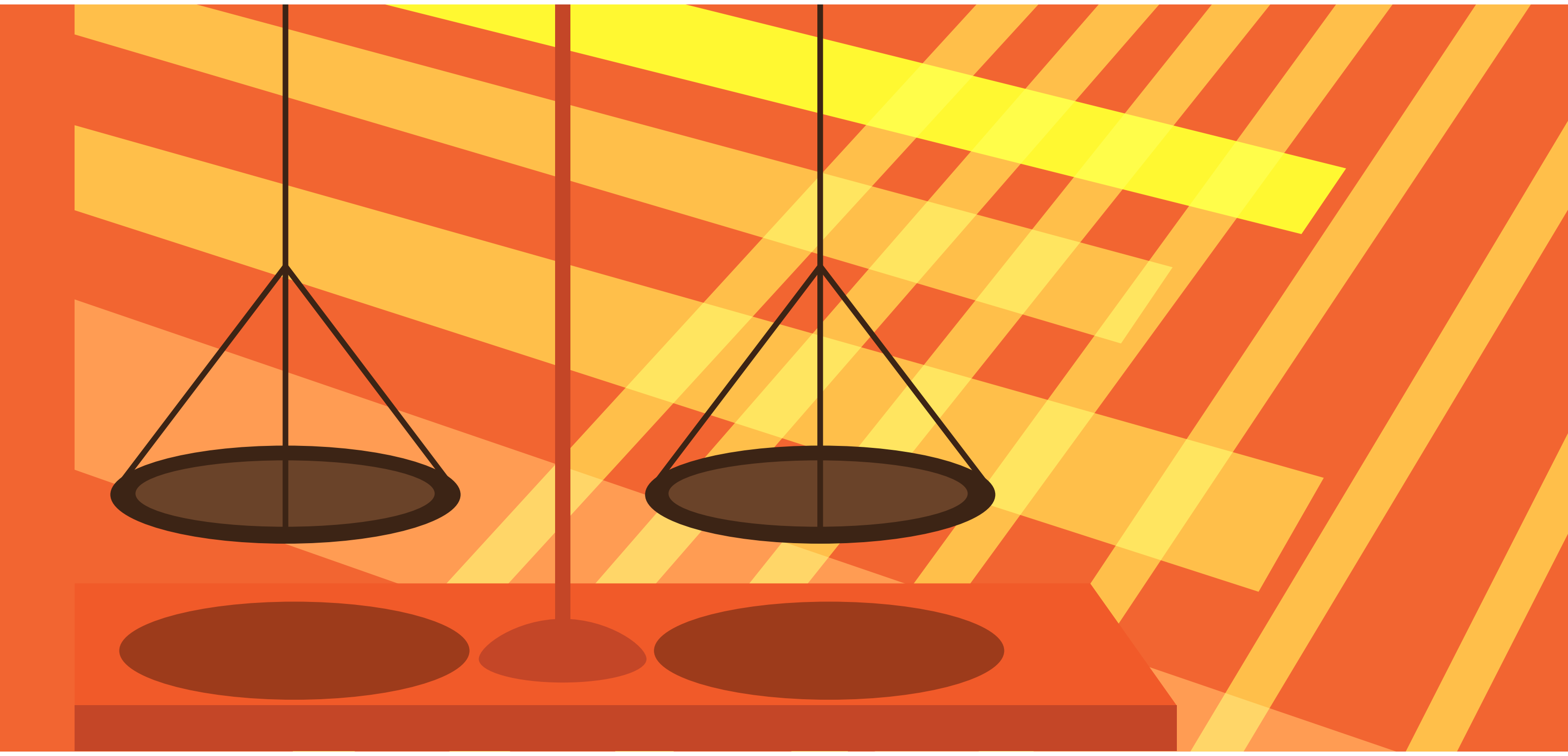
Implications of a Financial Transaction Tax for the European Regulatory Reform Agenda

SPECIAL INTEREST PAPER CITY OF LONDON CORPORATION



CITY OF LONDON

Deloitte.

Implications of a Financial Transaction Tax for the European Regulatory Reform Agenda

SPECIAL INTEREST PAPER CITY OF LONDON CORPORATION

www.cityoflondon.gov.uk/economicresearch

Implications of a financial transaction tax for the European regulatory reform agenda was prepared for the International Regulatory Strategy Group (IRSG) and is published by the City of London. The author of this report is Deloitte.

January 2014

PO Box 270, Guildhall
London
EC2P 2EJ

http://www.cityoflondon.gov.uk/economicresearch

The International Regulatory Strategy group (IRSG) is a practitioner-led body comprising leading UK-based figures from the financial and professional services industry. It aims to contribute to the shaping of the international regulatory regime, at global, regional and national levels, so that it promotes open, competitive and fair capital markets globally that support sustainable economic growth. Its role includes identifying strategic level issues where a cross sectoral position can add value to the existing industry views. It is an advisory body both to the City of London Corporation and to TheCityUK, an independent practitioner-led body which has been established to coordinate the promotion of the UK-based financial services industry.

Executive Summary

Objective

The International Regulatory Strategy Group has commissioned Deloitte to investigate the impact on financial stability of the financial transaction tax proposed by the European Commission in the draft Directive dated 14 February 2013 ("the FTT"). Broadly, the FTT is a proposal to tax each secondary financial transaction involving shares, bonds and the entering into and secondary trading of derivatives where there is a link to at least one of the EU Member States which implement the tax.

The main objective of this qualitative research paper is to consider the extent to which the FTT is compatible with a number of significant financial sector regulatory initiatives based on evidence combining existing research, impact assessments and analysis, supplemented by two interviews with financial services groups.

The regulatory initiatives considered for the purposes of this report are primarily those resulting from the commitments made in the 2009 Pittsburgh declaration of the Group of Twenty (G20) with respect to "Strengthening the International Financial Regulatory System" (see Annex 3). The significant financial sector regulatory initiatives that have been considered for this report are set out below in the summary of findings.

Qualitative assessment of impacts

FTT policy objectives

One of the three policy objectives set out in the original proposal of 2011 for an EU FTT is:

- "**Disincentives for transactions that do not enhance market efficiency thereby complementing regulatory measures to avoid further crises".** *The design of the FTT is in fact likely to conflict with a number of key regulatory initiatives (as set out below). Furthermore the design of the FTT and limited number of exemptions will mean that the FTT does not distinguish between transactions that do enhance the efficiency of financial markets and transactions that do not enhance it.*

The other two objectives set out in the original FTT proposal are also unlikely to be met:

- **Harmonisation of indirect taxation of financial transactions to ensure proper functioning of the internal market, avoid distortions of competition or double taxation.** *The harmonisation objective will not be met as the FTT is only being implemented in 11 EU Member States, leading to double taxation of financial instruments within the EU. For example under the current design of the FTT, the purchase of a UK equity by a French bank would result in both a UK Stamp Duty Reserve Tax charge and an FTT charge. While it is possible that agreements to avoid double taxation may be entered into, achieving this between Member States participating in the FTT and those not participating could be politically difficult.*

- **Fair and substantial contribution by financial institutions to cover costs of the global financial crisis.** *The FTT in its current design is estimated to raise €34bn per annum. The contribution objective will put further pressure on the regulatory push for financial institutions to strengthen their capital and liquidity positions. This makes it more likely that the economic cost of the tax will be passed on to end consumers.*

Summary of findings

We have identified several conflicts and compatibility issues between the impacts of the FTT and the regulatory initiatives. The table below sets out a summary of the objectives of each of the regulatory initiatives and how the impact of the FTT is compatible with these objectives. Annex 2 sets out the terminology abbreviations used below for the regulatory initiatives.

Capital, Liquidity and Leverage	Interaction / compatibility with the FTT	Analysis Ref
Basel III – CRDIV/CRR Ensure proper functioning of banking markets and restoring confidence in the banking sector, through: (a) Effective, proportionate and deterrent sanctions which better ensure compliance with CRD rules. (b) Development of a level playing field which minimises the opportunities for regulatory arbitrage. (c) Effective supervision of banking service providers. (d) Effective corporate governance within credit institutions which should contribute to avoid excessive risk taking.	• There is likely to be a conflict with liquidity and capital policy, as the FTT could decrease market liquidity of high-grade securities and will tax funding models (especially repurchase agreements or 'repos'). This may raise issues for banks trying to build up their liquidity buffers to meet the Liquidity Coverage Ratio (LCR). • To the extent that the banking markets bear the significant costs of the FTT, this is in direct conflict with the CRDIV/CRR general objective of banks strengthening their capital positions. • The fragmentation of the EU common market – i.e. the FTT Zone and non-FTT Zone Member States – could conflict with proper functioning of banking markets (firms covered by the CRDIV/CRR i.e. mainly credit institutions but also other "financial institutions").	4.1.1.1

Monetary Policy Operating Framework (a) Implement monetary policy in order to meet the inflation target. (b) Reduce the cost of disruption to the liquidity and payment services supplied by banks to the economy.	• The FTT counteracts the European Central Bank's (ECB's) post-crisis efforts to wean Eurozone banks off ECB liquidity and into secured funding markets, as the FTT taxes secured funding, thereby pushing banks back towards ECB liquidity provision. • Taxing repos could severely impair the transmission of monetary policy by Central Banks of Member States and the ECB. • Taxing repos and similar secured funding will incentivise the use of non-taxed secured funding where there is no transfer of legal ownership of the collateral (often high quality securities). This will mean that the lender has to enforce the security, generally considered less "safe" than repos, thereby resulting in a potential conflict between the FTT taxing secured lending and the preference of lenders for secured lending where they take legal title of the collateral.	4.1.1.2
Solvency II (a) Deepen the integration of the EU insurance market. (b) Enhance the protection of policyholders and beneficiaries. (c) Improve the international competitiveness of EU insurers and reinsurers. (d) Promote better regulation.	• There is not as much interaction between Solvency II and the FTT as other regulatory initiatives. • The FTT could reinforce various incentives for life insurers to hold fixed interest instruments to maturity. • The active management of portfolios for other insurance businesses will result in FTT costs which are likely to be passed on to policyholders.	4.1.1.3

<table>
<tr><th>Market Infrastructure</th><th>Interaction / compatibility with the FTT</th><th>Analysis Ref</th></tr>
<tr><td>European Market Infrastructure Regulation (EMIR)

(a) Obtain complete and comprehensive information on over-the-counter (OTC) derivatives positions.
(b) Increase the use of central counterparties (CCP) clearing.
(c) Improve bilateral clearing practices.
(d) Increase the standardisation of OTC derivatives contracts.</td><td>The cascading effect of the FTT (taxing each leg of an overall transaction) is likely to weaken incentives for the use of CCPs that EMIR tries to establish.
The FTT will further increase the cost of trading in OTC derivatives, in addition to the costs resulting from EMIR. Higher costs of trading are likely to reduce volumes traded, which could lead to knock-on effects on the industries that depend on the use of OTC derivatives for risk management purposes, e.g. an internationally trading industrial company may be left with a currency risk it would otherwise have hedged.
For financial institutions that use OTC derivatives for hedging purposes, e.g. global non-financial services groups, the FTT is likely to increase the cost of hedging commercial risk.
The FTT could countervail efforts to get more transactions subject to margin requirements, to the extent that collateral is charged to the FTT.
The joint and several liability clause of the FTT may impact on the stability of CCPs.
The FTT cascade effect could lead to restructuring trading in OTC derivatives thereby making the market more complex, conflicting with the EMIR objectives of increasing the safety and efficiency of the OTC derivatives market.</td><td>4.1.2.1</td></tr>
</table>

Markets in Financial Instruments Directive (MiFID II/MiFIR) General objectives of the revision of MiFID: (a) Strengthen investor confidence. (b) Reduce the risks of market disorder. (c) Reduce systemic risks. (d) Increase efficiency of financial markets and reduce unnecessary costs for participants. Specific policy objectives: (a) Ensure a level playing field between market participants. (b) Increase market transparency for market participants. (c) Reinforce transparency towards and powers of regulators in key areas (d) Increase coordination at European level. (e) Raise investor protection. (f) Address organisational deficiencies and excessive risk taking or lack of control by investment firms and other market participants.	• The fragmentation of the EU common market – i.e. the FTT Zone and non-FTT Zone Member States – is in conflict with the overall MiFID objective of harmonising and integrating the market for financial instruments. • To the extent that the FTT slows the price discovery process due to reduced trading volumes and market information, the FTT could result in complicating market pricing which would conflict with the MiFID objective of increasing market transparency.	4.1.2.2

Crisis Management	Interaction / compatibility with the FTT	Analysis Ref
Recovery and Resolution Directive (RRD) (a) Maintain financial stability and confidence in banks. (b) Avoid contagion. (c) Minimise losses for society as a whole, in particular for taxpayers. (d) Reduce moral hazard. (e) Strengthen the internal market for banking services while maintaining a level playing field.	• The FTT is likely to add complexity to recovery and resolution that could undermine the objectives of the RRD to some degree. • Some of the transactions involved in a recovery and resolution (e.g. asset sale) will be subject to the tax while other transactions are not. For instance, transactions with the ECB, the European Stability Mechanism and other transactions "related to financial assistance" are out of scope of the FTT. • The FTT will tax bail-inable instruments and make their pricing more complex. There is already considerable uncertainty in the market around bail-in and the appropriate pricing of bail-in risks. The FTT will exacerbate this uncertainty. • The FTT is likely to make it more difficult to sell in-scope assets and result in decreased returns of the sale of these assets.	4.1.3.1

Inter-connectedness and regulatory perimeter	Interaction / compatibility with the FTT	Analysis Ref
Shadow banking (a) Strengthen regulation and supervision of shadow banking entities. (b) Promote financial stability by addressing potential systemic risks arising in this sector.	• The FTT could drastically reduce the securities lending market, leading to an increase in the risk of settlement failure and the mobility of collateral, thereby conflicting with the shadow banking objective of promoting financial stability. • The FTT could severely affect the money market fund (MMF) markets as they invest heavily in short-term debt. If FTT was to diminish MMFs as a crucial player in the money market, this would have knock-on effects on the way that financial institutions, corporate bodies and governments manage their day-to-day liquidity needs.	4.1.4.1
Short selling (a) Reduce the risk of negative price spirals arising from short positions (including those obtained through credit default swaps or CDS). (b) Increase the transparency of short positions (including those obtained through CDS). (c) Reduce settlement risk linked with naked short-selling. (d) Reduce the scope of regulatory arbitrage and compliance costs.	• As stated above, the FTT could lead to an increase in the risk of settlement failure which is in conflict with the short selling objective to reduce settlement risk linked with naked short-selling.	4.1.4.2

Transparency and Investor Protection	Interaction / compatibility with the FTT	Analysis Ref
Undertakings for Collective Investment in Transferable Securities (UCITS) General objectives: (a) Investor protection, financial stability and transparency. Specific objectives: (a) Enhance investor protection; increase effective recourse; increase legal certainty; remuneration practices to be transparent and consistent with risks; management; clear rules on administrative sanctions and their consistent enforcement.	• The market fragmentation of the EU caused by the FTT would have adverse consequences for the UCITS market - so far, one of the biggest success stories in harmonisation and integration in the market for financial services in the EU. • Taxing UCITS will reduce the returns of these funds and make them a less attractive investment compared to savings and investment that are not subject to the FTT. • The cascade effect of the FTT is likely to render some business models of investment funds unviable. • Retail and institutional investors may switch from funds to saving deposits and life insurance products that are not subject to the FTT.	4.1.5.1
Long-term finance (a) Foster the supply of long-term financing. (b) Improve and diversify the system of financial intermediation for long-term investment in Europe.	• The FTT could result in an increase in the cost of capital which is likely to also affect price and availability of long-term finance.	4.1.5.2

The FTT in its current design is therefore likely to conflict with rather than complement a number of key regulatory initiatives aimed at increasing financial stability in the financial services sector. This is in addition to the FTT also being likely to fail in achieving its own policy objectives.

The impacts of the conflicts between the FTT and existing regulatory initiatives would be felt on both a micro and macro level as follows:

Micro impacts

- *Cost of trading*: the FTT is likely to increase cost of trading, with the impact being magnified by the cascade effect of the FTT taxing multiple legs of an overall transaction.
- *Asset prices*: the FTT is likely to reduce values of in-scope traded instruments, as investors reduce bid prices due to needing to pay the FTT charge, with the possible consequence of increasing the cost of capital.
- *Market fragmentation*: there will be a split priced EU market between the FTT Zone and Member States outside the FTT Zone for certain financial instruments, thereby distorting competition within the EU.
- *Trading volumes*: evidence suggests that the FTT is likely to reduce trading volumes. This could result in asset prices not reflecting their fundamental value, as instruments are traded less frequently.
- *Market liquidity*: market liquidity is the ability to buy or sell an asset in a market without causing a significant movement in the price. The reduction in trading volumes is likely to reduce market liquidity, possibly widening spreads which could negatively impact the market. Investors require higher return on assets with lower market liquidity to compensate them for the higher cost of trading these assets.
- *Price volatility*: the higher costs of trading and lower market depth could lead to increases in price volatility. Price volatility is a concern to market participants as very volatile prices may send flawed price signals about fundamental asset values and might in consequence cause mispricing of assets.
- *Portfolio optimisation and diversification*: the FTT may provide a disincentive for turnover in portfolios and might therefore lengthen holding periods. This could undermine certain business models, especially trading strategies based on high turnover with low profit margins, e.g. corporate treasury activities that require frequent portfolio adjustments in money markets or foreign exchange derivatives.

Macro impacts

- *GDP and growth*: as with most other taxes, the FTT will have a "dampening effect on the economy", with the increased cost of capital also having a negative impact on growth.
- *Cyclicality*: the overall impact of the FTT on cyclicality is not clear cut. On the one hand, market fragmentation, reduced volumes and decreased market liquidity and depth, combined with possible outflows of capital may all contribute to additional cyclicality. However, as the FTT inhibits price discovery, it might slow both the upswing of the asset cycle and also corrections towards fundamental value, in overall terms smoothing cycles.
- *Interconnectedness*: the FTT could redistribute risks and inhibit risk sharing.
- *Leverage:* the FTT could provide an incentive for firms to move towards sources that are not subject to the FTT, such as bank loans. Possible outcomes could be either an overall increase in leverage or an increase in the cost or a constraint in supply of corporate bank borrowing.

The FTT is therefore generally considered an ineffective instrument to enhance financial stability. Its impact on financial stability is likely to be negative or, at best, neutral.

1. Objective

The International Regulatory Strategy Group has commissioned Deloitte to investigate the impact of the financial transaction tax proposed by the European Commission (EC) in the draft Directive dated 14 February 2013 (the FTT) on financial stability policy.

A key element of the commitments made in the 2009 Pittsburgh declaration of the Group of Twenty (G20) with respect to "Strengthening the International Financial Regulatory System" (see Annex 3), was to identify "how the financial sector could make a fair and substantial contribution towards paying for any burdens associated with government interventions to repair the banking system". In this context, the G20 commissioned the International Monetary Fund (IMF) to produce a report to set out a range of options for such a contribution, taking into account the experience of countries that have adopted different measures for financial sector taxation.

In June 2010, the IMF published its report on financial sector contribution (the IMF Report) requested by the G20. The IMF Report proposed a dual approach: a Financial Stability Contribution (FSC – a levy that would pay for future resolution of financial institutions), combined with a Financial Activities Tax (FAT) levied on the sum of financial institutions profits and wages. The EC also published a Communication for the Taxation of the Financial Sector in October 2010 (the 2010 Communication) which also recommended an EU-wide FAT over an EU-wide FTT.

Despite the recommendation for an EU-wide FAT in the 2010 Communication, on 28 September 2011, the EC published its initial proposal for a Council Directive on a common system of financial transaction tax and subsequently published a revised draft FTT Directive on 14 February 2013. The revised draft Directive limited the number of participant EU member states (Member States) to those implementing the FTT through the Enhanced Cooperation Procedure (ECP) and broadened the scope and basis of the tax.

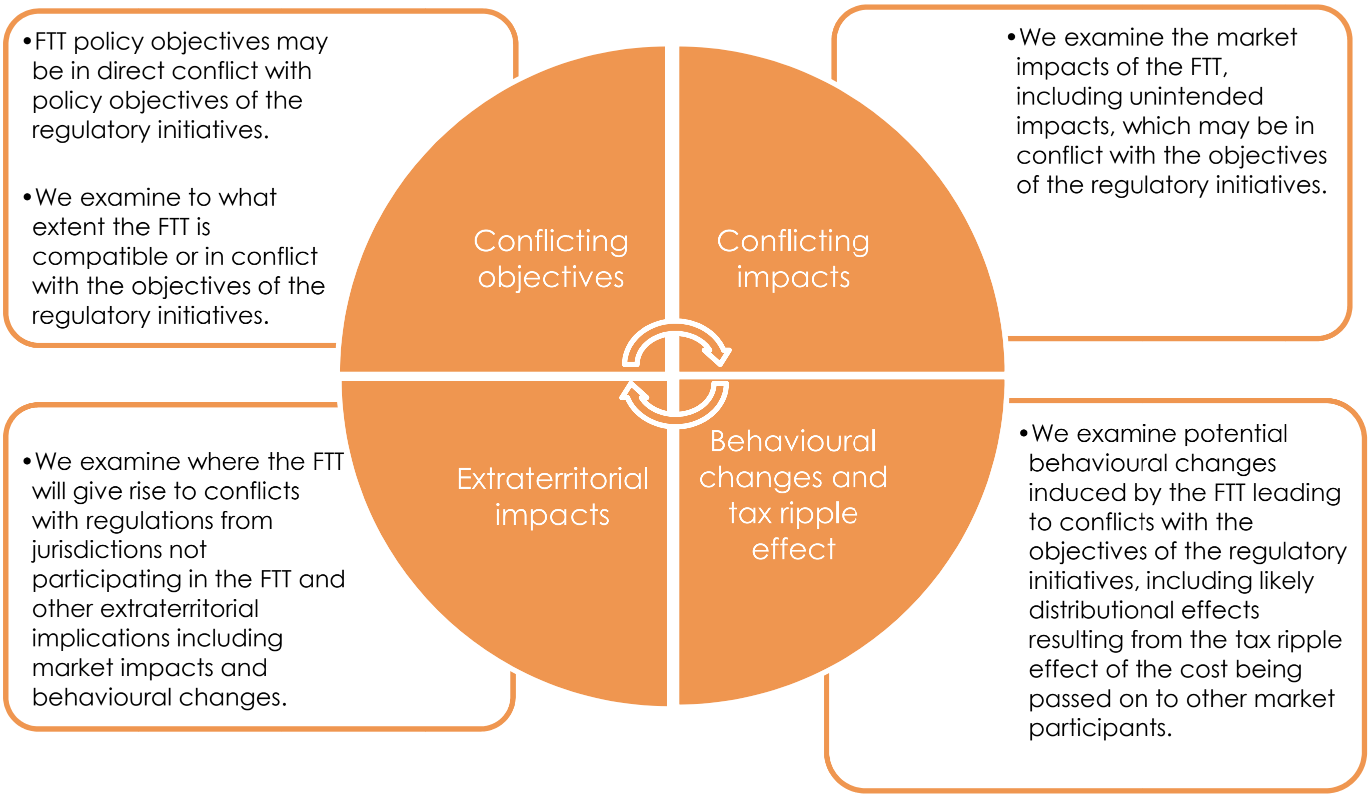
One of the stated aims of the proposed FTT is to contribute towards financial stability through changing financial market structures and behaviour, and disincentivising transactions that "do not enhance the efficiency and stability of financial markets", as well as excessive risk-taking or leveraging, "thereby complementing regulatory measures to avoid future crises".

The objective of this qualitative research report is to consider the impact of the FTT on financial stability on both a macro and micro level, in particular the extent to which the FTT is compatible with current regulatory reforms designed to improve the resilience and stability of the financial sector, with particular reference to the stated objectives of the FTT in relation to financial stability, and the aims of the G20 reform agenda. In doing so, this report relies on combining existing impact assessments and analysis, supplemented by interviews with two global financial services groups.

2. Methodology

2.1 Analysis methodology

This report provides a qualitative assessment of the proposed FTT's impact on financial stability, specifically the extent to which the FTT is compatible with significant financial sector regulatory initiatives introduced by the G20 as part of the post-crisis regulatory reform agenda. The report identifies conflicts between the regulatory initiatives and the FTT in terms of:



- Micro level: The report analyses the FTT's compatibility with the regulatory initiatives and identifies any potential conflicts including extraterritorial implications of such conflicts.
- Macro level: The report analyses the combined effects of the micro-level analysis and summarises the expected FTT impact on financial stability and on the financial system as a whole.

2.2 Sources of evidence

- A core group of Deloitte subject matter experts have contributed to this report, including those from its EMEA Centre for Regulatory Strategy and Financial Services Tax practice.
- Interviews with two global financial services groups to identify key compatibility issues arising from the FTT.
- The report relies on existing impact assessments and reports – many trade associations, academics, think tanks and commercial organisations have published impact assessments for the FTT proposal. We have used certain conclusions from these studies to determine the likely impacts of the FTT.

3. The FTT Proposal

3.1 Introduction of the FTT

The original proposal for an FTT in the EU was to introduce a harmonised financial transaction tax in all EU Members States. As there was no unanimous support for the introduction of the FTT across the EU, 11 Member States (Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia and Spain; subsequently referred to as the FTT Zone) voted to take forward the FTT by way of the ECP pursuant to which a minimum of nine EU Member States can implement European legislation. The use of the ECP to implement the FTT in the FTT Zone has been legally challenged by the UK Government at the European Court of Justice.

The FTT was initially due to come into force on 1 January 2014, but will in practice be delayed and its scope potentially changed as political negotiations continue. This report is based on the FTT proposal published by the EC on 14 February 2013.

3.2 Financial transactions subject to the FTT

Each financial institution that is a party to a chargeable financial transaction is liable to pay the FTT in respect of that transaction, i.e. if two financial institutions are party to a chargeable transaction then there are two separate FTT charges on each party.

A financial transaction between parties is a chargeable transaction where one of the parties is a financial institution which is established, or deemed to be established, in the FTT Zone.

In other words, the FTT applies where a financial institution:

- undertakes a financial transaction (e.g. shares, bonds, derivatives, repo transactions) with another party; and
- either party is established, or deemed to be established, in the FTT Zone, i.e. there is a link to the FTT Zone.

The rate of the FTT for chargeable financial transactions is set to be no lower than:

- 0.1% for financial instruments other than derivatives; and
- 0.01% for derivative contracts.

3.3 Exemptions from the FTT

The FTT is conspicuous in terms of the limited number of exemptions for types of financial institutions, financial transactions and financial instruments. The key exemptions are currently limited to the following:

- Primary market transactions are exempt from the FTT charge – this may include:
    - share issues;
    - entry into insurance contracts;
    - mortgage lending; and
    - original lending transactions.
- Transactions with central banks of Member States and the European Central Bank (ECB).
- Certain transactions with the European Financial Stability Facility, the European Stability mechanism and the EU.
- Central Counter Parties (CCPs), Central Securities Depositaries (CSDs) and Member States when exercising the function of managing the public debt are not chargeable to respective buy or sell side of a chargeable transaction (although they can be held jointly and severally liable).

3.4 FTT definitions

The definitions of financial institutions, financial transactions and financial instruments as defined by the FTT are set out in the table below:

Financial Institutions	Financial transactions	Financial instruments (definitions taken from MiFID)
• Banks. • Markets. • Insurances and reinsurers. • Collective investment funds and their managers. • Pension funds and their managers. • Holding companies. • Leasing companies. • Special purpose vehicles including securitisation SPVs. • Group finance / treasury entities of non-financial services groups (if entity breaches turnover test).	• Purchase, sale, exchange of a financial instrument, such as derivatives, before netting or settlement. • Transfer between group entities of right to dispose of financial instrument or transfer of risk associated with the financial instrument. • Repurchase agreements, reverse repurchase agreements, securities lending and borrowing agreements. • Conclusion of derivative contracts before netting or settlement.	• Shares. • Bonds, including government bonds. • Other securities. • Options. • Futures. • Other derivatives. • Units in unit trusts and other investment funds. • Repurchase agreements. • Securities lending agreements. • "Structured products" – tradeable securities or other instruments offered by way of a securitisation.

4. Analysis

4.1 FTT impacts and policy objectives – conflicts and compatibility issues with the regulatory initiatives

At this stage, we identify the conflicts and compatibility issues arising between the impacts of the FTT and the stated policy objectives of the regulatory initiatives.

4.1.1 Capital, Liquidity and Leverage

In the Communique of the 2009 Pittsburgh summit, the G20 committed "to developing by end-2010 internationally agreed rules to improve both the quantity and quality of bank capital and to discourage excessive leverage." Basel III has been a key initiative to enact the commitment of raising prudential standards for banks globally. In the EU, Basel III has been implemented by the CRDIV/CRR package.

4.1.1.1 Basel III - CRDIV/CRR

Basel III has the general objective of strengthening the regulation, supervision and risk management of the banking sector. These measures aim to: (a) improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source; (b) improve risk management and governance; and (c) strengthen banks' transparency and disclosures. Key policy measures include an increase in the minimum quantity and quality of regulatory capital, and introduction of new liquidity standards.

General objectives of CRDIV/CRR are: (a) ensuring that the effectiveness of capital regulation in the EU is strengthened and adverse impacts on depositor protection and pro-cyclicality of the financial system are contained; and (b) tackling regulatory shortcomings in: management of liquidity risk; definition of capital; counterparty credit risk; pro-cyclicality of institution lending; and options, discretions and harmonisation.

In addition CRDIV/CRR has the specific objectives of: (a) effective, proportionate and deterrent sanctions which better ensure compliance with CRD rules; (b) development of a level playing field which minimises the opportunities for regulatory arbitrage; (c) effective supervision of banking service providers; and (d) effective corporate governance within credit institutions which should contribute to avoid excessive risk taking.

Potential conflicts and compatibility issues

- *Interaction of objectives*: the introduction of the FTT resulting in increased market fragmentation and reduced market depth is likely to conflict with the general objective of proper functioning of banking markets[1].

[1] Firms covered by the CRDIV/CRR are mainly "credit institutions" (deposit-takers) but also include other "financial institutions" (undertakings other than a credit institution, being mostly investment firms).

- *Interaction of impacts:* on the liquidity side, one of the firms interviewed for this report voiced concerns that the FTT may re-model the entire market for bank funding, especially for internationally active financial groups.

  A key issue arising for the market for bank funding from the introduction of the FTT is that repos will become more costly. Repos and reverse repos are important cash management tools in the interbank market. Repos have become a much more important bank funding instrument since the onset of the crisis. This reflects increasing concerns about bank counterparty risk and the reluctance of lenders to lend without security. This trend is unlikely to reverse in the near future. Indeed, the introduction of a bail-in power within the proposed Bank Recovery and Resolution Directive may increase the prevalence of secured lending, which is exempt from bail-in.

  The EC's argument is that repos comprise a sale and purchase of securities and are therefore subject to the FTT. One of the businesses interviewed for this report is a heavy user of reverse repos to store cash overnight held by its non-financial services operations and pointed out that the increased cost of carrying out repos will reduce the availability of day-to-day liquidity and funding models.

  The FTT may impair market efficiency and depth for certain instruments which fall under the definition of high quality liquid assets for the Liquidity Coverage ratio (LCR). The FTT 'penalises' financial institutions which are trading in high quality liquid assets to build up liquid asset buffers.

- *Behavioural changes and tax ripple effects:* the CRD IV/CRR package aims at raising capital standards for financial institutions. The introduction of FTT could make this more difficult. To the extent that the FTT will not be passed on but reduces profitability of financial institutions, retaining profits to improve capital positions will become more difficult. Issuing new equity to raise capital would not be taxed directly, as it is a primary market transaction. However, the cost of equity is likely to increase anyway as secondary market transactions are subject to the FTT.

4.1.1.2 Monetary Policy Operating Framework of Central Banks

Closely related to the above discussion is the question of how the FTT will affect the monetary policy operating framework of central banks. Central banks use operations in the interbank market to implement monetary policy in order to meet the inflation target and reduce the cost of disruption to the liquidity and payment services supplied by banks to the economy.

Potential conflicts and compatibility issues

- *Interaction of objectives:* the FTT may undermine the ECB's post crisis efforts to wean Eurozone banks off ECB liquidity and into private secured funding markets. Taxing repos may reinforce banks' reliance on ECB liquidity provision.

- *Interaction of impacts:* although transactions with the ECB and central banks of Member States are out of scope of the FTT, repos and other transactions in the interbank market are subject to the FTT. As central banks use the interbank market as a transmission channel for their monetary policy, the FTT is likely to have an impact on how the monetary policy operating framework works. The FTT may also impair the ability of central banks to influence the 'marginal rate' in the market.

  Christian Noyer, Governor of the Banque de France, summarised the impact of the FTT on monetary policy operating framework: "The most important concern for the central banks is the risk of the total drying up of repo markets. That means the transmission of our monetary policy would be seriously impaired and the risk in terms of financial stability would not be negligible."[2]

- *Behavioural changes and tax ripple effects:* the exemption for central banks of Member States and the ECB could lead to the central banks becoming a preferred counterparty, potentially making them a *de facto* CCP for repo activities.

4.1.1.3 Solvency II

Solvency II is the new risk and solvency regime for (re)insurance firms that aims to enhance the way in which the industry understands and manages its risk and solvency position. It establishes a supervisory system that is consistent across EU Member States. Solvency II requirements are divided across three pillars: (Pillar I) quantitative requirements; (Pillar II) qualitative requirements and rules on supervision; and (Pillar III) supervisory reporting and public disclosure. Objectives include: (a) reduce the probability of consumer loss or market disruption in insurance; (b) reduce likelihood of insurer insolvency through robust solvency requirements – focus on (re)insurance regulated entity level and group solvency positions; and (c) better understanding of inherent risks in business across the firm – greater focus on self-assessment and board insight and understanding of the full risk profile.

Potential conflicts and compatibility issues

- *Interaction of impacts:* the FTT could reinforce certain incentives for insurance companies created by Solvency II. Under Solvency II, there could be some incentives (in the form of reduced liabilities) for life insurers to hold fixed interest instruments to maturity for some lines of business, such as annuities. These incentives could be reinforced by the FTT taxing the trading of fixed interest instruments.

  For other types of business, we expect companies to continue to actively manage their portfolio as required given the nature of their liabilities and their risk profile. It is therefore likely that the additional cost arising from the FTT will be passed on to policyholders.

[2] Financial Times, 28 October 2013 http://www.ft.com/cms/s/0/1c686796-3ee6-11e3-b665-00144feabdc0.html?siteedition=uk#axzz2j0askSnK

- *Behavioural changes and tax incidence:* Solvency II creates incentives for insurers to move to less risky product lines. The FTT is likely to reinforce these incentives for insurers to move to products that require less risk management with financial instruments, as financial market and hedging activities will be more expensive after the FTT introduction.

  We expect companies to continue to actively manage their portfolio as required given the nature of their liabilities and their risk profile. It is therefore likely that the additional cost arising from the FTT will be passed on to policyholders.

  To the extent that hedging using financial instruments can be replaced with a reinsurance agreement, insurance firms may also consider using more non-taxed reinsurance arrangements rather than taxed financial instruments for hedging purposes.

4.1.2 Market Infrastructure Regulation

Another key commitment made by the G20 in Pittsburgh was improving the resilience and transparency of the over-the-counter derivatives markets.

4.1.2.1 European Market Infrastructure Regulation (EMIR)

In the EU, reform of the OTC derivatives market has been implemented by the European Market Infrastructure Regulation (EMIR). EMIR will introduce mandatory clearing and reporting requirements for OTC derivatives contracts as well as new authorisation and regulatory requirements for CCPs and Trade Repositories. The general objective of EMIR is to "reduce systemic risk increasing the safety and efficiency of the OTC derivatives market". The specific objectives include: (a) increasing transparency; (b) reducing counterparty credit risk; and (c) reducing operational risk associated with OTC derivatives. Operational objectives of EMIR are: (a) obtain complete and comprehensive information on OTC derivatives positions; (b) increase the use of CCP clearing; (c) improve bilateral clearing practices; and (d) increase the standardisation of OTC derivatives contracts.

Potential conflicts and compatibility issues

- *Interaction of objectives:* if the FTT was to lead to a (re-)structuring of transactions to avoid tax, or take advantage of the lower rate for derivatives transactions, the FTT may make derivatives markets more complex, conflicting with the EMIR general objectives of increasing the safety and efficiency of the OTC derivatives market.

- *Interaction of impacts:* EMIR increases the cost of trading in OTC derivatives. The FTT could magnify these costs further. Higher costs of trading are likely to reduce volumes traded. The EC's impact assessment uses scenarios by Schulmeister (2011) in which trades in OTC derivatives fall by as much as 68.6%. OTC derivatives enable financial institutions and non-financial corporations to manage risks and play a "vital role in virtually every industry – from financial services to international trade to home mortgages"[3]. Lower volumes in OTC derivatives could therefore lead to knock-on effects on the industries that depend on the use of these instruments for risk management purposes, e.g. an internationally trading industrial company may be left with a currency risk it would otherwise have hedged.

  The FTT will not apply to a CCP itself when performing its function, but the FTT will be charged for all other legs of a transaction. The whole chain from clearing member to end user will be subject to the FTT, in effect multiplying the 0.01% tax on derivatives, similar to the cascading effect for a clearing equities trade in Illustration 2 in Section 4.4.1, albeit at the lower rate for derivatives. The cascade effect is likely to weaken the incentives for the use of CCPs that EMIR tries to establish, as taxing each leg of the central clearing process will mean that the cost of using CCPs would be higher.

  For financial institutions that use OTC derivatives for hedging purposes, the FTT could aggravate the increase in costs of hedging. One of the businesses interviewed for this report stated that this will particularly apply to hedging foreign exchange and interest rates. Non-financial corporations are very active in the derivatives market, mostly for hedging international trade and interest rates.

  As confirmed by one of the businesses interviewed, the FTT could be one of the decisive factors (alongside commercial considerations) in choosing which counterparties to transact with. However, the replacement of counterparties is difficult (it may not be possible to find counterparties that are willing to take on large exposures) and costly.

  Although CCPs are exempt from the buy/sell side of transactions chargeable to the FTT, they are jointly and severally liable for the FTT charge on their counterparties. This could decrease the stability of CCPs as they have a greater risk exposure, which could decrease the safety and efficiency of using CCPs.

  Central clearing and data collection in trade repositories could help with administrative issues of the FTT and facilitate tax collection, but only to the extent that CCPs/CSDs are able to administer the tax within the entire FTT Zone. For this purpose, relevant tax authorities would need to have full access to the data.

[3] ISDA (2013), Non-Cleared OTC Derivatives: Their Importance to the Global Economy, http://www2.isda.org/attachment/NTM2OA==/Non-Cleared%20OTC%20Derivatives%20Paper.pdf

- *Behavioural changes:* EMIR provides incentives for or mandates the exchange of collateral for OTC derivatives transactions. Although the taxation of collateral is not clear yet, most financial instruments used as collateral are likely to be subject to the tax. The FTT could therefore set an incentive that countervails efforts to make more OTC derivatives transactions subject to margin requirements.

4.1.2.2 MiFIDII / MiFIR

In October 2011, the EC adopted a legislative proposal for the review of the Markets in Financial Instruments Directive (MiFID), which was implemented in 2007 and replaced the Investment Services Directive (ISD). The MiFID review is designed to establish a safer, sounder and more transparent financial system in the aftermath of the financial crisis as well as ensuring a more integrated, efficient and competitive EU financial market. MiFIDII will introduce a split into a Directive (MiFID) and a Regulation (MiFIR), along with other changes. These include changes to the market structure, introduction of mandatory trading requirements for eligible derivatives and an enhanced transparency regime. MiFIDII will address issues of market fragmentation, implementation of G20 commitments for OTC derivatives, rapid changes in market structure and technology, and investor protection.

The general objectives are to: (a) strengthen investor confidence; (b) reduce the risks of market disorder; (c) reduce systemic risks; and (d) increase the efficiency of financial markets and reduce unnecessary costs for participants. Specific objectives include: (a) ensure a level playing field between market participants; (b) increase market transparency for market participants; (c) reinforce transparency towards and powers of regulators in key areas and increase coordination at European level; (d) raise investor protection; and (e) address organisational deficiencies and excessive risk taking or lack of control by investment firms and other market participants.

Potential conflicts and compatibility issues

- *Interaction of objectives:* the increased market fragmentation arising from the FTT implementation - the FTT is essentially splitting the common market of the EU into an FTT Zone and non-FTT Zone – conflicts with the overall MiFID objective of harmonising and integrating the market for financial instruments.

  If the FTT was to complicate price formation processes as suggested in some studies[4], there would be a conflict with another key MiFID objective, namely the objective to improve post-trade transparency to enhance price discovery.

[4] Matheson (2011) quotes e.g. Liu (2007) and Batagli et al. (2006).

4.1.3 Crisis management

Following the G20 commitment of "we should develop resolution tools and frameworks for the effective resolution of financial groups to help mitigate the disruption of financial institution failures and reduce moral hazard in the future", the Recovery and Resolution Directive (RRD) has been proposed in the EU.

4.1.3.1 Recovery and Resolution Directive (RRD)

The initiative provides national competent authorities with a comprehensive framework for dealing with credit institutions, investment firms and financial holding companies in financial distress. It includes provisions on recovery and resolution plans, early intervention, resolution funding and a set of specific tools and powers available to supervisors and resolution authorities, including bail-in. There are also provisions on cross border cooperation particularly regarding group resolution including requirements for resolution colleges, intra-group financial support and a mediation role for the European Banking Authority (EBA).

To ensure firms in financial difficulty either recover or are allowed to fail in an orderly manner without serious disruption to vital banking services, contagion to the financial system or tax-payer bail-out by, RRD aims to: (a) introduce tools and powers to address a banking crisis pre-emptively; (b) increase cooperation and coordination between the resolution authorities of cross border banking groups; and (c) strengthen and harmonise national resolution regimes.

Recovery Plans require firms to identify options to recover financial strength and viability should a firm come under severe stress. Resolution planning requires firms to submit detailed information about their business and operational structure in the form of a Resolution Pack.

Potential conflicts and compatibility issues

- *Interaction of objectives:* the IMF has argued that an FTT is not the best way to finance a resolution mechanism and the RRD provides for a separate resolution fund for the EU. However, the funds raised through an FTT could still contribute to achieving the RRD objective to "minimise losses for society as a whole, particular for taxpayers" to the extent that the tax burden of the FTT is borne by the financial sector. However, as stated in 4.3 and 4.5.2, the tax incidence is likely to be passed on to end users of financial instruments such as retail customers. Therefore, it is unlikely that the funds raised through an FTT could contribute to achieving the RRD objective to "minimise losses for society as a whole, particular for taxpayers" as part of the tax burden of the FTT is likely to be borne outside of the financial sector.

  If the FTT was to add complexity to recovery and resolution as described below, this may undermine the objectives of the RRD to some degree.

- *Interaction of impacts:* the FTT will apply to bail-in-able instruments and therefore render the pricing of these instruments even more difficult. There is already considerable uncertainty in the market around bail-in and the appropriate pricing of bail-in risks. The FTT will exacerbate this uncertainty as it adds to the complexity of the price discovery process for financial instruments.

  The framework for recovery and resolution in the EU has not been finalised to date, but it is likely that FTT will add to the complexity of recovery and resolution as some of the transactions involved such as asset sales will be subject to the tax while other transactions are not. For instance, transactions with the ECB, the European Stability Mechanism, and other transactions "related to financial assistance" are out of scope of the FTT according to Article 3 of the proposed Council Directive.

- *Behavioural changes and tax-ripple effect:* in a situation in which a firm needs to sell assets according to a recovery plan, the FTT could make it more difficult to sell assets or decrease the return that the firm could achieve from the asset sale.

  The RRD will require banks to meet a minimum amount of eligible liabilities (MREL) – liabilities that are available for bail-in. While the FTT could encourage the issuance of longer dated instruments, potentially increasing the amount of available bail-inable debt, our initial view is that the FTT would not be a significant determining factor in the choice of debt instruments/maturity.

4.1.4 Inter-connectedness and regulatory perimeter

4.1.4.1 Shadow Banking

A special Financial Stability Board (FSB) task force was established following the request to the FSB by the G20 Leaders in November 2010 to develop recommendations for strengthening the oversight and regulation of the shadow banking system. The FSB defined the shadow banking system as "the system of credit intermediation that involves entities and activities outside the regular banking system."

Subsequently five workstreams were launched to assess in greater detail the case for further regulatory action. The workstreams cover: (a) regulating banks' interactions with shadow banking entities; (b) regulating the reform of money market funds (MMFs); (c) regulating other shadow banking entities; (d) regulating securitisation; and (e) regulating securities lending and repos.

The overarching objective is to assess the need to apply regulatory safeguards to shadow banking and determine which measures are most appropriate. The EC has published its own communications on how to regulate shadow banking setting the policy objective of: (a) strengthening regulation and supervision of shadow banking entities; and (b) promoting financial stability by addressing potential systemic risks arising in this sector. The FTT will interact with shadow banking proposals in particular as far as workstream (b) regulating MMFs and workstream (e) regulating securities lending and repos are concerned.

Potential conflicts and compatibility issues with workstream (b) regulating MMFs

- *Interaction of impacts:* the FTT-induced increase in transaction costs is likely to disproportionately affect MMFs. MMFs are significant investors in short-term debt and adjust portfolios far more often than other funds. The portfolio turnover of MMFs is very high and the weighted average maturity of MMFs is short: 60 days maximum for short-term MMFs and six months maximum for MMFs. Having to pay the FTT on every transaction will have an impact on the performance of MMFs. The European Fund and Asset Management Association (EFAMA) estimates the costs of the FTT relating to the turnover of MMF portfolio to reduce the annual investment performance of MMFs by at least 1%. The impact of the FTT on the business model of MMFs could be severe. EFAMA even expects that the "FTT would put the MMF industry out of business".

  If the intention of policy makers was to curtail the market for MMFs altogether, the FTT could reinforce this objective. However, in its Green Paper, the EC has explicitly acknowledged that activities performed by shadow banking entities such as MMFs, "can constitute a useful part of the financial system."

- *Behavioural changes and tax-ripple effect:* EFAMA has estimated that based on 2011 data, the hypothetical contribution of MMFs in total FTT revenue would have reached 67%. Investors use MMFs to manage their cash and invest and disinvest continuously: total value of sales and redemptions of MMFs shares/units reached €11.2tn in 2011. The FTT will tax every transaction of these portfolio changes which means that investors in MMFs would have paid a total FTT of €11.2bn. This amounts to a very large cost for the MMFs, and could render a lot of funds unviable. MMFs are an important source of short-term financing for financial institutions, corporations and governments and "represent a crucial link bringing together demand and offer for short-term money"[5]. If the FTT was to diminish MMFs as a crucial player in the money market, this would have knock-on effects on the way financial institutions, corporate bodies and governments manage their day-to-day liquidity needs.

[5] European Commission (2013c), New rules for Money Market Funds proposed – Frequently Asked Questions, http://europa.eu/rapid/press-release_MEMO-13-764_en.htm?locale=en

Potential conflicts and compatibility issues with workstream (e) regulating securities lending and repos

- *Interaction of impacts:* the FTT impact on the securities lending market is likely to be similar. The FTT would apply to securities lending transactions, with both borrower and lender paying 0.1% on the value of the respective financial instrument (assuming both financial institutions).

  The International Securities Lending Association (ISLA) expects that "the FTT would effectively close down the securities lending markets" across the FTT Zone with "considerable implications for long-term investors and the mobility of collateral". ISLA expects that at least 65% of the European securities lending market would disappear as a result of the FTT, with the largest impact on the markets in France and Germany.

  ISLA pointed out the wider importance of the securities lending sector. According to ISLA, almost €500bn of eurozone government bonds would be removed from the lending market, reducing the quantity of high-quality collateral available to back derivatives trades and other transactions. The lack of available inventory would increase the risk of "settlement fails" by as much as 100%, increasing systemic risk.

- *Behavioural changes and tax-ripple effect:* ISLA has suggested that the FTT will disproportionately affect shorter dated transactions with "severe negative implications for coverage of settlement failures and market making activities". Although CSDs are excluded from the FTT, they rely on securities lending to cover imminent settlement fails.

4.1.4.2 Short selling

The Regulation on short selling and certain aspects of CDS introduced a new harmonised EU approach to the regulation and supervision of short selling (SSR). The SSR has been in force since November 2012 and includes requirements for market participants to notify the competent authorities and to disclose their net short positions once certain thresholds have been exceeded. The SSR bans uncovered short sales in shares or EU sovereign debt as well as uncovered long positions in EU sovereign CDS.

The policy objectives of the SSR have been to reduce risk to market confidence/ financial stability by: (a) increasing transparency on short positions; (b) giving The European Securities and Markets Authority (ESMA) / national competent authorities power to intervene in exceptional circumstances; (c) introducing a harmonised EU approach to the regulation and supervision of short selling; and (d) reducing settlement risk.

Potential conflicts and compatibility issues

- *Interaction of objectives:* The FTT's impact on the securities lending market as discussed above could undermine the objective of the Short Selling Directive of reducing settlement risk. The FTT is expected to increase the costs and dramatically reduce the supply of financial instruments available for securities lending.

- *Interaction of Impacts:* As stated above, there could be "severe negative implications for coverage of settlement failures and market making activities". Although CSDs are excluded from the FTT, they rely on securities lending to cover imminent settlement fails.

4.1.5 Transparency and investor protection

4.1.5.1 UCITS

The Undertakings for Collective Investment in Transferable Securities (UCITS) Directive was adopted in 1985 with the objective to create a single market across the EU for collective investment funds. In order to keep the UCITS Directive in line with the evolution of investment markets, there have been various reviews of the UCITS Directive.

The current update of the Directive, UCITS V, is designed to clarify and introduce new provisions in respect of the depositary function, remuneration policies and sanctions, seeking to enhance investor protection and consistency across the EU. The estimated date for the UCITS V to come into force is Q3 2014.

General objectives of UCITS Directive are investor protection, financial stability and transparency. The specific objectives of UCITS include: (a) enhance investor protection; (b) increase effective recourse; (c) increase legal certainty; (d) remuneration practices to be transparent and consistent with risk management; and (e) clear rules on administrative sanctions and their consistent enforcement.

Potential conflicts and compatibility issues

- *Interaction of objectives:* under the current proposal, UCITS and Alternative Investment Funds (AIF) will be subject to the FTT with likely adverse consequences for this market, in particular with regard to assets and returns. So far, UCITS have been considered as one of the biggest success stories in harmonisation and integration in the market for financial services in the EU. According to the EC's impact assessment, UCITS manage assets worth more than €5.8tn across the EU and €1.97tn in the FTT Zone.

  The tax treatment of selling (units of) UCITS as well as the tax treatment of assets UCITS invest in, will be different in participating and non-participating Member States. It is possible that the additional market fragmentation arising from the tax differences within the EU will undermine the achieved harmonisation and integration in this market.

- *Interaction of impacts:* taxing UCITS will reduce returns of these funds and make them a less attractive investment compared to savings and investment that are not subject to the FTT. One business interviewed for this report confirmed that the FTT will change the competitive position of UCITS. Introduction of the FTT is also likely to add complexity to charging structures, decreasing transparency of charges and, in effect, have a negative impact on investor protection.

  EFAMA expects that the FTT will "have an extremely detrimental impact on the UCITS industry, its clients and the European economy". Assuming the FTT had been applied at the start of 2011, EFAMA has estimated that the annual total impact of the FTT would have reached €38bn with investors paying €15bn on the sales and redemptions of UCITS shares/units and UCITS fund manager €23bn. The potential impact at the portfolio level depends on the turnover ratio of UCITS portfolios.

- *Behavioural changes and tax-ripple effect:* one of the interviewees expressed concerns that the cascading effect of the FTT is likely to make some business models of investment funds unviable. For example, passively managed investment funds that use synthetic structures and engage in low margin activities such as stock lending and collateral transactions will be particularly affected and may become uneconomical. The business interviewed reported evidence from France and Italy where after introduction of a unilateral FTT, fund portfolios have been changing and some products have become uneconomical, e.g. contracts for difference in Italy. For other products and asset classes such as equities, impact on core investment strategies is likely to be lower.

  For retail markets, the interviewed business expects business model changes in terms of packaging, e.g. mutual funds into life policies in a way to realise tax efficiency. The trade associations AIMA and EFAMA further suggest that retail and institutional investors could switch from funds to saving deposits and life insurance products that are not subject to the FTT.

4.1.5.2 Long-term finance

In March 2013, the EC published a Green Paper on long-term financing, which was followed by a three month public consultation. The focus of the discussion on the long-term financing is how to overcome tendencies for short-termism in the financial sector and to facilitate access for governments and businesses to long-term finance. The policy objectives include: (a) to foster the supply of long-term financing; and (b) to improve and diversify the system of financial intermediation for long-term investment in Europe.

The expected outcome of the consultation is to develop a regulatory approach fostering long-term finance and to set out the role of the EU institutions in promoting coordination and best practices across the Member States.

Potential conflicts and compatibility issues

- *Interaction of impacts:* the FTT could increase the cost of capital as potential providers of long-term finance demand higher returns to compensate them for the costs incurred e.g. when they sell on their investments. If the FTT was to increase the cost of capital, it would also be likely to affect price and availability of long-term finance. This may countervail some of the measures proposed, especially the one aimed at fostering market-based provision of long-term finance such as developing well-performing SME-oriented stock exchanges to turn their investments into initial public offerings.

- *Behavioural changes and tax-ripple effect:* the FTT might also change the relative prices of different sources of funding and therefore create incentives for firms to move their funding more towards sources that are not subject to the FTT. There will be a conflict in objectives to the extent to which funding not within the scope of the FTT is more short-term, e.g. if firms were to move their finance from taxed equities more towards untaxed bank loans. The outcome may be a mix of funding sources that is not optimal to promote long-term investment.

  UCITS are an important source of long-term financing. As the FTT impact on the fund management industry might be severe (see impacts on UCITS in 4.1.5.1), there may be knock-on effects on the availability of long-term finance.

4.2 Conflicting objectives

4.2.1 Differences between the IMF recommendations and the FTT proposal by the European Commission

The IMF Report recommended a FAT rather than an FTT. While the IMF report did not dismiss the FTT concept *per se*, it identified various problems with it, including:

- an FTT is not the best way to finance a resolution mechanism, since the volume of transactions is not a good proxy for either the benefits it conveys to particular institutions or the costs they are likely to impose on it;
- an FTT is not focused on core sources of financial instability, i.e. institutional size, interconnectedness and substitutability that give rise to systemic risk;
- the real burden of an FTT may fall largely on end consumers rather than the financial sector. As set out in the report, we agree that the tax incidence of the FTT is likely to fall largely on the end consumers; and
- an FTT will have a negative impact on prices of certain non-financial products, as it taxes transactions between businesses, thereby negatively impacting prices at all further stages, unlike VAT which excludes certain transactions between businesses.

The IMF set out two key objectives for measures to pay for and contain the fiscal costs of future financial failures: 1) ensure that the financial sector pays in full for any fiscal support it receives; and 2) reduce the probability and the costliness of crises. The objectives and design of the FTT proposal as put forward by the EC are not clearly based on the IMF's recommendations.

While one of the FTT's objectives is "ensuring that financial institutions make a fair and substantial contribution to covering the costs of the recent crisis", the FTT's tax base is neither linked to the fiscal support the financial sector has received, nor to the impact of the crisis on real economic activity. As set out in this report, nor does the FTT in the proposed design directly address systemic risk to reduce the probability and impact (i.e. costs) of crises, despite one of the key objectives stated being "complementing regulatory measures to avoid future crises".

4.2.2 The FTT's Policy Objectives – potential conflicts and compatibility issues

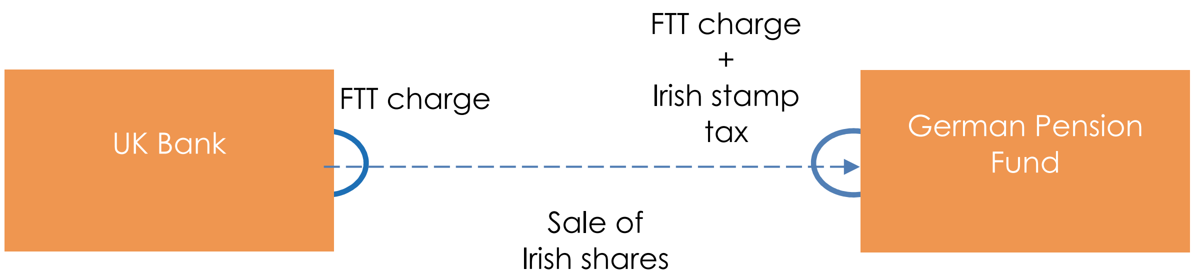
In this section, we examine to what extent the proposed FTT is compatible with the following three main policy objectives for an EU-wide FTT that the EC set in the original proposal of 2011.

i) *Harmonisation:* "Harmonising legislation concerning indirect taxation on financial transactions, which is needed to ensure the proper functioning of the internal market for transactions in financial instruments and to avoid distortion of competition between financial instruments, actors and market places across the European Union, and double taxation or double non-taxation".

The EC often chooses "harmonisation" as its overarching objective for policies as it provides the strongest legal basis for the EC to act. Given that the FTT is to be implemented under the ECP, the EC accepts that a common system of an FTT cannot be attained within a reasonable period across the EU as a whole. By having only certain Member States in the FTT Zone and other Member States not within the FTT Zone, the proposal cannot "ensure the proper functioning of the internal market for transactions in financial instruments" as there will still be coexistence of different FTT regimes and FTT-equivalent taxes in the EU (e.g. Hungarian, Irish and UK stamp taxes). Nor will the proposal at it stands "avoid distortion of competition between financial instruments, actors and market places" as several major financial centres are not participating and will compete, among other things, on the (absence of) FTT regimes.

The FTT will result in double taxation of financial transactions within the EU. In the example shown in Illustration 1, the sale of Irish shares from a UK bank to a German pension fund could result in separate FTT charges on the UK bank and German pension fund, and Irish stamp tax being payable on the Irish shares.

Illustration 1 – double taxation of financial instruments within the EU



ii) *Contribution:* "Ensuring that financial institutions make a fair and substantial contribution to covering the costs of the recent crisis and creating a level playing field with other sectors from taxation point of view".

The EC has estimated in its impact assessment that revenues from the FTT will amount to €34bn annually for the FTT Zone, with c. €13bn stemming from the taxation of transactions in securities and c. €21bn stemming from the taxation of derivatives[6].

As with most other taxes, the FTT is likely to be passed on and part of the tax burden is likely to eventually fall on market participants other than the taxed entity, e.g. retail investors or pension funds. As financial institutions are required to strengthen their capital and liquidity positions, the passing on of the tax incidence is more likely so that financial institutions are not suffering the economic cost of the FTT.

It should also be noted that the financial services sector already makes a substantial contribution to public revenues, estimated at £65bn in the UK during the financial year 2012/13[7]. The fact that financial services are exempt from VAT generates tax cost for the sector (as opposed to being VAT neutral as many other sectors are). This is in addition to other sector specific taxes e.g. bank levy.

iii) *Disincentive:* "Creating appropriate disincentives for transactions that do not enhance the efficiency of financial markets thereby complementing regulatory measures to avoid future crises".

The FTT will tax a financial transaction regardless of the features of the transaction e.g. whether it is viewed as supporting real economy activity or whether the transaction gives rise to systemic risk. The FTT design does not distinguish between transactions that do enhance the efficiency of financial markets and transactions that do not enhance it. Therefore, the FTT will create disincentives for both "socially useful" transactions and transactions that are not socially useful. While the FTT may reduce activity by speculators and "noise traders", it may also prevent trades that benefit the real economy as well as efficiency enhancing trades e.g. taxing commercial hedging through derivatives could create a disincentive for businesses to hedge genuine economic risk within the FTT Zone.

Summary of conflicting objectives

We agree with the conclusion the European Banking Federation arrived at in its report that "the Directive will not meet most of the objectives it has set."[8] In addition, we note that by proposing an FTT in its current shape and form, the EC has not addressed the problems with the FTT concept identified by the IMF. In its 2010 Communication on taxation of the financial sector, the EC explicitly recognised the challenge of designing "a global financial transaction tax that would generate sufficient revenue while minimising its adverse economic effects" and recommended exploring a FAT at an EU-level.

[6] European Commission (2013b), p 24.
[7] City of London (2013), Total Tax Contribution of UK Financial Services, prepared by PwC.
[8] European Banking Federation (2012), Report on the Proposed FTT Directive.

4.3 FTT impacts – macro and micro level

4.3.1 FTT impact on the wider economy and the financial system – macro impacts of the FTT

Most academic literature and available impact studies suggest that the FTT will have a negative impact on GDP and growth especially in the countries in the FTT Zone and non-participating EU Member States. Higher costs of capital mean increased cost of funding for the real economy with likely negative knock on effects for GDP and growth. Darvas and Weizsäcker (2010) refer to this effect as "probably the most obvious and direct argument against transaction taxes". The EC has estimated in its impact assessment that the FTT introduction would result in an overall total decrease of EU GDP in the long term of between 0.5% and 1.76%. If introduction of the FTT led to less liquid and deep financial markets, this would affect the main function of financial markets - risk sharing and capital allocation. Shrinking financial market activity will therefore impair the allocation of capital to its most productive use, in effect stifling economic growth.

The impact of the FTT on cyclicality is not clear cut. On the one hand, market fragmentation, reduced volumes and decreased market liquidity and depth, combined with possible outflows of capital may all contribute to additional cyclicality. However, as the FTT inhibits price discovery, it might slow both the upswing of the asset cycle and also corrections towards fundamental value, in overall terms smoothing cycles.

The FTT is likely to affect interconnectedness as it contributes to redistributing risks and inhibits risk sharing.

In consequence, risks may build up in places where they are more difficult to manage. One of the businesses interviewed for this report pointed out that the FTT, particularly the cascading effect associated with the FTT, is affecting intra-company transactions and undermining the case for centralised risk management in multinational financial institutions. If risk management activities of financial institutions are decentralised in national subsidiaries rather than centralised on the group level, the advantages of offsetting exposures of different national subsidiaries and having centralised risk management expertise cannot be realised. Unlike many other taxes, e.g. UK corporation tax and VAT, there is no exemption for intra-group transactions, such as hedging arrangements.

The FTT will make transactions in financial instruments including instruments traded for hedging purposes more costly and therefore may impair risk sharing through financial markets – the allocation of risks to economic actors who are capable and willing to take them. In addition, without an exemption for collateral, the FTT could unwittingly encourage uncollateralised risk-taking by financial institutions.

The FTT may provide incentives for firms to move towards funding sources that are not subject to the FTT such as bank loans. This will, in effect, create increased demand for bank loans. The result could be an overall increase in leverage. However, at a time when micro and macro prudential regulators are seeking to reduce both bank leverage and leverage across the system, the outcome could also be an increase in the cost of corporate bank borrowing or an absolute constraint of supply.

The FTT is generally considered an ineffective instrument to enhance financial stability. Its impact on financial stability is likely to be negative and, at best, neutral. Evidence suggests that the FTT is not an effective policy tool to prevent bubbles or other risks to financial stability. Those risks are better addressed by other, more targeted, macro prudential policy instruments. The FTT may create risks to financial stability to the extent that it may increase volatility, create incentives for leverage and contribute to mispricing of assets or risk. Moreover, to the extent that the FTT interacts with other policy tools such as the monetary policy operating framework as discussed above, the FTT may give rise to new risks to financial stability.

Summary of macro impacts of the FTT

- *GDP and growth*: as with most other taxes, the FTT will have a "dampening effect on the economy", and the increased cost of capital will have a negative impact on growth.
- *Cyclicality*: the overall impact of the FTT on cyclicality is not clear cut.
- *Interconnectedness*: the FTT could redistribute risks and inhibit risk sharing.
- *Leverage:* the FTT could provide incentives for firms to more towards sources that are not subject to the FTT such as bank loans. Possible outcomes could be either an overall increase in leverage or an increase in the cost or a constraint in supply of corporate bank borrowing.
- *Financial Stability*: the FTT is generally considered an ineffective instrument to enhance financial stability. Its impact on financial stability is likely to be negative or, at best, neutral.

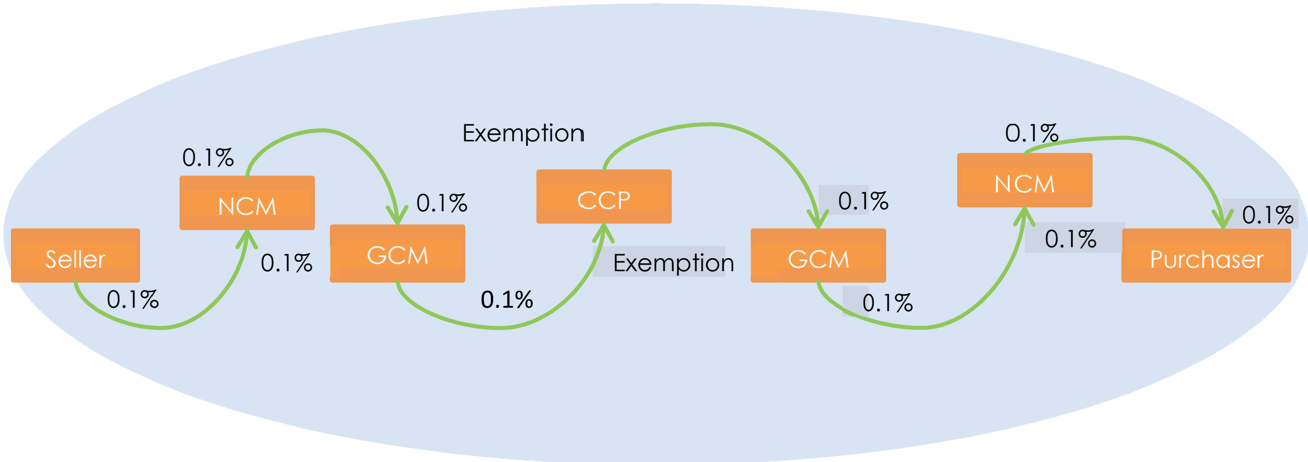
4.3.2 FTT impacts on financial markets - micro impacts of the FTT

In this section, we summarise the main impacts of the FTT on a micro level. There is a large amount of academic literature and impact studies available that assess the impacts of an FTT in various configurations. For the purpose of this report, we rely on leading studies such as the ones produced by Darvas and von Weizsacker (2010) for the European Parliament, Honohan and Yoder (2010) for the World Bank and Matheson (2011) for the IMF, to identify the emerging 'consensus view' of the empirical literature and to conclude on the most likely market impact of the FTT.

Many studies agree that introduction of the FTT will raise the costs of trading, in a similar way as widening bid-ask spread or an increase in exchange fees or brokerage commissions. This will apply across all financial instruments in scope of the FTT: equities, bonds, and derivatives. Higher costs of trading are likely to increase the average holding period of securities, as the FTT provides a disincentive for turnover in portfolios which could impact portfolio optimisation and diversification. They are also likely to have a significant impact on the profits of various lines of business.

As shown in Illustration 2, the cascading effect of the FTT, taxing multiple legs of a transaction, may magnify the rise in trading costs. In particular, there is no exemption for market making activities, resulting in multiple FTT charges on seemingly simple transactions, thereby increasing the effective FTT rate for the transactions. In the below typical broker-to-broker trade example, the trade involves securities being transferred by a broker to a clearing member of a settlement system to a CCP (which is itself exempt from the charge) to a clearing member of the settlement system of the buying broker. This could impose 10 FTT charges as each financial institution established, or deemed to be established, in the FTT Zone (apart from the CPP) is chargeable at a minimum of 0.1% on each leg of the transaction. There could be further charges if collateral is posted to reduce risk in relation to trades.

Illustration 2 – the cascading effect



- *NCM – Non-clearing member*
- *GCM – General-clearing member*
- *CCP – Central Counter Party*

Higher costs of trading are generally associated with lower asset prices and, in effect, a higher cost of equity. Asset prices will be lower as investors will bid the prices down as they need to pay more to buy or sell the asset. Oxera (2007) quantified the impact of the UK stamp duty reserve tax (SDRT) on the cost of capital to be in a range between 66 and 80 bps. The full cost of cascading would have to be reflected in the price paid by the investor lowering the expected return at that price. As confirmed in one of the interviews conducted for this study, financial institutions will try to pass on higher funding costs to their clients. The degree to which firms or their clients will bear the ultimate costs of the FTT will depend on how price-sensitive supply and demand are.

To the extent that the FTT costs cannot be passed on, some transactions will become unprofitable after the introduction of the tax. In consequence, trading volumes are likely to decrease. Academic studies have found that a 1% increase in the FTT will reduce trading volumes in equities by between 0.4% and 1.7%[9]. A Citibank research note quotes evidence that trading volumes in derivatives and cash trading in government bonds across markets could fall up to 75% and 15% respectively.

[9] See for instance, Jackson and O'Donnell (1985), Umlauf (1992), Baltagli et al. (2006) or Liu (2007). For an overview of studies see Matheson (2011), p. 17.

Decreasing trading volumes will normally lead to reduced market liquidity. Other FTT impacts such as the reduced availability of financial instruments for securities lending purposes will further decrease market liquidity and depth. Market liquidity is the ability to buy or sell an asset in a market without causing a significant movement in the price. The more players participate in a market, the less likely it is that a buy or sale will cause a movement in prices. Market liquidity is often measured by the spread between the bid and the offer price in a market. A more liquid market would have narrower spreads. There is currently a debate about just how much liquidity is required in a market and whether there may be 'excess' liquidity in a market. To the extent that FTT-induced reductions in liquidity would affect 'normal' market liquidity, there are likely to be negative consequences for the market outcome.

If the FTT reduces trading volumes and liquidity, it could also increase price volatility. Empirical evidence tends to support this argument, e.g. a study on UK SDRT which found that increases in transaction taxes lead to higher short-term price volatility.

The timely incorporation of new information into market prices is called "price discovery". With more market participants using one trading venue, information is incorporated into prices in a more timely way, the effect being that asset prices better reflect their fundamental value. If the FTT resulted in reduced trading volumes, this price discovery process could take longer as there would be less market price information if fewer trades are transacted through exchanges and clearing houses.

As there are participating and non-participating Member States, there will be market fragmentation with a split-priced market for instruments traded in venues inside and outside the FTT Zone. Some financial instruments will be subject to the FTT when traded in the FTT Zone but not when traded outside the FTT Zone. In such cases, market prices of financial instruments traded in venues within the FTT Zone will incorporate the tax while those traded in other venues will not. This will lead to different prices for the same financial instrument depending on where the instrument is traded.

Summary of micro impacts

- *Cost of trading*: the FTT is likely to increase cost of trading. This impact could be magnified by the cascade effect of the FTT taxing multiple legs of an overall transaction.
- *Asset prices*: the FTT is likely to reduce values of in-scope traded instruments, as investors reduce bid prices due to needing to pay the FTT charge, with the possible consequence of increasing costs of capital.
- *Market fragmentation*: there will be a split priced EU market between the FTT Zone and Member States outside the FTT Zone for certain financial instruments, thereby distorting competition within the EU.
- *Trading volumes*: evidence suggests that the FTT is likely to reduce trading volumes. This could result in asset prices not reflecting their fundamental value, as instruments are traded less frequently.
- *Market liquidity*: the reduction in trading volumes is likely to reduce liquidity and market depth, possibly widening spreads which could negatively impact the market.
- *Price volatility*: the higher costs of trading and lower market depth could lead to increases in price volatility.

- *Portfolio optimisation and diversification*: the FTT may provide disincentives for turnover in portfolios and might therefore lengthen holding periods.

4.4 Behavioural changes and tax incidence

4.4.1 Market impacts and behavioural changes

As with most other taxes, the FTT will have impacts on markets as it alters relative prices and incentives. There are potentially distortionary effects. As the World Bank has pointed out, the distorting effect of a transaction tax may be significant and the IMF argues that the FTT is more distortive than taxes on net income or value added.

In this context, it is likely that the FTT will have impacts on business models and lead to behavioural changes, e.g. the FTT will influence investor behaviour including saving, trading and risk-taking decisions. As acknowledged in the EC's impact assessment, increasing transaction costs as a result of the FTT introduction "might trigger some changes in business models and other market reactions".

Market participants may change their behaviours so that they are not trading in financial instruments, activities or counterparties that result in FTT charges. For example, the EC's impact assessment pointed out that the activity of repos "could easily be substituted by an economically rather similar non-taxed secured loan". However, there are other commercial factors to consider, for example repos are generally considered 'safer' from a purchaser's perspective as they take legal ownership of the collateral (often high quality securities), whereas with a secured loan the lender has to enforce the security.

The impact of the FTT on the repo market is likely to result in some repo agreements being replaced by more FTT efficient lending contracts. Although most repo transactions are usually relatively short-term (meaning that many existing repo agreements at the date the final FTT design is agreed would likely end before the FTT came into force), many repo agreements are routinely "rolled over" such that they are effectively in force for longer than the original term. Therefore, there could be a need for the financial sector and group treasury companies to renegotiate existing repo agreements on a market wide scale to be replaced by FTT-efficient lending agreement, which could be a significant operational risk in itself if there is a very short transition period between the finalisation of the FTT and its operational start date.

The increase in transaction cost leading to a reduction in market liquidity and a widening of spreads will, for instance, significantly affect trading strategies (across asset classes) that necessitate frequent trades, fundamentally changing business models. As pointed out before, the FTT will provide a disincentive for turnover in portfolios and is likely to lengthen holding periods. This will undermine certain business models, especially trading strategies based on high turnover with low profit margins. Corporate treasury activities that require frequent portfolio adjustments in money markets or foreign exchange derivatives may be particularly affected as well. The Alternative Investment Management Association (AIMA) has added that the FTT will also impose unintended investment incentives for asset managers, affecting practices such as diversification, hedging and efficient execution.

The impact on risk-taking incentives on the micro level of individuals and firms is not entirely clear. On the one hand, the FTT will have the effect of discouraging risk-taking "by imposing positive costs on both good and bad realisations". However, the FTT could also provide incentives for investment in 'riskier' assets as, for example, asset managers are forced to consider greater levels of risk to deliver the same level of return to investors. This could particularly affect portfolio performance for pension funds and more conservative fixed income portfolios.

Like capital and income taxes, transaction taxes lower the return on savings which – in effect – may lead to an incentive to save less. As there are no exemptions for pension funds, this applies to pensions as well. Lower rates of savings and higher cost of capital are likely to cause investment to fall as a result of the FTT. Evidence reviewed for this report further suggests that retail and institutional investors will be switching from funds to saving deposits and life insurance products that are not subject to the FTT.

The definition of a financial institution includes an entity of non-financial services groups where the entity breaches a "turnover" test based on the three preceding years (typically a group finance/treasury entity – see 3.4). Therefore, the financial institution status of a certain entity may not be known at the time of a financial transaction with a known financial institution. As each party to a financial transaction can be jointly and severally liable for its counterparty's FTT charge resulting from the financial transaction, it is likely that a party to a financial transaction would seek increased contractual protection from the counterparty in respect of any uncertainty regarding its financial institution status (i.e. the uncertainty that an FTT charge is due from the counterparty). The FTT could also encourage parties to deal directly with non-financial institutions in respect of certain transactions, thereby spreading financial risks outside of the financial sector.

Additionally, the types of financial transactions that are subject to the FTT is wider for intra-group transactions than for transactions between third parties as the definition of financial transactions includes "the transfer between entities of a group of the right to dispose of a financial instrument as owner and any equivalent operation implying the transfer of the risk associated with the financial instrument" (see 3.4). As a result, the FTT will not be consistent as it will tax more types of transactions between group companies than between third parties, thereby creating further disincentives for group entities to enter into commercial arrangements between themselves (e.g. hedging arrangements). The taxing of intra-group financial transactions could also add complexity and increase the cost of the proposed "ring-fencing" of UK banks' retail and investment operations.

4.4.2 Revenue estimates and tax incidence

The EC has estimated in its impact assessment that revenues from the FTT will amount to €34bn annually for the FTT Zone, with about €13bn stemming from the taxation of transactions in securities and about €21bn coming from the taxation of derivatives. We consider this a high estimate[10]. The base of the FTT is vulnerable to erosion over time due to market participants changing behaviours and international financial market integration. Already in its 2010 Communication, the EC acknowledged that "FTT appears less suitable for unilateral introduction at EU-level since the risks of relocation are high and would undermine the ability to generate revenue".

Any revenues collected from the FTT will be reduced by higher funding costs for governments of participating Member States. Although issuing government bonds will not be subject to the FTT, there will be higher costs of financing for sovereigns as the FTT will apply to secondary markets of sovereign debt, increasing the yield differential and therefore the price. As stated in the EC's impact assessment, the increase in transaction costs in the secondary market following the FTT implementation on government bonds trading may impact on the primary market by increasing the interest rates to be offered for newly issued public bonds, therefore implying an increased cost for public budgets. The EC has estimated that the increase in the cost of capital could be about 7bps. Applied to the amount of government bonds outstanding of Member States participating in the FTT, this could lead to an increase in the cost of debt of about €3.85bn. Other estimates are higher. Citibank estimate additional costs of about €10bn based on an increase in funding costs of 10bps which they describe as "an assumption that seems conservative". Financial services groups interviewed for this report expressed concerns that the FTT may undermine the financing ability of a number of sovereigns.

Tax incidence refers to the question of who bears the true economic burden of a tax. Businesses interviewed for this report confirmed that in the short-term, they would seek to pass on a proportion of the FTT charge to investors and/or clients. The question of what share of the tax will be borne by financial institutions and/or their clients depends on how price-sensitive supply and demand are.

The asset price of instruments subject to the FTT will fall by the present value of the expected future FTT liabilities at the time when the FTT is introduced. A large part of the FTT burden will therefore fall on owners of those securities at that point in time. In the longer run, market forces are likely to equalise after-tax return to capital in the taxed and untaxed capital market.

The question of who will bear the burden of the FTT in the long run will also depend on some "second round effects". If the FTT impact was to lower return on capital, the tax burden would be shared between capital and labour. If capital was to flow out of the FTT Zone and other jurisdictions impacted by the extraterritorial scope of the FTT, higher financing costs imposed by the FTT would fall more heavily on labour than on capital owners, i.e. a smaller capital stock reducing labour productivity and therefore decreasing wages which could result in reduced consumer spending.

[10] European Commission (2013b), p 24.

The burden of the FTT will disproportionately fall on sectors that are more active in financial market activities and trade more heavily in instruments subject to the FTT. Obviously, this includes the financial sector itself, but also pension funds, public corporations, businesses in international trade, and public entities. The cascade effect of the FTT (see Illustration 2 in 4.4.1) would impose multiple layers of tax on some transactions, so that even an apparently low-rate for the FTT could result in a high tax burden on some activities.

4.5 Extraterritorial impacts

4.5.1 The FTT design

The FTT in its current design has a far broader global reach than existing financial transaction taxes and equivalents, e.g. Belgian, Irish, Hong Kong and UK stamp taxes. As stated in section 3, the FTT applies where a financial institution:

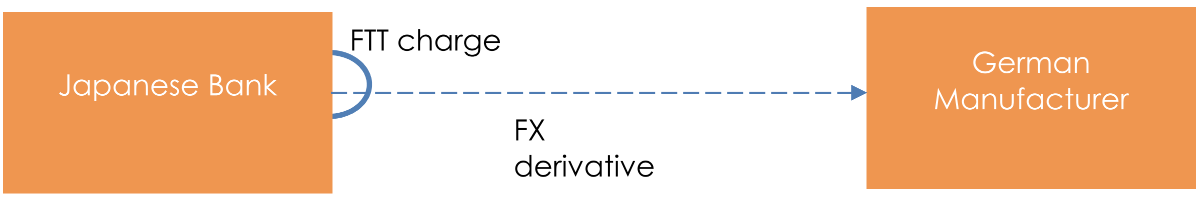
- undertakes a financial transaction (e.g. shares, bonds, derivatives, repo transactions) with another party; and
- either party is established in the FTT Zone, i.e. there is a link to the FTT Zone.

The rules to determine if a party is established, or deemed to be established, in the FTT Zone are very wide and are based on the residency and issuance principles. Each financial institution that is party to a chargeable financial transaction is liable to pay the FTT in respect of that transaction irrespective of whether it is incorporated in the FTT Zone.

4.5.2 Residency principle

- Authorised by the authorities of one of the FTT Zone Member States.
- Incorporated or resident in an FTT Zone Member State.
- Carrying out the transaction through a branch in an FTT Zone Member State.
- Party (as principal or agent) to a financial transaction with a financial institution or other entity which is established in an FTT Zone Member State (deemed established).

Illustration 3 – residence principle



The Japanese Bank is deemed to be established in Germany under the ***residence principle*** *and pays the FTT charge to the Germany authorities.*

A leaked document originating from the Legal Service of the Council of the European Union has called into question the legality of the FTT insofar as it might apply to parties outside the FTT Zone. The document takes the view that the imposition of the FTT on financial institutions deemed to be established in the FTT Zone by virtue only of the location of their counterparty would breach EU law.

The document specifically deals with Article 4(1)(f) of the proposed FTT Directive which deems a party not established in the FTT Zone and that transacts with a financial institution which is established in the FTT Zone, to also be established in that FTT Zone Member State. For example, as shown in Illustration 3, the Japanese bank is deemed to be established in the FTT Zone by virtue only of the location of the German Manufacturer counterparty under the residence principle.
The opinion is confined to the deemed establishment of non-FTT Zone financial institutions and does not comment on the legality of other aspects of the FTT Directive. It is however important to note that a non-paper from the EC Services from December 2013 has dismissed the opinion of the Legal Service of the Council of the European Union as "unfounded".

The document prepared by the Legal Service of the Council of the European Union offers the opinion that Article 4(1)(f) of the proposed FTT Directive:

- exceeds Member States' jurisdiction under international customary law;
- is discriminatory and likely to lead to a distortion of competition to the detriment of non-participating Member States; and
- is not compatible with Article 327 of the treaty of Functioning of the European Union which states "any enhanced cooperation shall respect the competencies, rights and obligations of those Member States which do not participate in it. Those Member States shall not impede its implementation by the participating Member States".

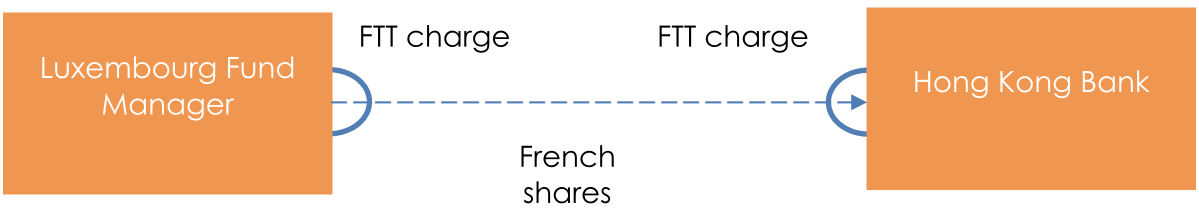
The UK's legal challenge against the use of the ECP to introduce the FTT is based on the third point.

The document does not declare the whole FTT project to be illegal, nor the use of ECP, as it confines itself to the extraterritoriality of Article 4(1)(f). For example, the document does not consider the legality of an FTT which only applies to financial institutions established in the FTT Zone or which applies to financial instruments issued in the FTT Zone (wherever the parties are located), similar to UK/Irish stamp taxes and the existing French and Italian financial transaction taxes.

4.5.3 Issuance principle

This brings transactions into scope of the FTT when the financial instrument subject to the financial transaction is issued in an FTT Zone Member State.

Illustration 4 – issuance principle



Both the Luxembourg fund manager and Hong Kong Bank are deemed to be established in France under the ***issuance principle,*** *even though neither is.*

4.5.4 Summary of extraterritorial impacts

The unprecedented reach resulting from the combined effect of the residence and issuance principles is likely to cause distortion of markets outside the FTT Zone. Evidence suggests that the FTT will lead to relocation of financial market activity, possibly on a large scale. The interviews undertaken for this report confirmed this view. The House of Lords report pointed out that the residence principle will not "overcome the significant risk of relocation to avoid the FTT". A likely outcome is that trading will move to banks that reside outside the FTT Zone. As the example above illustrates, the FTT would still apply if the underlying instrument is issued in the FTT Zone.

Therefore, it is likely that capital will flow out of countries that introduce the FTT. Non-financial corporations may restructure and reconsider the geographical location of their treasury companies and subsidiaries.

Implementing and enforcing issuer and residence principles will also give rise to practicality issues such as transaction reporting for tax purposes and data sharing.

To the extent that FTT affects markets outside the FTT Zone, conflicts with regulations from other jurisdictions could arise. For instance, if the FTT was to affect one or more legs in a cleared OTC derivative transaction, it could increase the costs of clearing in other jurisdictions in a similar way as it does in the EU under EMIR (see section 4.1.2.1). This could undermine the objectives of various OTC derivative market regulations around the world that try to provide incentives for or mandate the use of CCPs, e.g. the Dodd-Frank Act in the US.

Annex 1 – References

AIMA (2012), Financial Transaction Tax – An assessment of the European Commission's proposed Financial Transaction Tax.

Batagli, B., Li, D. and Li, Q. (2006), Transaction Tax and Stock Market Behavior: Evidence from an Emerging Market, *Empirical Economics*, 31, pp. 393-408.

Citi Research (2013), A European Financial Transaction Tax, Citi Research

Council of the European Union (2013), Opinion of the Legal Service on the Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax (FTT), Inter-institutional File 2013/0045 (CNS).

Deutsche Bank Research (2013), Financial Transaction Tax, Research Briefing, Global financial markets.

European Banking Federation (2012), Report on the Proposed FTT Directive
European Commission (2010), Taxation of the Financial Sector, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of Regions, SEC(2010)1166.

European Commission (2012), Shadow Banking Green Paper, COM(2012)102.
European Commission (2013a), Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013)71.

European Commission (2013b), Implementing enhanced cooperation in the area of financial transaction tax – Analysis of policy options and impacts, Impact Assessment, Accompanying the document Proposal for a Council Directive, COM(2013)71, 14.2.2013.

European Commission (2013c), New rules for Money Market Funds proposed – Frequently Asked Questions, http://europa.eu/rapid/press-release_MEMO-13-764_en.htm?locale=en

Darvas, Z. and von Weizsacker, J. (2010), Financial Transaction Tax: Small is Beautiful, Policy Report for the European Parliament Economic and Monetary Affairs Committee.

European Fund and Asset Management Association (xxxx), UCITS Industry: EFAMA's impact analysis of the Commission's proposal for a Council Directive on a common system of financial transaction tax.

Carnegie, H. and Stothard, C. (2013), France central bank chief says Robin Hood tax is 'enormous risk' , Financial Times, 28 October 2013 http://www.ft.com/cms/s/0/1c686796-3ee6-11e3-b665-00144feabdc0.html?siteedition=uk#axzz2j0askSnK

Honohan, P. and Yoder, S. (2010), Financial Transaction Tax – Panacea, Threat, or Damp Squib, The World Bank Development Research Group, Policy Research Paper, 5230.

International Securities Lending Association (2013), Impact of the Financial Transactions Tax on Europe's Securities Lending Market,
International Swaps and Derivatives Association (2013), Non-Cleared OTC Derivatives: Their Importance to the Global Economy, http://www2.isda.org/attachment/NTM2OA==/Non-Cleared%20OTC%20Derivatives%20Paper.pdf

International Monetary Fund (2010), A Fair and Substantial Contribution by the Financial Sector, Final Report for the G-20, June 2010.

Johnson, S. (2013), Financial transaction tax could 'wipe out' securities lending, Financial Times, 4 August 2013 http://www.ft.com/cms/s/0/faada0c0-f904-11e2-a6ef-00144feabdc0.html#axzz2iLOoyhMR

Liu, S. (2007), Securities Transaction Tax and Market Efficiency: Evidence from the Japanese Experience, *Journal of Financial Services Research*, , 32, pp. 161-76.

Matheson, T. (2011), Taxing Financial Transactions: Issues and Evidence, International Monetary Fund, Working Paper WP/11/54.

McCulloch, N. and Pacillo, G. (2011), The Tobin Tax: A Review of the Evidence, Institute of Development Studies, Research Report, Vol. 2011, No. 68.

Menkveld, A. (2011), Financial Transaction Tax, DSF Policy Brief, Duisenberg School of Finance.

Millar, A. (2012), A Financial Transactions Tax – Review of Impact Assessments, Report prepared for the International Regulatory Strategy Group, City of London.

Schulmeister, S. (2010), A General Financial Transaction Tax: A Short Cut of the Pros, the Cons and a Proposal, WIFO – Austrian Institute of Economic Research.

Schulmeister, S. (2011), Implementation of a General Financial Transactions Tax, http://stephan.schulmeister.wifo.ac.at/fileadmin/homepage_schulmeister/files/Implement_FTT_end_06_11_korr.pdf

Annex 2 – Terminology abbreviations

AIMA – The Alternative Investment Management Association

Basel III– a comprehensive set of reform measures, developed by the Basel Committee on Banking Supervision, to strengthen the regulation, supervision and risk management of the banking sector

bps – basis points

CCP – Central Counter Party

CDS – Credit Default Swap

CRDIV – Capital Requirements Directive IV

CRR – Capital Requirements Regulation

CSD – Central Securities Depositary

EBA – European Banking Authority

EC – European Commission

ECB – European Central Bank

ECP – Enhanced Cooperation Procedure

EFAMA – The European Fund and Asset Management Association

EMIR – European Market Infrastructure Regulation

ESMA - European Securities and Markets Authority

FAT – Financial Activities Tax

FSB – Financial Stability Board

FTT – Financial Transactions Tax

EU – European Union

G20 – The Group of Twenty

IMF – International Monetary Fund

ISLA – The International Securities Lending Association

MiFID II / MiFIR – Markets in Financial Instruments Directive II and Markets in Financial Instruments Regulation

MREL – Minimum amount of eligible liabilities for RRD

RRD – Recovery and Resolution Directive

OTC – Over-the-counter

Member States – Member States of the European Union

Shadow Banking – the system of credit intermediation that involves entities and activities outside the regular banking system

Solvency II – the new risk and solvency regime for (re)insurance firms

Short selling – Short selling is the sale of a security that the seller does not own, although the seller will subsequently need to buy the security in order to be able to deliver the security to the buyer.

Repo – Sale and repurchase agreement

UK SDRT – UK Stamp Duty Reserve Tax

UCITS – Undertakings for Collective Investment in Transferable Securities

Annex 3 – The Pittsburgh declaration and commitments with respect to "Strengthening the International Financial Regulatory System"

FSB Progress Report – We call on the FSB to report on progress to the G20 Finance Ministers and Central Bank Governors in advance of the next Leaders summit.
Global standards – We are committed to take action at the national and international level to raise standards together so that our national authorities implement global standards consistently in a way that ensures a level playing field and avoids fragmentation of markets, protectionism, and regulatory arbitrage.
Stress tests – We commit to conduct robust, transparent stress tests as needed.
Commodity markets – We have agreed to improve the regulation, functioning, and transparency of financial and commodity markets to address excessive commodity price volatility.
Capital and cyclicality - We call on our Finance Ministers and Central Bank Governors to reach agreement on an international framework of reform in the following critical areas: Building high quality capital and mitigating pro-cyclicality.
Capital and leverage – We commit to developing by end-2010 internationally agreed rules to improve both the quantity and quality of bank capital and to discourage excessive leverage.
Basel II implementation – All major G20 financial centers commit to have adopted the Basel II Capital Framework by 2011.
Remuneration – Reforming compensation practices to support financial stability. We fully endorse the implementation standards of the FSB aimed at aligning compensation with long-term value creation, not excessive risk-taking, including by … (i) avoiding multi-year guaranteed bonuses; (ii) requiring a significant portion of variable compensation to be deferred, tied to performance and subject to appropriate clawback and to be vested in the form of stock or stock-like instruments, as long as these create incentives aligned with long-term value creation and the time horizon of risk; (iii) ensuring that compensation for senior executives and other employees having a material impact on the firm's risk exposure align with performance and risk; (iv) making firms' compensation policies and structures transparent through disclosure requirements; (v) limiting variable compensation as a percentage of total net revenues when it is inconsistent with the maintenance of a sound capital base.
Compensation Committees – Ensuring that compensation committees overseeing compensation policies are able to act independently.
FSB standards – We task the FSB to monitor the implementation of FSB standards and propose additional measures as required by March 2010.
OTC Derivatives – Improving over-the-counter derivatives markets.
Cross-border resolution – Addressing cross-border resolutions and systemically

important financial institutions by end-2010.
Crisis management and cross-border firms – Our authorities should establish crisis management groups for the major cross-border firms and a legal framework for crisis intervention as well as improve information sharing in times of stress.
Resolution – We should develop resolution tools and frameworks for the effective resolution of financial groups to help mitigate the disruption of financial institution failures and reduce moral hazard in the future.
Global accounting standards – We call on our international accounting bodies to redouble their efforts to achieve a single set of high quality, global accounting standards within the context of their independent standard setting process, and complete their convergence project by June 2011.
Tax havens and money laundering – We are committed to maintain the momentum in dealing with tax havens, money laundering, proceeds of corruption, terrorist financing, and prudential standards.
Countermeasures against tax havens – We stand ready to use countermeasures against tax havens from March 2010.
FSB Peer Review – We call on the FSB to report progress to address NCJs with regards to international cooperation and information exchange in November 2009 and to initiate a peer review process by February 2010.
IMF Report on financial sector contribution – We task the IMF to prepare a report for our next meeting with regard to the range of options countries have adopted or are considering as to how the financial sector could make a fair and substantial contribution toward paying for any burdens associated with government interventions to repair the banking system.

Source: University of Toronto, http://www.g20.utoronto.ca/analysis/commitments-09-pittsburgh.html

Implications of a Financial Transaction Tax for the European Regulatory Reform Agenda

SPECIAL INTEREST PAPER CITY OF LONDON CORPORATION **JANUARY 2014**

www.cityoflondon.gov.uk/**economicresearch**

DOMINE DIRIGE NOS
CITY OF LONDON

Deloitte.