The Association of Corporate Treasurers

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Comments in response to
Consultation paper on Financial Transactions Tax
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The Association of Corporate Treasurers (ACT)

The ACT is a professional body for those working in corporate treasury, risk and corporate finance. Further information is provided at the back of these comments and on our website www.treasurers.org.

Contact details are also at the back of these comments.

General

The ACT welcomes the opportunity to comment on this matter.

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Specific response

Before considering the implications of the Commission proposals it is necessary to question their rationale which is stated to be general revenue raising and specifically to address "undesirable behaviours for the society as a whole (systemic risks) e.g. excessive risk-taking."

The Commission seems to presume that financial transactions in shares, bonds and derivatives are speculative and are therefore in some way risky and bad and must be penalised. The Commission fails to recognise that these sorts of transactions and the related markets assist in the provision of capital and risk reduction for companies and as such are essential for the operation of the economy. Furthermore, Investment in shares and bonds with risks managed using derivatives is fundamental to operation of pre-funded pension schemes, etc. and to much of other savings by individuals.

To the extent that risk positions in derivatives can build up this is already being addressed though EMIR, the European Markets and Infrastructure Regulation with properly targeted measures.

If there are other particular "undesirable activities" going on, these should be specifically addressed rather than blanket measures being adopted that target necessary and desirable activity along with the undesirable.

The Commission proposals for a Financial Transactions Tax (FTT) or a Financial Activities Tax (FAT) fail to relate the measures to the genuine excessive risk taking.

The ACT does not wish to comment on whether the financial sector is over or under-taxed – which is a different subject. However, if raising additional revenue is the objective, we believe that a FTT or a FAT is not the ideal method and that a profits tax is likely to be less distorting on financial activity and on the economy as a whole.

Our particular approach to the concept of a Financial Transactions Tax or a Financial Activities Tax is to consider the implications for non-financial companies and hence on activity in the real economy.

Non-financial companies have long been used to getting the negative backwash of any problems of the financial sector as funding availability declines and costs go up. In the response to the recent crisis, it has been dispiriting to see the effect on non-financial companies from new regulation of the banks not being taken into account. Society needs the design of smart regulation of banks that avoids excessive risk taking by a sector regarded as "too important to fail" and which needs to be seen primarily as a supplier of services to the "real economy" and not autarchic activity to be distorted at the whim of politicians and regulators.

Financial Transactions Tax

We would certainly argue that if the objective is to tax financial rather than non-financial companies and there is a desire not to increase profits taxes for those financial institutions, any transaction tax should apply to transactions between financial institutions and not directly to those with non-financial companies.

However, even if such exemption existed, non-financial companies would nonetheless still be impacted. The tax levied on the chain of transactions in the markets generated from one end user would have a multiplier effect and would surely be mostly passed on in the pricing to the end user. (In simplified terms a bank dealing with a customer will often lay off that deal or risk, in whole or in part, through another transaction in the financial markets which in turn gets successively laid off in the markets until it reaches a party with a trading book position that suits absorbing that transaction.)

Although no detailed structure for the tax is proposed we understand that the FTT might be broadly based and cover stock, bond, currency and derivative transactions or could be narrow based and cover only shares and bonds. Based on the October 2010 Podimata Report the level of the tax might be between 1bp and 5bp[1]. Such a rate may look low but in some highly liquid derivative markets the bid offer spread is itself just a few basis points. The multiplier effect as deals work through the market could quickly create a significant burden on the end user of financial transactions. Relief for previously paid FTT could reduce the multiplier effect for the financial company but in all likelihood the cost would be passed to the end user, not the financial industry.

There is also a multiplier effect at the user end too. Consider an example. A company hedging an expected receipt of a foreign currency in 12 months time would do a deal to

[1] (1bp or basis point = 1/100th of a %)

sell that currency 12 months forward. As that date gets closer the treasurer learns that the receipt may be delayed so they close off the original deal and reinstate it for a date one month later. This may be repeated several times and perhaps the amount adjusted too.

For non-financial companies their financial transactions are typically to provide finance or to manage risk. Both activities are in our opinion perfectly proper activities and are beneficial for the economy as a whole, and certainly not “excessively risky” for the firm or society as a whole. We fail to see the benefit of specifically attacking such activity – and, indeed, much harm.

If the objective is to raise revenue from the financial sector the Commission should investigate other mechanisms that have a less widespread distorting effect and, especially, taxes on profits in the sector.

For any commercial activity or investment a company needs to measure its return against the risk and the benchmark of cost of capital. Any addition to cost of capital will inevitably lead to reduced activity taken across the economy as a whole.

Turning to the details, countless practicalities would need to be addressed, not least the valuation basis for transactions. On page 7 the paper states "The tax base for spot transactions is the price paid or to be paid, while the one for derivative transactions is in principle the value set for the underlying."

If the same rate of tax is to be applied to both, then this is intellectually dubious. In no way can the market value of an actual share being sold be compared with the notional principal amount of a derivative transaction being undertaken. Typically the market value of a derivative when first transacted is zero and even when it changes in value due to market conditions, the value of the derivative is almost never remotely comparable with the notional principal amount.

For certain financial transactions such as an initial offer of shares or a primary listing of a bond, the deep and well regulated financial markets in Europe may mean that a FTT is directly a minor consideration for issuers. However secondary market trading of shares and bonds or trading in currencies and derivatives are both largely electronic and may migrate to a more favourable tax regime. Where such taxes are applied and migration is restricted, the effect is seen in the secondary market pricing of the security. This, of course, lowers the price at which new issues by the issuer or by other companies may be made – increasing the cost of capital for the issuer[2].

Thus at Q11 the response is 3 – in case of an FTT implemented at EU level only the transactions will simply move outside the EU, hurting EU competitiveness.

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[2] The impact of the 50 b.p. transaction tax (“stamp duty” on UK share transactions has been estimated as material were it to be abolished: “There could be a reduction in the nominal post-tax cost of equity of 7–8.5% (or 0.66–0.80 percentage points), and in the nominal post-tax cost of capital of 5.4–6.5% (or 0.50–0.60 percentage points). (Report for the local government body for London and two investment organisations, *Stamp duty: its impact and the benefits of its abolition*, 2007, http://secure-uk.imrworldwide.com/cgi-bin/b?cg=downloadsedo&ci=cityoflondon&tu=http://217.154.230.218/NR/rdonlyres/27537B8B-E089-4A71-A41F-F7E7CA7FBE46/0/BC_RS_stampduty_FR.pdf.)

Financial Activities Tax

On page 10 section 4.4 introduces the Financial Activities Tax. This tax is regarded as "compensation for the VAT exemption in the financial sector." This comment illustrates the widespread but incorrect belief that the VAT exemption in the financial sector benefits financial services companies such as banks. It does not. Indeed banks suffer an additional cost because they cannot recover much of the VAT that they pay on their expenditures such as telecommunications and electricity and bought in goods and services. The cost is, of course, passed on to their customers.

On the other hand, if financial services were standard rated, banks would become "fully taxable persons" and be able to recover all of their VAT input tax. In turn they would charge VAT to their customers. Customers engaged in business would recover this input VAT and it would make no difference to them or to the prices they charge their own customers. Bank customers who were private individuals would have to bear the VAT as an additional cost. Accordingly the beneficiaries of the VAT exemption of financial services are to some extent private individuals and other non-business consumers of financial services although they suffer the increased costs on non-recovery by the banks passed on to all customers.

Accordingly the entire discussion of the *"Addition method financial activities tax"* is based upon a false premise and muddled thinking.

The addition method FAT would simply represent an additional cost to the financial services sector which would be passed on to its customers. The only thing preventing the cost being passed on would be if customers could purchase competitively financial services from outside the EU that did not suffer the FAT; in this case the EU would simply be driving business away.

The Commission paper defines a *"rent taxing FAT"* to be based on profit plus wages less an allowance for equity at a rate similar to that for the cost of debt financing but only applied above a certain level of profits. This basis is more logical if taxing excess profits is the objective. It misses the point that in financial services the beneficiaries of rent are the staff in excessive remuneration rather than the shareholders, staff costs being deducible in arriving at profits subject to tax.

The third form of FAT is called a *"risk taking FAT"* and is similar to the rent taxing FAT but with the allowance rate on equity set at a higher level, and thus taxing just the topmost portion of the excess profits. Again, if taxing excess profits is the objective it is wrong to give the impression that this is taxing risk taking. There is no direct linkage in this taxation definition to risk taking. And risk taking can result in (tax allowable) losses, too.

Turning to the detailed questions:

Q28 the response is 2 – individual statements are more appropriate rather than consolidated statements. There would be huge practical issues in taxing operations conducted elsewhere by separate legal entities.

Q34 The tax will ultimately be shifted to the customers. It is simply a cost like other costs and needs to be covered by revenues. If financial institutions are seen as excessively profitable, improving competition law and reducing unnecessary regulation and other barriers to entry of competitors to those financial institutions are surely the answers.

Q36 the response is 1 – any FAT will have a negative effect on the economy and the desired behavioural changes giving social gains are unlikely to be realised.

Bank Levies

The use of taxation to encourage or discourage certain activities is well established, but does distort normal market pressures and the messages they carry. Unintended negative consequences are hard to avoid.

An asset based levy incorporating a risk weighting would reinforce the messages enshrined in the Basel accords, but may have the perverse outcome of causing a distorted concentration of assets held by financial institutions, increasing institutional and systemic risk. Of course, previous assessments of which assets were most risky have often turned out to be wrong, for example prior to the recent crisis mortgage backed securities were generally considered to be high quality assets, much safer than corporate bonds.

A liabilities based levy has more logic in that the hierarchy of stability in funding is more clearly defined such that the riskier liabilities can be discouraged through a levy.

As with any of the taxation proposals in the Commission's paper the danger is that the cost is ultimately transferred to the end customer and will have a depressing effect on the economy. In particular, being specifically related to the balance sheets of the banks, it would create yet another driver of bank behaviour to discourage them from funding business at just the time when it may be hoped medium sized companies are seeking finance as the economy moves to a recovery phase.

Turning to the detailed questions:

Q48: Our response is 2 - A system of credits by the Member State of the group/head office must be embedded in the provisions (credit method in the home Member State, because the risk is borne by the host market).

Q50: Our response is 2 - All individual levies based on the balance sheet must allow for a credit for the EU-wide levy.

TREASURY, RISK
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The Association of Corporate Treasurers

The Association of Corporate Treasurers (ACT) is a leading professional body for international treasury providing the widest scope of benchmark qualifications for those working in treasury, risk and corporate finance. Membership is by examination. We define standards, promote best practice and support continuing professional development. We are the professional voice of corporate treasury, representing our members.

Our 4,000 members work widely in companies of all sizes through industry, commerce professional service firms.

For further information visit www.treasurers.org

Guidelines about our approach to policy and technical matters are available at http://www.treasurers.org/technical/manifesto.

Contacts: Stuart Siddall, Chief Executive (020 7847 2542 ssiddall@treasurers.org) John Grout, Policy and Technical Director (020 7847 2575; jgrout@treasurers.org) Martin O'Donovan, Assistant Director, Policy and Technical (020 7847 2577; modonovan@treasurers.org) Michelle Price, Technical Officer (020 7847 2540; mprice@treasurers.org)	The Association of Corporate Treasurers 51 Moorgate London EC2R 6BH, UK Telephone: 020 7847 2540 Fax: 020 7374 8744 Website: http://www.treasurers.org