

A Sterling Solution



Implementing a stamp
duty on sterling to finance
international development

A report for Stamp Out Poverty by Dr Stephen Spratt of Intelligence Capital Limited

Foreword

At The Co-operative Bank we pride ourselves on our customer-led Ethical Policy and the pursuit of sustainable business. Some of the key ethical concerns of our customers surround Corporate Responsibility and Global Trade, so of course we were pleased to back this research. This report demonstrates how a stamp duty on sterling currency transactions is technically feasible and not worth the risk and expense for banks to avoid. Over the last two years we are delighted to have played a supporting role in strengthening the argument for a levy on the trade in currencies with revenues dedicated to international development. Through this work Stamp Out Poverty is making as powerful a case as it can for the implementation of a measure that can harness new finance towards the saving and improving of lives in poorer parts of the world. An initiative we heartily applaud.

Simon Williams, Director of Corporate Affairs, The Co-operative Bank

About the author

Dr Stephen Spratt is Head of Research at Intelligence Capital Limited. His specialist areas include: financial market stability, international regulatory issues, financial crises, domestic financial infrastructure and international capital flows. Stephen holds a BA from the University of East Anglia, an MSc from the University of London and a PhD from the University of Sussex.

About Intelligence Capital Limited

Intelligence Capital Limited is a respected economic think-tank and financial advisory firm which specialises in research-led, innovative financial solutions. With close links to key global financial institutions, Intelligence Capital's work focuses on increasing the flow of capital to emerging and developing markets, often with a developmental or socially responsible objective.

Peer review

This report was peer reviewed by leading international finance expert Professor Rodney Schmidt of the North-South Institute, Ottawa, Canada; Richard Murphy, Director of Tax Research Limited; and Sony Kapoor, International Finance and Development Consultant and senior advisor to major UK NGOs on economic policy and advocacy issues.

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Preface

While this report examines an industry that is global and highly profitable, it is not anti-profit or anti-globalisation. That said, the banking sector's profitability and global nature is an important backdrop to this study. The global airline industry has a good year when profits reach \$2 billion. The global banking sector delivered \$100 billion of profit in 2005 – a substantial part of which is related to globalisation: the financing of trade and arranging of capital flows.

Today, government ability to raise national taxes is hampered by the globalisation of well-paid individuals and large corporations. At the same time, voters are demanding more global goods such as a clean environment and physical security. Consequently, we need to embrace global taxes that may in time replace national taxes. It would be odd if in doing so we end up taxing airlines but not banks. Separately, when considering how to finance initiatives that support those less positively affected by globalisation, it would seem fair that the main beneficiary of globalisation should make a contribution. Banks recognise this. They are involved in a number of initiatives to support education and community lending around the world. But these are often too small or diffuse to make more than a public relations impact.

Unsurprisingly, given the sector's size and profitability, it has one of the strongest lobbies. This lobby projects a view about the fragility and elusiveness of global finance that does not sit with today's reality of highly regulated banking institutions. But in their lobbying they are often supported by politicians who generally have a low level of understanding of finance and a high level of fear of doing anything that might jeopardise the jobs, taxes and political contributions of the sector. Some of you will know me as a former leading currency analyst and senior manager of currency trading businesses at JP Morgan and State Street and I have witnessed much of this at first hand.

It was with some apprehensiveness, however, that Intelligence Capital accepted the invitation to provide an objective and expert opinion on the feasibility of a sterling stamp duty. You never know where good research will take you until the end. I am now convinced that given the Basel Capital Adequacy Accord for internationally systemic banks, the Financial Action Task Force on money laundering and the new continuous linked, real-time settlements system for global foreign exchange, that a Currency Transaction Tax would now be relatively easy for any country to adopt, hard for any bank to evade and possible for most countries to implement unilaterally. I recommend this report to you.

Avinash Persaud

President, Intelligence Capital Limited – former head of currency research at JP Morgan, UBS Philips and Drew and State Street Bank and former visiting scholar at the IMF

Progress and opportunity

In 2006 a distinct, novel area of financing became established with the implementation of three pilot projects to create new income streams for development. In February, in Paris, President Chirac and Kofi Annan opened a conference attended by representatives from 93 countries, including 70 Ministers. Here, the first ever 'development tax' was agreed – an airline-ticket solidarity levy that is set to raise \$200–500 million in its first year. Funds are earmarked for an International Drug Purchase Facility (IDPF) to combat HIV/AIDS, tuberculosis and malaria. In addition, the IFF for immunisation (IFFIm) is about to be launched and is set to raise \$500 million. As well, a Global Lottery is due to start before the end of the year with an estimated income of \$400 million to finance the World Food Programme.

At one level this is remarkable progress – the three pilot initiatives will produce between them more than \$1 billion of new development aid annually. And these are just 'pilot' projects, testing the ground, showing the way – potential revenue is exponentially greater. As well, crucially, such income has an in-built quality, for it is long-term and predictable – such security and reliability is of immense value for development to be successfully planned. Just six months ago 'innovative sources of finance' consisted of no more than a menu of ideas. Now words are turning into actions.

At another level, given the urgency of meeting the Millennium Development Goals, progress is still painfully slow. Our challenge is this: if you are convinced by the arguments in this report concerning the feasibility of a stamp duty on sterling currency transactions, then surely it is time for this initiative to be piloted here (or by any other country with a well-traded currency). A tiny levy on sterling transactions alone could raise as much as these three pilot schemes combined. The need to act – as pandemics rage and the climate warms – has never been greater!

David Hillman

Coordinator, Stamp Out Poverty – formerly Campaigns and Mobilisation Partner at Drop the Debt and Campaign Coordinator at Landmine Action

Executive summary

This report has six principal aims:

- To establish the global funding gap in terms of meeting the UN's Millennium Development Goals (MDGs), and consider the role that 'innovative sources of finance' can play in filling this gap.
- To show that it is not necessary for a Currency Transaction Tax to be universally implemented: it could be introduced unilaterally by any country or currency zone that may wish to do so.
- To highlight the effectiveness and simplicity of other financial transaction taxes that have been implemented in recent years without difficulty, and without provoking the adverse consequences that were predicted beforehand.
- To establish that the UK government could implement a stamp duty on all sterling foreign exchange transactions.
- To consider concerns and objections to the sterling stamp duty (SSD) proposal, and respond to them.
- To produce quantitative estimates of the ultimate impact of the sterling stamp duty (SSD) on the financial institutions that participate in the foreign exchange market, weighing these impacts against the cost to them of avoiding the duty.

This research shows that the UK government could unilaterally implement the SSD in a cost-effective way that causes minimal disruption to sterling currency markets, but raises significant sums that could be used for international development purposes with the potential to increase UK aid expenditure by £1,120 million. Why is this needed, however?

In the last few years it has become increasingly clear that the Millennium Development Goals – the historic agreement in the year 2000 by all UN countries to halve world poverty by 2015 – will not be met, due to lack of financial resources. A significant funding gap exists. This has led many observers to consider whether 'innovative sources of finance' could provide the additional income required. A number of options are in various stages of progress, including the Air Ticket Levy, the International Finance Facility (IFF) and the Currency Transaction Tax (CTT). In the latter case, however, conversation has been muted because it has been widely assumed that, to be effective, such a tax would have to be universally adopted and enforced.

While it may have been the case in the past that a CTT could not be implemented unilaterally, this is no longer so. Historically, the global foreign exchange (FX) market has consisted of disparate parts with little or no links between them. Trades were executed manually by phone between counterparties, and settled through a variety of systems with few linkages between them.

Today, the different components of the global FX market are built on the same technical platforms, use the same electronic messaging providers and trade electronically using the same systems. Furthermore, these trades are settled through either the recently established Continuous Linked Settlement (CLS) Bank – which now settles around half

of all global FX transactions – or through the high value domestic settlement systems run by the world’s central banks.

At this ‘wholesale’ settlement level, the world’s domestic systems are linked to the CLS Bank and to each other. Trades are settled electronically and efficiently, producing real financial gains to international financial institutions, who certainly would not want to sacrifice these benefits. However, these benefits are conditional on participation in the relevant national and international settlement systems. It is this participation that makes an SSD feasible today.

Sterling trades are ultimately settled either through the CLS Bank or the UK’s high value settlement system, CHAPS. The use of a common messaging provider – SWIFT – conveys significant cost savings to participants, but also enables records to be kept of all sterling transactions and allows these records to be cheaply and efficiently relayed to the UK’s tax collecting authorities. Given that banks trading in sterling hold central accounts at the Bank of England – for settling domestic transactions or for inputting to the CLS system – the SSD, once identified, can be cost-effectively collected from these central accounts.

In order to avoid market distortions, the proposal is to levy the SSD at the rate of half of one basis point, or 0.005%. At this rate, the US \$160 billion of sterling that is traded every day in both the ‘traditional’¹ and over-the-counter (OTC) FX derivatives markets results in an annual tax take of \$2.12 billion.

Of course, this assumes that the implementation of the SSD has no impact upon volume traded. Given the extremely low level of the tax, this is not an unreasonable assumption. However, in order to err on the side of caution, we assume a 2.5% reduction in the volume of sterling traded, and this would amount to an annual receipt of \$2.07 billion, or £1.12 billion. The 2.5% figure is based on a report written for the UN on the revenue-raising potential of Currency Transaction Taxes (Nissanke, 2003).

When considering the incentives for financial institutions to avoid the SSD, we focused on the benefits that accrue from membership of the CLS system, and set these against the cost of the SSD resulting from CLS Bank settled trades. As around half of all sterling transactions are settled in this way, the annual SSD take from the CLS system would be a little over \$1 billion. However, when the benefits of the system to its participants are added up, the annual figure is more than \$17 billion. Consequently, it is abundantly clear that there is no incentive for financial institutions to leave the CLS system to avoid the SSD.

The report has also considered other possible objections to the proposal, notably that it would provide an incentive for institutions to a) increase their use of multilateral netting systems, and b) increase their use of derivative instruments to avoid the stamp duty.

The derivatives issue is largely addressed by the fact that the SSD would also be levied on sterling derivatives transactions, which again use common technical platforms and messaging systems. In any case, it is not possible for derivative markets to exist in isolation as derivatives are both hedged and mostly settled in the traditional FX market. These linkages mean that more exotic derivatives such as *options*, *non-deliverable forwards* and *contracts for difference* generate a significant footprint in the traditional FX market and hence the avoidance of SSD through the use of derivatives is not possible.

¹ FX spot transactions, outright forwards and foreign exchange swaps.

The netting issue is also assessed, with the same conclusion being reached as with the CLS system: the costs of hugely increasing the use of multilateral netting systems to avoid an SSD far outweigh the impact of a very modest 0.005% tax on sterling FX transactions.

The fundamental point is that the only way a financial institution could avoid the SSD would be to effectively remove themselves from the international FX transaction, messaging and settlement systems that are described in this report. However, the benefits they obtain from being in these systems dwarf the cost of an SSD levied at the rate proposed.

A further key point relates to the current regulatory environment. The CLS Bank was established to eliminate settlement risk from the global FX market. Given the scale of this market, systemic risk has the potential to seriously undermine the stability of the international financial system. Given this, central banks would simply not allow the world's major financial institutions to leave the CLS system, unless the alternative system that they set up also eliminated settlement risk. This alternative, to be acceptable under the Basel 2 framework and compliant with money laundering regulation, would therefore also be one through which the SSD could be collected.

In summary, an SSD could be implemented today, at relatively low cost and with little scope for avoidance. It would raise substantial annual sums with the potential to increase UK aid expenditure significantly. This would make a real difference to the people of the developing world, whilst its impact on the sterling FX market would be minimal. This report sets out in detail, for the first time, how in practice this could be done.

Introduction

The purpose of this report is to describe in detail how, if it chose to do so, the UK could unilaterally implement a sterling stamp duty (SSD). Why might it wish to do so, however?

Over the past few years it has become increasingly apparent that the UN's Millennium Development Goals (MDGs) are not going to be met without substantial additional financing. This is despite the new resources pledged by the G8 at the 2005 summit at Gleneagles.

This funding gap has increased attention on alternative sources of income: often called 'innovative sources of finance'. Various proposals have been on the table at various times in this respect, each seemingly with its own national champion. Although there has been some discussion of deriving revenue from a Currency Transaction Tax (CTT) to date, the idea has stalled because of the wide assumption that to be feasible and effective a CTT would have to be universally implemented and universally enforced. For many this meant the proposal faced a seemingly insurmountable barrier, since the necessary international consensus could never be built.

This report shows that a CTT does **not** need to be universally adopted: it **could** be implemented unilaterally by any country for its own currency. As we shall see, this has been made possible by developments in the international financial markets in general, and domestic and cross-border payments and settlement systems in particular.

The foreign exchange (FX) market has historically been a rather ad hoc affair, which is surprising considering its sheer scale. Over recent years, however, this has changed considerably. In particular, technological advances have replaced contracts agreed by phone, with correspondence using the internet. This has greatly increased the speed and efficiency of the market, bringing big gains to market participants in terms of both costs and higher turnover.

These developments have also enabled domestic large value payments systems (LVPS) to become increasingly interlinked, facilitating automated transfers of funds at a speed and of a size previously unimaginable. Moreover, domestic LVPS have established formal, cross-border linkages with the establishment of the Continuous Linked Settlement (CLS) Bank, which now settles about half of all global FX transactions.

Major financial institutions would clearly not want to give up these benefits. However, it is exactly the interdependence that has been described – in combination with the common technical platforms and communication systems that are now used – that makes an SSD feasible today.

Common communication and messaging systems make it possible to identify sterling transactions wherever they occur. Interdependent and interlinked LVPS make it possible to collect the SSD efficiently and make avoidance extremely difficult. Finally, the huge benefits that financial institutions have obtained from organising the system in this way cannot be retained if an SSD is to be seriously avoided. An SSD at a very low rate and with negligible impact is a fractional cost in comparison with these benefits. No bank would rationally choose to give up the latter to avoid the former.

As well as demonstrating the feasibility and cost effectiveness of the proposal, this report gives an estimate of the annual tax take, which at £1.12 billion per year would increase UK aid by nearly a third, allowing the UK to make a greater contribution to meeting the MDGs.²

All that is needed now is the political will to make it happen.

The rest of this report is structured in the following way. Section 1 describes why a CTT is needed in the context of meeting the Millennium Development Goals. Section 2 provides some background on the history and schools of thought on financial transaction taxes. Section 3 discusses recent trends in the global foreign exchange (FX) market. Section 4 examines developments in domestic and international payments and settlements systems. Section 5 sets out the sterling stamp duty proposal in detail. Section 6 provides responses to possible objections to the proposal.

2 Statistics on International Development: 2005 Edition
Key Statistics – The UK's Gross Public Expenditure on Development (GPEX) amounted to £4,823mn, the DFID aid programme accounted for £3,838mn in 2004/05.

1 Meeting the Millennium Development Goals: the need for innovative sources of finance

In the year 2000 the United Nations published the Millennium Declaration. The document, ratified by 189 heads of state, expressed a commitment on behalf of its signatories to address critical global problems of poverty, diseases and underdevelopment in a way compatible with environmental sustainability.

Following the Declaration, eight Millennium Development Goals (MDGs) were formulated, with explicit indicators established for each and a deadline of 2015 set for the achievement of most targets.³

The UN General Assembly met in September 2005 to review progress, which to date has been uneven both in terms of the specific MDGs themselves, and the pattern of geographical progress towards meeting them.

In the summer of 2005, the UN Secretary-General, Kofi Annan made these concerns explicit in the UN's progress report on the MDGs:

*If current trends persist, there is a risk that many of the poorest countries will not be able to meet many of them [MDGs]. Considering how far we have come, such a failure would mark a tragically missed opportunity. ... As I said in my March report: 'Let us be clear about the costs of missing this opportunity: millions of lives that could have been saved will be lost; many freedoms that could have been secured will be denied; and we shall inhabit a more dangerous and unstable world.'*⁴

These concerns are backed up by empirical evidence, perhaps most comprehensively set-out in the 2005 report, *Investing in Development: A Practical Plan to Achieve the Millennium Development Goals*,⁵ which was drawn up by 265 of the world's leading development experts and – although positive in some regards – clearly portrays how much still needs to be done.

3 The MDGs are as follows:
Eradicate extreme poverty and hunger; achieve universal primary education; promote gender equality and empower women; reduce child mortality; improve maternal health; combat HIV/Aids, malaria and other diseases; ensure environmental sustainability; develop a global partnership for development

4 UN (2005a)

5 www.unmillenniumproject.org/reports/index.htm

TABLE 1
Global progress
on the MDGs

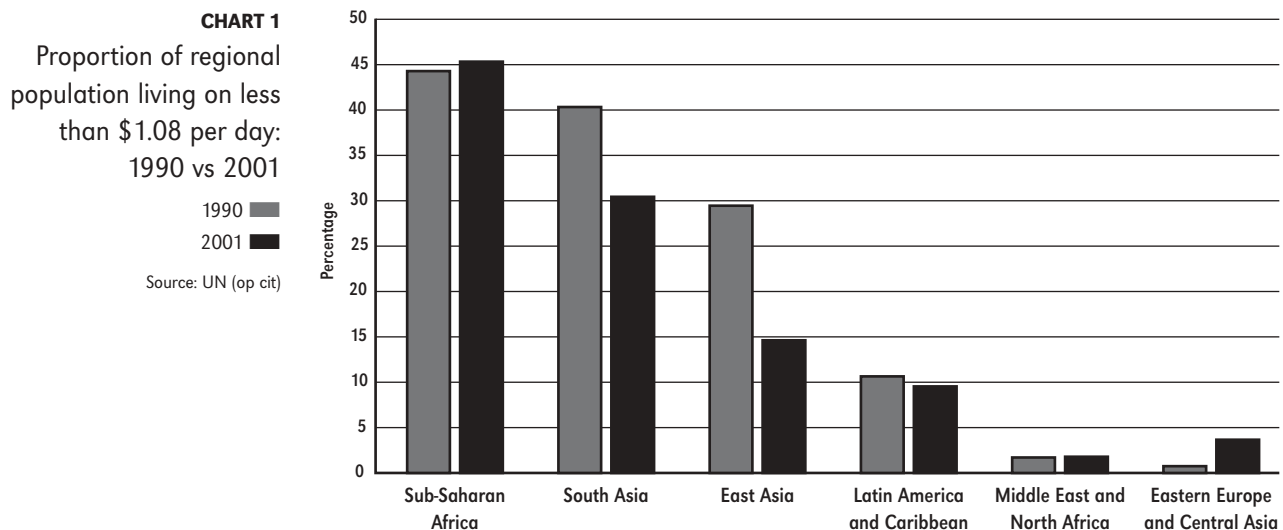
Source: UN (2005a)

Indicator	1990	2002
GDP per capita (1995 US\$)	1,071	1,299
Headcount poverty (%)	28	21
Undernourishment prevalence (%)	20	17
Under-five mortality (per 1,000 live births)	103	88
Life expectancy (years)	63	65
HIV prevalence (%)	0.5	1.6
Access to improved drinking water (%)	71	79
Access to improved sanitation (%)	34	49

Table 1 details aggregate global progress on the key indicators. As can be seen, there has been positive change on every indicator, with the notable exception of HIV

prevalence. However, whilst this aggregate picture is broadly encouraging, it gives a very unrealistic picture of the reality on the ground at the regional and country level.

Table 1 shows that the proportion of people living in absolute poverty (measured as those living on less than \$1.08 per day) has fallen from 28% to 21% over the past 12 years. However, as Chart 1 below demonstrates, these global aggregate figures give little sense of the prevalence of absolute poverty in each region: in 2001, the figure for sub-Saharan Africa was more than 45% of the population, whilst the corresponding figure for the Middle East and North Africa was just 2%. Furthermore, the decline in the global average over the period considered is almost entirely the result of large reductions in poverty levels in East Asia and South Asia, containing the billion-plus populations of China and India respectively.



In East Asia, the proportion of the population living in absolute poverty fell from 30% to 15%, whilst South Asia saw a reduction of 10 percentage points, from 41% to 31%. In contrast, Latin America and the Caribbean saw a very small improvement, the situation in the Middle East and North Africa was unchanged, and Eastern Europe and Central Asia saw a significant deterioration. The most alarming region, however, is sub-Saharan Africa, where the proportion of the population living in absolute poverty actually rose from 45% to 46% between 1990 and 2002.

Much of these regional differences can be explained by two factors: economic growth rates and levels of population growth. For example, while India's growth record has been impressive in recent years, the country's population has also increased substantially. In contrast, China's relatively stable population growth has allowed its impressive economic growth rates to feed through into significantly higher per capita incomes. Sub-Saharan Africa has seen the worst of both worlds: low (even negative) economic growth combined with rapid population growth.

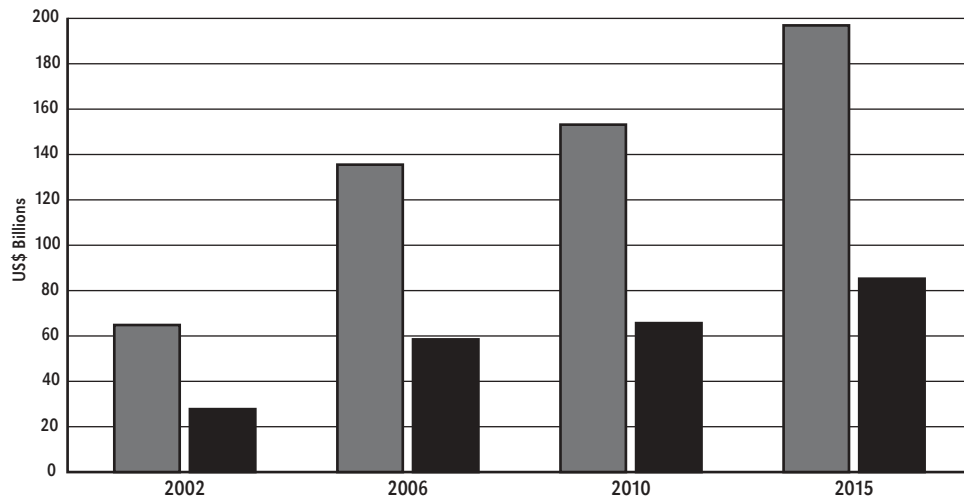
Indeed, the situation in sub-Saharan Africa is such that, on current trends, few if any of the MDGs have a realistic chance of being met. It was concerns of this kind that motivated the Make Poverty History campaign in 2005, and which contributed to the

announcement of modestly increased official development assistance (ODA) by the G8 at their summit that year.

Recognising the crucial importance of accelerating progress if the 2015 deadline is to be met, particularly in Africa, G8 leaders committed to incremental increases in aid budgets – with some setting a deadline to meet the long-standing 0.7% of GDP target – and reductions in the debt burdens of some of the poorest developing countries. Meeting in Gleneagles, Scotland, in July 2005, the Heads of Government therefore agreed to double aid to Africa from \$25 billion per year to \$50 billion by 2010, and to increase total ODA to \$129 billion by the same year.

If fulfilled, these pledges have the potential to accelerate progress on meeting the MDGs. However, even with this additional funding, it is likely that many MDGs will not be met, particularly – though not exclusively – in sub-Saharan Africa. Chart 2 below gives the most authoritative estimate of the total ODA needed to meet the MDGs by 2015. As can be seen, in 2010, required ODA is more than \$150 billion, significantly above that promised at Gleneagles – indeed, the figure needed for 2006, is higher than that currently committed to for 2010. Furthermore, historically less than half of ODA has been spent in a way that would contribute to the MDGs, as depicted with the darker bars in Chart 2. If this trend were to continue, then MDG-dedicated-ODA, would be less than half that required, with clear implications for the world’s ability to meet the development goals.

CHART 2
 Estimated global ODA required to meet MDGs
 Total required ODA
 ODA allocated to MDGs (2002 proportion)
 Source: UN (2005b)



A final issue in this regard relates to the willingness (or ability) of donor governments to honour the pledges made in 2005. The G8 Summit had barely finished before a number of governments began talking of budget constraints and fiscal considerations affecting their ability to honour these pledges. Past experience suggests that it is highly likely that these pledges will become ‘aspirations’ – indeed, it is important to note that actual dispersals of ODA have been equally as volatile as private capital flows. However, even if this were to change fundamentally and all pledges were to be fully honoured, the world would still face a significant funding shortfall from that required to meet the MDGs by 2015.

Other sources of income are clearly needed, which has led attention to ‘innovative sources of finance’. The preface to this report describes the dramatic progress that is happening in 2006, with three pilot projects to create new income streams for development being launched:

In February, in Paris, President Chirac and Kofi Annan opened a conference attended by representatives from 93 countries, including 70 Ministers. Here, the first ever ‘development tax’ was agreed – an airline-ticket solidarity levy that is set to raise \$200–500 million in its first year. Funds are earmarked for an International Drug Purchase Facility (IDPF) to combat HIV/AIDS, tuberculosis and malaria. In addition, the IFF for immunisation (IFFIm) is about to be launched and is set to raise \$500 million. As well, a Global Lottery is due to start before the end of the year with an estimated income of \$400 million to finance the World Food Programme.

At one level this is remarkable progress – the three pilot initiatives will produce between them more than \$1 billion of new development aid annually. And these are just ‘pilot’ projects, testing the ground, showing the way – potential revenue is exponentially greater.

A closer look at these initiatives reveals the following. Firstly, all are clearly linked to outcomes: ATL for drug treatment; IFFIm for immunisations; Global Lottery to the World Food Programme. Secondly, the concept of a number of ‘complementary’ mechanisms is now broadly accepted and has seemingly prevailed over the idea of one all-encompassing initiative (such as a large-scale IFF), which was effectively ‘in competition with’ all other proposals. Thirdly, there are clearly three different strands of financing: the ATL is a **tax**, the IFFIm a **borrowing mechanism**, and the Global Lottery a **voluntary contribution**. Fourthly, there is a growing awareness that the phenomenon of innovative financing is as much about aid **quality** – secure on-going revenue streams providing predictability of finance, which is essential for development planning – as it is about aid **quantity**.

However, despite this progress, there is still a critical funding shortfall when it comes to financing the MDGs. It is, therefore, necessary to look urgently at other possible sources of finance such as Currency Transaction Taxes. The UN’s *World Economic and Social Survey 2005* considers various innovative financing options, distinguishing between the proposals in terms of the need for universal adoption, and the speed with which each option could be implemented. Clearly, the need for universal adoption is a key drawback of any proposal – even if such agreement could be reached, it would inevitably take a long time to be implemented. Therefore, in one crucial respect we disagree with the UN’s taxonomy as set out in this survey.

The UN report classifies the currency tax option as requiring universal adoption. On the contrary, as this report strongly argues, a CTT can and should be implemented individually at the national level.⁶ The proposal is feasible, cost effective and would cause minimal disruption to markets. Furthermore, a sterling stamp duty would raise significant finance, enabling the UK to contribute more towards paying for the MDGs.

⁶ See Kapoor, S (2005) for a comprehensive rationale for this position.

2 Financial transaction taxes

Financial transaction taxes have a long and distinguished intellectual and practical history. In 1936, John Maynard Keynes proposed that a small transaction tax should be levied on dealings on Wall Street, where he argued that excessive speculation⁷ by uninformed financial traders increased volatility.

For Keynes, the key issue was the proportion of ‘speculators’ in the market, and his concern that, if left unchecked, these types of players would become too dominant.

Speculators may do no harm as bubbles on a steady stream of enterprise. But the situation is serious when enterprise becomes the bubble on a whirlpool of speculation. (1936:159)

It is usually agreed that casinos should, in the public interest, be inaccessible and expensive. And perhaps the same is true of stock exchanges. That the sins of the London Stock Exchange are less than those of Wall Street may be due, not so much to differences in national character, as to the fact that to the average Englishman Throgmorton Street is compared with Wall Street to the average American, inaccessible and very expensive. ... The introduction of a substantial Government transfer tax on all transactions might prove the most serviceable reform available, with a view to mitigating the predominance of speculation over enterprise in the United States. (1936:159-60)

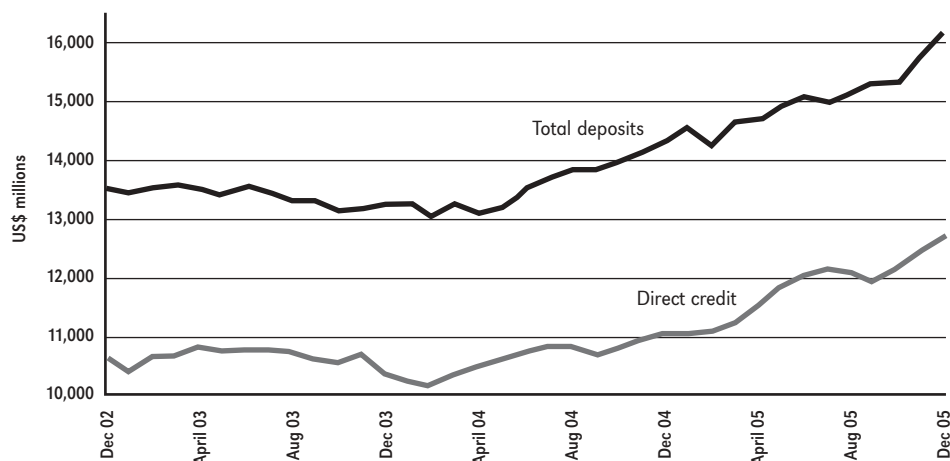
Although the US government did not act on this advice, the stamp duty on shares in the UK remains in place today. It should be stressed that at 0.5% this is 100 times larger than the rate of the SSD proposed here. Indeed, as shown in Table 2 (page 15), taxes on financial transactions have been common historically, remain so today, and are generally many times greater than the SSD rate proposed. In many ways, the ‘anomaly’ is that no tax is levied on foreign exchange transactions, despite the FX market having the greatest volume in the world.

A common objection to the introduction of financial transaction taxes is that they will a) distort the market, and b) drive investors/financiers out of the economy or

⁷ Keynes distinguishes between ‘speculation’ and ‘enterprise’, with the former being akin to gambling, and the latter a financial transaction serving an underlying economic purpose.

CHART 3
Bank deposit and credit levels following Peru’s introduction of a financial transaction tax in 2003

Source. Superintendencia de Banca y Seguros, Lima. December, 2005



sector to other, untaxed economies. In reality, however, the practice is often very different. For example, in 2003 the Peruvian government introduced a 0.1% general financial transaction tax, with the aim of raising finance for the education sector. At this time, the national and international financial press, concerned private investors and international financial institutions such as the IMF predicted severe negative consequences to the Peruvian economy. In particular, they feared that bank deposits would be withdrawn, adversely affecting the availability of credit in the economy, and thereby restraining growth rates.

Chart 3 illustrates what actually happened in practice in this respect. As can be seen, far from reducing bank deposits and therefore credit, the period following the introduction of the financial transaction tax saw both bank deposits and access to credit increase steadily.

Furthermore, as shown in Table 2, general financial transaction taxes have also been introduced in Argentina, Brazil and Colombia in recent years. As with the case of Peru, dire warnings were given about the consequences of these taxes, but as with Peru, these proved to be unfounded. In each case, the financial sector has adapted itself to the transaction tax with no major repercussions, and this is despite the fact that the rate at which these taxes are levied are many multiples of the SSD rate proposed here.

Despite this, these countries remain under pressure – not least from the IMF – to remove this tax that efficiently and effectively raises significant sums to fund education. The fact that the dire consequences of implementing the tax – that had been predicted – did not happen suggests that this continuing pressure is not based upon empirical analysis. It is of course unsurprising that private investors will predict doom following the implementation of taxes that directly affect them, but the evidence strongly suggests these concerns are unfounded. An SSD would be no different in this respect. Indeed, given the extremely low rate proposed, it is likely that very little impact of any kind would be felt in the financial markets.

2.1 Evolution of the Currency Transaction Tax

For many observers, a Currency Transaction Tax (CTT) is related to the work of Nobel Laureate James Tobin. The Tobin Tax, as it came to be known, was first proposed in 1973 with the aim of discouraging speculation in the FX markets, and therefore reducing volatility.

His aim was to ‘throw sand in the wheels’ of the global FX market by disproportionately taxing short-term, high turnover currency trading. He argued that this would reduce speculation and lower volatility by bringing market prices more in line with underlying fundamentals, which drive the behaviour of longer-term investors.

Opponents cited Friedman (1953), arguing that speculators act to stabilise markets through rational arbitrage. That is, when prices rise above their fundamental ‘fair value’, rational speculators will sell and drive prices back to their equilibrium level. Conversely, when speculators see prices below this equilibrium level, they will buy thus bidding prices up. Reducing speculation would not therefore reduce price misalignments, but rather would enable them to persist for longer periods.

TABLE 2
Security transaction
taxes around the world

Source: Pollin (2005)
V = VAT on trade costs

Country	Stocks	Corp Bonds	Govt Bonds	Futures	Detail
Argentina	0.60%	0.60%	0.60%	0.60%	Tax of 0.6% on all financial transactions approved by legislature March 2000
Australia	0.30%	0.15%	–	–	Reduced twice in 1990s: currently 0.15% each for buyer and seller
Austria	0.15%	0.15%	–	–	Present
Belgium	0.17%	0.07%	0.07%	–	Present
Brazil	0.3% [0.38%]	0.3% [0.38%]	0.3% [0.38%]	–	Tax on FX from 2% to 0.5% in 1999. Tax on stocks increased and bonds reduced 1999
Chile	18% V	18% V	–	–	Present
China	0.5% or 0.8%	[0.1%]	0	–	Tax on bonds eliminated 2001. Higher rate on stock exchanges applies to Shanghai
Colombia	1.5%	1.5%	1.5%	–	Introduced 2000
Denmark	[0.5%]	[0.5%]	–	–	Reduced in 1995, 1998. Abolished 1999
Ecuador	[0.1%]	[1.0%]	–	–	Tax on stocks introduced 1999, abolished 2001. Tax on bonds introduced 1999
Finland	1.6%	–	–	–	Introduced 1997, applies only to trades on HEX electronic exchange
France	0.15%	See note	–	–	Present. Sources ambiguous as to whether tax applies to bonds
Germany	[0.5%]	0.4%	0.2%	–	Removed 1991
Greece	0.6%	0.6%	–	–	Imposed 1998, doubled 1999
Guatemala	3%	3%	See note	–	Present. Sources ambiguous as to whether tax applies to government bonds
Hong Kong	0.3% + \$5 SF	[0.1%]	[0.1%]	–	Tax on stocks reduced from 0.6% in 1993. Tax on bonds eliminated 1999. \$5 stamp fee
India	0.5%	0.5%	–	–	Present
Indonesia	0.14% + 10% V*	0.03%	0.03%	–	* VAT on commissions. Introduced 1995
Ireland	1.0%	–	–	–	Present
Italy	[1.12%]	–	–	–	Stamp duties eliminated 1998
Japan	[0.1%], [0.3%]	[0.08%], [0.16%]	–	–	Removed 1999
Malaysia	0.5%	0.5%	0.015% [0.03%]	0.0005%	Present
Morocco	0.14% + 7% V	7% V	7% V	–	Present
Netherlands	[0.12%]	[0.12%]	0	–	1970–1990
Pakistan	0.15%	0.15%	–	–	Present
Peru	[0.1%], 0.08% + 18% V	[0.1%], 0.08% + 18% V	[0.1%], 0.08%	–	Financial transaction tax implemented 2003, reduced to 0.08% 2005. VAT Present
Philippines	[0.5%] + 10% V	–	–	–	VAT present
Portugal	[0.08%]	[0.04%]	[0.008%]	–	Removed 1996
Russia	0.8% [†] + 8% V	–	–	–	[†] 0.8% on secondary offerings. Present
Singapore	0.05% + 3% V	–	–	–	Reduced 1994, eliminated 1998. VAT present
South Korea	0.3% [0.45%]	0.3% [0.45%]	–	–	Reduced 1996
Sweden	[1%]	–	–	–	Removed 1991
Switzerland	0.15%	0.15%	0.15%	–	Present 0.3% on foreign securities, 1% new issues
Taiwan	0.3% [0.6%]	0.1%	–	0.05%	Reduced 1993
UK	0.5%	–	–	–	Present
Venezuela	0.5% [1%]	–	–	–	Reduced May 2000
Zimbabwe	0.45% V	–	–	–	Present

Those taking the opposite view,⁸ however, argue that ‘noise traders’ do not tend to move the market towards fundamental equilibrium but, in fact, do the exact opposite. Consequently, a transaction tax that disproportionately targets such traders – such as the Tobin Tax – would, *ceteris paribus*, keep prices closer to their fundamental values by increasing the proportion of traders in the market who base their decisions on underlying fundamentals.

The evidence on this issue remains inconclusive. For example, Umlauf (1993) concludes that the imposition of a transaction tax increased the volatility of the Swedish stock market. Habermeier and Kirilenko (2001) report similar findings, where the imposition of a securities transactions tax increases volatility through a reduction in the volume of trading. Aliber et al (2003) find evidence that transaction costs were positively related to volatility (and inversely related to volume) for four major global currencies between 1971 and 1999. In contrast, using a model-based approach, Wei and Kim (1997) find transaction taxes reducing volatility in the FX market, a result confirmed in a separate model developed by Westerhoff and Dieci (2004), which uses a behavioural finance approach to the issue.

Interest in the idea of the Tobin Tax grew substantially in the 1990s, largely due to the increased incidence of financial crises in general and currency crises in particular. Early theoretical work on currency crises, offered little explanation for many of these events. For example, ‘first generation’ currency crises models⁹ typically saw crises as resulting from policy inconsistencies within the countries affected, which prompted rational investors to sell their holdings, thus initiating a run on the currency. That is, they were primarily the ‘fault’ of the countries affected. For many, these explanations often seemed to be at odds with the facts of crises, resulting in the development of ‘second-generation’ crisis models with more explanatory power.¹⁰ These models stressed the self-fulfilling, herd-like nature of many currency crises, with the role of speculators being key: market actors did not simply respond to changing fundamentals; their behaviour itself shaped those fundamentals. Changing this behaviour would therefore change the incidence of crises.

Most commentators came to view the second-generation models as being more reflective of the real world, which raised hopes that the Tobin Tax could reduce the incidence of these developmentally damaging events, by influencing the (individually rational, but collectively irrational) behaviour of speculators. However, this view was countered by the observation that, in many such events, speculators are betting on forcing a devaluation from a fixed exchange rate peg, where ‘success’ might see the currency devalued by as much as 40%. In the face of potential profits of this magnitude, a small CTT is no disincentive.

This shortcoming in the original CTT concept was effectively addressed in Spahn (1996), where a two-tier structure was proposed. Under normal market conditions, a minimal (perhaps zero) ‘transaction charge’ would apply to all currency transactions. However, this charge would be augmented by an ‘exchange surcharge’, which would only come into effect when the exchange rate moved outside a predetermined range. In these circumstances, a very high rate of tax would apply to transactions in the affected currency, which would act as a severe disincentive to currency speculators, who would no longer be facing a ‘one-way’ bet. In effect, the Spahn proposal would short-circuit

8 See Stiglitz (1989) and Summers & Summers (1989), for example.

9 See Krugman (1979) for the canonical model in this regard.

10 See Obstfeld (1986)

speculative attacks. Indeed, as Spahn argued, in practice the exchange surcharge might never be invoked, since speculators seeing the exchange rate approach the level at which it would become operational would adjust their behaviour to avoid being caught by the tax.

This discussion has, it is hoped, served to highlight an important, but often overlooked point: it is rarely made clear that there is not one CTT, but three. The original proposal by James Tobin had the aim of reducing short-term, high-frequency currency trading. The second proposal, the Spahn variation, had the aim of ‘short-circuiting’ speculative attacks and currency crises, rather than raising tax revenue. This framework is best suited to middle-income emerging and developing countries which wish to protect their economies from the highly damaging impacts of exchange rate volatility and financial crises.

The third form of the CTT, however, is quite explicit in its tax raising objectives. This approach is exemplified in Schmidt (2001), where the author demonstrates convincingly that, contrary to received wisdom, it is entirely possible for countries to unilaterally impose a duty on their own currency’s transactions. Furthermore, although the revenues raised could be used for any purpose by the government concerned, it has been historically argued that these should be ring-fenced and used for international development objectives. This approach is therefore suited to developed countries seeking ways to increase aid volume for purposes such as meeting the MDGs.

It is this third form of CTT that is addressed in this report. It will be demonstrated that the UK government **could** unilaterally initiate a stamp duty on sterling transactions. Furthermore, we will see that this measure would be relatively straightforward to implement and would raise significant sums that could be used to make progress on the MDGs.

As was described in Section 1, there is a clear need for ‘innovative sources of finance’ for this purpose. A sterling stamp duty (SSD) is one feasible means to increase revenue for aid, and one that would be relatively easy to implement, enforce and collect. The same is also true for any developed country or regional zone, whose currency is traded in sufficient volume as to yield a significant revenue stream. Clearly, the scale of the MDG shortfall is such that a currency stamp duty such as the SSD cannot fill the gap on its own. It can certainly reduce it, however. Yet if the UK were to implement an SSD, as sterling is one of the world’s most traded currencies, it would set an important example encouraging other countries and currency zones to follow its lead, thus increasing revenues and making an even greater developmental difference. In this regard, Appendix 1 presents a picture of the potential annual revenues obtainable from a CTT implemented on the world’s most traded currencies.

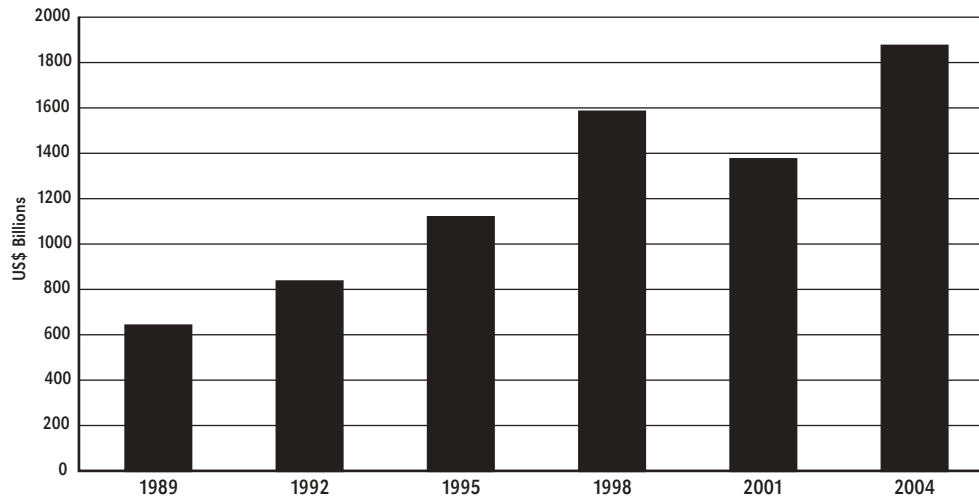
Before describing the sterling proposal in detail, the next two sections give a review of broad trends in the global FX market and developments in international payment and settlement systems – trends that are directly relevant to the detailed exposition of the proposal that will follow.

3 The global foreign exchange market

In March 2005, the Bank for International Settlements (BIS) released the results of its triennial survey of foreign exchange market activity.

CHART 4
Daily foreign exchange market turnover

Source: BIS (2005)



The results show that the size of the market continued to grow rapidly, as illustrated in Chart 4 above. Following the fall in daily turnover reported in 2001 – largely the result of the introduction of the euro, which significantly reduced the number of traded currencies – the upward trend continued.

By 2004, global FX markets saw average daily turnover of US \$1,880 billion, which is broadly equivalent to the annual GDP of the United Kingdom.

CHART 5
Global foreign exchange market shares

spot transactions
outright forwards
FX swaps
Source: BIS (2005)

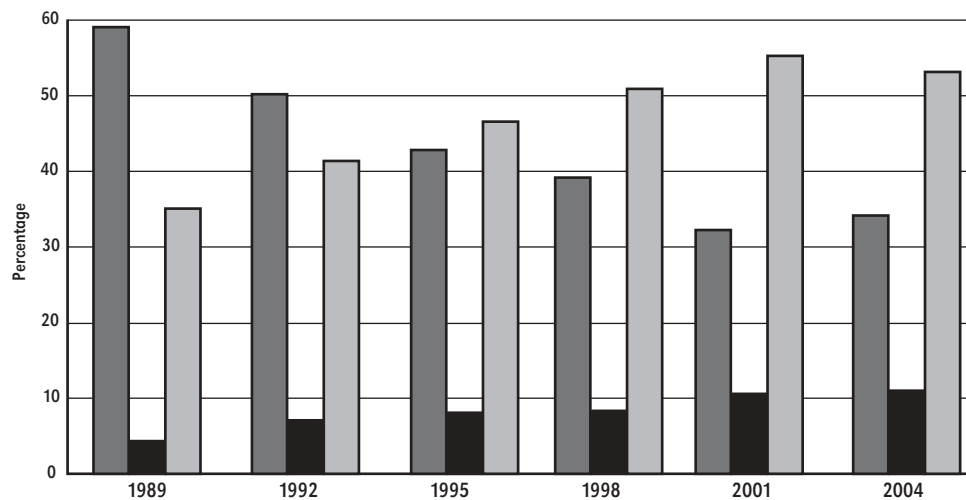
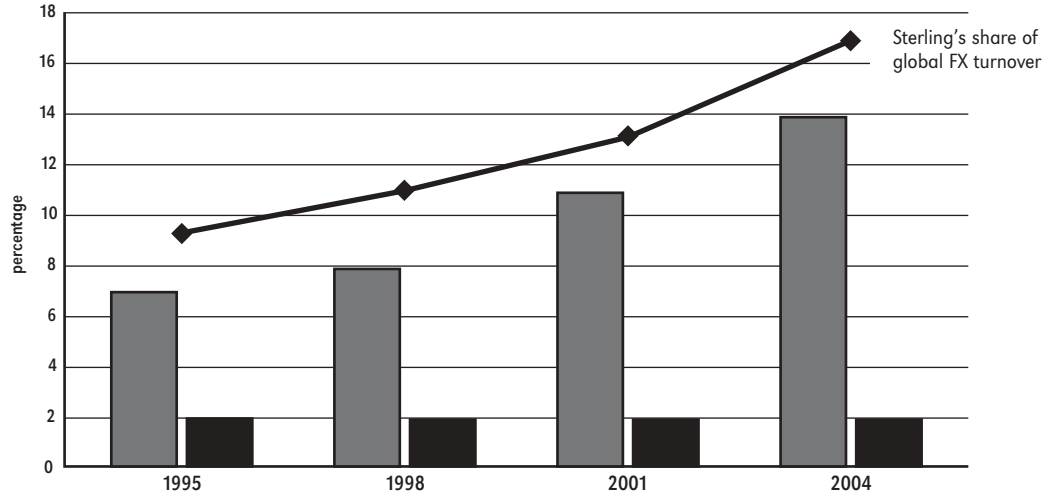


Chart 5 breaks down this headline figure into its major components in terms of market share. The biggest change over the period is the relative decline in the importance of

the spot market and the increase in the importance of the swap market. However, a closer look at Chart 5 shows this trend reversing between 2001 and 2004, as growth in the size of the spot market accelerated.

CHART 6
Sterling's share of global foreign exchange turnover and key currency pairs
dollar/sterling
euro/sterling
(mark/sterling before 2001)
Source: BIS (2005)



Turning to the UK, Chart 6 shows that sterling's share of global FX transactions has increased significantly, from less than 10% in 1995 to almost 17% in 2004 (ie: 17% of all global FX trades had sterling on one side). Consequently, we can say that sterling transactions account for 8.5% of the \$1,880 billion daily figure, or \$160 billion. As Chart 6 also makes clear, sterling's recent increase is almost entirely accounted for by the rise in the market share of the dollar/sterling currency pair, which alone accounted for 14% of the global FX market in 2004. In contrast, euro/sterling's (mark/sterling before 2001) share has remained constant at around 2% of the market.

CHART 7
The UK's share of global foreign exchange market and number of banks in UK that account for >75% of transactions
number of banks
Source: BIS (2005)

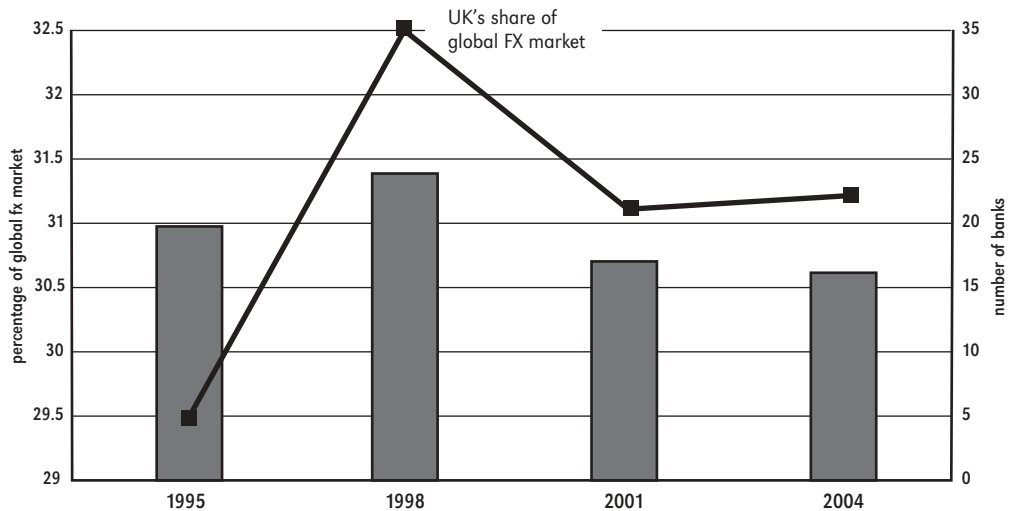


Chart 7 highlights the fact that although sterling trades are on one side of 17% of the total market, more than 30% of all FX transactions occur in the UK, highlighting the importance of London as an international financial centre.

There has also been considerable consolidation in the banking sector, so that by 2004 just 16 UK-based banks dominated the local market.

CHART 8
Daily turnover in the
foreign exchange OTC
derivative market

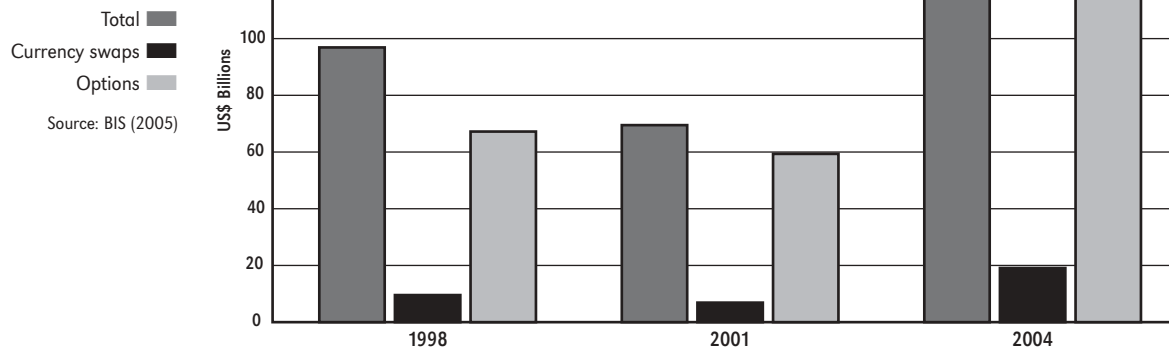


Chart 8 shows trends in the OTC FX derivatives market. Although ‘outright forwards’ and ‘foreign exchange swaps’ are classified as OTC derivatives, they are ultimately settled in the ‘traditional’ market and would therefore fall unavoidably within the ambit of the SSD. Consequently, the data for these trades are included in the total traditional FX market figures, as shown in Chart 5 above. The main derivative figures not included in this section are ‘currency swaps’ and ‘options’, details of which are given in Chart 8. As can be seen, by 2004, daily turnover equalled \$138 billion, with the overwhelming majority being accounted for by FX options.

Since all options are not ultimately executed, this market needs to be treated differently from the traditional market where the gross amounts change hands. Some commentators have suggested that if the SSD were not applied to FX option contracts, this would risk undermining the general effectiveness of the duty – as traders would naturally gravitate towards the untaxed sector and greatly increase their use of those option contracts that do not settle in the spot market.¹¹ To prevent this occurring, it is proposed that the SSD be applied to all executed FX options contracts that settle on a cash for difference basis, as well as to the traditional FX market.

However, this risk is not as great as often supposed, as hedging activity related to FX option contracts will also leave a significant ‘footprint’ in the traditional FX market, which would be also be captured by the SSD. Most sellers of options (mostly banks and big financial institutions) and other contingent derivatives, will not carry a ‘naked’ or un-hedged position, which is fundamentally risky, but will cover their exposed positions through a series of hedging transactions in the traditional market – the most common of which is called delta hedging. This means that option (and other contingent derivative) transactions are not stand alone but are intimately linked to the underlying traditional market and generate a significant footprint in these markets. So by virtue of having sold an option, a bank will in most cases increase its transactions in the traditional markets and thus pay a proportionately higher amount of SSD. As well, while most options (and other contingent derivatives) expire worthless, some will be exercised – in which case the currency value that changes hands will be captured by the traditional markets in any case.

¹¹ FX options can be settled either with an exchange of currency in the spot market, which would fall within the ambit of the proposed SSD, or may be settled on a cash for difference basis with no exchange of currencies.

As with the main FX market described above, the UK jurisdiction accounts for a large share of the global FX OTC market. In 2004 the UK's market share was just under 35%, up two percentage points on the 2001 figure.

This macro overview gives a sense of the sheer scale of the global FX market. However, it says nothing about the mechanics – or 'plumbing' – that allow these huge daily transfers of funds to actually happen. For this we must examine developments in domestic and international payment and settlement systems. This is the subject of Section 4.

4 International payment and settlement systems

The past two decades have seen major changes in both national and international payment and settlement systems. The most relevant developments, from our perspective, relate to the structure and practice of Large Value Payment Systems¹² (LVPS). From the perspective of this report, it is these changes that make the SSD proposal feasible today in a way that was not the case in the relatively recent past.

The LVPS of any country is fundamental to the smooth functioning of its economy. Consequently, such systems tend to be directly or indirectly owned and operated by the financial authorities of the country concerned, usually the central bank. In the UK, the Bank of England has this responsibility, and describes the importance of this function as follows:

*A payment is a transfer of value between agents. A payment system can then be defined as any organised arrangement for transferring value between its participants. So defined, it is clear that payment systems are fundamental to the functioning of all economies. If transactions are the lifeblood of market economies, then payment systems are the circulation system for these transactions.*¹³

Any LVPS entails inherent risks, which relate to a) the smooth functioning of the system itself – ie: the efficiency of the ‘plumbing’ – and b) to the behaviour of participants in the system. In particular, a default by any member of the LVPS has the potential to trigger a multiplier effect, where the ultimate outcome may far outweigh the magnitude of the original default, perhaps even threatening the viability of the entire system.

Much of the reforms to LVPS that have occurred have been designed to mitigate this ‘settlement risk’, which turns on the timing of payments. Historically, most LVPS have operated on a Deferred Net Settlement (DNS) basis. In a DNS system, payment orders are accumulated throughout the day, and then typically settled as a block at close of business. Trades are settled on a net basis, thus reducing liquidity requirements on participants in the system, and ultimately the central bank.

Despite these advantages, however, DNS systems do carry particular risks. In particular, settlement risk accumulates throughout the day, and remains unmitigated until the final net settlement occurs. Up to this point, any participant could default which, given the netted nature of the final settlement, would result in a large proportion of netted trades having to be unwound. The initial default therefore has the potential to trigger further defaults throughout the system. For many regulatory authorities, this ‘systemic risk’ inherent in DNS systems has long been unacceptably high, which has led directly to the replacement of DNS with Real Time Gross Settlement (RTGS) systems.

In an RTGS system, as the name suggests, payments are settled in real time – ie: as soon as they enter the system, but in gross rather than netted form. Real time settlement is dependent on the participant in question having sufficient funds within the system to settle the transaction. RTGS systems have the key advantage that,

¹² Large Value Payment Systems can be distinguished from large Volume systems in that the former typically refer to the wholesale sector, whilst the latter refer to the retail sector.

¹³ Bank of England (2004)

unlike DNS systems, settlement risks do not accumulate throughout the day – thereby cumulatively increasing systemic risk – but are settled on a case-by-case basis as they enter the system. Crucially, trades are settled **simultaneously** in RTGS systems, thus eliminating settlement risk. This is done on either a payment versus payment (PvP) basis, or as delivery versus payment (DvP) for securities transactions.

One disadvantage of RTGS systems, however, is that by settling on a gross rather than a net basis, participants in the system are required to maintain higher levels of liquidity than is the case with DNS systems. This is a trade-off, wherein central banks have had to balance their desire for robustness, with the desire of participants in the system to minimise liquidity requirements and maximise operational efficiency. Concerns over systemic risk clearly outweighed other considerations in the 1990s, however, when RTGS systems became the dominant form of LVPS, first in developed markets, but increasingly in emerging markets also.

The process of developing and refining LVPS within countries has been greatly facilitated by advances in IT and communication systems. In particular, for nearly 30 years, financial transactions between institutions have been facilitated by the Society for Worldwide Interbank Financial Telecommunications (SWIFT). SWIFT is a cooperative body owned and managed by its members, which are the world's major financial institutions. Domiciled in Belgium, SWIFT provides secure messaging services between financial institutions. SWIFT also serves the same function in providing messaging between these financial institutions and a) the infrastructure of LVPS (eg: CHAPS in the UK), as well as b) the respective oversight bodies for each jurisdiction (eg: the Bank of England).

Originally, SWIFT developed its own system to perform these functions, but developments in telecommunications – notably the worldwide web – have allowed it to move to an internet based service: SWIFTNet. The SWIFTNet FIN messaging service today has more than 7,500 active users in more than 200 countries. The service sends an average of nearly ten million messages a day, which are divided into ten categories organised as five separate functions. By far the largest of these functions relate to payments messages.

SWIFTNet also provides secure messaging services to the vast majority of major LVPS globally, as well as to the major international payment and settlements systems, which have been developed in recent years.

The most relevant of these, for the purposes of this report, is the Continuous Linked Settlement (CLS) system for settling FX transactions. As described above, a key advantage of RTGS systems is that payment is not deferred, but occurs as orders arrive and are settled on a PvP or DvP basis. That is, both sides of any transaction are settled simultaneously, ensuring that one side cannot execute its side of the transaction and then run the risk of a default by the other party. In foreign exchange markets, however, which almost by definition are cross-border, this is often not possible due to different time zones.

Historically, institutions have tried to mitigate this risk – often called Herstatt Risk¹⁴ – through bilateral and then multilateral netting systems. Examples of the former include FXNet and VALUENet. These bilateral systems enabled pairs of financial institutions to offset concurrent obligations to each other, leaving only each institution's 'net-net'

14 On 26th June 1974 at 15:30 CET, the German authorities closed Bankhaus Herstatt, a middle-sized bank with a large FX business. Prior to the closure, however, a number of Herstatt's counterparty banks had irrevocably paid Deutsche marks into Herstatt but, as US financial markets had just opened, had not yet received their dollar payments in return. This failure triggered a ripple effect through global payment and settlement systems, particularly in New York. Ultimately, this fed into New York's multilateral netting system, which over the following three days, saw net payments going through the system decline by 60% (BIS 2002).

position to be settled. The Exchange Clearing House (ECHO) subsequently extended this function from two participants to a wider group, where each institution's net-net position was settled through a central party. ECHO ultimately merged with the other large multilateral netting system, MultiNet, as it had become clear that, in order to operate efficiently and cost-effectively, multilateral netting systems needed to include a high proportion of significant international banks.

In 1997, however, the G20 announced the plan to develop the CLS Bank, so as to eliminate settlement risk in the FX market. ECHO was brought under the CLS aegis in 1998, before being switched off in 1999. ECHO was ultimately stopped due to its relatively high cost, demonstrating that such systems are only viable if operating with very high values and the highest possible proportion of relevant participants. The CLS Bank became operational in September 2002, and since that point its market share has grown rapidly.

The CLS system – like the national RTGS systems – settles transactions on a PvP basis, thereby eliminating Herstatt Risk. The CLS Bank is linked to all the national RTGS systems, and settles FX transactions during a five-hour window when the time zones of the major LVPS overlap. Up until 06:30 CET, members are able to submit settlement instructions to the CLS Bank. At 06:30 members receive their final 'pay-in schedule' for the day and pay the necessary funds into their settlement accounts at their respective central banks (which are directly linked to the CLS system). From 07:00 to 09:00 the CLS Bank receives funds from its members' accounts and settles all trades across its books, by paying out to settlement members. If trades cannot be settled due to insufficient funds being transferred – thereby preventing PvP settlement – they are placed in a queue and regularly revisited until settlement is achieved. By midday, assuming no problems, all funds have been dispersed to members.

The CLS Bank is owned by 71 shareholders, which comprise the major international banks that are active in the global FX market. To be a member of the CLS Bank, and therefore be entitled to hold a multi-currency account, it is necessary to also be a shareholder. There are also a larger – and growing – number of third-party members of the CLS Bank, who do not hold their own accounts, but are customers of settlement members, who act on their behalf in settling FX trades. In 2004, it was estimated that around 80% of third-party members were banks. However, the CLS Bank is becoming increasingly attractive to non-bank financial institutions, and is specifically targeting this market with a number of initiatives.

In particular, through its 'Enhanced Fund FX' programme, the CLS Bank has the capability to settle FX trades for both treasury and securities clearing. The CLS Bank expects the next wave of participants to be fund managers working in the pension fund sector, as well as the asset management divisions of banks and insurance companies. In 2005 this process has already begun and the proportion of fund managers using the CLS system is expected to grow steadily.

Today, the CLS Bank settles around 50% of all FX trades globally, and 60% of all interbank FX trades. This represents a doubling of market penetration in the past year, and it now settles 90% of all its members' FX trades. The stated aim of the CLS Bank is

to settle 95%¹⁵ of all FX trades globally, and if current growth rates continue, it seems likely that they will reach this figure within a few years.¹⁶

4.1 The UK's payment and settlement system

The UK's payment and settlement system is one of the world's largest, reflecting both the size of the UK economy and London's role as an international financial centre. In 2003, for example, around £130 trillion passed through the various parts of the system, which is equivalent to 120 times UK GDP. To put this into perspective, a value equivalent to approximately 50% of the UK's annual GDP passes through the UK's payment system on every business day of the year (Bank of England 2004).

The Bank of England Act of 1998 sets out the powers and responsibilities of the Bank of England (hereafter 'the Bank'). Under the Act, the Bank has statutory power to maintain price stability, and, in conjunction with the other key UK financial institutions (the FSA and HM Treasury¹⁷) is also charged with:

- maintaining the integrity and value of the currency
- maintaining the stability of the financial system, both domestically and internationally
- seeking to ensure the effectiveness of the UK's financial services sector.

Clearly, maintaining the integrity and efficiency of the payments and settlement system is central to these functions. In the payments sector, the key private sector organisation is the Association for Payment Clearing Services (APACS), which represents the major banks and provides a forum for them to discuss payment issues. APACS is currently comprised of three clearing companies, with each focusing on one aspect of the payment system:

- CHAPS Clearing Company
- BACS Ltd¹⁸
- Cheque and Credit Clearing Company.¹⁹

For the purposes of this report, the Clearing House Automated Payment System (CHAPS) is the most important of these bodies. CHAPS is the organisation through which most high-value wholesale payments are processed, and it operates an RTGS system, of the form described above. CHAPS provides two different types of clearing: sterling and the euro. CHAPS sterling moved from a DNS to an RTGS system in 1996, and CHAPS Euro began operations – also using RTGS – in 1999.

CHAPS Euro connects to the European Union's LVPS – TARGET – with the result that members are able to process both domestic and cross-border payments through CHAPS. From 2001, both CHAPS systems have been fully integrated, and now operate on a common technical platform run by SWIFT.

For all the UK's clearing systems, there is a two-tier structure similar to that more recently developed by the CLS Bank. That is, direct settlement members hold accounts at the Bank of England, which are credited and debited using RTGS to settle their

15 See interview with Joseph De Feo, Chief Executive of CLS Bank, 9 September 2004, FX&MM magazine.

16 From 2004 – 2005 the volume of transactions being settled in CLS doubled, for example.

17 The relationship between these three parties is formally set out in a Memorandum of Understanding (MOU) between them, which establishes the roles each party is expected to perform.

18 The BACS system handles electronic payment orders.

19 As the name suggests, the Cheque and Credit Clearing Company handles paper items such as cheques.

trades. Indirect, third-party members access the CHAPS system via their links with direct members, much as occurs with the CLS Bank.

The Bank of England plays a pivotal role in each of the UK's payments systems in four main ways. First, it is a member and shareholder of each of the clearing systems, as well as of APACS. Second, it owns and operates the RTGS system upon which the payment and settlement systems rely. Third, the Bank facilitates payment flow in CHAPS by providing intraday liquidity through repo agreements.²⁰ Finally, given its responsibility for ensuring the stability of the UK's financial system, the Bank plays an active role in ensuring systemic risks are adequately managed and controlled.

In addition to these payment systems, the UK has three separate clearing organisations that deal with securities transactions. These are:

- the London Clearing House (LCH), which provides clearing services for the London International Financial Futures Exchange (LIFFE)
- the European Central Counterparty (EuroCCP), which provides clearing services for NASDAQ Europe
- CREST, which is the primary settlement system for UK securities, government bonds and corporate bonds.

CREST is operated by CRESTCo, which assumed responsibility – from the Bank – in 1999 for settling gilts and other sterling debt, and money market instruments. CREST has developed increasingly strong links with other securities clearing organisations in Europe and North America, enabling non-UK transactions to be settled in CREST. As a culmination of this process, CREST merged with Euroclear in 2002.

Following the closure of CGO and CMO the Bank is therefore less directly involved with clearing and settling securities based transactions (CPSS 2003), but retains its overarching oversight function. In addition to overseeing these major UK payment systems, the Bank performs an oversight role with respect to SWIFT. This is considered necessary because of SWIFT's importance to the UK economy: the UK accounts for 17% of all SWIFT messages globally; the highest proportion for any country.

In addition, the Bank owns and operates the RTGS system upon which CHAPS sterling and CHAPS Euro rely, placing it at the heart of the UK's largest and most systemically important payment systems. Finally, in the international sphere, the Bank also has a joint oversight role for the CLS system in conjunction with other major central banks, with the US Federal Reserve having the primary responsibility in this regard.

Unlike many central banks, the Bank of England does not have statutory powers over payment systems. However, it is generally able to exercise decisive influence on the basis of the central role it plays. Furthermore, under the *Financial Markets and Insolvency Regulations* (1999), the Bank does have statutory power to 'designate' UK payment systems. This designation protects the system's rules from legal challenge in the event of insolvency on the part of a system member, and is therefore very important to the major private sector players. Consequently, although in theory the Bank cannot require payments systems to seek and obtain 'designated' status, in practice this is the case. The Bank designated both the CHAPS systems in May 2000, and the CLS system in August 2002.

²⁰ A repo – or 'repurchase' – agreement, is a financial transaction in which a market actor sells securities and simultaneously agrees to buy them back at a higher price at a later time. It is therefore, effectively a means of borrowing money. In a reverse repo agreement, the market actor does the opposite by buying securities and agreeing to sell them back at a higher price at a later date.

The power to award – or to deny – designation status therefore gives the Bank considerable leverage over the functioning of these systems.

Perhaps the most important lever possessed by the Bank, however, relates to settlement. In particular, interbank settlement ultimately takes place through central accounts held by members at the Bank of England. Therefore, full membership of these payments systems – notably CHAPS sterling, CHAPS Euro and the CLS Bank – is dependent upon being eligible to hold such an account at the Bank of England. This gives the Bank the option of imposing direct contractual obligations on banks wishing to access these systems.

As with other major central banks, the Bank of England's oversight functions are benchmarked against the *Core Principles for Systemically Important Payment Systems*, produced by the Bank for International Settlements (BIS).²¹ The fact that the other major central banks also use the Core Principles as a benchmark facilitates smooth and effective cooperation between both the banks themselves, and the systemically important payments systems that they oversee. The Core Principles therefore provide a 'level playing field', which ensures that systemically important payment systems in different countries are similar enough in key respects to enable effective cooperation and interaction between them.

To summarise, the last two decades have seen significant changes in the practice of payments and settlement systems globally. As overseeing authorities have sought to reduce settlement risk **and** enhance systemic efficiency, DNS systems have given way to RTGS systems, where – at least domestically – settlement risk is effectively eliminated due to the use of PVP and DvP. In general terms, advances in IT have led to greater uniformity, as heterodox forms have gradually been replaced by a more homogenous approach based on commonly used technical platforms, thereby greatly reducing costs through increased efficiency. Major LVPS in developed countries are increasingly interdependent. They rely on the same technological infrastructures, which ensure that this interdependence functions smoothly and effectively. The messaging function pioneered by SWIFT has become central to this process, as economies of scale considerations have made it increasingly sensible for all global players to use the same system.

Internationally, cross-border FX Herstatt Risk – one of the last remaining outposts of settlement risk in the global financial sector – has also been addressed with the launch of the CLS Bank, which enables FX transactions in different time-zones to be settled on a PVP basis. As with national LVPS, this effectively eliminates settlement risk.

Therefore, whilst the Bank of England has responsibility for ensuring the effective functioning of systemically important UK-based payments systems, the UK is **not** an island in this respect. Rather, it operates in an interconnected – and interdependent – global network of central banks and national payment systems, and cooperates in the oversight of cross-border payment systems such as the CLS Bank.

The next section sets out the proposal for a unilateral sterling stamp duty in the context of these developments. We shall see how the automation and standard messaging systems described make such a tax feasible. Furthermore, we shall also see how the interdependence that has been described makes avoiding it extremely difficult. Finally, we shall see how the benefits of the developments described above – in terms of

21 Of the ten Core Principles, the first addresses legal risks; Principles II-VI cover financial risks; Principle VII deals with operational risk issues, while Principle VIII addresses efficiency in the system; Principle IX covers criteria for system access, and Principle X focuses on governance.

efficiency, cost and systemic stability – far outweigh the cost of a sterling stamp duty set at the rate proposed.

Consequently, even if regulators were to allow them to do so – which they would not – there would be no rational incentive for banks and other financial institutions to seek to move outside the existing frameworks in order to avoid the tax. To do so would be hugely expensive, would make previous large capital expenditure on ensuring system compatibility a ‘dead-weight’ cost, would reduce systemic efficiency (and increase operational risk) and would carry significantly higher operating costs on an ongoing basis.

Importantly, however, the only feasible way that banks would be permitted to exit the CLS system (by their respective central banks), would be to build a parallel system that effectively dealt with Herstatt Risk, that was acceptable under Basel 2 and that was compliant with anti money laundering regulations. Such a system could not avoid the SSD proposed here.

In contrast, the effect of an SSD set at a modest rate would be of little consequence, especially if the tax is ‘hardwired’ and ‘piggy-backs’ on existing system capability.

5 The sterling stamp duty proposal

The proposal is for a 0.005% stamp duty to be levied on all sterling FX transactions worldwide. It would be implemented, as any other financial transaction tax, by announcement in a budget and enactment through a finance bill.

As detailed in Section 4, the past two decades have seen significant changes in the way FX transactions are settled both nationally (using RTGS systems) and internationally (using the CLS Bank). It has been suggested that these developments have made a unilaterally implemented CTT feasible, which has not always been the case. A leading scholar in the field today is Rodney Schmidt, who put the issue as follows in 2000:

... the infrastructure for settling foreign exchange trades is increasingly formal, centralized and regulated. This is due to new technology, subject to increasing returns to scale, and to cooperation between trading and central banks to reduce settlement risk. Settling a foreign exchange trade requires at least two payments, one of each of the currencies traded. Settlement risk is eliminated when payment obligations are matched and traced to the original trade, and then payments are made simultaneously. The technology and institutions now in place to support this make it possible to identify and tax gross foreign exchange payments, whichever financial instrument is used to define the trade, wherever the parties to the trade are located, and wherever the ensuing payments are made.²²

To be effective a sterling stamp duty would need to have the following attributes:

- It could be implemented relatively easily and cheaply, using existing market infrastructure and networks.
- It would capture the vast majority of sterling transactions globally.
- It would be set at a sufficiently modest level as to neither distort the market nor provide incentives for financial institutions to move outside current systems in order to avoid the SSD.

This section provides details of how the proposed SSD meets each of these three criteria.

5.1 Implementing a sterling stamp duty

Since the launch of the CLS Bank in 2002, a growing share of sterling FX transactions have migrated to it. Today it is estimated that a little over 50% of all global sterling trades are conducted through the CLS system. Of the remainder, the overwhelming majority are processed through the UK's CHAPS RTGS systems. The UK's CHAPS sterling system is therefore directly connected to the CLS member banks, and through this link also connected with the other major national RTGS systems. Furthermore, CHAPS Euro is directly linked to the EU's RTGS system, TARGET.

To be effective, therefore, the SSD must be implemented at a number of levels. The most straightforward of these is through the CLS Bank. As pointed out above, more than 50% of

22 Schmidt (2000)

all sterling transactions are settled in the CLS system, where it would be a straightforward task to identify sterling transactions. Indeed, the UK Treasury has accepted the validity of this point, not least because it would be practically straightforward and that, if implemented in the UK, would have to be adhered to by the CLS Bank.

Technically, it is possible to apply a unilateral sterling CTT via CLS ... CLS Bank settle in fifteen currencies, and in doing so must apply the relevant laws in each jurisdiction – including, for example, a unilateral sterling Currency Transaction Tax.²³

In time it is highly probable that an ever-larger proportion of global sterling transactions will be settled through the CLS system. The objective of the CLS Bank is to settle 95%²⁴ of all FX trades globally – which, given growth in market share since the bank's launch, does not seem an unreasonable aspiration. Consequently, over time the proportion of sterling trades on which the SSD can be directly levied through the CLS Bank is likely to rise steadily. A key driver in this regard – of which more will be said below in Section 6 – is the economies of scale and intra-organisational efficiency gains that can be achieved through a large financial institution moving all of its FX operations into the CLS system. Growth in new participants to the CLS system continues apace. Furthermore, once an institution becomes a participant it faces strong incentives to move all of its FX business to the system. This is demonstrated by the fact that, although the CLS Bank settles around half of all FX trades globally, it settles around 90% of its members' trades.

Having accounted for more than 50% of all sterling FX trades, the SSD must also address the remainder – though, as described above, this 'remainder' is likely to become an ever-smaller proportion in the years ahead. By far the most important organisation, in this regard, is the UK's LVPS – CHAPS. Here, the developments in the LVPS sector that have been described are key to the feasibility of implementing an effective SSD.

The CLS Bank was launched with the aim of removing Herstatt Risk. In respect of this, a key consideration was that Herstatt Risk had already been effectively removed from domestic LVPS through the introduction of RTGS systems, and, in particular, the development of PvP and DvP networks. What does this mean in practice?

Domestically, we can imagine a situation where UKBank1 wishes to purchase a UK financial asset from UKBank2. If the sale price is agreed, UKBank1 sends a SWIFTNet message to the relevant LVPS with an instruction to debit its settlement account at the Bank of England, and to credit the settlement account of UKBank2. At the same time, UKBank2 sends a SWIFT message requesting ownership of the relevant asset be transferred to UKBank1. SWIFT then matches the two messages, and after requesting and receiving confirmation from both banks, transfers both the sterling amount and the ownership of the asset. In this instance, both sides of the transaction are in sterling and therefore represent a domestic transaction that does not attract the SSD.²⁵

Internationally, however, the situation is rather different. Suppose UKBank1 wishes to buy US dollars for sterling. UKBank1 makes an offer to USBank1 (through any of a number of possible channels) and the offer is accepted. As with the domestic example, UKBank1 then sends a SWIFT message to the LVPS requesting it to debit its settlement account at the Bank of England for the appropriate quantity of sterling, and to credit the account of

23 HM Treasury (2004), written response to points raised by Stamp Out Poverty

24 See interview with Joseph De Feo, Chief Executive of CLS Bank, 9 September 2004, *FX&MM* magazine.

25 This stylised example is an adaptation of that used in Schmidt (2001).

UKBank2 at the central bank (we assume that USBank1 keeps its sterling holdings with an account at UKBank2, which reflects standard international banking practice). At the same time, USBank1 sends a message to its LVPS requesting that the appropriate dollar amount is transferred from its balance to that of USBank2 (again, we assume that UKBank1 keeps its US dollar holdings in an account with USBank2).

In the UK, SWIFT requests confirmation of the trade from UKBank1, upon receipt of which it debits UKBank1's account at the Bank of England, and credits that for UKBank2. Unlike the domestic transaction, however, it is unable to match the message from UKBank1 to another sterling-based message in the system. Therefore, although domestically the PvP process requires matching of trades and removes settlement risk, an international FX trade cannot be settled on a PvP basis in a national system such as CHAPS, as each leg of the trade takes place in different domestic LVPS operating in different time-zones. Indeed, it was this particular feature of the international FX market, which first led to the creation of cross-border multilateral netting systems such as ECHO, and ultimately to the launch of the CLS Bank, which does allow settlement of FX trades on a PvP basis. A consequence of this feature of modern LVPS, however, is that the failure to match both legs of a transaction in sterling identifies the transaction as an FX trade, upon which the SSD can be levied.

It is clear therefore that an SSD could feasibly be implemented unilaterally in the UK, with the overwhelming majority of sterling transactions undertaken globally being identified through the CLS system and CHAPS. As the stylised example above makes clear, this is based on PvP systems in domestic LVPS, as well as the PvP approach employed by the CLS Bank. The 'oil' that lubricates this process and makes it possible, however, is the ubiquity of standardised messaging formats within the financial sector.

A key feature of the various interlinked systems through which sterling FX transactions can be settled is their use of the SWIFTNet messaging system. Importantly, SWIFT also provides messaging services for major electronic FX trading platforms such as FXall, as well as for the major global bilateral and multilateral FX netting systems, past and present. This global reach offers the chance to further extend the scope of the SSD, and ensure that all sterling trades in CHAPS are identified.

Within each of the systems in which it operates, SWIFTNet provides secure payment messaging between members through its FIN system and, crucially, has a dedicated message form – the MT300 – which is used to confirm individual FX trades. That is, whether in the CLS system, CHAPS, TARGET, FXall or a multilateral netting system, an FX trade is confirmed between the counterparties by means of a SWIFTNet FIN MT300 message, or one of its variants.

The MT300 message performs the following functions:

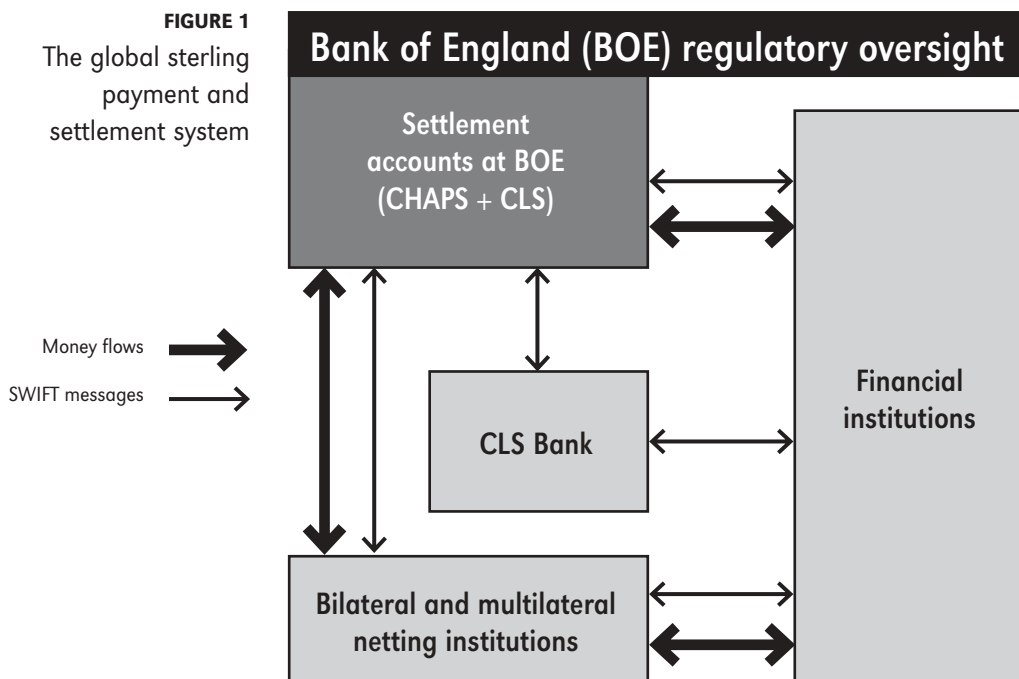
- It confirms the details of a new FX contract between the parties.
- It confirms an exercised foreign currency option.
- It confirms the details of an amendment to a previously sent confirmation.
- It cancels a previously sent confirmation.

The MT300 message is initially exchanged by or on behalf of the parties that have agreed to a foreign exchange contract. The fact that MT300 messages also provide notification of amendments to contracts and cancellations of previously held confirmation is important for the purposes of this proposal, as it ensures that the SSD is only levied on sterling FX transactions in the form in which they are ultimately transacted. Also, because MT300 messages confirm individual FX trades, they precede any subsequent bilateral netting process that may occur, after which identifying the individual trades concerned may not be possible.

Within each MT300 message, a number of fields must be completed. For an FX trade, the currencies concerned and the amounts bought and sold are included here. In the Mandatory Subsequence sections of the MT300 message, the relevant sections are B1 (Tag 32b) for the currency and amount bought, and B2 (Tag 33b) for the currency and amount sold. Consequently, all the information needed to identify sterling transactions is already in place. No dedicated infrastructure is required.

The MT300 messaging system can therefore capture the lion's share of sterling transactions in the 'traditional' FX market. However, this still leaves the important area of the OTC derivatives market. In one important respect, this market is also covered by the MT300 messaging series, which is used to confirm that FX options have been executed. In this case, MT305 and MT306 are used as messaging formats.

All other FX OTC derivative contracts are contained within the third category of SWIFT standard messaging formats, which range from MT300 to MT341 and from MT350 to MT399. As with the traditional market, messages require the currency, amount and counterparties to be identified within the message, as well as the facility to amend or cancel contracts.



The next piece of ‘plumbing’ is to gather relevant messages of this form in a central location, to enable the SSD to be levied. Again, however, it is possible to ‘piggy-back’ upon existing networks by using the SWIFTNet FIN Copy messaging function.

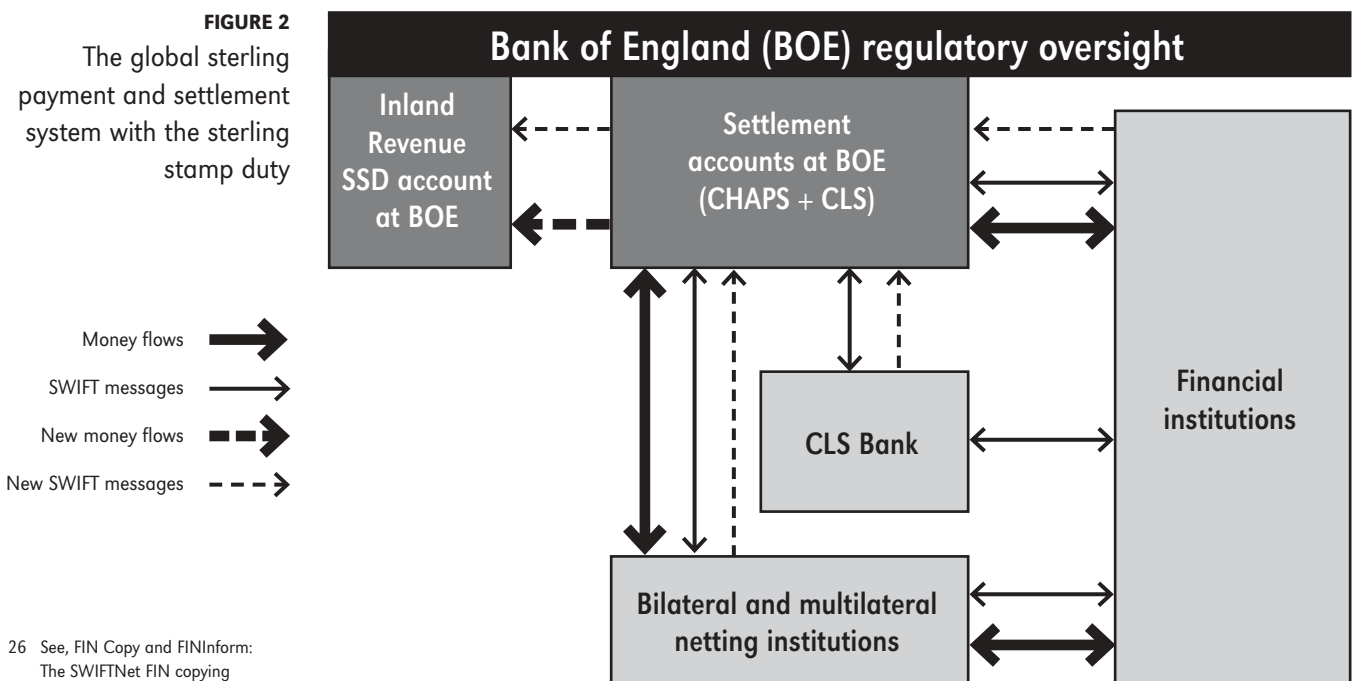
SWIFT describe the Copy service as follows:

The SWIFTNet FIN store-and-forward messaging service includes the option of automatically sending copies of messages to a third party by means of the SWIFTNet FIN copying services. The simple, flexible and secure functionality of FIN Copy and FINInform caters to the diverse needs of the SWIFT community in a broad range of scenarios, such as clearing and settlement, monitoring and reporting and third-party or outsourced services.²⁶

The majority of recipients of SWIFT FIN Copy messages are central banks, as the messages facilitate settlement in the centralised RTGS systems described above. To perform this function, Copied FIN payment messages take the Y-Copy Form, where the message is sent to the central bank – but not the counterparty – in the first instance. Once the central bank has established that the bank initiating the transfer has sufficient funds in its settlement account, the transaction is performed and the message released to the counterparty.

For our purposes, however, the simpler T-Copy form, where the copied message is released to the central bank at the same time as to the counterparty, is closer to what is needed. A problem with both Y and T Copies, however, is that they are automatically triggered regardless of the type of transaction. The ideal template, however, is FINInform, where copied messages are triggered to the central bank depending on either the identity of the parties or, crucially, the type of message sent.

A key aspect of the proposal is therefore to establish a SWIFTInform messaging service, which is triggered by the sending of an MT300–MT399 FX message, in either



²⁶ See, FIN Copy and FINInform: The SWIFTNet FIN copying services at: www.swift.com

the traditional or the OTC derivatives market. In this instance, a copy of parts of the message – currency, volume and counterparties – is automatically sent to the Bank of England for every FX transaction involving sterling. As with all aspects of the proposal, this process would be automated and would require no dedicated infrastructure.

The next aspect of the proposal considers how, when in receipt of this information, the sterling stamp duty would be collected.

5.2 Collecting a sterling stamp duty and preventing avoidance

Once identified in the manner described above, collecting the SSD would be a relatively straightforward process. To be able to participate in the CLS system, financial institutions must hold an account with the CLS Bank. However, in practice, UK-based CLS Bank members actually hold their accounts within the Bank of England. These accounts can then be credited and debited by the institution in accordance with their liquidity requirements for the CLS Bank. To collect the SSD from the CLS system, therefore, the tax could be directly taken from the relevant accounts.

Similarly, in order to be a member of CHAPS, a financial institution must hold a settlement account at the Bank of England. Therefore, once the tax to be paid is identified and traced to the CHAPS member, it can be transferred from the relevant settlement account held at the Bank of England to HM Revenues & Customs' CHAPS account, also held at the Bank of England.

The SWIFT messaging system in general, and the FINInform Copying function in particular, are completely automated on a day-to-day basis. Consequently, though the relevant systems would have to be slightly modified to facilitate tax identification and tax take from the appropriate centrally held accounts, the changes would be relatively minor. Furthermore, once the fixed, start-up costs were met, the marginal cost of operating the system would be very low.

Direct members of both the CLS system and CHAPS are relatively few in number, with a significant proportion of all trades being undertaken by members on behalf of their third-party customers. Whilst these market participants would not be directly taxed, they would be affected by the SSD, which would be directly reflected in the spread charged them by the CLS Bank/CHAPS members in exchange for executing their FX business.

The remaining sterling trades undertaken – by corporations, for example – would still be identified by use of the SWIFTNet messaging service described. Furthermore, these trades would be settled by correspondent banks on behalf of the underlying corporate. These correspondent banks would hold accounts with the Bank of England, the CLS Bank, or both. Consequently, such sterling trades would ultimately also incur the stamp duty.

On average SWIFT messages cost approximately £0.067 each. The CLS Bank settles 200,000 transactions a day, which is about half of all FX trades. To capture the entire FX market, therefore, would equate to 400,000 messages a day. Since sterling transactions account for 17% of the total, this amounts to the generation of 68,000 SWIFT copy messages daily. This would cost £4,556 a day, or £1.18 million per year. If we assume the same running cost for the Bank of England to set up their own systems

to manage this inflow of information, we reach a little over £2 million as the annual running costs.

5.3 Avoiding market distortions: the appropriate rate

Having established the feasibility of a) identifying sterling FX transactions, and b) collecting the SSD, the final question relates to the appropriate level at which to set the duty. The objective is not to maximise income *per se*, but to strike a balance between raising sufficient revenue to make a contribution to meeting the MDGs, and avoiding market distortions.

In Section 3 we saw how – as of 2004 – sterling accounted for 8.5% of all FX trades globally, out of an average daily total of \$1,880 billion. This equates to a potentially taxable daily total of around \$160 billion.

TABLE 3
Potential daily revenue raised from SSD using differing tax rates in traditional FX market

SSD rate	Daily revenue raised	Annual revenue raised*
1%	\$1.6bn	\$424bn
0.1%	\$0.16bn	\$42.4bn
0.01%	\$0.016bn	\$4.24bn
0.005%	\$0.008bn	\$2.12bn

* assuming 260 trading days

Table 3 illustrates the potential daily revenue from differing SSD rates. As can be seen, a 1% tax would theoretically raise \$424 billion. However, an SSD at such a level would be likely to have a distorting effect on the market, reducing volumes traded significantly.

At the 0.10% level the annual revenue would be \$42.4 billion. However, it is likely that a 10 basis points (bp) tax rate would also have a sizeable impact on the market. In particular, it would provide a clear disincentive to trade sterling, with the result that volumes could fall considerably, with the tax take therefore also falling by a significant amount.

A more realistic rate to set the SSD at would be 0.01%, or 1 basis point, where annual revenues would be in the order of \$4.24 billion, or £2.3 billion. While it is likely that a 1 basis point SSD would not cause major disruptions in the sterling market, this rate is not proposed. Rather, the proposal is to set the SSD at half of one basis point: 0.005%. At this low rate, it is difficult to argue that the tax would distort the market. It would, however, raise \$2.12 billion annually.

A point that is often overlooked is that most FX derivative transactions are themselves ultimately settled in the traditional market, leaving no room for avoidance. However, as discussed above,²⁷ OTC options contracts can be drawn up so that no currencies are exchanged, and would thus not be detectable in the traditional market. Consequently, as well as the traditional FX market, the proposal is that the SSD should also be levied on OTC FX derivative contracts that settle on a cash for difference basis.

As with the traditional FX markets, all executed FX option contracts – whether settled in the traditional market or on a cash for difference basis – require a transfer of payments of some kind and trigger a specific MT300 SWIFT message. As described above,

27 See page 22

therefore, cash for difference payments can be identified using the same SWIFTNet FINInform messaging system, and taxed directly through settlement accounts held at the Bank of England. Given a degree of uncertainty over the proportion of sterling FX options that are ultimately executed in this way, we do not include this source of income in the total estimate of the SSD's annual revenue.

Based on conservative assumptions we therefore estimate that the SSD would produce annual revenues of \$2.12 billion, which at current exchange rates equates to a little under £1.2 billion per year.

Of course, this assumes that the implementation of the SSD has no impact upon volume traded. Given the extremely low level of the tax, this is not an unreasonable assumption. However, in order to err on the side of caution, we assume a 2.5% reduction in the volume of sterling traded, and this would amount to an annual receipt of \$2.07 billion, or £1.12 billion. The 2.5% figure is based on a report written for the UN on the revenue raising potential of Currency Transaction Taxes (Nissanke 2003).^{28, 29}

As with other UK taxes, HM Revenue & Customs would be the agency with statutory power to collect the SSD. The mechanics of collection, however, would be greatly eased by taxable funds being held in accounts at the Bank of England. It is already possible to pay taxes through the CHAPS system, which suggests that the simplest method of collection would be for the tax to be paid directly into a dedicated HM Revenue & Customs' CHAPS account, also held at the Bank of England.

The 'economic footprint' of the SSD would, in the first instance, fall upon the large financial institutions that are members of the CLS Bank and CHAPS. These are primarily international banks. If this was as far as the process went, there is little doubt that major international banks could comfortably absorb this (Table 4).

- 28 Some of the fall in volume could reflect a migration to stock exchanges, where FX deals can be executed by trading stocks denominated in different currencies. This practice already occurs to some extent, though its potential growth is limited. However, traded stocks are also settled in centralised systems of the kind described in this report, and could therefore be brought within the ambit of the SSD relatively easily.
- 29 More clarity will be gained on this issue, when Professor Rodney Schmidt's ongoing research into the price elasticities of FX volumes is published.
- 30 US banks' data: http://money.cnn.com/magazines/fortune/fortune500/full_list/index.html; non-US banks' data: each institution's consolidated financial statements 2005; US Dollar figures for non-US banks converted at exchange rate of 3/1/2006.

TABLE 4
Major global FX trading banks³⁰

Bank	Annual profit 2005
Citigroup	\$24.59bn
HSBC	\$15.84bn
UBS	\$10.80bn
JP Morgan Chase	\$8.48bn
Barclays	\$6.68bn
Goldman Sachs	\$5.63bn
ABN Amro	\$5.32bn
Merrill Lynch	\$5.12bn
Morgan Stanley	\$4.94bn
Deutsche Bank	\$4.23bn

Furthermore, the majority of sterling transactions are not undertaken by UK institutions. Even within the UK, for example, 56% of all sterling transactions are undertaken by non-UK institutions, of which the great majority (40%) are non-UK banks.

Although relatively few in number, large international banks dominate the global FX market. These banks' trades are ultimately undertaken for a wide range of clients – for example, the CLS Bank estimates that an average of 200,000 separate transactions are settled every day, which gives some sense of the number of ultimate participants in the global FX market. Consequently, 40% of the impact of the SSD – a little under US \$1 billion per year – would be passed on by the major non-UK international banks to their global clients in the form of a slightly higher spread. The situation with non-UK resident non-bank-financial-institutions (NBFIs), which account for 11% of all sterling transactions would be similar, while non-UK transnational corporations (TNCs) account for a further 4% of sterling transactions. The impact of 55% of the SSD would therefore be dispersed widely throughout the global financial system, with minimal impact on any one institution.

For those UK institutions that would be affected by the SSD, 22% of all sterling trades are undertaken by UK banks, 16% by UK NBFIs and just 5% by UK corporations. As with their international counterparts, UK financial institutions would pass on the cost of the SSD as a slightly higher spread to their clients.

As we have seen, the CLS Bank processes an average of 200,000 FX transactions every day. In line with the global picture, we assume that 17.5% of these have sterling on one side of the trade, which gives 34,000 sterling transactions in the CLS system per day. However, the CLS Bank settles only around half of all FX transactions, which suggests a global figure of 68,000 sterling trades per day. Over a year, therefore, we can estimate the total number of sterling transactions as being somewhere in the order of 17.7 million.

TABLE 5
Impact of SSD

Source: Bank of England (2006) and author's calculations

Type	Market share of sterling transactions	US\$ annual impact of SSD on sector	Estimated no of ultimate FX transactions
UK institutions			
Banks	22.4%	\$463 mn	3.96 mn
NBFIs	16.4%	\$339 mn	2.88 mn
Corporations	5.6%	\$115 mn	na
Non-UK institutions			
Banks	40.5%	\$838 mn	7.12 mn
NBFIs	11.2%	\$231 mn	1.96 mn
Corporations	3.8%	\$78 mn	na

As can be seen from Table 5, the impact of the SSD would be spread very widely internationally. For the 17.7 million ultimate transactions carried out by tens of thousands of participants in the FX market, the impact of the SSD would be somewhere in the region of \$117 per trade, on an average trade size of a little over \$2 million.

For corporations, however, the situation is clearly different. The UK exports somewhere in the region of \$380 billion worth of goods and services per year. Based on the profit margins of UK companies from 1990 to 2002, we assume an average margin of 10%.³¹ Ten percent of \$380 billion is \$38 billion, which we take as a rough estimate

of the annual profit of the UK's export sector. As can be seen from table 5, the impact of the SSD on UK corporates would be somewhere in the region of \$115 million. Consequently, the impact on UK exporters would be just 0.3% of their annual profits, which is very small when set against the many other factors that influence company profitability. For example, over the past ten years, UK companies' average profitability has fluctuated by up to 10% per year. It is therefore clearly the case that when compared to the impact of changes to general business conditions, and movements in indicators such as interest rates and the sterling exchange rate, an SSD of 0.005% will have hardly any discernable impact.

To summarise, we have seen how developments in international payment and settlement systems have resulted in an interrelated global network which is lubricated by common technological and communication systems. It is precisely this highly interdependent network that makes it feasible today to unilaterally implement a sterling stamp duty. In order to avoid producing market distortions, the proposal is that the duty be set at a rate of 0.005% on the sterling half of all FX transactions. As well, the mechanism through which the SSD could be efficiently identified and collected has been demonstrated.

We have produced an estimate of the likely annual revenue that would be raised through the SSD, and suggested that a figure in the region of £1.12 billion per year is a reasonable expectation. When compared with the estimated running costs of the system given in Section 5.2, it is clear that the cost of administration and collection of the duty would be minimal, maximising the amount available for international development purposes.

Finally, we have shown that more than half of the 'footprint' of the SSD would be felt outside the UK, and widely spread globally. Furthermore, for the UK-based financial institutions that would be effected by the SSD, the impact would again be highly diffused throughout the financial system – both in the UK and overseas – and would amount to just \$117 on an average FX trade of \$2 million. For the UK corporate export sector, we see a similarly modest impact of 0.3% of average annual profits of 10%. Clearly both the financial and non-financial private sector could comfortably absorb the impact of the SSD at the rate proposed, as do comparable institutions in other countries and regions. In Brazil and Colombia, for example, financial transaction taxes are more than 100 times greater than the duty proposed, at between 0.5% and 1.5% respectively. In this respect, it is worth adding that the existing stamp duty on share transactions in the UK, at 0.5%, is also 100 times larger than the rate of the SSD here proposed.

The next section considers objections to the proposal and provides responses to them.

31 See Citron and Walton (2002)

6 Responses to objections

This section responds to both general objections and detailed concerns regarding the SSD proposal raised in high-level dialogue with UK Government departments and EU institutions.

6.1 **Would a stamp duty on sterling not cause the financial market to trade the currency abroad in order to avoid payment, therefore taking transactions away from the UK?**

In responding to this key question it is critical at the outset to make a distinction between the trade of sterling throughout the world, and the trading of all currencies in the UK. The proposal here is for a stamp duty on sterling transactions alone. It would be implemented by announcement in a budget, and enactment in a finance bill. Like any other tax, such as the UK's current stamp duty on shares, it would be illegal to avoid, and major financial institutions, who rely on having and maintaining their good reputations, would pay it. This unilateral approach both underlies the only way for progress in this field to happen – since it is clearly completely unrealistic that all countries would agree to levy some kind of CTT at the same time – and also defines why avoidance is not realistically possible. In a nutshell, a small levy on sterling transactions cannot be avoided because the global settlement system provides sufficient electronic connection to the UK that the duty can be collected regardless of the geography of the trade, including tax havens.

To explain briefly, while it may have been the case in the past that an SSD could not be implemented unilaterally, this is no longer so. Historically, the global foreign exchange (FX) market had consisted of disparate parts with little or no links between them – trades were conducted and settled manually by phone between counterparties. Today, however, the different components of the global FX market are built on the same technical platforms, use the same electronic messaging providers and trade electronically using the same systems. Furthermore, these trades are settled through either the recently established CLS Bank – which centralises the system and now settles around half of all global FX transactions – or through the High Value Domestic Settlement systems run by the world's central banks.

The only way financial institutions could avoid a CTT on a specific currency would be effectively to remove themselves from the international FX transaction, messaging and settlement systems. However, the benefits they obtain from being in these systems dwarf the cost of a CTT levied at the low rate proposed. Since no advantage would be gained by trading sterling abroad there would be no incentive to re-locate trading.

6.2 Where would the incidence of the SSD fall? Which actors would bear the economic footprint?

The 'economic footprint' of the SSD would, in the first instance, fall upon the large financial institutions that are members of the CLS Bank and CHAPS. These are primarily major international banks. However although these institutions could comfortably absorb this cost in its entirety – or a large proportion of it – in fact they will pass it on to their FX customers in the form of a slightly wider spread. Consequently, the impact of the SSD will be dispersed throughout the FX system, with minimal impact on any one institution.

Please see Section 5.3 for a more detailed explanation in which, for example, it is shown that the impact on UK exporters would be just 0.3% of their annual profits, which is very small when set against the many other factors that influence company profitability. For example, over the past ten years, UK companies' average profitability has fluctuated by up to 10% per year. It is therefore clearly the case that when compared to the impact of changes to general business conditions, and movements in indicators such as interest rates and the sterling exchange rate, an SSD of 0.005% will have hardly any discernable impact.

6.3 Would an SSD encourage a move away from the CLS system?

As has been discussed, the primary reason for establishing the CLS Bank, was to eliminate settlement risk – as manifested with the collapse of Herstatt Bank – from cross-border FX transactions. In this, the CLS Bank has been remarkably successful.

Since its launch in 2002, the system has worked virtually flawlessly. By moving to a PvP system in a dedicated settlement window that applies for all participants globally, the CLS Bank has removed one of the largest remaining risks in the financial system for its participants. As described in Section 3, this initiative is particularly significant, given the huge size of the global FX market. Considering the sums involved in daily transactions, the failure of a major international bank involved in the FX market has the potential to produce a ripple of systemic risk around the world, with unknowable consequences for both individual banks and, ultimately, national and international payment and settlement systems.

This concern is therefore important. If the implementation of the SSD did result in existing members leaving the CLS system, or provided a strong disincentive for those considering joining the network, this would have serious consequences. In what follows, however, we shall demonstrate that, ultimately, these fears are unfounded, not least because the SSD would also be levied on transactions outside the CLS system, rendering the issue of leaving the CLS Bank to avoid it relatively meaningless.

Having said that, the hypothesis is incorrect, even on its own terms. For the SSD to create an incentive for banks to leave the CLS system, the costs of paying it would have to be greater than the benefits which accrue from CLS Bank membership. This is therefore a straight cost-benefit question. How do the two sides of the equation stack up?

Before addressing the costs to CLS Bank members of paying the SSD, we will consider the benefits they derive from CLS Bank membership and, where possible, attempt to quantify these to allow a direct cost-benefit comparison.

CLS Bank members face both fixed and variable costs as a result of their membership of the system. On the fixed cost side, these relate to the cost of developing IT systems, organisational logistics and the training of staff to enable them to function on the system. If a member were to leave the CLS system these costs would be 'dead-weight', and must therefore feature in any sensible cost-benefit assessment. Furthermore, the costs of leaving would effectively double this figure, as the systems and processes put in place would have to be removed and replaced with new systems.

From the variable cost perspective, there are a number of relevant factors that need to be considered.

- Participation in the CLS Bank brings significant – and quantifiable – efficiency gains, relative to the alternatives.
- Transaction costs in the CLS system are lower than costs elsewhere.
- Liquidity requirements/net funding costs also differ significantly in the CLS system. This is a serious concern for major international financial institutions, and again no assessment of the costs and benefits of remaining within the CLS system can be made without taking this issue into account.
- CLS Bank membership brings differential treatment under the new Basel Capital Accord due to varying risk factors in different settlement systems. Again, an assessment of the benefits and costs to banks in this respect must be incorporated in the analysis.
- Finally, there are a number of less quantifiable factors that will also weigh heavily in any such decision.

6.3.1 Fixed costs of joining the CLS Bank

To be a full member (and therefore shareholder) of the CLS Bank requires a \$5 million subscription fee. However, as presumably a member/shareholder who wished to leave the system would be able to sell its shareholding – assuming another party wished to buy it – it should be possible to recoup some or all of this upfront investment.

The same does not hold for investment in the internal systems required to operate effectively within the CLS system. For example, upfront investment in IT systems is likely to account for a large part of the potentially dead-weight fixed costs of joining the CLS Bank. In 2004, the TowerGroup conducted a survey of financial institutions to assess the costs and benefits of participation in the CLS system. In terms of fixed costs, their results were reported as follows:

The Tower Group (the financial services IT research and consultancy) has estimated the total spending by settlement members, user members and third parties for changes and enhancements to existing IT applications to be approximately US \$183 million between 1999 and 2003. This expenditure will be similar to that for the euro and Y2K

in the sense that it is a one-off cost for related enhancements. Given that the top 25 member banks, who will market CLS services globally, are likely to spend up to US \$5 million on IT applications, one has to question whether there is an alternative.³²

Clearly, such investment is a one-off and is specific to the system needs of the CLS Bank. That is, if a financial institution were to leave the CLS Bank, the systems they had developed – at a cost of up to \$5 million per bank – would not be compatible with any potential alternatives. Therefore, not only would the \$5 million be effectively lost, but also IT systems would have to be fundamentally changed to be compatible with another system, at considerable additional costs.

Third-party participants in the CLS system face lower fixed costs, though it is reasonable to assume that these would not be negligible. Furthermore, third-party participants directly benefit from the larger up-front costs incurred by full settlement members, without which they would have no access to the benefits of the CLS system.

By the middle of 2003, the CLS Bank had approximately 50 direct settlement members, and 70 third-party members. If we therefore assume an average up-front investment of \$4 million for the top 25 member banks, and an average \$2 million investment for the remaining 25 members, we can assume that third-party participants have incurred upfront investment costs relating to IT systems of approximately \$0.5 million each. These are not negligible sums, particularly for some of the smaller third-party players. However, if they were to leave the CLS Bank this would be lost, and further investment would be required to engineer new IT systems.

6.3.2 Variable cost differential of CLS Bank participation vs alternative systems

Prior to its launch, proponents of the CLS system argued that, despite the relatively high up-front investment costs, participants would see benefits in terms of lower variable – or operating – costs. For the purposes of this report, we can divide these into distinct categories:

Efficiency gains

For participants in the CLS Bank, a key benefit has been the ability to increase FX volume traded, but with the same or even with fewer staff. This was illustrated in the results of a survey by the London-based Z/Yen Research group, which was based on data for 2004.³³ The results show that average interbank FX volume increased significantly over the year, whilst average headcount fell over the same period.

The survey demonstrates that participation in the CLS Bank has resulted in direct efficiency savings of 32% for participants in the system.

If we assume that, on average, each FX transaction produces clear profit (in terms of the spread) of 1.5 basis points – a reasonable assumption³⁴ – we can estimate the impact of this efficiency saving. The CLS system processes \$2 trillion of trades every day. However, CLS Bank data includes both sides of each transaction, with the result that the headline figure produced must be halved. One and a half basis points' worth of \$1 trillion is \$150 million in estimated profit per day. However, as pointed out above, operational efficiency

³² See www.gtnews.com/payments/clsreport.cfm

³³ See www.zyen.com/ for full copies of this survey.

³⁴ In 2002, for example, spreads in inter-bank wholesale markets were 0.023% for the US dollar/yen transactions and 0.021% for the US dollar/UK pound. (Spahn 2002).

gains within the CLS system enable participants to increase the scale of transactions by 32% with no impact upon operating costs. Consequently, participation within the CLS system offers the opportunity to increase FX profits from \$150 million to \$198 million per day, a system-wide daily profit increase of \$48 million. Taken annually, this amounts to a direct benefit to CLS Bank participants of \$12.48 billion.³⁵

Operating costs

As well as the efficiency gains described, the same survey provides data on the impact of CLS Bank participation on average inter-bank transaction costs for FX trades. In the non-CLS interbank market, for example, the average internal cost of processing an interbank FX trade is \$3.70. Within the CLS system, however, the cost falls to just \$1.30, a saving of \$2.40 per trade.

On average, the CLS Bank settles 200,000 trades every day. However, as with its value data, it is necessary to halve this figure to get a true picture. Applied to 100,000 daily trades, the efficiency gains described therefore represent a daily saving to participants of \$240,000, or \$62.4 million per year. By October 2005, the CLS Bank had approximately 550 participants, including banks, non-bank financial institutions and investment funds. Clearly some banks will benefit far more than this, particularly the key settlement members who are processing the largest quantity of trades in the system. However, for comparative purposes, it is useful to consider the savings (and costs) on an average basis.

Liquidity / net funding costs

In domestic RTGS systems, the 'G' stands for gross rather than net. Whilst CLS Bank transactions are also settled in gross form, they are **funded** on a net basis. The benefits this produces are described as follows by the CLS Bank:

By providing Settlement Members with a multilateral net position on which to base necessary daily funding rather than gross transaction-by-transaction funding, CLS reduces necessary funding by over 90%.³⁶

This feature of the CLS system brings real financial benefits to participating banks, which we assume fund 10% of their net funding requirements in the interbank market.³⁷ The 10% figure is the average funding gap faced by major UK banks from 2000–2003. The funding gap represents the difference between the banks' total deposits and total lending.³⁸ This shortfall must be met by external borrowing, either domestically or overseas. Clearly, a bank's activities in the domestic loan and international FX markets are very different. However, at a group level, a liquidity saving (in terms of a 90% reduction in net funding requirement for CLS Bank financing) frees up group-wide liquidity for other functions. The result is a reduction in the funding gap, and therefore a decrease in the quantity of funds that must be externally raised to support the bank's activities. The size of this reduction, it can reasonably be assumed, directly reflects the reduced liquidity requirement resulting from CLS Bank membership.

The CLS Bank's 550 members execute an average daily value of \$2 trillion through the CLS system. Gross funding would therefore necessitate the entire \$2 trillion being available for settlement – unlike the previously halved data, however, this is an

35 Here and throughout we assume 260 trading days per year.

36 See, About CLS: <http://www.cls-group.com/>

37 In reality, of course, Banks fund their activities from diversified sources. However, the LIBOR rate offers a reasonable estimate of these sources in the aggregate.

38 See Bank of England (2003) for a detailed review of the funding patterns of the UK banking sector.

accurate reflection of the real situation, since both parties to the transaction would, in the absence of any netting, be required to provide the full quantity as liquidity.

By reducing the net funding requirement by 90%, however, the system requires only \$200 billion to be made available, a saving to CLS Bank participants as a whole of \$1,800 billion per day in liquidity. If we assume that, on average, 10% of this would have been financed externally, the figure 'saved' in this regard becomes \$180 billion per day. To fund this every day at an overnight LIBOR rate of 3% would cost \$5.4 billion over the course of a year (the 3% being an annualised rate and assuming 260 trading days per year). This therefore represents a saving to CLS Bank participants, which is a direct result of their participation in the system, of \$5.4 billion per year.

As with the previous estimate, the savings will clearly be considerably higher for the largest participants with the greatest number of trades. However, the savings are perhaps most relevant when viewed at the level of the entire CLS system.

The CLS system and Basel 2

Under the new Basel Capital Accord (Basel 2) the regulatory capital that banks are required to hold with respect to their loans will vary according to the creditworthiness of the counterparty. For the Basel Committee on Banking Supervision (BCBS), settlement risk is an important factor in this regard. It has been suggested that financial institutions that settle FX transactions through the CLS system – and have therefore eliminated settlement risk – will attract lower capital charges than institutions that do not use the system. Specifically, the Accord will ultimately levy a capital charge on FX trades where both legs are not settled on the same day – the CLS system was specifically designed to overcome this Herstatt Risk and so CLS Bank participants' trades will not be subject to this charge.

At the time of writing, however, no final decision had been taken on this issue, and it is therefore not possible at this stage to quantify the impact. It is clear from publications of the Basel Committee, however, that they do intend to level such a charge. The BCBS explains the delay as follows, distinguishing clearly between 'settled' FX transactions (ie: PvP systems, as employed by the CLS Bank) and 'unsettled' transactions (ie: those that do not settle simultaneously):

With regard to unsettled securities and foreign exchange transactions, the Committee is of the opinion that banks are exposed to counterparty credit risk from trade date, irrespective of the booking or the accounting of the transaction. Until the treatment of counterparty credit risk has been reviewed further, however, the specification of a capital requirement in this Framework, for foreign exchange and securities transactions, will be deferred. In the interim, banks are encouraged to develop, implement and improve systems for tracking and monitoring the credit risk exposure arising from unsettled transactions as appropriate for producing management information that facilitates action on a timely basis. (BIS 2006)

As with the benefits from lower net funding requirements, the option of holding less regulatory capital is a real benefit to banks, as it frees up valuable group capital that

can be employed more productively, and reduces the need for external borrowing to fund group activities. When the new Accord is fully operational, CLS Bank participants will directly benefit from being exempt from this capital charge.

Comparing the quantitative benefits of CLS Bank participation with the quantitative impact of the proposed SSD

We have seen how trades involving sterling account for 8.5% of all FX transactions globally. If we assume that the composition of trades within the CLS system is the same as that in the broader FX market, this produces a taxable quantity of \$85 billion per day (8.5% of \$1 trillion). Levying the SSD at the rate of 0.005% therefore results in a daily tax take of \$4.25 million, and an annual take of around \$1 billion.

TABLE 6
Benefits of CLS Bank participation vs impact of sterling stamp duty

Annual SSD tax take	Benefit category	Annual benefit of CLS
\$1bn	Efficiency gains	\$12.48bn
	Operating cost gains	\$0.0624bn
	Net funding requirement gains	\$5.4bn
Total: \$1bn	versus	Total: \$17.94bn

As is clear from Table 6, with the benefit of CLS Bank participation equating to almost \$18 billion annually, the introduction of an SSD at a rate of 0.005% would not create any incentive for participants to leave the CLS system to avoid the duty. Indeed, in order for such an incentive to exist, the SSD would have to be levied at more than seventeen times the rate proposed.

In addition to the variable cost benefits that have been described above, CLS Bank participants’ decision-making process in this regard would also be affected by the fixed cost investment they have already made. Both fixed and variable cost factors, therefore, clearly outweigh the impact of an SSD set at 0.005%.

As well as the direct and indirect financial benefits, however, there are a number of other aspects of CLS Bank participation, which, although not necessarily quantifiable, would also provide strong incentives to remain within the system. Furthermore, as pointed out above, even if banks chose to exit from the CLS system they would still have to pay the SSD.

Assessing the unquantifiable benefits of CLS Bank participation

Beyond the quantifiable benefits described, CLS Bank participants are discovering other advantages, which flow from the increasing sense of the CLS Bank settlement system being the ‘gold standard’ in global FX settlement terms. For example, Reuters trading conversations are beginning to include ‘this price CLS only’ messages, which suggests a price advantage being available for CLS Bank participants.

This is supported by 2005 survey evidence from TowerGroup research, who report that 54% of third-party CLS Bank users have altered their approach to counterparties depending on whether they are CLS Bank participants or not. Specifically, the survey

evidence shows that 68% of respondents – who were already third-party CLS Bank users – said they favoured counterparties also within the CLS system, and 47% said they had obtained larger trading lines as a result of their participation in the CLS Bank.

Anecdotal evidence of these types of ‘softer’ benefits is steadily accumulating. The quote below from the Director of Transaction Services for a major international bank explains how this produces both benefits of CLS Bank participation, and costs for those choosing not to participate.

*Latent business opportunities are emerging because counterparties do not have to worry about settlement limits on every day trades once they are both on CLS. On the other hand, you are starting to see people regularly being turned down on large funding trades because they are not on CLS.*³⁹

Another benefit that is emerging but was not necessarily predicted, is the reduced need for market participants to retain expensive Nostro accounts in separate currencies as more and more of their FX business is settled through the CLS system.

As well as these benefits, there is also the issue of third-party credit ratings. At present, it is not clear if or how the major ratings agencies will differentiate between participants and non-participants in the CLS Bank. However, given the elimination of settlement risk enjoyed by CLS Bank users, it seems highly probable that such a differentiation will occur. Clearly, this will have a direct impact on banks’ activities, not least through the terms upon which they can finance themselves.

To summarise this section: CLS Bank participation brings both tangible and intangible benefits. On the tangible side, the quantitative benefits of participation far outweigh the costs of an SSD levied at any realistic rate. This can be seen at the system-wide level – as shown in Table 6 – but is evidently true for individual participants. Clearly, a member bank with a high level of FX trades going through the CLS system will be disproportionately affected by the SSD. However, this cost will be more than offset by the additional financial benefits that this high volume flow brings to the bank. The implementation of an SSD in the CLS system, therefore, would not produce an incentive for participants to move outside of the CLS Bank – even if they could avoid the SSD by doing so – as they would become subject to Herstatt Risk.

Furthermore, to be acceptable to central banks (with oversight responsibilities) and compatible with Basel 2 and anti money-laundering regulations, those wishing to leave the CLS Bank would have to set up a parallel system with similar features to those described above. Consequently, the SSD could also be levied through any feasible alternative system.

6.4 Would an SSD encourage a return to large-scale netting in the international sphere?

Another issue often raised, is that an SSD would encourage greater use of large-scale netting in order to avoid the tax. Would this be the case?

³⁹ Quote from Olaf Ransome, Director Transaction Services & Solutions, CSFB, in Special Reports: Continuous Linked Settlement, at www.gtnews.com/payments/clsreport.cfm

The first point to make is that such a multilateral netting system does already exist, and it is integral to the CLS system. Furthermore, as we have seen, the benefits to participants in terms of lower net funding requirements are large. This is not, however, an inevitable feature of netting systems. Historical experience has demonstrated that the benefits of such systems only become meaningful as the number of participants reaches a critical mass. Consequently, there would be no incentive – rather, there would be a real cost – for a small number of banks to exit the CLS system and set up their own multilateral system. The benefits of netting within the CLS system could only be replicated if **all** the current participants decided to leave the system.

Given the benefits of participation that have been described, as well as the fixed-cost investment in systems and processes, it is difficult to argue that banks would abandon the CLS Bank in order to set-up their own hugely expensive multilateral netting system in order to avoid a half a basis point charge on a small percentage of their FX transactions.

Even if they were to do so, however, it must be remembered that multilateral netting systems cannot operate in isolation. In particular, given their importance to domestic and international payment and settlement systems, national central banks maintain an oversight role over their activities.

In order to be acceptable in this respect – and capable of smooth interaction with domestic LVPS – any multilateral netting system must operate as an RTGS using PVP settlement techniques. In this basic respect, central banks therefore have considerable leverage over the activities of multilateral netting systems. No international system of this sort could function without access to the UK's LVPS. As the 'gatekeeper' to these systems the Bank of England therefore has direct leverage over the activities of any multilateral netting system.

As with domestic RTGS infrastructures, multilateral netting systems require efficient messaging between participants to match and net gross trades (Schmidt 2001). Major multilateral netting systems have therefore been built on technical platforms by the market leader, and virtual monopoly-provider, in this area: SWIFT.

Therefore, just as SWIFT messaging can identify and inform the Bank of England of gross sterling FX transactions in the UK's CHAPS system, the same would be true of multilateral netting systems.

The question that this raises is whether banks could abandon SWIFT and move to a proprietary messaging system. As with CLS Bank participation, however, this is essentially a cost-benefit decision facing banks. And as with CLS Bank participation, the benefits of SWIFT membership are likely to far outweigh the cost savings from avoiding the SSD.

Again, similar to the CLS example, full participation in the system requires significant upfront investment in IT systems and processes. For a large financial institution such investment is likely to run into many millions. Again, to leave the SWIFT system would transform this investment into a 'dead-weight' cost, which would be amplified by the need to develop alternative messaging systems at equally high cost.

Much of SWIFT's competitive advantages come from its size, ubiquity and consequent efficiency. A group of banks starting from scratch could not hope to replicate these

benefits for the same cost as SWIFT. Again, the financial incentives to remain in the existing system, would far outweigh the impact of the SSD, and this would be greatly amplified by the huge cost of setting up a parallel system to replace it.

Finally, as has been pointed out, concerns over systemic risk in the FX market are such that any alternative system that was acceptable to central banks – as well as compatible with Basel 2 and money-laundering regulations – would have to be of a form that it could not be used to avoid an SSD.

6.5 Would an SSD encourage much greater use of tax-avoiding derivative products?

This issue addresses whether the introduction of an SSD would lead to greater use of derivatives in order to avoid the duty. In large part, this objection has already been addressed: by ensuring that the SSD covers both traditional **and** the OTC FX derivative market, it cannot be avoided by moving activities into the derivative market, particularly as derivative contracts are also ultimately settled in the traditional FX market. One possible exception to this relates to ‘contracts for difference’ (CFDs) and ‘non-deliverable forwards’ (NDFs), where only the difference between the contracts (ie: the net position) is settled, as opposed to the gross value of the transactions. However, although this is the case, it is also true that financial institutions which sell CFDs and NDFs are unwilling to carry this exposure on their books, and therefore seek to hedge the risk these contracts entail. This hedging process can only be undertaken in those sectors of the FX market already covered by the SSD, meaning that this also would fall within the ambit of the duty.⁴⁰

There are a number of other relevant factors in this regard also. First, the CLS Bank is progressively increasing its abilities to settle derivatives contracts within the system. By 2007, the CLS Bank will offer a ‘complete end-to-end’ service for the settlement of cash positions for NDF contracts, and for FX option premiums, further simplifying the SSD collection process.

As with its other services, it is likely that the increased capacity to settle derivative contracts will result in significant cost savings within the CLS system. As we have seen, once an institution starts to participate within the CLS system, it becomes increasingly efficient to settle a high proportion of all their FX business within it. The same will be true for derivatives.

6.6 Would an SSD move derivative activity relating to sterling outside UK jurisdiction, and therefore outside the reach of the tax?

As we have seen, it is technically entirely possible for an SSD to be collected on sterling derivative transactions, wherever they occur – unless it is being suggested that in order to avoid a 0.005% on a small fraction of their FX activities, the world’s leading financial institutions would wish to sever all links with the UK’s financial system. Equally, as we

⁴⁰ See Kapoor (2005) for a more detailed account of this aspect of the global FX market.

have mentioned elsewhere in the report, it is not possible for derivative markets to exist in isolation from traditional markets – OTC derivative transactions will generate a footprint in the traditional market through the process of hedging. So this is not a viable way to avoid the SSD as no benefits will come about from shifting derivative transaction overseas.

As with all the issues addressed above, the key question is: why, in purely financial terms, would a major international bank choose to act in this way? There exists today an efficient, profitable, IT-dependent financial infrastructure for FX transaction of both the traditional and derivative form. Much of this activity is made possible (and cost-effective) by standardised messaging and communication provided by SWIFT. To extricate oneself from this system would mean that financial institutions would have to write-off their initial investments and invest an even larger amount setting up an alternative. Furthermore, as we have seen, there are real financial benefits from participation in large, global networks which exhibit real economies of scale as they grow. Again, financial institutions would have to abandon these benefits, despite the fact that, quantitatively, they far outweigh the impact of the SSD.

Finally, it is not feasible for financial institutions of world-scale to operate in the sterling FX and derivative markets in a sustainable manner without the support of the Bank of England. This support would only be forthcoming, however, if these institutions were operating in a system that reflected best practice in terms of risk management and anti money-laundering. Such a system could not be used to avoid the SSD.

Ultimately, were a sterling stamp duty to become UK law, financial institutions would have to abide by it, as is the case with all other legal obligations.

Concluding remarks

This report has set out the mechanism by which the UK could unilaterally implement a sterling stamp duty (SSD). The measure proposed is specifically designed to raise revenues. Furthermore, it has been argued that these revenues should be ring-fenced and used to help fill the funding gap required to meet the Millennium Development Goals. There is a clear need for ‘innovative sources of finance’ in this regard, and we have demonstrated that a Currency Transaction Tax does not need to be universally implemented to be feasible, but could be implemented by any developed country or currency zone.

It has been suggested that an SSD would provide incentives for market participants to leave particular national and international payment and settlement systems. By levying the SSD across all of these systems, however, no such incentive exists. Moreover, even if it were possible to exit these systems and avoid the duty, we have clearly demonstrated that banks would not rationally choose to do so: the real, financial, benefits they receive from membership of these systems far outweigh the negligible impact of a 0.005% levy on a small percentage of their foreign exchange activities.

We have shown that the SSD could be implemented easily and cost effectively. Initial start-up costs would clearly have to be centrally met – as is the case with any new tax – however, once established, the ongoing cost of maintaining the system would be relatively small, as it is specifically designed to ‘piggy-back’ on existing networks and best practice. A small fraction of the £1.12 billion estimated annual take from an SSD would be sufficient to cover these operating costs.

To conclude, a unilaterally implemented SSD is perfectly feasible. It could be implemented quickly and relatively easily. It would cost very little to maintain and would raise significant funds – funds that are urgently needed to help finance the Millennium Development Goals.

In short, with the potential to substantially increase UK aid expenditure, this proposal offers a **sterling** solution.

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APPENDIX 1 Potential income for development from a transaction levy on the world's most traded currencies

The table shows the amount of income that can be generated by a CTT at rates of 0.005% and 0.01%.

TABLE
Estimates of annual revenue (in US \$ billions) from levying a Currency Transaction Tax on the world's most traded currencies

First figure:
CTT=0.005%

Second figure:
CTT=0.01%

*The figures in the final column reflect a downward adjustment of 2.5% for the 0.005% CTT and 5% for the 0.01% CTT to allow for a possible reduction in volumes

There is a certain margin of error in these calculations, as the figures in respect of sterling have been extrapolated to other currencies without taking full account of their individual circumstances. However, the estimates given are, we believe, a broadly realistic picture of the potential revenues available.

Country/zone	FX spot	FX derivatives	Total	Adjusted*
USA	\$4.20bn \$8.39bn	\$6.82bn \$13.64bn	\$11.02bn \$22.03bn	\$10.73bn \$20.93bn
Eurozone	\$1.76bn \$3.52bn	\$2.65bn \$5.31bn	\$4.41bn \$8.83bn	\$4.30bn \$8.39bn
Japan	\$0.96bn \$1.92bn	\$1.60bn \$3.19bn	\$2.56bn \$5.11bn	\$2.50bn \$4.85bn
UK	\$0.80bn \$1.60bn	\$1.32bn \$2.65bn	\$2.12bn \$4.25bn	\$2.07bn \$4.04bn
Australia	\$0.26bn \$0.52bn	\$0.51bn \$1.01bn	\$0.77bn \$1.53bn	\$0.75bn \$1.45bn
Switzerland	\$0.29bn \$0.58bn	\$0.32bn \$0.63bn	\$0.61bn \$1.21bn	\$0.59bn \$1.15bn
Canada	\$0.20bn \$0.40bn	\$0.39bn \$0.77bn	\$0.59bn \$1.17bn	\$0.58bn \$1.11bn
Hong Kong	\$0.09bn \$0.18bn	\$0.38bn \$0.75bn	\$0.47bn \$0.93bn	\$0.46bn \$0.88bn
Sweden	\$0.11bn \$0.22bn	\$0.25bn \$0.49bn	\$0.36bn \$0.71bn	\$0.35bn \$0.67bn
Norway	\$0.07bn \$0.13bn	\$0.15bn \$0.31bn	\$0.22bn \$0.44bn	\$0.21bn \$0.42bn
Korea (South)	\$0.06bn \$0.11bn	\$0.14bn \$0.28bn	\$0.20bn \$0.39bn	\$0.20bn \$0.37bn
Denmark	\$0.04bn \$0.09bn	\$0.16bn \$0.32bn	\$0.20bn \$0.41bn	\$0.20bn \$0.39bn
Singapore	\$0.05bn \$0.09bn	\$0.12bn \$0.23bn	\$0.17bn \$0.32bn	\$0.17bn \$0.30bn
Mexico	\$0.05bn \$0.10bn	\$0.07bn \$0.15bn	\$0.12bn \$0.25bn	\$0.12bn \$0.24bn
South Africa	\$0.04bn \$0.08bn	\$0.11bn \$0.22bn	\$0.15bn \$0.30bn	\$0.15bn \$0.29bn
New Zealand	\$0.05bn \$0.09bn	\$0.06bn \$0.12bn	\$0.11bn \$0.21bn	\$0.11bn \$0.20bn
Brazil	\$0.01bn \$0.02bn	\$0.02bn \$0.04bn	\$0.03bn \$0.06bn	\$0.03bn \$0.06bn
Chile	\$0.005bn \$0.01bn	\$0.02bn \$0.03bn	\$0.03bn \$0.04bn	\$0.02bn \$0.04bn
Totals	\$9.05bn \$18.05bn	\$15.09bn \$30.14bn	\$24.14bn \$48.19bn	\$23.54bn \$45.78bn

APPENDIX 2 Abbreviations and acronyms

APACS	Association for Payment Clearing Services
ATL	Air Ticket Levy
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
CFD	contracts for difference
CHAPS	Clearing House Automated Payment System
CLS	Continuous Linked Settlement
CTT	Currency Transaction Tax
DNS	Deferred Net Settlement
DvP	delivery versus payment
ECHO	Exchange Clearing House
FX	Foreign Exchange
IDPF	International Drug Purchase Facility
IFF	International Finance Facility
IFFIm	International Finance Facility for Immunisation
LVPS	Large Value Payment Systems
MDGs	Millennium Development Goals
NDF	non-deliverable forwards
ODA	Official Development Assistance
OTC	over-the-counter
PvP	payment versus payment
RTGS	Real Time Gross Settlement
SSD	sterling stamp duty
SWIFT	Society for Worldwide Interbank Financial Telecommunications
TARGET	Trans-European Automated Real-Time Gross Express Transfer



Stamp Out Poverty is a network of more than 50 UK charities, faith groups and trade unions campaigning for innovative sources of finance for development.

To find out more about Stamp Out Poverty please visit our website

www.stampoutpoverty.org

All Hallows on the Wall
83 London Wall
London
EC2M 5ND
UK

Telephone 020 7374 0305

Email: info@stampoutpoverty.org

Network members

- ActionAid (UK)
- Action for Southern Africa
- Africa Europe Faith and Justice Network – UK
- African Initiatives
- Amicus
- ATTAC
- Bakers, Food and Allied Workers Union
- British Youth Council
- CAFOD
- Christian Aid
- Chartered Society of Physiotherapy
- Christian Socialist Movement
- Communications Workers' Union
- Fellowship of United Reformed Youth
- Fire Brigades Union
- Freedom to Care
- Friends of Le Monde Diplomatique
- Friends of the Earth (England, Wales and Northern Ireland)
- GMB
- Greenpeace UK
- Hope for Children
- ICFTU
- Movement for the Abolition of War
- Muslim Parliament of Great Britain
- National Board of Catholic Women
- National Council of Hindu Temples
- National Federation of Women's Institutes
- National Justice and Peace Network
- New Economics Foundation
- New Internationalist Cooperative
- National Union of Journalists
- One World Trust
- Oxfam
- People & Planet
- Progressio
- RESULTS (UK)
- Save the Children
- Simpol
- Stakeholder Forum
- STUC
- Tearfund
- Traidcraft
- Transport and General Workers' Union
- TUC
- United Nations Association
- United Reformed Church
- United Society for the Propagation of the Gospel
- War on Want
- Welsh Centre for International Affairs
- World Development Movement
- World Vision
- WWF (UK)

A Sterling Solution
Implementing a stamp duty on sterling
to finance international development

by Dr Stephen Spratt

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