subject to double taxation if the transaction is subject both to the FTT and Stamp Duty Reserve Tax.**
  - Double taxation would impact the liquidity and pricing of equities issued in the UK. However, we note that this impact would be mitigated for small and mid –sized businesses when Stamp Duty is abolished for shares admitted to trading on growth markets such as ISDX from 2014.
  - The French FTT led to a 26% decline in turnover during 2012 and a relative reduction in activity from 17% share of European equity trading to 12%.*
- **We estimate over 30% of OTC derivatives that are currently traded through London involve an FTT-zone counterparty on at least one leg of the transaction.**
  - FTT-zone counterparties will find it more expensive to hedge and may choose to create subsidiaries outside the FTT zone, possibly in the UK as London has the largest OTC derivatives market.
  - It is not clear how the Issuance Principle can be made to apply to OTC derivatives.

** Source: TABB, http://tabbforum.com/opinions/ftt-migraines-in-milan-could-cripple-european-equities*

Market Response

- **Market behaviour is hard to predict but we could envisage:**
  - **Wholesale markets migrate outside FTT zone**: FTT-zone banks would add 2 or 20 bps to the cost of any transaction and would not be able to price competitively in wholesale markets.
  - **'Market access' trades would be a single hop** e.g. a French bank or corporate with a trading requirement would find its best pricing with a non-FTT counterparty who could price most competitively by accessing the non-FTT zone wholesale market for hedging. In due course one would expect to see this pressure weigh heavily on FTT-zone banks who would be structurally less competitive and FTT-zone corporates and other customers of the market would migrate their business to banks outside the FTT-zone.
  - **FTT-zone corporates become natural takeover targets**: as the cost of equity will be structurally significantly higher in the FTT-zone, companies outside it will find a natural pricing arbitrage when considering, say, a takeover e.g. target stock is priced down (reflecting reduced yield due to FTT); predator stock can price that out; and a tax synergy helps foreign takeovers make sense. (We don't see this in UK as the intermediary exemption means the pricing impact is less pronounced).
  - **Corporates restructure**: as a defence against a takeover threat, a company might choose to structure itself outside the FTT-zone and re-domicile by inserting a new non-FTT zone topco over its existing group. Although the anti-avoidance provision might apply here, it may be difficult to apply if the company’s topco is in the UK, due to the protection offered there by the EU Treaty freedoms, or if the company is a multinational.
  - **Companies issue debt outside the FTT-zone**: companies set up subsidiaries in London to issue debt and lend back to the group.

Case Study: Derivatives

- **The negative impact will be more pronounced in listed derivatives compared with OTC.**
  - Futures trading tends to be concentrated in the front contracts which would attract more FTT (i.e. rolling a futures contract on a quarterly basis would attract quarterly FTT).
  - Euro- denominated German government bond futures are the most heavily traded derivatives and would fall within scope of the Issuance Principle.

- **The FTT may lead to the development of an offshore (i.e. non-FTT zone) derivatives market but this will depend on how "Issuance" applies.**
  - We do not believe that the Issuance Principle can apply to derivatives other than equities derivatives or derivatives that are listed on an exchange in the FTT zone.
  - OTC derivatives are not "issued" and often do not have an underlying instrument that could easily determine place of issuance. We do not consider it would be possible to deem euro-aggregate based derivatives contracts as "issued" in the FTT-zone when six Eurozone members lie outside it. Similarly, Euribor-based swaps (Euro IRS, forward FX, cross currency basis swaps).

Case Study: Derivatives

- **The FTT will interpose itself between the bid and offer, especially given the current very narrow bid/offer spreads that are observed in many of the markets to which it would be applied.**
  - Bid/offer spreads on Interest Rate Swaps would widen between 2 and 30 times (for shorter maturity swaps).
  - Self-cancelling IRS chains that use liquidity channels to recreate synthetically less liquid swaps, which support market liquidity and lower end-user costs, would likely be unviable under FTT as proposed.
  - Bid/offer spreads are broadly similar across the euro IRS curve (0.5bp for all maturities) but in cash terms they are different. This is because the longer the maturity a swap rate refers to, the larger the cash value of changes in this swap rate. However, whereas the cash bid/offer is different, the FTT is uniform (referencing only the underlying notional of the swap, not its maturity).
  - Applying FTT on a uniform basis to varying bid/offer spreads across the swap curve has different proportionate effects on bid/offers. The distributional impact of the tax is to bias trading interest towards longer dated swaps.

Swap Term (Years)	Bid /Offer in basis points	PV01 €25m €IRS (€m value of 1 bp)	Bid/Offer in €25m	Total Tax	Post-Tax Bid/Offer in €25m	Multiple Increase in Bid/Offer Spread
2	0.5	496	248	5000	5248	21
5	0.5	1232	616	5000	5616	9
10	0.5	2435	1218	5000	6218	5
15	0.5	3608	1804	5000	6804	4
30	0.5	6956	3478	5000	8478	2

Case Study: Corporate Bonds

- **European corporate bonds are relatively illiquid: it is very unusual for there to be a simultaneous matching buyer and seller.**
  - Trading typically occurs on a relative value basis (i.e. a corporate bond is traded against an underlying government bond). This means a straightforward exchange of a corporate bond between end-investors can be composed of several transactions that necessitate position adjustment through the inter-dealer market.
- **The FTT will interpose itself between the bid and offer: dealers need to retain bid/offer spread net of tax to make trading viable.**
  - High quality, new corporates debt trades with especially tight bid/offer spreads. These would be most impacted by the FTT as the spreads would widen significantly.
- **The nature of trading in secondary corporate bond markets magnifies the transactions costs.**
  - The relative value pattern of trading in these markets also raises transactions costs as an underlying government bond exchanged for the corporate would be subject to FTT.
  - The net effect would be to lower trading volumes dramatically by dislocating preferred trading levels of buyers and sellers and significantly impair European corporate bond liquidity, thereby increasing their liquidity premium.
  - It is difficult to estimate the upward effect on corporate bond yield levels, which would already be raised due to the FTT impact in the underlying government markets. However, it is reasonable to assume that corporate borrowers would have to offer investors higher returns with consequential negative effects on investment, production levels and employment.