European Banking Federation

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REPORT ON THE PROPOSED FTT DIRECTIVE

KEY POINTS

The EBF herewith sets forth its comments on the Commission's Proposal for a Financial Transactions Tax (FTT), as elaborated by its Financial Sector Tax Working Group (FST WG). Those comments are cast around the Directive's objectives as stated in the Proposal and its preceding Impact Assessment:

- Ensuring that the financial sector makes a fair contribution to public finance;
- Limiting undesirable market behaviour and stabilising markets;
- Raising revenues;
- Ensuring a proper functioning of the Internal Market, eliminating double taxation and reducing competitive distortions.

The EBF questions the appropriateness and proportionality of the FTT proposal as a mechanism for addressing the stated objectives, given the anticipated economic impact of the proposed FTT and probable unintended consequences.

The EBF is unconvinced by the arguments put forward by the Commission to support the presentation of the proposed Directive. Furthermore, we refute entirely the assertion that the financial sector is under-taxed. The EBF further finds that the impact assessment underpinning the proposed Directive, though flawed and not sufficiently comprehensive, does not support the case for an FTT. The EBF is disappointed that the Commission's economic analysis has been performed using an oversimplified model and that there has been a failure to publish any country-by-country analysis. Also, it is concerning that the Commission has not adequately understood the structural disruption of financial markets and wider negative economic impacts to the Member States and their citizens that an FTT would cause.

In its impact assessment, the Commission explicitly assumes that 90% of derivatives could disappear as a result of the implementation of the FTT in the EU. **The EBF is stunned to see that such a disruption of the market is considered by the Commission as an acceptable consequence** of the FTT, as if it were merely trivial collateral damage or even a welcome structural break.

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CONCLUSIONS & RECOMMENDATIONS

As proposed, the Directive will not meet most of the objectives it has set.

1. The proposed FTT is first intended to ensure that the financial sector makes a fair contribution to public finances. The underlying assumption is that the financial sector is under-taxed compared with other sectors. In this context, it is assumed that additional taxation of the financial sector and/or of financial activities would be fair and would shelter citizens from having to bear the costs of additional taxes. However, the proposed Directive fails to take into account that the financial sector bears significant costs of hidden VAT and already contributes greatly to the Member States' budget notably via bank levies already introduced in several Member States as well as corporate taxes paid by the sector.

- The EBF understands the highly sensitive political dimension of this debate and this objective. However, the industry is concerned that the proponents of additional taxation of the financial sector are silent on some significant aspects and consequences of such a policy and that some of the key arguments they put forward to underscore the introduction of an FTT (at EU level) are far from being peremptory.

- Firstly, the assumption that the financial sector is under-taxed is mainly based on the fact that financial services are exempt from VAT. Although this VAT treatment may be perceived at first sight as providing the financial sector with fiscal advantages, this is far from being the case. The current treatment actually generates hidden VAT costs for EU banks and other providers of financial services for which, as a result, VAT neutrality is not ensured in the same way as for other sectors. This is the reason why a reform of the VAT treatment of financial services, widely supported by the sector, has been in the pipe-line for more than five years. It is still lagging, because EU Member States have failed so far to reach political agreement on the proposal for a Directive presented by the Commission in 2007. From a VAT perspective, this reform is a must. The FTT is not an alternative.

- Secondly, the belief that the cost of additional taxation of the financial sector will be absorbed by the sector is a misconception of the way financial activities are managed. A bank, in particular, is a conduit and any tax incurred by this structure is ultimately passed on to its customers, employees and/or shareholders (including pension funds). If policy-makers, who have to take on fiscal consolidation efforts, want to relieve individuals from additional income taxes, they have to envisage compensatory taxation of either capital or consumption. Targeting a specific sector is not a panacea.

- In addition, the financial sector already contributes greatly to the Member States' budgets notably through specific banking contributions: many Member States have already introduced bank levies e.g. in France, the Systemic Risk

Bank Levy is expected to reach € 1 billion as from 2014. The IMF also found[1] that the corporate taxes paid by the financial sector amounted respectively to 18%, 26.3% and 20.9 % of the total share of corporate taxes in France, Italy and the UK from 2006 to 2008.

2. The proposed FTT Directive is meant to limit undesirable market behaviour and to help stabilise markets, but it will in fact create market disruptions and significantly affect liquidity

- In its impact assessment, the Commission explicitly assumes that 90% of derivatives could disappear as a result of the implementation of the FTT in the EU. The EBF is stunned to see that such disruption of the market is considered by the Commission as an acceptable consequence of the FTT, as if it were trivial collateral damage or even a welcome structural break. In the context of the current crisis, a more detailed analysis of the "usefulness" of derivatives must be conducted before adopting measures which are perceived as potentially leading to a further and deeper disruption of financial markets.

- In addition, the FTT as currently designed, notably because of its high rates and cascading effects, would encourage a move away from low-margin and high-volume activities (primarily the liquidity provider role) in favour of higher margin activities, which by nature are more complex and therefore often more risky. For example, in imposing an FTT on repurchase agreements, also known as repos (which are a form of secured lending), but not on deposits and other forms of unsecured lending, the EU would create a tax bias towards unsecured lending.

- Any concerns over potential market inefficiencies or possible systematic risks should be addressed by policy makers through appropriate financial markets regulation and supervision and not through an FTT.

- As the FTT will increase the cost of financial services, it will discourage clients to use the EU's financial sector. Risk management will be an issue for investors and clients as they will have to reduce their hedging activity. In imposing FTT on collateral payments, the EU would be creating a counter-incentive to the mitigation of counterparty credit risk.

- Banks will also reduce their market making activities; the decrease in volumes of financial transactions will have a significant impact on liquidity.

- Finally, in imposing an FTT on intra-group transactions, the EU would be discouraging the centralisation of risk and in turn sound risk management, whilst imposing an FTT which has a cascading effect, the EU would undermine the secondary market for financial investments in Europe, thereby creating a greater requirement for direct bank financing of the economy at a time when other measures (notably Capital Requirements Directive IV) are making that more onerous.

[1] IMF, "A fair and Substantial Contribution by the Financial Sector, interim report April 2010.

3. **The FTT is aimed at raising revenues, but as currently designed will result in massive delocalisation/disappearance of certain activities: thus little revenue is to be expected from such an FTT. With the impact assessment far from being conclusive and the accuracy of the figures presented being uncertain, final conclusions cannot be drawn based only on assumptions.**

- As currently designed and due notably to the non-calibrated high rates, there will be little revenue raised. The tax will very often outweigh the margin on transactions. In France, first estimates by large banks confirm that the amount of tax will be many times more than their profits before tax (an initial figure of € 40-50 billion has been estimated – not taking into account any change in the operators' behaviour). It is obvious that the banking sector cannot support such a high tax pressure and that the end-result will be either a massive delocalisation (when possible) or an abandonment of certain activities.

- In addition, the impact on GDP in the Commission's impact assessment is simply not acceptable for Member States, even considering the lower range of 0.53%. Both ranges (0.53% to 1.76%) are challenged in the recent OXERA study on the FTT, which suggests a much higher 2.42% figure. OXERA recalls that a 0.53% reduction in GDP amounts to an annual loss of about € 26 billion for Member States based on current estimates of annual GDP. In France, a reduction of 1% GDP is assumed to correspond to a loss of € 8 to 10 billion for the French Treasury.

4. **The proposed Directive aims to ensure a proper functioning of the Internal Market, to help eliminate double taxation and reduce competitive distortions. There are however serious concerns over delocalisation of financial transactions towards other international financial centres (especially the US and Asia). Europe's economic independence is at stake.**

- Double Taxation Treaties provide for clear guidance on how to avoid or eliminate economic double taxation. However, the prevention of a double tax burden where taxable bases are totally different (e.g. country A raises an FTT on trading activities, country B an FAT, and country C a bank levy) is another objective which may be challenged by governments. Given the factual situation created by the governments of EU Member States, which have already introduced similar measures at national level, it is difficult to see, in the interest of the Internal Market's cross-border business, how an FTT could resolve these double taxation issues and competitive distortions.

- Introducing an FTT in the EU would also put most of the tax burden on certain Member States, such as the UK.

- As a response to such an FTT, massive delocalisation would occur, harming the European economy while favouring other international financial centres such as the US and Asia. The FTT as currently designed may undermine Europe's economic independence. In particular, Member States' balances of payments may suffer with financial services being manufactured abroad.

5. Recommendations:

As currently designed, the FTT Directive would meet virtually none of the objectives set forth by the European Commission. Worse still, it would have significant negative impacts on the financial sector's profitability, affecting in turn the European economy in general.
Therefore, the EBF urges Member States to drop the EU-wide FTT project and to consider more appropriate ways to address issues such as reducing systemic risk and limiting speculation.

FACT-FINDING STUDY

Would the FTT directive ensure that the financial sector makes a fair contribution to public finances?

Our fact-finding study focuses on the FTT, since it is the only detailed proposal that is currently on the table. However, this does not mean that other ideas of taxing the financial sector cannot be envisaged by policy-makers. To date, however, those alternatives have not been sufficiently detailed.
The FTT aims to ensure that financial institutions pay a fair contribution to cover the costs of the recent crisis and to ensure a level playing field with other sectors from a taxation point of view. No evidence has been produced that the financial sector is under-taxed compared to other sectors of the economy.

- The argument typically advanced that the financial services' exemption from VAT generates disproportionate advantages for the financial sector has been rejected by academic authorities. New research[2] by Prof. Ben Lockwood of the University of Warwick, undertaken together with PwC, has revealed that the VAT exemption does not lead to a tax advantage for the banking sector. The report concludes that if bank services were subject to VAT (in place of the current exemption system) this would not lead to any significant increase in VAT revenues, as it is unlikely that the VAT raised from consumers would be significantly higher than the tax governments would lose from banks recovering VAT on their costs. The report estimates that the financial services sector is paying € 33 billion per annum of irrecoverable VAT in the EU.

- The Commission's impact assessment even acknowledges that "*Broadly speaking, the study does not find any significant differences in the tax treatment of the financial sector compared to other sectors*".

- Furthermore, a number of Member States have already introduced some form of additional taxation on the financial sector, such as a bank levy.

[2] 'How the EU VAT exemptions impact the Banking Sector, Study to assess whether banks enjoy a tax advantage as a result of the EU VAT exemption system', PWC & University of Warwick, 18 October 2011, http://www.pwc.com/en_GX/gx/financial-services/pdf/2011-10-18_VAT_Study_final_report.pdf,

Would the FTT directive limit undesirable market behaviour and help stabilise markets?

The FTT is intended to erect appropriate disincentives for transactions that do not enhance the efficiency of financial markets. The Commission in this regard, however, fails to:

- provide empirical evidence to demarcate activities are useful for the market from certain activities are superfluous and even damaging;
- explain reasonably the effectiveness of taxation in controlling market behaviour.

Whilst the EBF recognises that recent events and market developments have demonstrated weaknesses in the way markets function and, hence, have eroded investor confidence, we are of the opinion that any concerns arising from potential market inefficiencies or possible systemic risks should be addressed through adequate financial markets regulation and supervision. In this respect, the European Commission has already proposed regulatory and supervisory remedies to address potential challenges in connection to, among others, high frequency trading (HFT), derivative transactions and short selling and certain aspects of credit default swaps. These three topics are raised in the impact assessment of the FTT.

HIGH FREQUENCY TRADING

In the explanatory memorandum of the October 2011 proposal for a review of the Market in Financial Instruments Directive (MiFID)[3], the Commission states: "*While the effects are generally perceived as positive for market liquidity and to have improved the efficiency of markets, specific regulatory and supervisory measures have been identified as necessary in order to adequately deal with the potential threats for the orderly functioning of markets arising from algorithmic and high-frequency trading*".

In the articulated text, the Commission proposes the introduction of a series of safeguards both on market participants who trade in the markets at high speeds and on trading venues where high-frequency trading takes place. For example, information requirements towards regulators on trading strategies pursued by means of speed trading will be enhanced, and stricter checks will be imposed on arrangements whereby members of trading venues allow other firms employing high-frequency algorithms to access public markets through their systems. Furthermore, trading venues will also be required to have robust controls against problems such as disorderly trading, erratic price movements, and capacity overload and to halt trading in case of significant price movements ("circuit breakers") in a harmonised fashion.

DERIVATIVES

Back in October 2009, the Commission opened its Communication on "Ensuring efficient, safe and sound derivatives markets: Future policy actions"[4] with the following statement:

[3] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0656:FIN:EN:PDF
[4] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2009:0563:FIN:EN:PDF

"*Derivatives play a useful role in the economy: they can be used to transfer (all or part of) the risks inherent to economic activity from economic agents who are not willing to bear them to those who are*". The Commission also noticed that derivatives contributed to the financial turmoil by allowing leverage to increase and by interconnecting market participants. As a result, the Commission has, over the past two years, issued a number of proposals (e.g. the European Market Infrastructure Regulation, and amendments to the Capital Requirements Directive) to reduce the negative impact of OTC derivatives markets on financial stability. These various proposals aim at (i) increasing derivatives standardisation, (ii) using trade repositories, (iii) strengthening the use of central counterparty clearing houses (CCPs), and (iv) increasing the use of organised trading venues.

SHORT SELLING AND CDS

In the explanatory memorandum of the September 2010 proposal for a regulation on Short Selling and certain aspects of Credit Default Swaps[5], the Commission states: *"Most studies conclude that short selling contributes to the efficiency of markets. It increases market liquidity (...) Also, by allowing investors to act when they believe a security is overvalued it leads to more efficient pricing of securities, helps to mitigate price bubbles and can act as an early indicator of underlying problems relating to an issuer. It is also an important tool that is used for hedging and other risk management activities and market making".*

As with high frequency trading and derivatives, the Commission, however, considered that it was important to ensure that the regime governing short selling is made more robust. To that effect, the Commission proposed, among other things, greater transparency to the market on short selling.

As the European Commission has considered all the above described activities as beneficial to the market and the wider economy - provided they are carried out according to an adequate regulatory framework - it is evident that a proposal for an FTT does not only run counter to established financial markets policy but may also constitute a disincentive to good market practice and may thus significantly hinder economic growth and competitiveness.

Finally, as regards investment vehicles, we would like to point out that shares of pension funds and mutual funds are, to a very large extent, held by and thus represent private individuals. An FTT on pension funds′ and mutual funds′ trading and hedging activities will impact the creation of wealth for private individuals. According to data provided by the fund management industry[6] the FTT might translate into a € 15,785 reduction to the final payout for a long-term savings plan typical for smaller investors, (compared to the situation without the FTT). Investment funds will probably also be exposed to multiple taxation, as the tax might be levied on transactions within the fund, as well as at the level of individual investors (when buying or selling fund units/shares). This multiple taxation is further multiplied in the case of fund-of-funds vehicles.

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[5] http://ec.europa.eu/internal_market/securities/docs/short_selling/20100915_proposal_en.pdf

[6] Union Investment Luxembourg. The calculation is based on the assumption of a retirement provision savings plan with a monthly investment of € 200, a 30-year term and an average yield of approx. 8.2 per cent per annum.

Would the FTT directive enable Member States to raise substantial revenue?

The overall working hypothesis used by the Commission to support the presentation of the FTT proposal and the related revenue estimate is blurred. To a large extent, the figures communicated in the impact assessment and in the explanatory memorandum are incorrect or incomplete. In addition, the Commission does not appear to have properly taken into consideration the anticipated economic impact of the proposed FTT. Therefore, there is a high degree of uncertainty as to the efficiency of the tax and the probable unintended consequences for the whole economy.

SHORTCOMINGS IN THE IMPACT ASSESSMENT

It is unclear why the impact assessment's revenue estimate of € 37 billion (i.e. 3% of the current EU GDP), which was broken down as shown below, has been increased to € 57 billion in the explanatory memorandum[7].

Table (5). Illustrative revenue potential per category of products

Segment	Revenue potential (EUR bn)
Equity spot	5.6
bonds spot	10.4
Exchange interest rate derivatives	12.5
Exchange equity-linked derivatives	0.9
OTC Interest rate derivatives	9.2
Currency Swap	4.0
Currency outright forward	1.0

Note: See assumptions hereabove in the text.
The estimates are for the total market. The total is EUR 43.6 billion. 85% of this amount brings the EUR 37 billion mentioned above.

Transactions between financial institutions represent 85% of total transactions

The impact assessment which led to a € 37 billion revenue estimate is not sufficiently comprehensive and as emphasised by a number of expert reports has significant flaws, such as *inter alia*:

- an oversimplified model based on a closed economy;
- a failure to publish any country-by-country analysis;
- a failure to perform an appropriate analysis by category of products; and
- a failure to take into account the cascading effect.

Even based on the unconvincing Commission's own assumptions, the tax would not appear efficient in collecting revenue, since a significant part would be lost due to the negative impact on GDP and, indirectly, on other tax sources. Rather than accepting the output of the

[7] This is the Commission's expectation of tax revenue described on p. 11 of its proposal.

model in terms of impact on GDP, the Commission applied a number of downward adjustments to the estimated impact.

Oversimplified model

The Commission's economic analysis has been performed using an oversimplified model based on a "closed economy", i.e. an economy without competition. The closed economy model would be relevant in a global approach, but in the scenario of an EU FTT (or Eurozone FTT), the FTT will be an incentive for capital and financial market operators to relocate outside the EU, with a potentially significant impact on revenue.

Failure to publish any country-by-country analysis

The Commission has failed to publish any country-by-country analysis, which would highlight the uneven impact of an EU FTT (or Euro-zone FTT).

Failure to perform an appropriate analysis by category of products

The Commission has failed to perform a proper and transparent analysis by category of products.

Concerning derivatives, the impact assessment takes into account a "shrinking" of activities by 70-90% through delocalisation, ceasing of existing activities and related jobs and wealth loss[8].

- As regards spot securities (bonds in particular), the hypotheses used by the Commission are unclear. Indeed, there are important discrepancies between the volumes of bonds exchanged in the EU which the Commission used in its impact assessment as part of the taxable base; and
- the volumes of bonds exchanged according to ECB data on the settlement of transactions[9].

In the Commission's impact assessment, the figures of volumes exchanged in the EU are (in € bn)[10]:

Bonds trading	13,432.7
Equity trading	7,237.2
Derivatives, of which:	
- Exchange traded:	468,171.1
- OTC derivatives:	312,926.7
- FX swaps:	225,170.7
- FX outright forward:	53,532.6

[8] section 6.1 of the impact assessment (SEC(2011)1102), page 32

[9] http://sdw.ecb.europa.eu/browse.do?node=2517704. The data relates to deliveries of securities only. To estimate FTT liability, it is necessary to add a compensating number of securities receipts and to adjust for the presence of non-EU financial institutions and exempt institutions from the reported totals.

[10] Impact assessment, annex 11, page 12

The European CSDs report on annual securities settlements indicates that, taking only the 8 EU Member States where the larger volumes of transactions are settled, bonds delivery instructions processed in 2010 amounted to approx. € 688,200 billion.

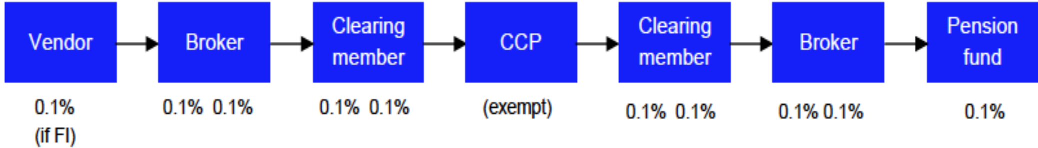
In addition, the Federation of European Securities Exchanges (FESE) has pointed out that only 5% of total bond trading is executed on exchanges. The biggest share of bonds (around 95%) is traded on OTC markets.

Therefore, either the impact assessment is incorrect or the Commission has assumed that the introduction of the FTT would have a huge impact on the volumes of spot securities transactions[11].

Failure to take into account the cascading effect

Another flaw of the impact assessment is that the cascading effect, which is illustrated in a recent publication form Clifford Chance[12], is totally ignored by the Commission:

"*The cascade effect makes the effective rate of the FTT on securities much higher than the headline rate of 0.1% - perhaps ten times higher. The reason is the chain of trading and clearing that lies behind most securities transactions. A purchase of securities on the London Stock Exchange, for example, ordinarily involves the sale and purchase by a number of parties, including brokers, clearing members and the central counterparty to the clearing system. Each sale will be subject to the FTT (with only the central counterparty exempt), so a typical purchase by a pension fund would look like this*:



The FTT therefore "cascades", taking the effective rate for the transaction to 1% (if the original vendor is a financial institution) or 0.9% (if it is not). If the securities pass through market makers as well then the rate will be even higher. This represents a very significant hidden cost increase for European pension funds and collective investment schemes."

Net fiscal impact

In order to estimate the net fiscal impact of an FTT, one should take into account the expected loss of revenue generated by other taxes, including the corporate income tax on financial institutions, the income tax levied on salaries of the financial sector's employees and any other taxes the revenue of which would be impacted by a decrease of GDP.

The Commission recognises that the FTT will have a negative impact on GDP and employment, but is unable to measure the magnitude of such impact, which it roughly estimates between 0.53% and 1.76% of EU GDP in the long run.

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[11] Impact assessment (volume 1) states on page 44/45

[12] Financial Transaction Tax : Client Briefing, October 2011

A number of expert reports have emphasised the weaknesses of the impact assessment resulting from the Commission's own uncertainty as to the potential impact of the FTT on GDP:

- According to the OXERA Report[13], over half of the € 37 billion revenue would be lost due to the negative impact on other tax sources;

- In their report[14], Ernst & Young consider: "*In fact, it is quite likely that the net impact on tax revenue could be negative, as our calculations do not take account of the likely fall in capital gains tax, nor the full extent of the likely decline in revenues from the financial sector itself. The Commission also acknowledges that the GDP loss could be as much as 1.76% if various mitigating factors in the design of the FTT prove less effective than hoped. If output losses were this substantial they would result in a loss of government revenue of around €128bn… As an illustrative exercise, assume that the FTT results in a reduction of 40% in equity volumes, 10% in bond volumes, and 98% in derivatives volumes. In this case, the estimated revenue from the FTT would be reduced to just €12bn. In light of the preceding discussion, it is clear that the net impact on government revenues would be significantly negative. If output losses amount to 1.76% of GDP, the FTT could leave a €116bn hole in the EU's public finances. Although this should not be interpreted as a central forecast, it does highlight the high degree of uncertainty within the Commission's own estimates.*"

Additional adjustments made by the Commission

Rather than accepting the output of the model in terms of impact on GDP, the Commission applied a number of downward adjustments to the estimated impact.

- Exclusion of primary markets from the scope of the tax;

- Exclusion of transactions that do not involve financial institutions;

- The assumed zero value of high-frequency trading activity;

- The assumption that the tax would have less of an effect on the cost of financing investment through retained earnings and bank lending.

The data may be or need to be adapted in function of topical events, as the Commission is working on a new Impact Assessment, which will demonstrate that the impact is lower than initially thought (by taking on board a longer term view). The EBF report needs to be able to go forward and take these changes on board.

ADVERSE EFFECTS

A further question is whether adverse effects of the tax have been sufficiently taken into account by the macro-economic impact assessment of the Commission. As some of the

[13] « What would be the economic impact of the proposed financial transaction tax on the EU ? », Review of the European Commission's economic impact assessment, OXERA, 22 December 2011.

[14] http://www.ey.com/Publication/vwLUAssets/Eurozone_FSO_-_Winter_2011/$FILE/Eurozone%20outlook%20for%20financial%20services%20-%20Winter%202011-12.pdf

intermediaries in the chain shown above (e.g. market makers) are operating with very small margins, their business will very likely be heavily affected or not be viable anymore. A presentation given by the Commission (which can be found on the internet site on DG Taxud), contains the following slide:

Some expected impacts

- **Revenue estimation:**
  - ≈ €55 bn annually, depending on market reactions and effectiveness of tax collection
- **Market reaction / functioning:**
  - The turnover on securities markets is assumed to decline by up to 20%, namely with respect to the segment of HFT
  - The turnover on derivatives markets is expected to decline by up to 90% in some market segments, especially in the market segment of HFT and highly-leveraged products
- **Impact on financial centres:**
  - Important decline in the (inflated) turnover in some market segments (namely HFT and highly-leveraged products)
  - Need for adjusting business models to the new tax environment
  - Small impact on employment
- **Economic impacts:**
  - Non-financial economy largely ring-fenced – so no direct increase in the cost of capital
  - No impact on the effectiveness of monetary policy
  - Positive impact on the effectiveness of financial markets

European Commission Taxation and Customs Union 17

The following economic effects of the tax have (to some extent) been mentioned in the Commission's impact assessment, but one might wonder whether they have been sufficiently analysed in detail[15]:

- **Investment horizon**
  - The FTT, based on the Tobin tax theory, will impose a significant penalty for investments with a short term horizon.
- **Bid/offer spreads**
  - The FTT can also be considered as imposing a widening of the bid/offer spread. Different instruments are traded with very different bid/offer spreads, which tend to be lower at highly liquid markets with high competition. In some cases, the cost of infrastructure also increases the bid/offer spread (fee on exchanges, settlements etc).
  - For financial market users (investors, hedgers etc.) the implementation of the FTT means an increased cost of investments. Any purchase is more expensive and there is a lower income from sale. In volatile markets, price fluctuation of the asset can play a greater role than the bid/offer spread.
  - For financial institutions involved formally or informally in market making, the bid/offer spread constitutes their income from the activity, as well as a buffer for losses incurred.

[15] These reflections are from an experienced economist in the EBF Working Group, many of them can also be found in the report from the EU Parliament cited several times already (cf. footnote 7), as well as in other documents referenced in this report (including IMF reports).

- **Impact on liquidity**

  - The impact of the FTT would likely be split between an increase of the bid/offer spread and a decrease of the profits of market makers. The proportion of this split will very much depend on the markets and (mainly) on the liquidity of the market before the FFT implementation.

    The liquidity of each market after the application of the FFT will depend on the mentioned split as well as on the situation of the market before introduction of an FTT. There will be a primary and a secondary effect: The primary effect will be an increase of the bid/offer spread caused by implementation of the FTT, which will be followed by another increase of the spread, as a reaction to the lower liquidity of the market caused by the primary effect.

    As a consequence, the increase of the spreads, which are the key factors for liquidity of the markets, will be greater than just the current spreads plus FTT minus the part absorbed by market makers (assuming that market makers cannot absorb the entire FTT in their bid/offer spreads). So a decline in the liquidity on all markets is very likely the most important impact of the FTT.

  - If the FTT is imposed on low margin products these products will either disappear or see their margins increased. Companies will no longer be able to use the products that are designed for hedging purposes in a prudent manner and are far from any speculative intention.

  - The FTT would not disincentivise speculation and is more likely to increase than reduce volatility, leaving the tax not only futile in its aim to reduce the potential for crises, but also counterproductive.

  - Increased transaction costs are bad not only for market participants, but also for market users using such a transaction in support of their own economic activity. The risk exists that certain markets may even cease to exist. On the other hand, in some markets with very low transaction costs, a situation can exist, where a certain reduction of the liquidity can indeed reduce market volatility. The proportion of the volatility reduction (good for the real economy) and the increase of transaction costs (bad for the real economy) will then define the total impact on economic activity.

- **Impact of the level of FTT on the markets**

  - With the level of FTT proposed to be the same for all “cash transactions” and the same for “all derivatives“, the FTT will cause an adverse balance of fiscal income and cost for the financial sector and market participants.

- **Impact on asset classes and markets**

  - The key variables are the current bid/offer spread (including all costs) and the structure of the market and its participants.

Another area of potential interest is the development of the cost of transactions over time. A hypothesis could be that in the past years, due to the introduction of new technologies and, for example, regulation supporting the growth of competition, the liquidity of many markets has increased and so the cost of transactions has gone down. If we follow and quantify this development over the past years, the result could serve to very approximately estimate the link between transaction costs and liquidity on some markets. In practice, however, there are more factors playing a role, including the growth of alternative markets, where some of the market participants could go after the introduction of an FTT.

- **Other factors, relevant for net revenue**

  - The cost of implementation, which could be estimated as very significant based on some large investments, which took place in the financial industry in the past as a result of changes to regulation.

  - The cost of collection. This is a cost that does not only occur in the banking sector.

- **Feasibility of taxation of some OTC derivatives**

  A substantial issue in the case of OTC derivatives is setting up a tax base for non-plain vanilla structures, where pay-off is not just a simple function of the notional amount. This issue (e.g. partly leveraged OTC derivatives with non linear pay-offs) must be addressed at reasonable cost, otherwise this would represent a way of market distortion and would boost instruments that have proved to be a source of high risk in case of market turbulences.

- **Transactions within groups**

  - Large cross-border institutions need to frequently balance their risk positions. While there would be an argument that such transactions with other market participants should be subject to the FTT, it is hard to argue that such movements, which are sometimes of substantial size within a financial group, should also be subjected to the FTT. In some cases these movements are imposed by regulators (e.g. requirements to reduce some risks overnight on entity level). If an exemption for such transactions is not accepted (because governments fear arbitrages between national tax regimes), it would force financial and non-financial institutions to undergo large reorganisations that would not only engender high costs, but also distract, for a limited period of time, from the key functions of the financial industry, which is to service the needs of the economy.

- **Bank funding**

  - With banks being increasingly required by regulators to fund themselves using secured financing in the form of repurchase (repo) and reserve transactions, the introduction of an FTT applicable to these transactions is completely at odds with the regulatory environment.

Would the FTT help ensure a proper functioning of the Internal Market, eliminate double taxation and reduce competitive distortions?

The primary purpose of the proposal has to be consistent with the chosen legal base, namely the proper functioning of the Internal Market (Article 113). The legitimacy of the internal market objective must be called into question given the significant adverse impact on specific parts of that Internal Market. This calls into question the compliance of the FTT proposal with the principle of subsidiarity, which regulates the exercise of powers in the European Union. The key test is that of comparative efficiency– is it better for the action to be taken by the Union or by the Member States?

To avoid fragmentation in the Internal Market for financial services, bearing in mind the increasing number of uncoordinated national tax measures being put in place. This seems to be a political objective of the Commission as Member States have expressly reserved the right to manage their own fiscal response to the financial crisis, with some but not all introducing bank levies. A blend of national measures, with robust double tax relief, is a reasonable price to pay to maintain competitive tax systems and fiscal sovereignty. National measures that threaten the free movement of goods, services, persons or capital within the Single Market can already be challenged under the EU Treaty. There appears to be no evidence that the levies introduced in a number of Member States have caused any fragmentation in the European market for financial services. Moreover, the measures that Member States have introduced have not been transaction taxes, and so the introduction of an EU-wide FTT would do nothing to address any concerns the Commission might have about the impacts of a proliferation of these national measures.

Different taxes within the EU (and within the space where OECD rules apply) and double (or multiple) taxation situations have always been considered as something to be addressed with urgency in order to not penalise cross-border economic activities. As indicated above, double or multiple taxation issues, however, only exist and can be avoided (*ex ante* or *ex post*) if two or more taxes are applied to the same taxable base (e.g. profits).

Double taxation treaties provide for clear guidance on how to avoid or eliminate economic double taxation. But avoiding the double charge (the term “double taxation” seems inappropriate) if the taxable bases are totally different (e.g. country A raises an FTT on trading activities, and country B raises a bank levy) seems to be a real challenge, as governments may need to discuss whether – legally, not economically speaking - there is a situation of double taxation at all.

Given the factual situation created by EU Member States who have already introduced national measures, it is difficult to see, in the interest of cross-border business, how an FTT could resolve these double taxation or – at least - distortion of competition issues.