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EUROPEANISSUERS' POSITION ON THE PROPOSAL FOR A COUNCIL DIRECTIVE IMPLEMENTING ENHANCED COOPERATION IN THE AREA OF FINANCIAL TRANSACTION TAX (FTT)

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SUMMARY

EuropeanIssuers strongly opposes the draft Directive proposing the introduction of a Financial Transaction Tax (FTT) in a part of the Eurozone and is very concerned about the potentially damaging impact that the FTT could have on the ability of companies to raise finance from the markets and hedge their risk exposures, and thus eventually the impact on the real economy.

After thorough analysis, EuropeanIssuers considers that:

1. **The FTT will directly and deeply affect non-financial companies;**
2. **The FTT will greatly hinder the ability of non-financial companies to raise finance from the markets and hedge their risk exposures…**
   - by affecting corporate access to finance;
   - by affecting savings;
   - by cascade effects in market trading and derivative transactions;
   - by deteriorating risk mitigating activities;
   - by unduly taxing intra-group transactions;
   - by affecting treasury / liquidity management;
   - by impacting market making activities and decreasing liquidity on markets.
3. **The FTT will reduce economic activity…**
   - by decreasing GDP growth;
   - by restricting capital's circulation;
   - by increasing the risk of competitive distortion;
   - by decreasing market efficiency;
   - by leading to the cession or relocation of certain activities.
4. **The FTT will not fulfil its intended objectives;**
5. **The FTT would have a negative impact on economic growth and jobs.**

ANALYSIS OF PROBLEMS

1. The FTT will directly and deeply affect non-financial companies

As documented in literature and experienced in practice, transaction costs are always passed on to the end users or investors (non-financial companies and savers), including a quite large number of small and medium-sized savers.

Ultimately, and due to the high elasticity of the tax base on this particular tax, the costs of the FTT would be borne by individuals, and businesses seeking funding and hedging, multiplying the costs to end-users (such as companies raising capital), instead of financial institutions, as there is no way to avoid the latter simply passing on the cost of the FTT to the final customers.

This is recognized by the International Monetary Fund, which therefore rejects the introduction of a FTT ("Its real burden may fall largely on final consumers rather than, as often seems to be supposed, earnings in the financial sector"), and, also, by the European Commission in its impact study from 2011 ("A large part of the burden would fall on direct and indirect owners of traded financial instruments.").

It must be added that the FTT would have an unprecedented cascading effect, applying separately to each element of a transaction and also separately to all material modifications of a contract, *e.g.* derivative contract modifications.

The impacts of this accumulation of costs would be felt by corporates on different levels: increased cost of funding and tightened credit conditions; increased cost of hedging, direct liability for a large number of corporates that typically achieve efficiencies and reduce their risks by centralised treasury operations and intra-group transactions.

Including these transactions in the scope of the FTT would be uneconomic, would increase the cost of meeting pension obligations to current and former employees in the framework of institutions for occupational retirement pensions (IORPs), etc…

Also, the FTT would undermine the attractiveness of the taxation area, adding disincentives to investors that will not look at companies established in the participating Member States.

Therefore, the FTT would have considerable direct effects on non-financial companies, affecting these companies, which are already in great difficulty in the current economic and financial context, in their financing, and especially long term financing.

2. The FTT will greatly hinder the ability of non-financial companies to raise finance from the markets and hedge their risk exposures…

The introduction of the FTT would involve much worse conditions for companies and individuals to access finance and further hamper the creation of liquidity in Europe's real economy as a variety of instruments used by the real economy would be negatively affected.

… by affecting corporate access to finance

Companies issue securities - equity or debt securities - that would be subject to the tax for transactions on secondary markets, although these securities generally are long-term financing instruments. While companies should make greater use of markets for their financing, this would have many negative effects, in particular as regards their financing costs and the need to finance long-term investment:

- discourage investors (even on primary markets), including:
  - some foreign investors, who seek to buy and sell securities under the best possible conditions, even when considering long-term investments;
  - retail investors, who should on the contrary be encouraged to invest in corporate securities;
  - asset managers, who could reduce their investments in the taxation area or their links with it, or relocate activities (funds, management mandates, financial management), especially for activities invested in short term assets or actively managed.
- reduce the liquidity of the securities issued in the taxation area and their prices, as investors would expect a higher return to compensate for the effects of the tax and the reduction of liquidity, notably if liquidity is supported by a market maker (lower volumes, higher cost of liquidity contracts);
- affect the management of corporate debt (bond buybacks) and share buybacks (for a reduction of the capital, the allocation of shares...).

… by affecting savings

The FTT would negatively affect corporate pension schemes, both by the taxing of securities transactions (such as the selling and buying of shares and bonds) and derivative transactions which are used by pension providers for risk-mitigating purposes.

In addition, pension schemes would be directly liable to pay the tax.

Therefore, the effect of taxing transactions undertaken by pension providers, together with the effect of taxing intermediate transactions, would be to affect the sponsoring companies and to reduce the yields and returns of pension products — this is not in the interests of people saving for their retirement.

… by cascade effects in market trading and derivative transactions

Cascade effects happen as one financial transaction often triggers additional transactions and thus more tax events; the burden of these cascade effects, which are ultimately borne by the end user as well, will exacerbate the costs of the FTT for the real economy.

Cascade effects would also have an impact regarding the use of derivatives: banks minimize the risk related to the derivative concluded with a non-financial end user by entering into other derivative contracts with other financial institutions. These derivative transactions, which are also taxable, would significantly increase the cost for end users.

… by deteriorating risk mitigating activities

According to the Proposal, the impact of the FTT on derivatives trading volumes is likely to be significant and derivatives to mitigate risks referring to exchange rate, commodity price or interest rate fluctuations would become significantly more costly or not be available anymore. Taxation would be all the higher in that non-financial companies often enter into derivative contracts to rollover their positions, with the objective of hedging their risks throughout the duration of their operations.

Access from non-financial companies to these risk-mitigating instruments will be more costly, difficult and, to a certain extent, even impossible.

… by unduly taxing intra-group transactions

As regards groups (non-financial and financial), the tax would be all the higher in that intra-group transactions, while economically inseparable, would not benefit from any exemption, regardless of the nature of these groups. The introduction of the tax would greatly reduce the necessary flow of liquidity within groups and could result in not returning to the taxation area the cash generated outside.

In non-financial groups, it is common that issuances, treasury operations and / or hedging transactions are performed by a dedicated company, which interacts with all industrial and commercial companies within the group. According to the proposed Directive, such an undertaking would generally be regarded as a financial institution and therefore be liable for the tax in respect of each financial transaction with any company of the group.

… by affecting treasury / liquidity management

The return from treasury management / liquidity management, which is sometimes practiced over a very short-term horizon, could be seriously affected, and the tax could even make this management ineffective, for non-financial and financial companies alike. This would impair the smooth flow of liquidity and significantly reduce the short-term financing of companies (commercial paper):

- the return on short-term investments that would be taxed would be reduced by at least 10 bps for each transaction, which, on an annual basis, would reduce or eliminate the interest of such investments The introduction of the tax would probably bring to a complete halt the money market, causing large reductions in the outstanding amounts of money market funds;
- the falling return would be all the stronger in that these investments are made in the short term. Financial institutions would be particularly affected by the 0,10% taxation of overnight securities repurchase transactions ("repos"), which are in fact overnight loans secured by securities: their performance would be so affected that the repo market would not survive the introduction of the tax (the market for repos in the 11 Member States was around €3.2 trillion in 2012).

Thus, it will be necessary to use other equivalent transactions, likely to have higher costs than the (current) repo transactions, increasing the costs of transferring funds from savers to investors, costs that will fall on companies in the form of higher costs of funding (including bank lending, which is not directly taxed).

… by impacting market making activities and decreasing liquidity on markets

Available academic literature shows that market makers tend to increase liquidity and reduce market transaction costs, through the lowering of spreads and rise in volumes.

The Proposal, which does not include an exemption for market making activities, would reduce market making and, by taxing secondary market transactions in government and corporate debt, would in both cases reduce liquidity and increase the financing costs facing companies, and eventually disincentive the presence of end-investors and companies on markets.

In the case of taxing of government debt trading, the FTT would be borne by end-users (investors and the government), not traders, given cause to higher government funding costs with potential serious negative consequences for the wider economy.

3. The FTT will reduce economic activity…

… by decreasing GDP growth

The European Commission conducted a first analysis on the impact of its proposal (for EU-27), which originally identified a potential annual reduction of GDP by 0.53% in the long run (and it was later reviewed, identifying a potential annual reduction of GDP by 0.28% in the long run (however, as shown in the Oxera study of June 2012, by assuming that the FTT will not have an impact on a number of sources of financing the Commission underestimates the impact of the FTT on GDP).

Thereby, even based on the Commission's own assumptions, the FTT remains an inefficient way to raise public funds. But by deepening the original analysis and considering a number of assumptions generally recognised as more realistic, Oxera, at the request of the EC, estimated a ratio of GDP loss for overall tax revenue gain of 10:1.

Also, in real terms, and still according to the Oxera study concerning the FTT impact on the transaction cost on shares, it is evident that a tax rate of 0.1% represents, on average, the duplication of the transaction cost for the investor, calculated end to end.

And another study, by Clifford Chance, shows that a "gross basis" model of application of the FTT would lead to a "cascade effect" which would massively increase the impact of the tax (the said tax rate of 0.1% could easily reach 1%). Furthermore, most transactions would be subject to taxation in respect of the purchase and the sale, thus doubling the minimum tax rates, to 0.02 % for derivatives and 0.2% for other financial instruments.

These factors, added together, allow one to foresee, as very likely, a reduction in the economic activity, possibly a significant one as well as a GDP drop which will hardly be offset by the revenue to be raised by the FTT.

… by restricting capital's circulation

Another negative impact of the FTT arises from the relation between transaction costs, market liquidity and business cycles, with several studies showing that an increase in transaction costs does have an impact on macro-economic variables, among which the GDP growth.

The FTT will be primarily liable to significantly restrict the circulation of capital, a wealth-generating factor and, as such, significantly harm the possibility of job creation.

And, since it represents increased costs on financial transactions, the measure may discourage the creation of savings or its channelling to capital market investments therefore aggravating the current situation of companies' dependence on bank financing.

… by increasing the risk of competitive distortion

Given the above, it is clear that the negative aspects of the introduction of this tax could only be mitigated if it was to be implemented globally or at least in Europe and the United States of America.

Introducing this tax in certain countries only would cause market distortions with extremely negative consequences in the competitiveness of countries which may come to introduce it in advance.

In effect, taking into account the present facility in carrying out cross-border financial transactions, we can easily foresee a geographical relocation of certain transactions of the participating Member States to non-participating jurisdictions.

This is a lesson that some governments have already learnt. Sweden saw around 50% of the volume of share transactions diverted when they introduced the FTT in 1994. In 1989, when the tax was extended to bonds, the volume fell by around 85%. The tax was abolished in 1991. In 1999, Japan also abandoned its failed experiment with the FTT.

Thus, the fact that a uniform introduction of this tax is not assured, fosters the creation of different models in their legal configuration, which may, from the point of view of the internal market, create competitive distortion.

… by decreasing market efficiency

The introduction of the FTT would represent an increase in transaction costs and thus would likely decrease the efficiency of the markets: the prices of transactions over assets would become less representative of the information they incorporate; trading volumes would decrease (at least in the area where the proposed tax is effective); the number of intermediaries participating in the transactions may also decrease and, as a consequence, market liquidity would be reduced.

As a result, companies' financing and hedging costs would increase and the return on investments would be reduced mainly for the final consumers.

… by leading to the cession or relocation of certain activities

In this context, the introduction of the FTT in a restrict number of countries would have significant consequences in terms of relocation of transactions and tax arbitrage with additional impacts on the economic activity of the participating countries as well as other negative impacts which must be assessed.

The FTT results as an "invitation" to investors and companies to abandon these markets which is particularly critical if we consider the vocation of the capital market to play the role of alternative market to bank financing.

The intended extraterritorial effects of the draft Directive, by applying the principles of issuance and residence to transactions carried out by financial intermediaries outside the taxation area, do not seem to solve the problem explained above and, further than that, the enforcement capacity of the EU on those effects is extremely limited even in terms of the European geography.

Ultimately, the introduction of the FTT only in some EU countries would add to the fragmentation of the internal market for financial services, one of EU's major strategies for growth and consolidation, implying a setback hardly recoverable in the future years.

4. The FTT will not fulfil the intended objectives

According to European officials, the rationale for the implementation of the FTT lies on a triple objective:

- First, *to ensure that the financial sector would bear part of the burden of the current financial crisis and raise tax revenues*

This would not happen.

As explained, ultimately, the costs of the FTT would be borne by individuals and businesses seeking funding and hedging.

Therefore, in the end, it would not be the financial sector to bear the burden of the current financial crisis, but essentially companies and businesses.

- Second, *to discourage the excessive risk taking behaviours in the financial sector mitigating systemic risk*

Indeed, one other said reason for the introduction of the FTT is its possible correction effect of market failures by allowing the placement of a "price" on negative externalities.

But, as a matter of fact, there is no evidence that the FTT can prove to be efficient in correcting these failures as no proven correlation between the FTT, the correction of market failures and the reduction of systemic risk has been found.

Indeed, the experiment already carried out in other European countries, regarding the taxation on financial transactions in stock markets has not proved able to deter the excessive risk-taking behaviours in the financial markets and the existing empirical evidence does not suggest that the introduction of the FTT would significantly reduce neither the market volatility nor the speculative “bubbles” around certain assets.

On the other hand, the efficiency of the FTT is likewise uncertain concerning the control of systemic risk: even if the measure was to be taken by all the EU countries (which up to date is far from being a reality, an aspect which is assumed to be determinant) several authors point out the fact that, even so, the introduction of the FTT is likely to create distortions because financial flows would further concentrate in markets where the regulations are less demanding thus creating bigger uncertainty over the control of systemic risk.

- Third, *to alleviate the Member States’ contributions to the European Union’s budget*

Again, one of the main assumptions for the introduction of the FTT is efficient tax revenue collection.

However, it is not clear how this would be possible, since according to the EC’s own conclusions regarding the revenues that may be collected and the potential costs incurred for the purpose, the FTT would not only lead to a lower economic activity but could also reveal itself highly inefficient in the collection of public funds.

And, using more realistic assumptions, the Oxera study states that, to raise 1% of FTT tax revenue, the European economy is estimated to sacrifice 2% of annual GDP and the ratio of GDP loss for tax revenue gain can be as high as 10:1.

Therefore, there is an evident risk that the introduction of FTT would cause a reduction of global tax revenues instead of a gain of additional tax revenues.

5. The FTT would have a negative impact on economic growth and jobs

The Commission’s own analysis suggests that in order to raise €1 of FTT revenue, the European economy could be expected to sacrifice €2 of economic output (GDP).

At the level of the 11 participating Member States, such a reduction in the level of economic activity would reduce government tax revenue from other sources, offsetting revenues collected by the FTT.

A more recent study by Oxera (2013), adjusting the modelling results to reflect more realistic scenarios, shows that the negative economic impact could be greater and there is a risk that the imposition of the FTT actually reduces total tax revenues from the economy.

CONCLUSIONS

We are strongly opposed to the draft Directive proposing the introduction of a Financial Transaction Tax (FTT) in a part of the Eurozone.

The introduction of an FTT would severely burden the real economy and retail investors, and would deeply affect non-financial players, with considerable direct and indirect effects on non-financial companies, which are already in great difficulty in the current economic and financial context, and would be contrary to the objectives pursued at European level.

In fact, the FTT, if implemented, would bring forth potentially unintended consequences on the real economy, financial stability, and the cost of borrowing, in particular in countries with a weaker economic and financial situation, which would suffer negative effects on economic growth and unemployment reduction.

Furthermore, while Europe needs to attract capital and investments and strengthen its competitiveness, the FTT would undermine the attractiveness of the taxation area and place its non-financial and financial players at a competitive disadvantage vis-à-vis other players.

It is estimated that, in the short term, the impact of the FTT would fall mostly on the current issuers and holders of financial instruments, as well as on users of derivatives, and ultimately it would be borne by the end consumers of these instruments. There may be questionable effects on economic growth and the risks of capital flight may come to exceed any raised tax revenues.

In this regard, one must add the strong likelihood that financial intermediaries, asset managers and operators responsible for much of the market's liquidity would relocate their activities/investments to other areas where there is no such taxation, the reduction in activity and corresponding results of several participants in the financial and capital markets (*e.g.* investors, intermediaries, brokers, financial institutions) and, last but not least, the potential relocation of holdings, companies and other activities to countries outside the Enhanced Cooperation Mechanism (e.g. United Kingdom, Netherlands, Luxembourg, Belgium).

EuropeanIssuers is willing to discuss with the European Institutions and the affected countries the details of the FTT: we believe that we may be able to contribute technical proposals, elements and additional suggestions, in particular, in the context of the ongoing discussions on the scope of the Enhanced Cooperation Mechanism.

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We aim to ensure that EU policy creates an environment in which companies can raise capital through the public markets and can deliver growth over the longer-term. We seek capital markets that serve the interests of their end users, including issuers.

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