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THE FTT AND EUROPEAN SOVEREIGN DEBT

By Sandy Bhogal, James Taylor and Alex Carr

The proposed tax could have a crippling impact on government's ability to fund themselves. Here's why

In the summer of 2012, talks on the proposed implementation of an EU-wide financial transaction tax were breaking down. By the time the July Ecofin [Economic and Financial Affairs Council] meeting ended, it had become clear that there would not be unanimous support for the proposal.

But that was not to be the end of the matter. On February 14 2013, following a number of requests from EU member states, the European Commission adopted a proposal for a Council Directive for a financial transaction tax (FTT) to be introduced in a subset of the EU: Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia and Spain (FTT Zone). This would be done using the Enhanced Cooperation Procedure (ECP). This procedure allows a subset of EU member states to establish closer cooperation with one another in any area covered by the EU Treaties, other than areas where the EU has exclusive competence.

Under the existing proposal, the FTT would be implemented by member states of the FTT Zone by September 30 2013 and come into force on January 1 2014. Although, as is discussed further below, there is serious doubt that this is an achievable target. There is also serious doubt that any FTT eventually introduced will be in the same form as the existing proposal. The Commission's proposal has been the subject of significant criticism, not only by financial institutions, lobby groups and member states outside the FTT Zone, but also by the participating member states. The impact of the proposal on sovereign debt markets, in particular, has given rise to much debate.

Scope of the FTT

In summary, the proposed FTT is payable on both sides of a financial transaction if a financial institution established in the FTT Zone is a party to the transaction (whether as agent or principal). As explained below, the term 'establishment' is given a controversially wide meaning. The minimum rates envisaged are 0.01% on derivatives transactions and 0.1% on transactions in other financial instruments (including those relating to the buying and selling of bonds and equities).

The financial transactions to which the FTT applies are, broadly, transfers and exchanges of financial instruments and conclusions of derivatives contracts or material modifications of any of the above. The types of financial instruments, transfers and exchanges of which are taxable, are structured products and instruments listed in section C of Annex I of Directive 2004/39/EC on markets in financial instruments (commonly referred to as MiFID). This includes shares, bonds, units in collective investment undertakings and derivatives contracts.

As mentioned above, for the FTT to apply, at least one party to a financial transaction must be a financial institution established in the FTT

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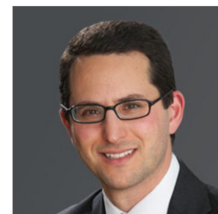

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Zone. Financial institution has been defined very widely to include, among others: banks; investment firms; insurers; funds and their managers (including pension funds); regulated markets; and, any other undertaking carrying out investment activities that constitute more than 50% of its average net annual turnover.

Certain entities and transactions are outside the scope of the FTT. Most importantly, the raising of capital through primary market transactions (eg the issue and initial subscription or purchase of shares and bonds) is not taxable, nor are transactions with central banks (including central banks of non-participating member states and the European Central Bank).

Territoriality

A party can be established in the FTT Zone by virtue of either the 'residence principle' or the 'issuance principle'.

A party is deemed to be established in the FTT Zone under the residence principle where it is:

- a financial institution authorised by an FTT Zone member state;
- a financial institution authorised from outside the FTT Zone to operate within the FTT Zone (eg a European Economic Area firm using a passport or a third country firm permitted to trade in the FTT Zone);
- a party with its registered seat, permanent address or usual residence in the FTT Zone;
- a party with a branch in the FTT Zone (with respect to financial transactions carried out by that branch); or
- a financial institution that is a party to, or acting in the name of a party to, a financial transaction with another party that is established in the FTT Zone under one of the bullet points above.

A party is also deemed to be established in the FTT Zone under the issuance principle where it is a party to a financial transaction in relevant financial instruments issued in the FTT Zone. Relevant financial instruments, for these purposes, are all financial instruments within the FTT definition, other than derivatives that are not traded on an organised platform.

It is particularly the last bullet point of the residence principle, and the issuance principle in its entirety, that have given rise to serious concerns over the seeming extraterritorial effect of the proposed FTT. It's this point that has led in part to the UK issuing a legal challenge, on April 19 2013, against the use of the ECP to implement the FTT. In a letter dated April 18 2013 to the European Scrutiny Committee of the House of Commons, HM Treasury explained that the UK's challenge focuses on the extraterritorial elements of the proposal which, it argues, are contrary to both EU laws as set out in the Treaties establishing the EU and international tax norms. According to HM Treasury, the FTT would infringe the rights and competences of non-participating member states and impose costs on them – consequences that are not permitted when using ECP.

There has been much comment recently by industry groups, central banks, national governments and even from within the European Parliament about the need for the FTT to be redesigned. A number of suggestions have been mooted. These include: the exemption of intermediaries (to help reduce the cascade effect which we describe below); the exemption of sovereign debt, repos and/or derivatives transactions; a staged implementation of the FTT which would see it first being applied to equities and then perhaps to bonds and, thereafter, perhaps to derivatives; and, reduced or variable rates on financial transactions by reference to their tenor and economic value. Given the high levels of speculation, and a number of other factors (including the German elections in September 2013), it is widely anticipated that the ambitious target to bring the FTT, as originally proposed, into effect from January 1 2014 is unlikely to be met.

FTT's impact on sovereign debt

It is widely expected that the FTT on bond transactions will be borne either by the investor accepting lower returns on its investment, or by the issuer increasing the interest rate on, or reducing the issue price of, the bonds. This is rather than intermediaries suffering a reduced margin. The FTT can therefore be expected to increase the cost of funding for bond issuances, both for corporates and governments, notwithstanding the primary market exemption described above.

Further, it is common for transfers of bonds between investors (and other transactions in bonds) to involve a number of separate transactions (eg by the inclusion of one or more intermediaries). This would give rise to more than one incidence of the FTT on the transfer. Although the headline rate of the FTT on bond transactions appears relatively low, given that modern day transactions (even seemingly simple transactions, such as transfers between investors) often involve a series of interconnected transactions. This means a so-called 'cascade effect' of tax-related costs arises, which could represent a significant extra transaction cost (particularly on short dated and lower yielding instruments).

The extent to which a government's cost of funding will increase would partly depend on the sensitivity of investors to increased transaction costs. A foreign investor (ie one located outside the FTT Zone) has the option to invest in a financial instrument that will always be subject to the FTT (by virtue of the issuance principle) or one that may not be, depending on where the other transaction parties are located. Therefore, FTT Zone member states that rely heavily on investment from outside the FTT Zone can expect a higher increased cost of funding. This is because the yield on its bond issues will need to reflect the opportunity cost to a foreign investor of choosing to invest in sovereign debt that will attract an FTT charge in the secondary markets, rather than bonds issued outside the FTT Zone, which may not. FTT Zone investors, on the other hand, will be aware that their own investment costs have increased, and so will be looking for investments offering greater returns.

The effect on bond transfers, which are traditionally traded over-the-counter (OTC) may, from a liquidity perspective, also affect the ability of investors to accurately benchmark prices in the secondary markets for further primary market issuance. This in turn may lead to investors pricing at the higher end of any proposed pricing parameters on bond transactions. Reduced liquidity would, in addition, impact investors' ability to sell their bonds easily or at prices that would provide them with the same yield as they could have achieved by an investment in more liquid assets with a more developed secondary market. This would further dampen the appetite of investors to hold investments in these bonds in the secondary markets. Historically, illiquid bonds have tended to be price volatile, so should the proposed FTT result in further liquidity squeeze in the secondary markets, this increased illiquidity could adversely affect the bonds' market value. In these circumstances, the FTT as envisaged today could, notwithstanding the intention of exempting primary market issuance, have a long-term negative effect on the issue and purchase of sovereign bonds in the primary markets.

Bonds with short maturities (less than two years) generally carry lower levels of credit risk than longer-term bonds, and so attract a lower return. Accordingly, the FTT will represent a proportionally higher percentage of returns on bonds with shorter maturity profiles. On this point, research has been prepared for the City of London (The Impact of a Financial Transaction Tax on Corporate and Sovereign Debt, April 2013). This report estimates that the average percentage of annualised returns of the FTT on sovereign debt issued by non-FTT Zone member states with less than a two-year maturity could be as high as 208%. The estimated impact is slightly

lower for sovereign debt issued by FTT Zone member states, at 128%, but is still a sufficiently dramatic proportion to have a serious impact on the sovereign bond markets. By contrast, the percentage of annualised returns of the FTT on sovereign debt with longer maturities has been estimated at only 13.2% or 9.8% (for FTT Zone member states and non-FTT Zone member states respectively) on sovereign debt with a maturity of four to six years, and an even lower percentage for sovereign debt with longer maturities.

One option that has been discussed would be to have a variable FTT rate on bonds, which decreases in line with their respective maturity profile. This could partially offset the problem identified above, but is likely to be difficult to manage in practice. Further, one of the stated aims of the FTT is to encourage more responsible investing practices, which includes a shift away from short-termism. Finally, reducing the rate on transactions would lead to a reduction in the FTT revenues expected to be received by FTT Zone member states. This was a central facet of the original proposal with the tax revenues generated to be ploughed back into the real economy.

European Commission Impact Assessment

The Impact Assessment published by the European Commission on February 14 2013 estimates that the revenue to FTT Zone member states from the FTT on transactions in sovereign debt will be €6.5 billion. The Impact Assessment also calculates the increased cost of funding at somewhere between €2 billion and €3.85 billion, depending on the impact of certain mitigating factors. The net gain to FTT Zone member states, according to the European Commission, will therefore be between €2.65 billion and €4.5 billion.

Within the FTT Zone, Italy and France have already expressed concerns about the impact of the proposal on government debt, as they fear it could discourage investors from buying their bonds. The Impact Assessment does not take into account the fact that, because of the design of the FTT, governments that issue bonds will not necessarily receive all revenues generated by the FTT on transactions in those bonds. The FTT (as a cross-border tax) must allocate taxing rights between members of the FTT Zone. This is achieved by prioritising the residence principle over the issuance principle when deeming a party to be established in the FTT Zone. Accordingly, by way of example, where two parties established (under the residence principle) in Germany enter into a sale and purchase transaction for a Spanish government bond, the FTT would be charged (on both sides of the transaction) in Germany and not Spain. This phenomenon will have the largest effect on member states with relatively few domestic investors, but high levels of issued debt.

A similar issue affects non-FTT Zone member states. Research suggests that these countries will also suffer an increased cost of funding on sovereign debt, albeit to a lesser degree than FTT Zone member states. For example, it is estimated that the increased cost of funding to the UK government will be £3.95 billion in 2013. However, the UK government will not be compensated by receipt of any FTT revenues. It is issues such as this that have contributed to the UK bringing its legal challenge, as mentioned above.

Possible behavioural changes

In addition to the financial impact on governments, the FTT as proposed would bring about changes in the behaviour of investors in bonds. Amendment of the proposal could, of course, encourage other changes in behaviour or make the changes discussed below more or less profound.

One option available to investors would be substitution – which may be geographical substitution or instrument substitution.

As discussed above, foreign investors have the option to invest in financial instruments within, or outside, the scope of the FTT.

Accordingly, and should secondary market transactions remain within the scope of the tax, issues of bonds by Asia-Pacific, American or even non-participating European nations may become comparatively more popular than FTT Zone issued bonds of a similar credit standing. Geographical substitution also has the potential to bring some benefit to investors located within the FTT Zone.

Another option is for investors to substitute investment in the capital markets with other investments that benefit from lower transaction costs. One such option would be derivatives, which at present carry a lower headline FTT rate. An example of how this might be achieved could be for one or more financial institutions to purchase an entire bond issue on the primary market (suffering no FTT charge as a result) and then enter into total return swap transactions with counterparties that would otherwise have purchased the bonds. The total return swaps could replicate the cash flow on the underlying bonds, while replacing transactions in bonds (taxed at 0.1%) with transactions in derivatives (taxed at 0.01%). This option would become even more attractive if the application of the FTT to derivatives were delayed beyond its application to bonds, or if derivatives were exempted entirely. Alternatively and eventually if the scope of the FTT were narrowed, it may be possible for financial institutions to devise new forms of instruments or transactions that do not come within the scope of the FTT at all. Either way, it is likely that there would be an associated increased risk to counterparties, which is contrary to the risk-reducing aim of the FTT.

Another impact could be, for certain types of investors, a shift from investments in bonds with short maturities to longer-term buy and hold strategies, in respect of which the negative effect of the FTT on yield to maturity would, as highlighted above, be of less potential significance.

Where an investor may today use an intermediary to broker a transaction, the cascade effect would, based on the FTT as proposed, lead to a multiplication of the total FTT liability on the transaction. Accordingly, investors may look to undertake a greater number of transactions directly with other investors. Not only would this lead to a reduction in business for intermediaries, but would come with an increased time cost to the investor. This is because they would need to locate, and negotiate suitable terms directly with, a suitable counterparty. Alternatively, the investor may look to employ an intermediary as its agent (which would not give rise to a second FTT charge).

Investors may also look at new or different ways of structuring transactions. For example, a repo can be structured in one of two ways: first (as is common in the UK), the underlying collateral is actually transferred to the counterparty; or second (as is common in the US), the underlying collateral is pledged. The first repo method would give rise to an FTT charge, whereas the second repo method would not, as there is no transfer of a financial instrument.

Repos

The FTT is expected to have a particularly negative effect on the repo market. The issue identified above concerning the comparative cost of the FTT on short-term bonds is multiplied significantly with respect to repos, which frequently have very short maturities of a few days or less. Margins on short-term repo transactions may be 0.05% or lower per transaction, so a tax of 0.1% is likely to make these transactions uneconomical, especially if, as is often the case, the transactions are also high frequency. Accordingly, there is significant concern that the FTT as proposed will all but wipe out the overnight repo market.

The European Commission accepts that applying the FTT to repos may mean that the short-term repo market will become unattractive as a business model, but expects it to be replaced by secured lending or transactions with central banks (neither of which would be subject to the FTT).

The repo market plays an important part in maintaining liquidity. It allows investors to hold longer-term investments, while maintaining high levels of liquidity to respond to market changes and opportunities. Repos can also be considered to mitigate risks, as holders can easily and quickly sell assets to offset losses. This is where the repo market interacts with the bond markets, as investors in long-term bonds also need to hold highly liquid (short-term) assets to maintain a balanced portfolio. A significant decline in the availability of repo transactions, making it comparatively harder for investors to hedge their long-term exposures to long dated European sovereign bonds, would further encourage investors to spurn this asset class.

Final thoughts

Given the level of uncertainty which now exists as to the timetable for implementation, and scope, of any FTT, it is difficult to draw any definitive conclusions at this stage. Suffice to say, the heightened levels of regulatory and tax uncertainty in this and other areas are and will continue negatively to affect the sovereign bond markets and the European capital markets generally.

Seen in this light, the saga of the FTT will not help facilitate a much needed recovery in the European capital markets which serve as the most significant means of channelling capital and investment into the real economies of EU member states.

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