

## *FTT – Non-technical answers to some questions on core features and potential effects*

### ***1. Is the FTT a tax on stock exchange transactions? How is it different from British ‘stamp duty’?***

The proposed FTT goes far beyond a simple stock exchange transaction tax of the kind that used to exist or has recently been introduced in some EU Member States. It is clearly different from traditional ‘stamp taxes’, for example British ‘stamp duty’, as it also applies to financial transactions that take place on unregulated markets or that are carried out directly between financial institutions without the medium of a trading platform (so-called ‘over-the-counter’ transactions).

Moreover, it is also a tax on proprietary trading by banks and similar activities, as well as on trading in bonds and derivatives. Thus, it neither disadvantages nor favours particular marketplaces or particular financial instruments, because all markets are treated equally. Therefore, it also has very high earning power, high revenue potential, even in the case of very low tax rates.

With British stamp duty, only the purchases of British companies’ shares are taxed, and only if the buyers are not financial institutions. This tax is therefore sometimes referred to in the UK as ‘old ladies’ tax’, because it is only paid by those clients who cannot take advantage of the exemption granted to the financial industry and who cannot simply switch to other markets or products or are unaware of the possibility of doing so.

In this regard the FTT proposed by the Commission takes precisely the opposite approach, in that only the financial industry is subject to the tax and evasion is virtually impossible.

### ***2. What is taxed?***

On the one hand, the proposed FTT is a tax on securities transactions, i.e. it applies to trading in (but not the issue of) shares, company bonds and government bonds. A transaction with a value of EUR 10 000 would be subject to FTT of EUR 10 (0.1% of EUR 10 000) to be paid by both the buyer and the seller.

On the other hand, and much more importantly from the point of view of revenue potential, it is a tax on derivatives, i.e. hedging activities and ‘betting’ on financial markets. For example, if someone bets on falling or rising share or bond prices, or wishes for commercial reasons to

hedge against future price fluctuations or against falling or rising raw material, energy or agricultural prices, they would have to pay tax. The same would apply to bets on falling or rising indexes (of whatever kind), or bets on interest rates or on countries or companies going bankrupt, or even more complicated bets.

Under the Commission's proposal, the amount of the tax on such financial market 'bets' would be determined not by the amount staked, i.e. how much of his own or borrowed money the investor wagers, but rather by how big the notional value is of the transaction underlying the 'bet'. For example, if an investor pays EUR 1 000 for an option to purchase or sell shares valued at EUR 1 000 000, tax of EUR 100 would be due (0.01% of 1 000 000), while an option with a nominal value of EUR 10 000 000 would attract tax of EUR 1 000. This would also apply in cases not involving an option to purchase or sell shares at a certain price, but rather involving the purchase or sale of raw materials or foreign currencies, or a 'bet' on credit default. Thus, the determining factor is not the amount of money staked, but the value of the underlying transaction. The higher this value, the higher the tax.

### **3. *Who has to pay the tax?***

The tax applies to the financial institutions, funds and asset managers that carry out taxable financial transactions or engage in proprietary trading. It does not apply to retail investors, pensioners or SMEs. Of course, it is highly likely that banks will pass the tax on to retail investors or companies if they carry out such transactions on these clients' behalf. However, this should not be problematic, as the tax rate is very low. The amount of FTT due on a EUR 10 000 purchase of shares would be EUR 10, while EUR 100 would be due in the case of hedging a foreign currency transaction valued at EUR 10 000 000. This means that the cost of such financial transactions would rise by 0.1% or even merely 0.01%, and not by the figure of 10, 15 or even 20% that some interest groups are bandying about.

### **4. *Who is most irritated by these taxation plans?***

The taxation plans are, of course, most irritating for high-frequency traders and for fund and hedge fund managers whose business model is based on quick successions of financial transactions and on frequent transactions with high profit (and loss) potential. The more frequently that things are bought and then sold again, the more short-term 'bets' are made with the same amount of capital, and the higher the 'bets' are in nominal terms, the higher will be the gains and the more the fees that are raked in.

So the FTT is facing intense lobbying from precisely those fund managers and investment bankers whose business model is not based primarily on generating high profits for their investors (this is merely of secondary importance) – whether they be retail investors or institutional investors such as pension insurance companies – but on generating high transaction volumes and therefore high administration and brokerage commissions, which they naturally pass on to their clients. The FTT would call this business model into question. These are often the operators whose published yield figures do not include administration and management fees and tax subsidies, figures that are often even described as ‘net yield’.

But they also include the proprietary traders, i.e. those banks and brokers that no longer only broker transactions such as the purchase and sale of shares, bonds or traded derivatives in exchange for a fee, but themselves take the opportunity to buy the product to be brokered first before selling it. This provides them with two sources of income: the brokerage fee and the difference between the purchase price and the selling price. The European Commission’s proposal would exempt simple brokerage transactions from the FTT but not proprietary trading, as this entails purchasing and selling.

**5. *Would retail investors, pensioners or SMEs not end up having to pay the tax?***

No. Generally speaking, there is no danger of this happening. On the contrary, retail investors, pensioners and SMEs could actually benefit from the FTT.

Firstly we must bear in mind that 80 to 90% of the financial transactions we are discussing here and almost all the ‘financial market bets’ that aim to make a large profit from a small initial investment take place between investment bankers and traders. Only a fraction of all so-called ‘hedging transactions’ taking place in the financial markets have a ‘real’ background, i.e. are the result of goods, services or shares actually provided, or the result of loans granted and the need to hedge against the associated price, exchange rate, interest or default risks. Instead, most ‘hedging transactions’ are ‘bets’ between two or several investment bankers with the aim of making a profit from the ‘bet’ itself. Retail investors and SMEs are not involved directly or indirectly.

If these bets work out well, most of the profits go to the investment bankers and traders involved, in the form of high bonuses, and only a very small part is paid out to the shareholders and investors. If, however, the bets backfire, then the bank’s shareholders or the

investors in a fund (including the small savers and pensioners indirectly involved), or – in the worst case scenario – the taxpayers suffer the consequences.

The FTT will enable the chaff (bets) to be separated from the wheat (hedging against real risks). There will be significantly fewer of these bets (the Commission estimates that their volume will be reduced by around 75%), and the size of the bets will shrink, i.e. the leverage effect of the capital invested, will be reduced. The size of the bonuses paid to the investment bankers involved is likely to shrink substantially, while retail investors' earnings will not. At the same time, the risks to shareholders and investors, including retail investors and pensioners, will be reduced.

Secondly, it will have a strong dampening effect on a deplorable practice, something that is a great irritation to the actual buyers and sellers of securities, namely the fact that a host of high-frequency traders and proprietary traders muscle in between the actual buyers and sellers and even charge extra for doing so. Thus, the FTT should ultimately result in better prices not only for retail investors, but also for large institutional investors, such as pension funds, insurance companies or also funds of funds.

So scenarios claiming that up to 20% of small investors' savings will be eaten up by the FTT should be assigned to the world of horror stories and fairy tales made up by those with vested interests. Their only aim is to maintain and avert scrutiny from their and the fund managers' extremely lucrative business model of high-frequency trading and asset churning. These business models, for example actively-managed private pension funds, have long been criticised for their high, and frequently hidden, administration costs and brokerage fees of up to 15% or more of savers' capital, and they would be most severely affected by the FTT. In contrast, products, such as private pension savings plans, which are already very attractive to retail investors, would be unaffected by the FTT.

If the FTT were to be implemented in its proposed form, the providers of such products would be forced to adapt their business model to the new reality in order to save administration costs and taxes. After all, if a traffic light were placed at a crossing, a driver would not drive through a red light simply because the road he is driving on used to be a priority road.

Ultimately it must not be forgotten that private pension provision is already heavily subsidised by the State, whether it be through payments from the government to boost savings or through

tax breaks for contributions. Further tax breaks could scarcely be justified in view of strained public finances and high public debt.

**6. *Won't the FTT be bad for the financial markets' efficiency? After all, even some economists are against the FTT!***

It is quite understandable that the 'modern' investment bankers – i.e. investment banks and hedge funds that have specialised in developing and trading in highly complex 'financial market bets' or high-frequency trading and proprietary trading – should put forward these arguments, as their current business model is under threat. They will have to adapt it, and the FTT could result in their losing a part of their field of operations. This might be bad for their bonuses, but it shouldn't harm the efficiency of the financial markets.

Some of the economists who criticise the FTT, be it at global or regional level, generally also still assume, despite all experience to the contrary, that the financial markets are inherently efficient. To them, certain terms, such as 'returns', 'liquidity', 'market-making' and 'rapidity', are ends in themselves and not just the means to an end. The advocates of this approach to the financial markets adhere to the creed of 'the more and the faster, so much the better!' To them every financial transaction and product is inherently good and boosts productivity, and so their growth should not be stunted by government regulation or taxes.

However, those economists who have thought carefully about developments in the financial markets over the past two decades or who have analysed the financial crisis critically have revised their ideas and now take a different view of the financial markets. Their new guiding principles are 'the dose makes the medicine/poison' and 'market excesses must be corrected!' Liquidity, for example, is no longer an objective in its own right, but rather a means to an end. A given level of liquidity will be enough to ensure that individual large sales or purchase transactions can be executed and do not affect market activity.

So it should come as no surprise that the Commission concluded in its analyses that the FTT will not negatively affect the financial markets' efficiency. Nor will it result in the markets drying up and there being fewer possibilities for hedging risks, even if the number of transactions on the financial markets – and especially derivative bets – does shrink. Instead, the FTT will help to bring about a 'normalisation' of transactions on the financial markets. This should also benefit retail investors and SMEs, as a large proportion of the expensive transactions will no longer be carried out.

**7. *Won't security operations shift to London or New York?***

This risk is relatively small because, under the Commission's proposals, it does not depend so much on where a financial transaction is carried out, but rather with whom and what the traded product is.

If a German bank were to transfer its operations to London, it would still have to pay the tax unless (1) it also moved its headquarters to London and (2) no longer offered financial products to clients from the eleven participating countries of the FTT zone, and (3) no longer offered products from these countries, such as shares, bonds or derivatives. If it were not prepared to do this, it would still have to pay the tax, even if its operations were carried out in London or New York. And if it were prepared to meet all the above-mentioned conditions, other banks would surely be only too happy to step in and take over these lines of business. Because it will still be financially worthwhile to provide financial services in the participating countries.

In addition, the Commission's proposal also contains relatively detailed provisions to prevent abuse, so that certain possible configurations can be ignored if they entail a transfer of business activities only in formal terms but not in substance. All in all, the risk of such a transfer for the purpose of avoiding taxation is therefore very slight, particularly in the case of securities.

**8. *How is the tax to be levied in practice, and how could this be enforced in financial centres that may possibly not cooperate, such as London or New York?***

The Member States have a relatively large amount of leeway on this, as the Commission's proposed framework for harmonising the FTT is a proposal for a directive rather than for a regulation. It would, of course, be preferable for the Member States to reach an agreement on this, as it would be much simpler and cheaper than if the eleven states introduced eleven different systems for collecting the tax.

The ideal scenario would, of course, be for them to agree to make it a tax, where the trading platforms and clearing houses, for example, would charge the tax at the same time as the administration fee or the purchase price. This would be very easy in technical terms. With some small financial incentives, cooperation between trading platforms and clearing houses in the participating countries on the one hand, and the financial authorities on the other could be

organised in such a way that the trading platforms and clearing houses would implement the process without much complaint and at little extra cost.

Quite apart from this, there is also the question of how to implement a similar process on markets outside the participating Member States. But here too, there are certain vested interests on the part of all the parties concerned. Thanks to the new regulatory systems, in future the financial markets will be more transparent than ever. This transparency will be universal, so that the supervisory and tax authorities will have access at any time to the books of the banks, traders, trading platforms and clearing houses.

Ultimately the electronic collection and payment of the FTT could even become a new line of business for cooperating trading platforms and clearing houses, as such a process would also allow the banks to reduce their costs considerably.

In turn, the tax authorities and tax investigators could then concentrate on keeping a closer eye on the books of those banks and funds that have strong business relations with non-cooperating trading platforms and clearing houses.