POSITION PAPER

ESBG Position on Financial Transaction Tax

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ESBG

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This paper briefly outlines ESBG's opinion re the introduction of a Financial Transaction Tax (FTT) in eleven EU Member States under the EU's Enhanced Cooperation mechanism.

The impact on financial activities essential to the functioning of financial markets and to the real economy could be extremely negative. We believe that:

- The issuance and secondary markets for sovereign bonds;
- The use of derivatives contract for hedging purposes;
- The use of repurchase agreements to provide secured liquidity to the market;
- Market-making activities;
- And the use of intra-group transactions for liquidity management and efficient capital allocation within a group will be impacted negatively by the proposed tax and we outline below the extended impact on the real economy that a reduction of these activities could have.

Our main concern with the current FTT proposal is that, in efficient fixed income markets, such as the markets for government and covered bonds, which are characterized by low spreads between bid and offer prices[1], the tax will be far higher than what can be earned on market making, especially on instruments with short remaining time to maturity. The consequence of the tax will be that market making will almost cease and the current liquid markets are likely to be transformed into buy and hold markets. As a result market liquidity will disappear or be significantly reduced.

This in turn will have a lot of negative consequences e.g.

- Higher funding costs especially for governments and issuers of covered bonds (i.e. in the currently most liquid markets)
- Reduced ability for banks and private sector actors to hedge financial risks and as a result higher volatility in earnings (i.e. higher risk levels both in banks and in the "real economy") which in turn will hamper the growth of the real economy
- The potential for developing market based measures to increase the supply of funds for long term investment will be significantly reduced
- There will be less financial instruments that fulfil the requirements for being included in banks liquidity reserves
- Accounting will be less transparent since it will be harder to determine fair values because trading will be less frequent and prices more volatile

These negative consequences will be most visible in the area of participating Member States but they will also be significant in the member states not participating, since market makers in these countries often trade in instruments and with counterparties from the FTT area in order to

[1] The spread between bid and offer prices are currently less than 0.01% on German or French government bonds with 1 year remaining maturity. The spread is in the range 0.03% on similar Italian or Spanish bonds and of similar magnitude for German Pfandbriefe. Adding at least 0.2% FTT will hence mean a significant additional cost for doing a transaction.

mitigate the risks associated with trades in their domestic instruments and counterparties. This is the case both for non-participating Euro and non-Euro member states.

In the longer run financial markets outside the FTT area are likely to adapt to the new circumstances and develop other risk mitigating measures which avoid trading with FTT counterparties and in FTT instruments. This development will reduce the negative impact of the tax outside the FTT area but at the same time it will increase the disintegration of financial markets within EU.

We do hence think that there are very strong reasons for the Commission and the eleven member states participating in the enhanced cooperation to reconsider the FTT initiative.

The Commission is supposedly intending to discourage transactions that do not improve the efficiency of financial markets, but by proposing a tax that will strike as broadly as possible, the tax will discourage all types of transactions, whether they might contribute to inefficiency and instability or not. Well-functioning fixed-income trading as a source of funding for states and a source of liquidity for squeezed banks, as mentioned above, provide examples of transactions that contribute to stability.

The proposed FTT excludes transactions on the primary market in order not to undermine the ability of the state and the corporate sector to obtain capital. What this proposal fails to consider is that a properly functioning secondary market is a crucial factor when an investor decides to buy securities in the primary market. If secondary markets were not important it is difficult to understand why companies would for example pay to list their shares on stock markets. As central governments in most countries are the issuers of the most heavily traded securities the impact on them and thus their borrowing costs in the form of higher interest will be more adversely impacted by a FTT on secondary market transactions than for example corporate bonds.

Including repos in the scope of the FTT would additionally drive financial institutions towards unsecured lending in order to maintain liquidity as the cost of repos with for example government securities as collateral would become too expensive. A less liquid market is highly undesirable for authorities as is a move towards unsecured funding for the provision of liquidity.

The proposed tax rate is to be charged to both buyer and seller. A large volume of transactions today are traded via agents which means that the cumulative taxation on a government bond transaction could be closer to 0.6% rather than the advertised 0.1% The cascading effect of this taxation will mean that financial instruments with tight spreads will no longer trade at a profit potentially ending trade in these instruments. It will additionally counteract the goal of EMIR (European Market Infrastructure Regulation 648/2012) of moving towards greater use of intermediation for OTC derivatives.

The flat rate of taxation on all transactions will proportionally inflict a greater cost on instruments that are less risky, for example government bonds and repo transactions, as they trade at a comparatively lower spread. The flat rate structure irrespective of maturity means that it will additionally have a disproportionately high impact on the short term markets including market making activities. This will reduce the availability of liquid assets and thereby cause an increase in the cost of holding liquidity reserves for financial institutions. It is not unlikely that in the end the only place a bank in the FTT area could hold its liquidity reserve is as deposits in ECB.

Although the Commission as a motive for the FTT expresses concern for financial stability, the effects of a transaction tax are substantially at odds with the on-going regulatory work in the financial sector. The emphasis in this work is put in particular on the importance of banks having liquidity buffers in the form of assets which can be rapidly and securely sold if the bank is facing a liquidity strain, including government securities. This assumes that there are deep and liquid markets where these assets can be sold when needed. By impairing the liquidity in the fixed-

income markets, a transaction tax undermines the on-going work on strengthening financial stability through better designed liquidity rules for banks.

We have historically seen examples where an FTT has been implemented and had an immediate detrimental effect on the market

In 1984 Sweden introduced a 0.5% tax on the purchase or sale of an equity security doubling the rate in July 1986. Share prices fell by 2.2% on the day that the tax was announced and when the tax was doubled, prices fell by another 1%.

A considerably lower tax of 0.002% on fixed-income securities was introduced in 1989 for a security with a maturity of 90 days or less. On a bond with a maturity of five years or more, the tax was 0.003%.

Even though the tax on fixed-income securities was considerably lower than that on equities, the impact on market trading was greater. During the first week of the tax, the volume of bond trading fell by 85% even though the tax rate on five-year bonds was only 0.003%. The volume of futures trading fell by 98% and the options trading market almost disappeared. The taxes were eliminated in the beginning of the 1990s and subsequent to the elimination trading volumes returned and increased substantially.

The overall impact on liquidity in the market must be considered in light of historical experiences. The impact on for example providing funding for long-term investment will be negatively impacted by limitations on liquidity. This in turn could have a severe impact on the real economy.

The introduction of the FTT in only eleven member countries under the enhanced cooperation mechanism appears to enforce rather than eliminate tax competition as member states outside of the taxation zone will be subject to a different tax regime to those within the FTT zone. All member states will be affected by the FTT regime due to the proposed scope but to different degrees and ESBG is concerned that disharmonisation seems to be guaranteed.

The tax is also likely to create a disparate demand for government bonds as for example the German Bund will be captured by the issuance principle but Treasury-Bills and UK Gilts are not if they are traded by EU Member States which are not part of the Enhanced Cooperation mechanism. It is not at all unlikely that the participating Member States' borrowing costs will increase with an amount several times greater than the revenue that a transaction tax of this kind would generate due to the reduction of liquidity in the market for these bonds.

Additionally, the proposal to include intra-company transactions in the taxation regime will reduce financial institution's capability to manage their business and ensure efficient risk management. The inclusion will place an unfair competitive disadvantage on decentralised credit institutions e.g. savings-banks associations as compared to larger "all-in-one" institutions, because of their structure. In decentralised groups, the primary customer-facing institutions will have to pay the FTT on each transaction with their central institution. Therefore, in our view, it cannot be the political result of the "too-big-to fail discussion" to tax decentralised groups more extensively than centralised institutions.

The residence and issuance principle will place a great administrative burden on institutions that are not resident in either of the eleven member states as the issuance and residence principle means that they will be required to pay the tax even if they are trading with a counterparty outside the enhanced cooperation area in a security issued by one of the eleven member states. It is currently unclear how the collection mechanism for the payment of this tax will be designed and also who will carry the cost of collecting the tax in nations outside the eleven member states introducing the FTT. Investors in fixed income instruments will not be interested in trading if spreads are increased to the levels needed to cover the tax.

As a final point of concern we would like to bring your attention to the proposed start date in 2014. We do not believe that it is possible to introduce the FTT by 2014 considering that there is a lack of clarity regarding collection methods etc. We propose that it will not be possible to introduce the FTT as institutions will require at least 18 to 24 months in order for all institutions impacted to prepare system and personnel for the additional requirements related to the implementation of the tax.

About ESBG (European Savings Banks Group)

ESBG – The European Voice of Savings and Retail Banking

ESBG (European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising of approximately one-third of the retail banking market in Europe, with total assets of over €7,470 billion, non-bank deposits of €3,400 billion and non-bank loans of €4,000 billion (31 December 2010). It represents the interests of its members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

ESBG members are typically savings and retail banks or associations thereof. They are often organised in decentralised networks and offer their services throughout their region. ESBG member banks have reinvested responsibly in their region for many decades and are a distinct benchmark for corporate social responsibility activities throughout Europe and the world.

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