European Union Financial Transaction Tax Webinar

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Overview

1. Overview of European Transaction Taxes
2. Scope of the EU FTT Proposal
3. Key Issues
4. Implications
5. Current actions by Citi
6. Status of the proposal negotiations

Q&A
Overview of European Transaction Taxes

Timeline:

- 1 January 2013: Hungarian FTT on payments effective
- 1 August 2012: French FTT effective
- 14 February 2013: EU FTT Proposal Adopted
- 1 September 2013: Italian FTT on Derivatives Comes into Force
- 1 January 2014: Hungarian FTT on Securities Transactions Comes into Force
- 1 January 2013: Ukrainian FTT effective
- 1 March 2013: Italian FTT on Equities and HFT effective
Scope of EU FTT Proposal

Eleven participating member states.
Scope of EU FTT Proposal – Key Features

- EU FTT applies to Financial Transactions to which a Financial Institution is a party, as principle, if at least one party is established in the EU FTT area
  - ‘Financial Transaction’ covers all securities transactions and all derivatives
  - FTT applies to each Financial Institution with joint and several liability
  - ‘Established’ also includes an issuance principle – ie EC area issued = taxable security
  - Applied before netting and settlement
  - Rate of 0.1% for financial instruments, 0.01% of notional for derivatives

- Financial Institution is very widely defined – including inter alia
  - Credit institutions, regulated markets/trading venues, investment firms
  - Insurers and reinsurers
  - UCITS, AIF, Funds, Pension funds and their managers
  - Leasing companies
  - SPV issuers and acquisition vehicles
  - And any entity where more than half of turnover is from financial activities, therefore likely to include most treasury entities for corporates

- Payment requirements
  - Payment required same day for electronic transactions, within three days otherwise
  - Joint and several liability for each Financial Institution party to the transaction
  - Entities not party to the transaction can be made jointly and severally liable for collection
Scope of EU FTT Proposal – Exemptions

- Exemptions (transactions)
  - New issuance
  - Spot FX transactions
  - Loans
  - Transactions with the ECB and Member State central banks
  - Transactions with certain EU and supranational bodies
  - One leg of repo/stock lending transactions

- Exemptions (entities)
  - CCPs, CSDs and ICSDs
  - Member States and public bodies managing the debt of member states (counterparties remain liable)
Key Issues – All markets! All instruments! All actors!

If implemented in anything like the proposed form, the EU Commission’s FTT would have much broader impact on liquidity and activity across financial markets than existing regimes in the UK, France and Italy.

- Cascading – effective tax rate far higher than headline figures suggest
  - Tax applied to both the buyer and seller
  - At the time of trade (not settlement) and no netting
  - No exemption of financial intermediaries

- Extraterritoriality – impacts jurisdictions outside the FTT zone itself

- Repo markets are captured
  - Vast majority of repo transactions would become uneconomical
  - Pivotal not just to interbank funding, but also to liquidity in many asset classes
  - Alternatives (secured lending) are far from perfect substitutes

- Disproportionate impact on short-dated, low-beta securities (fixed income > equities)
  - The Commission estimates trading volumes in derivatives and cash across markets will fall 75% and 15%, respectively
  - Cost of a flat rate tax is harder to recover if the price doesn’t move much
  - Primary dealer model in government debt markets would become uneconomical
  - Much of the existing corporate credit market would trade by appointment only

- At least 65% of the European securities lending market would disappear
Key Issues – Two Types of Cascade Effects

- **Horizontal cascading** effect from FTT on trading, market making and client hedging activities

- **Vertical Cascading** effect from FTT on trading level to clearing and settlement level
  - Post trade actors may also be held jointly and severally liable for the collection and payment even when not party to a transaction

- Same transaction hit by subsequent and unjustified multiple layers of taxation
Key Issues – Discourages Central Clearing

- Cascade effects through additional intermediaries (Broker/Clearing Member (CM))
- Tax exemption for CSD, ICSD and CCP (but not financial institutions dealing with the CCP)
- Cash collateral vs. security collateral. Frequent exchange of collateral (taxable transaction?)

Conclusion of an OTC derivative without CCP

Settlement chain by intervention of CCP
Key Issues – Extraterritoriality

While FIs in the FTT zone will be subject to FTT it will apply to financial institutions who simply transact with any counterparty in the FTT zone (not just with FIs).

- **Liability under the residence principle**
  - A financial institution will be deemed to be established in a participating Member State if any of the following conditions is fulfilled, in descending order:
    - It is authorised by that Member State
    - It is authorised to operate from abroad in the territory of that Member State
    - It has its registered seat within that Member State
    - Its permanent address or usual residence is located in that Member State
    - It has a branch within that Member State (where the branch is carrying out the transaction)
    - Its counterparty is established in that Member State
    - It is a party to a financial transaction in a financial instrument issued within the territory of that Member State

- A non-financial institution is be deemed to be established in a participating Member State if:
  - Its registered seat, permanent address or usual residence is located in that Member State
  - It has a branch in that Member State (in respect of transactions carried out by the branch)
  - It is a party to a financial transaction in financial instruments issued within the territory of that Member State
  - A financial institution will not be considered established if the person liable for payment of FTT proves that there is no link between the economic substance of the transaction and the territory of any participating Member State
Key Issues – Extraterritoriality (Cont’d)

**Liability Under the Issuance Principle**

- **No FTT as**
  - No FI party ‘resident’ in EU
  - No instrument ‘issued’ in the EU

- **FTT arises if instrument issued in a participating EU Member State**
Key Issues – Impact on Repos

- Secured lending likely to be more attractive
- The proposal would have an enormous impact on repo markets, where overnight rolling costs would amount to no less than 22% annually
Key Issues – Impact on Securities lending

- ISLA (International Securities Lending Association) has outlined some of the key effects that FTT could have on the market¹
  - At least 65% of the European securities lending market would disappear as a result of FTT
  - Over €2 billion of revenues would be lost to long-term investors
  - Approaching €500 billion of Euro Government Bonds would be removed from lending/collateral markets
  - Shorter dated transactions would be disproportionately impacted, increasing the risk of settlement fails by possibly as much as 100%
  - Securities lending fee levels would need to increase by over 400% just to maintain current revenue streams for long-term investors
  - Equity and bond markets will see reduced liquidity and wider bid-offer spreads for all participants

Implications

Investors/Asset Managers

• FTT charges arise at both investment portfolio level and trading of fund units
  – Transactions undertaken at the investment portfolio level
  – Sale, purchase or redemption of fund interests (but not initial issuance) when fund or management company located within the FTT zone; when fund located outside of the FTT zone where investors, distributors or brokers located within the FTT zone are involved in the distribution chain

• Increase transaction costs and risks

• Negative impact on investment performance
  – “European Fund Managers could contribute circa €17 billion in FTT annually ... investors could face annual tax of 17–23 bps on equity and bond portfolios”

• Distortion of competition
  – “Although impacts all asset managers, structure of the tax asymmetrically disadvantages asset managers based in the FTT area”
Implications (Cont’d)

Banks

- Knock on effects from reduced credit availability, increased pricing (credit quality), reduced ability to hedge risks, disruption of funding markets
- French, German and UK banks would experience the greatest impact on profitability
- If implemented major restructure of funding and business models would likely be necessary. Discontinuation of business lines.
- Relocation? Legal structure? Trading through subsidiaries?

Infrastructures

- Material volume declines are a stated policy objectives. Impact on volumes estimated by Goldman Sachs as circa 22%. Derivative exchanges would likely experience a far greater impact
- Exchanges and CCPs trading and clearing EU instruments or with EU membership base will be disadvantaged
- Exchanges, CCP, ICSD, CSD could be made collection points and held jointly and severally liable
- FTT discourages central clearing. Increase in margin costs, will securities collateral cease?
Implications – At Odds with General Trends in Financial Regulation

The proposed FTT runs counter to recent regulatory initiatives in a number of respects.

- Increases reliance on unsecured funding (and the ECB)
- Discourages intermediation
- Discourages hedging
- Discourages central clearing
- Reduces liquidity
- Encourages a shift in activity to derivatives in some markets
- A collateral problem? Regulatory push to mandatory clearing of derivatives will necessitate big collateral transfers – repo markets are the most natural forum
• Working through financial and industry based bodies to communicate industry wide concerns
  – Association of Financial Markets in Europe (AFME), Association of Global Custodians (AGC),
    British Bankers Association (BBA), European Banking Federation (EBF), ICMA, ISLA, SIFMA,
    AMCHAM EU
• Encouraging "real economy" companies and associations to focus on the potential impact of the
  proposals on them
Status of EU Negotiations

- No EU 11 agreement reached on the proposed EU FTT, or on a scaled back EU FTT. The German election in September is seen as critical to determine progress of proposal.

- The political impetus is such that an FTT of some sort is considered likely to emerge.

- No official deferral of 1 January 2014 start date, but some comments recognising difficulties reported from Germany. Phased approach?

- The unintended consequences of the proposal are beginning to be understood and focused on in the Working Group.

- Issue of residence or issuance is causing division. This impacts the distribution of the projected revenues between the EU 11.

- The UK has filed a challenge against the enhanced cooperation process, but the filing is protective and negotiations continue. UK believes unlawful because:
  - Of its extraterritorial effects and/or
  - It imposes costs on Non-Participating Member States.

- French Govt believes proposal does not work in current form. If the EU FTT is narrowed, the French Government is likely to be keen for an EU FTT which is broader in scope than the current French FTT (only on equities).
So What Should we Expect?

Expect a watering down of the initial proposal and FTT member states work out a compromise. But the political desire to reduce market activity levels should not be underestimated.

- A narrowing in scope
  - Exemption of repo
  - Exemption of government debt likely, but less likely on all fixed income instruments

- A variable rate?
  - Possibly lower on some assets (corporate credit, government bonds)
  - Possibly higher on others (OTC derivatives)
  - Would increase complexity in collection

- A more level playing field? Hard to see a regime that so obviously puts national champions of FTT zone countries at a disadvantage in global markets

- Timeline increasingly likely to slip

- Very unlikely to disappear entirely as much of the market still seems to assume
  - Too much political capital invested
  - Too popular with voters
  - Too important in setting a precedent on enhanced cooperation
1. Appendices
## European Transaction Taxes Summary

### Key Features.

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<th>Tax Rate</th>
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<th>Liability for Tax (Taxpayer)</th>
<th>Reporting and Payment</th>
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</tr>
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</table>
| **France** | Equities  
Certificates Representing Shares | 0.2% on value of transaction | Net purchases | Investment Service Provider (ISP) and Custodian where no ISP | The taxpayer, but must be submitted to the CSD through CSD member | Yes | Yes |
| **Italy** | Equities  
Derivatives  
Certificates Representing Shares  
High Frequency Trading | **Cash equities transactions**  
0.2% on the value  
(0.22% 2013 only)  
0.1% for regulated markets  
(0.12% in 2013 only)  
**Derivatives**  
Flat amount from €0.025–€200 depending on instrument and notional value  
**High Frequency Trading 0.02%** | Net purchases (equities and CRA)  
Both counterparties (derivative)  
Countervalue of cancelled or amended orders exceeding the day trading threshold of 60 (HFT) | Investor (final purchaser) | Intermediary intervening in the contract | Yes | Yes |
| **Hungary** | All transactions in equities and derivatives settled in Hungarian securities account | 0.1% securities  
0.01% derivatives | Both transfers and acquisitions | CSD Securities account holder | Liable taxpayer | TBC | TBC |
| **Europe** | Purchase, sale or exchange of a financial instrument  
Transferable securities (including equity and debt securities)  
Money market instruments  
Fund units  
Structured products  
Derivative contracts  
Repo and stock lending  
Swaps | Minimum of  
0.1% securities  
0.01% derivatives | Both parties to the transaction | Financial Institutions  
Investment firms  
Regulated markets and similar trade venues  
Credit institutions  
UCITS and a management company  
Pension funds  
AIF and AFIM  
Insurance and reinsurance  
Funds and management companies  
SPVs, including securitisation SPVs  
Other institutions carrying out financial activities where annual value of transactions more than 50% | Liable taxpayer | No | No |

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