

THE EU FINANCIAL TRANSACTION TAX: A TAX ON SAVERS



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Recent media reports have focused on the legality of certain aspects of the Financial Transaction Tax (FTT) and led some to believe that the proposal is now dead. However, the idea continues to attract strong support from some proponent countries and the European Commission (EC).¹ While this is the case, BlackRock believes it has a duty to its clients to explain why and how the FTT proposal will be very damaging to end-investors, in particular long-term savers and pensioners, and to express its strong objection to the FTT on their behalf.

Background

In September 2011, the EC presented a plan for a financial transaction tax that would apply to all 27 EU member states. However, in October 2012, when discussions failed to establish clear unanimous support for an EU-wide FTT, the 11 proponent countries asked the EC to prepare a revised proposal to be implemented using the Enhanced Cooperation Procedure (ECP).² The revised proposal took shape as the draft Directive, published by the EC on 14 February 2013. As stated in the draft Directive, the main objectives of the FTT are to:

- ▶ ensure that financial institutions make a fair and substantial contribution to covering the costs of the recent crisis;
- ▶ create appropriate disincentives for transactions that do not enhance the efficiency of financial markets;
- ▶ harmonise legislation to ensure the proper functioning of the internal market; and
- ▶ avoid distortion of competition between financial instruments, actors and market places across the EU.

The draft Directive is the most ambitious attempt ever made to implement a 'Tobin-style' tax on monetary transactions between financial institutions.³ Given that at least some of the FTT's proponents actively hope that it will dramatically shrink the financial services sector, it is also one of the most controversial regulatory proposals that the EC has put forward. Opinions on the FTT's merits vary even within the group of 11 member states (EU-11) that are committed to

its implementation and genuine questions exist over the legality of the tax as it is proposed. These relate largely to its extraterritorial impact, which some believe could lead to discrimination against non-participating states, distort competition within the EU and impede the free movement of capital. Others contest these views.

THE NEGATIVE IMPACT OF THE FTT

- ▶ Increases costs on pensioners and savers
- ▶ Increases cost of capital for issuers
- ▶ Affects EU-based companies for hedging and cash management
- ▶ Undermines the Single European Market
- ▶ Reduces liquidity of capital markets, including government bonds
- ▶ Creates incentives to shift portfolios outside the EU-11 countries

BlackRock recommends the FTT proposal be withdrawn.

ASSET MANAGERS ACT AS AGENTS – OUR CLIENTS WILL BE HIT DIRECTLY

- ▶ The role of BlackRock and other asset managers is to act as an agent for their clients.
- ▶ Asset managers invest on behalf of clients, acting in accordance with client guidelines and transacting in assets held by third-party custodians.
- ▶ The counterparty to investment transactions is the investing entity, for example, a UCITS fund, an AIF or the individual portfolio of a corporate or pension fund, and **not** the asset manager.
- ▶ Clients will therefore be **directly** affected by the FTT via:
 - client trades and transactions in the distribution chain;
 - investment transactions carried out by the asset manager;
 - subsequent clearing and settlement transactions; and
 - increased indirect market costs.

¹ For example, Germany's coalition partners (the CDU and SPD) agreed to support an EU financial transaction tax via the ECP "without having negative effects on instruments for retirement savings, small investors and the 'real economy'".

² The mechanics of the ECP are discussed later in this *ViewPoint*.

³ The tax is named after the economist, James Tobin, who proposed a small tax on foreign exchange transactions in 1972, just after the collapse of the Bretton Woods system, with the aim of restoring some kind of stability in foreign exchanges by slowing down transactions.

Problems with the FTT

BlackRock engages with policymakers in an effort to shape financial regulatory reform by acting as the voice of the end-investor. We are generally supportive of a regulatory regime that increases transparency, extends greater protection to investors and facilitates the responsible growth of capital markets, provided it also preserves consumer choice and has benefits that exceed implementation costs.

BlackRock is strongly opposed to the FTT and any form of transaction tax that affects end-investors. We do not believe the FTT meets the EC's stated goal of being a targeted measure through which the financial sector repays the cost of support it received during and since the financial crisis of 2008. Rather, it will significantly reduce investment returns for end-investors – pensioners, savers and corporates – and substantially undermine the ability to manage portfolios efficiently and to hedge risks. End-investors will be hit both directly and indirectly: directly, because of the direct cost of the FTT on the transactions undertaken in their portfolios; and indirectly because even if the market restructures to avoid the FTT, the difference between the buying and selling price of securities ('trading spread') will increase, further reducing savings and pensions.

Clearly, the FTT will hit end-investors within the EU-11 hardest, but it will also hurt those in the rest of the EU – without passing on to their governments any of the revenues it may raise. It will severely affect capital markets, thereby increasing the cost of capital for companies in the EU-11, which will make many activities uneconomic and impede economic growth in the region. It will also prompt a relocation of activity outside of the EU-11, distorting the balance of transactions taking place within and outside the zone, undermining the Single European Market.

BlackRock's recommendation

The FTT penalises Europe's citizens – in particular its pensioners and long-term savers – by directly taxing their savings and retirement income and indirectly increasing the cost of their investment in the European economy. As our clients are Europe's end-investors, we oppose all forms of FTT as this is in our clients' best interests.

Further, we believe that the FTT is an inappropriate tool to achieve the regulatory objective of changing the behaviour of financial market participants. The suite of regulatory initiatives to separate proprietary activity from client activity in financial markets (the structural reform of banks, MiFID II, etc.), coupled with holistic regulation to address risk wherever it may occur in the financial system (CRD IV, Solvency II, AIFMD, and the forthcoming SLL) are better suited to address risk and to prompt the reform of business models and commercial attitudes towards risk.

For these reasons, **we recommend that the proposal for the FTT be withdrawn.**

The draft Directive

The 11 countries committed to implementing the FTT under the ECP are: Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia and Spain. The key features of the proposal are shown in the box below.

THE FTT IS SIGNIFICANTLY WIDER-REACHING THAN OTHER STAMP DUTIES

- ▶ The definition of 'financial institution' in the draft Directive is very broad, covering UCITS, AIFs, separate accounts, pension funds, insurance companies and holding companies.
- ▶ The FTT will cover all financial instruments (equities and debt securities) and derivatives, whether OTC or on-exchange, and include securities and repo transactions. It may also apply to the posting and return of collateral.
- ▶ The FTT is charged on transactions in which at least one party is a financial institution and one of the parties or the issuer of the underlying instrument is established in the EU-11.
- ▶ The range of exemptions from the FTT is very narrow. Real estate, bank deposits and insurance policies will not be chargeable. Spot foreign exchange (FX) transactions are also exempt (although FX forwards and currency forwards are included), as are member states, their central banks, other supranational bodies, their central counterparties and depositories. However, other persons transacting with such entities will be taxable. Primary market transactions are also exempt.
- ▶ The tax is 0.1% for financial instruments and 0.01% for derivatives. As both the seller and buyer are charged, each transaction will be taxed twice (except for securities lending and repo), resulting in effective rates of 0.2% and 0.02% per transaction.
- ▶ Unlike almost all existing stamp taxes and FTTs, there is no form of relief for market-makers or for transactions within the system. The FTT will be charged on either of two geographical bases:
 1. A 'residence' principle, under which in-zone investors are taxed on all transactions in all stocks worldwide.
 2. An 'issuance' principle, under which investors worldwide are taxed on transactions with in-zone securities.
- ▶ There will be an extraterritorial impact in that financial institutions outside the 11-country zone would be liable to collect tax where they conduct trades directly with end-investors inside the zone.
- ▶ Political agreement earliest mid-2014.

The EC's proposal is much wider-reaching than any transaction tax to date. It is also highly unusual in that it:

- ▶ seeks to tax even very short-dated fixed income instruments (most existing stamp taxes focus on equities);
- ▶ will have a significant extraterritorial impact; and
- ▶ will tax transactions on a gross rather than net basis without a market-maker exemption.

The thinking behind the FTT is not new. In fact, there is a long history of academic interest in a tax on financial transactions, most notably from John Maynard Keynes in the 1930s and James Tobin in the 1970s. In our view, there are three main reasons why European governments have been the first to adopt the idea as a serious policy proposal:

1. The end-cost of supporting the financial sector during and after the 2008 crisis was particularly high in Europe, and the political desire of some to make the financial sector help to meet this cost is correspondingly strong.

While we acknowledge the desire to make the financial sector 'pay' for the financial crisis, the FTT will hit end-investors, Europe's pensioners and savers, much harder than financial services companies, its intended primary target.

2. The view that there is excessive high-frequency trading in 21st-century capital markets, and that this is both socially inefficient and a cause of market instability, has supporters in Europe.

While we agree that some – although by no means all – high-frequency trading may have some negative impacts, we believe these should be tackled through regulation, not taxation.

FTT VS. TRADITIONAL TRANSACTION TAXES

- ▶ Taxes on financial transactions are not new: stamp duties and similar taxes have existed successfully for many years in countries such as the UK, Ireland, Hong Kong, Greece and South Africa. All these taxes work on the issuance principle, and apply to equities only. The EU FTT goes beyond and includes fixed income as well.
- ▶ Typically, 'cascading' is avoided by having fairly extensive exemptions for market-making. There is also typically some ability to invest synthetically (using derivatives) without paying the tax.
- ▶ Importantly, unlike the FTT, none of these taxes is extraterritorial to any great practical extent. Firms in, say, London or Tokyo are not expected to play any part in the collection of the tax on behalf of the levying government – the requirement sits almost entirely on domestic firms.

3. The more radical proposition, that the financial sector is simply too large in aggregate and involves too many layers of intermediation, also has some support. Those in this group regard the FTT as a powerful method of discouraging such intermediation, and even of reducing the size of the financial sector as an objective in its own right. **We believe that the FTT will reduce financial transactions supporting the real economy and isolate the EU from potential investors, running the risk of turning it into a 'financial ghetto'.**

The impact of the FTT on end-investors

The FTT will directly affect the clients of asset managers, including charities, foundations, endowments, banks and insurance companies, and those investing in mutual funds and pension plans. This is because the clients of asset managers 'own' the assets that asset managers invest on their behalf. The investing entity, typically a mutual fund, pension plan or other separate account manager, is the counterparty in any investment made – not the asset manager. The FTT will therefore apply to client trades and transactions within the distribution chain for investment into funds, to investment transactions carried out within the portfolio and their subsequent clearing and settlement transactions. Clients will also bear significant indirect market costs as market-makers reflect the cost of the FTT by increasing spreads or by ceasing certain activities.

We note in this context that the FTT applies to client redemptions from pooled investment vehicles (client subscriptions are exempt as they qualify as primary issuance).⁴ Applying the FTT to client redemptions in this way breaches the fundamental principle that investing via investment funds should be tax-neutral compared to direct investment in the underlying fund assets.

More significantly given current stresses on national budgets, many governments in Europe are making extensive efforts to encourage individuals to save for their own retirement. **A number of countries encourage such savings through tax incentives. These include: the Riesterfond in Germany, Zukunftsvorsorgeeinrichtung in Austria, fonds épargne-pension in Belgium, the eluagne pension in Estonia, fundos poupança ações in Portugal, the plan d'épargne en actions in France, plan de pensiones individuales in Spain, and piani individuali pensionistici in Italy.**⁵

It seems illogical, to say the least, that governments are attempting to persuade European citizens to invest in some of these funds via tax incentives while simultaneously imposing the FTT tax upon them.

⁴ In practice, many client purchases of fund units do not take the form of true 'original issuance' or are heavily intermediated, and one or more FTT liabilities are likely to arise.

⁵ The three remaining member states, Greece, Slovenia and Slovakia, do not have an individual saving tax-incentivised system.

Table 1: IMPACT OF THE FTT ON INVESTMENT TRANSACTIONS IN SELECTED INVESTMENT FUNDS (EXCLUDING SUBSCRIPTIONS AND CASCADE EFFECT)

	IMPACT H1 2013 (% PER HALF)	EXTRAPOLATED TO COVER 12 MONTHS (% PER ANNUM)	DOMICILE
ETF STOXX 600 Fund	0.01%	0.01%	Germany
ETF DAX 30 Fund	0.02%	0.04%	Germany
ETF Euro Aggregate Bond Fund	0.03%	0.07%	Ireland
ETF Europe Ex-UK Fund	0.12%	0.24%	Ireland
European Active Equity Fund	0.13%	0.26%	Luxembourg
Euro Core Bond Fund	0.29%	0.58%	Luxembourg
Euro Short-Term Money Market Fund (MMF)	1.16%	2.33%	Ireland
Euro Government MMF	1.17%	2.34%	Ireland

For example, a recent study by Deutsches Aktieninstitut and Oliver Wyman estimated that over the lifetime of a typical Riester savings plan, the FTT would completely consume the maximum state Riester allowance of €4,620 (without allowances for children).⁶

Safety-conscious investors will be excessively penalised

BlackRock has analysed the impact of the proposed FTT on a number of our representative mainstream equity, fixed income and money market funds (see Table 1 above). We calculated the impact of the FTT on the actual transactions carried out by our fund managers within the selected funds over the first half of 2013 and extrapolated this to determine its impact over 12 months. Our analysis takes into account the domicile of the fund and that of the counterparties to the transaction. However, it does not take into account the impact of the FTT on repo collateral and collateral received (that is, securities lending). It is important to understand that we are not seeking in this analysis to capture the impact of client redemptions, the subscription chain or the impact of subsequent clearing and settlement trades. As such, the analysis significantly underrepresents the total impact of the FTT on the end-investor.

The table shows that the impact of the FTT on portfolios differs significantly according to investment strategy. **The FTT will hit disproportionately 'safer' money market and fixed income funds as the flat rate tax applies irrespective of the duration of the underlying investments in the portfolio.**

Short-term MMFs typically have an average weighted maturity of just 20 to 30 days, which means the entire portfolio turns over between 12 and 20 times a year. This translates into a 2% per annum FTT hit for investors – typically companies, pensions funds, charities, foundations, universities and public entities – investing in such an MMF. Government MMFs invest a significant portion of their portfolio in overnight reverse repo to be able to meet client redemptions (given that Government auctions do not take place on a daily basis). For these funds, the impact on the end-investor is even higher at 2.3% per annum.

IMPACT OF FTT ON EUROPE'S COMPANIES

Many European companies are highly risk-averse and hold significant amounts of cash on their balance sheets. The primary concern of such companies is to preserve the capital of their cash and to diversify credit exposure by investing in a range of options including – depending on their level of sophistication – bank deposits, MMFs, reverse repo and individual securities. Of these, MMFs and reverse repo are often favoured, the former because assets are held in bankruptcy remote custodian accounts and the latter because it is a secured form of investment. However, the imposition of the FTT will mean that MMFs and reverse repo will no longer be able to preserve capital, forcing corporations to rely to a greater extent on bank deposits, thereby subjecting them to more concentrated credit risk exposure.

⁶ A Riester savings plan is a government-subsidised pension saving product, which has been created to promote private old age provision in Germany. The Deutsches Aktieninstitut /Oliver Wyman July 2013 paper estimated that the FTT charges over the lifetime of a typical Riester plan would amount to around €7,600, reducing the average annual pension from €3,790 by €380 per year to just €3,410.

Unintended investment incentives and the undermining of sound asset management principles

As the tax will be applied to all transactions regardless of purpose, it will discourage portfolio diversification, hedging and other forms of efficient portfolio technique, as all of these generate additional transactions. Reducing diversification and hedging will increase the exposure of pensioners and savers to country, asset class, currency, interest and inflation risk. They will face tough decisions and perhaps will choose to sacrifice a degree of protection to compensate for the impact of the FTT on their investment returns.

IMPACT OF FTT ON CORPORATES' ABILITY TO HEDGE OPERATIONS

European companies will be broadly affected by the FTT. They seek to protect their operations against fluctuations in exchange, interest and inflation rates and against fluctuations in commodity prices and other inputs required to provide services and products. This is particularly important for companies that manufacture or distribute on a global basis and companies with long-term commitments (for example, pension liabilities, infrastructure and plant commitments). Companies gain this protection by using derivatives to hedge against such fluctuations. These transactions, as well as transactions between the different entities within a company, will attract the FTT. **The Deutsches Aktieninstitut / Oliver Wyman July 2013 study estimated the total annual tax burden for German companies to be between €2.4 billion and €3.7 billion, or around 15% of Germany's total revenue from corporate income tax in 2012. This estimate does not include the impact on companies of a higher cost of capital (because of reduced market liquidity) or increased dependency on bank finance (because of smaller bond markets).**⁷

The distortion of the investment case for active and passive investment strategies

Passive portfolios track indices and can take the form of 'index' mutual funds and exchange-traded funds (ETFs). Investors in such funds will be subject to the FTT when the index rebalances, while managers of active funds will invest more frequently in an attempt to outperform their index or benchmark. Although passive investing is gaining ground among institutional investors, active investing is still predominant among retail investors in Europe.

The FTT will hit the investment transactions within active portfolios hardest. Table 1 shows that the FTT will impact active bond and equity investment strategies (in our example, the Euro Core Bond Fund and the European Active Equity Fund) more than passive funds (ETF Aggregate Bond Fund and ETF Europe ex UK Fund). However, end-investors who use index funds to express a market view, and therefore invest in them relatively frequently, will be affected by the FTT to a far greater extent than our analysis of the effect of the FTT on investment portfolios in Table 1 suggests. BlackRock typically finds that gross flows in and out of our passive products are three or more times the trading flows created by index rebalancing. In addition, considering the impact of the FTT purely on investment transactions significantly underestimates the impact of the FTT on end-investors in passive funds. The 'cascade effect' – that is, the clearing and settlement transactions that follow an investment (see next section) will multiply the impact of the FTT on ETFs. **The FTT will therefore affect all types of investment portfolios significantly, albeit in different ways.**

IMPACT OF FTT ON INDIVIDUAL SAVERS

A 25-year-old adult who is willing to take on more investment risk (because of the length of time before their retirement) and invests €10,000 in the European equity fund would see €3,700 of his or her investment returns absorbed by the FTT over a 20-year period. A 45-year-old with a more conservative outlook investing €6,000 in the same European equity fund and €4,000 in the fixed income fund would face a 8.2% tax loss by the time they were approaching retirement at 65.

This impact may appear small in terms of percentage reduction in investment performance each year, but the cumulative impact will be significant. The FTT will make it fundamentally more difficult for investment managers to meet the expected return for clients, exacerbating the pension shortfall faced by many individuals. Clients investing in active portfolios seeking to maintain the same returns after the FTT will have to invest in strategies with greater directional risk and/or leverage and/or derivatives, or accept less hedging and greater investment risk.

Passive portfolios cannot seek to compensate for the FTT performance hit by taking active investment decisions. The FTT will therefore undermine the objective of passive funds, which is to provide close-to-benchmark returns, and instead lock end-investors into consistent underperformance against indices.

⁷ Deutsches Aktieninstitut / Oliver Wyman, 'Die Finanztransaktionssteuer – Ein Politischer Irrweg? – Auswirkungen Auf Private Haushalte Und Unternehmen In Deutschland, July 2013.

Diagram 1: THE CASCADE EFFECT OF THE FTT ON AN ETF



The impact of cascading on returns for pensioners and savers

The ‘cascade effect’ affects investment in two main ways: first, it makes the cost of each investment change within a managed portfolio more expensive by a factor far greater than the headline rate of tax would imply; and second, it also increases the cost to the end-investor of contributions to, and withdrawals from, that portfolio.

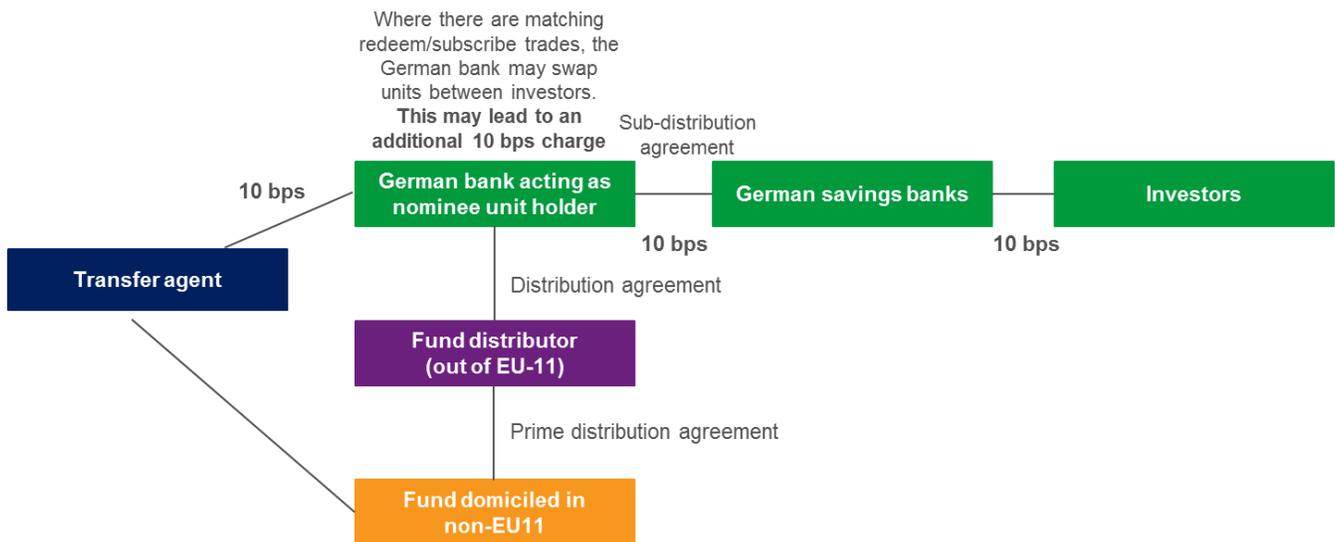
These issues affect most investment products and situations; we have used here the impact on an investment into an ETF as just one example (see Diagram 1). Although the headline rate of charge is the same 0.1%, the act of investing (in sufficient scale to trigger a creation trade, and related purchase of portfolio stocks, in the ETF) results in 14 occasions of charge, such that the effective rate of charge

is 1.4%. Not all ETF investment would result in a charge as high as this, but the transaction described above is not untypical.

Impact of FTT on a mutual fund distribution chain

The FTT will apply to all transactions within the distribution chain for investment in funds. These include master-feeder funds, funds of funds and pooling structures that aim to achieve efficient distribution, diversification and/or economies of scale. The FTT will also have a disproportionate effect on investors in countries with disaggregated distribution, particularly Germany and Italy. Diagram 2 shows that investors in German investment vehicles, for example, will be subject to an additional 40 bps on each subscription and redemption. It is likely that certain intermediaries and structures will become unviable as a consequence of the FTT.

Diagram 2: IMPACT OF THE FTT ON A TYPICAL GERMAN RETAIL DISTRIBUTION CHAIN



Impact of the FTT on capital markets

End-investors will also be indirectly affected, sometimes severely, by the negative impact of the FTT on capital markets. These include reduced investment (hence the increased cost of capital and lower share prices for corporates in the EU-11) and a drastic reduction in market liquidity and the amount of available collateral.

Investors will reduce the price they are willing to pay for the shares of companies inside the EU-11, to reflect the FTT burden. Research indicates that the UK stamp duty significantly reduced the share price of UK companies.⁸

This price reduction was estimated to range from 1.3% to 12.5% depending upon a number of factors, including dividend yield, and the level of turnover of the shares (shares that are more frequently traded being affected more severely). The impact of the FTT proposed by the EC is likely to be far greater than this on companies in the EU-11 given its far broader scope and cascading effect.

Impact of the French and Italian FTTs

More recently, the introduction of national FTTs in France and Italy has negatively affected equity volumes. France introduced its national FTT in August 2012; Italy followed in March 2013. Since their taxes were launched, France's and Italy's market shares have fallen 30% and 45% respectively.⁹ Germany appears to have gained from their volume share losses.

Reduced liquidity and collateral

A wide range of activities will become uneconomic. We highlighted MMFs and repo and the implications for European companies above. The International Securities Lending Association (ISLA) estimated that at least 65% of the European securities lending market would disappear as a result of the FTT.¹⁰ Markets will lose a valuable source of liquidity, and settlement failure rates will increase.

Collateral is a key tool for clients to protect their assets, as they use it to secure their transactions. Regulators have put collateral at the heart of the financial system, increasing the demand for high-quality collateral, but the FTT will significantly reduce the supply of such collateral. Government debt and the debt of corporations in the FTT zone is unlikely to be accepted as collateral unless the FTT is amended to ensure it does not apply to transfers of collateral.

We believe that the FTT will reduce the choice of counterparties, as investors will avoid counterparties in EU-11 countries. The increased investment risk this implies will of itself, over and above the direct impact of the tax on expected

returns, negatively affect security prices. Cash markets will shrink and some derivatives issuance would move outside the EU-11. We understand that the Italian derivatives markets shrank in preparation for the July go-live date for the Italian FTT, which applies to derivatives.

IMPACT OF THE FTT ON GOVERNMENT BOND AND REPURCHASE AGREEMENT

A repurchase agreement or 'repo' is an agreement for the sale of a security, coupled with an agreement to repurchase it at a specified price at an agreed later date. Repos are flexible and secure instruments that are collateralised with high-quality government assets and are widely used by end-investors, banks and central banks.

- ▶ Pension funds, for example, use repo to manage interest rate and inflation risk in a more secure, capital-efficient manner with a higher yield and less counterparty risk than using derivatives. Repos allow banks to effectively manage their risks and be an effective counterparty to investors. Repos are highly effective for central banks to manage liquidity and influence the evolution of short-term interest rates.
- ▶ We anticipate that the impact of FTT on short-term repo contracts would be acute, increasing costs and risks to end-investors. The increased costs would reduce returns to pension funds and, in the extreme, render this instrument unviable.
- ▶ The central clearing of derivatives and new wide-ranging capital and liquidity requirements for banks heighten the importance of being able to use repo to manage liquidity and collateral. If the costs of flexibly converting high-quality government securities to cash (and vice versa) by repo are dramatically increased, banks will likely pass on costs to their transactions with investors, or reduce their appetite for certain types of business, to the detriment of long-term investors.
- ▶ Finally, the orderly functioning of government bond markets and their corresponding repo contracts are symbiotic. We anticipate that the impact of the proposed tax on repo (even if government bonds themselves are excluded from the tax) would lead to greater price volatility and to higher yields to reflect heightened risk.

⁸ 'Stamp Duty on Shares and Its Effect on Share Prices', IFS, June 2004.

⁹ See Thomson Reuters article, 'Impact of trading taxes seen in declining French, Italian stock turnover', 2 August 2013.

¹⁰ See 'ISLA's analysis on the proposed European FTT': <http://www.isla.co.uk/index.php/latest-news/214-islas-analysis-on-the-proposed-european-fft>

Table 2: ILLUSTRATION OF IMPACT OF FTT ON AN INSTITUTIONAL CLIENT WITH PORTFOLIOS DOMICILED INSIDE AND OUTSIDE THE EU-11

TYPE OF FIXED INCOME SECURITIES	COUNTRY OF ISSUANCE	COUNTRY OF COUNTERPARTY	NET ASSET VALUE (IN €M)	FTT IMPACT (IN €) PER ANNUM
Treasury bills	US	UK and Germany	100	140,000
Corporate bonds	Various FTT-zone countries	UK and US	1500	4,000,000
Collective investment schemes	Ireland	US	500	0
Asset-backed securities	Ireland	UK	10	0
Synthetic exposure over bonds	Various FTT-zone countries	US and UK	2000	850,000

The undermining of the Single European Market

The proposed FTT is likely to undermine the Single European Market and distort the level playing field for the fund management industry, to the detriment both of the countries concerned and of the savers in those countries.

Residents in the EU-11 will be penalised whether they invest in vehicles domiciled inside or outside the EU-11, and whether or not those investments involve ECP securities. By contrast, residents living outside the EU-11 can decide not to invest in vehicles domiciled in the EU-11 and can avoid strategies and counterparties with exposure to the EU-11. Table 2 shows the impact of the FTT on an institutional client with portfolios domiciled in countries inside and outside the EU-11. This shows why the proposal may fail certain requirements of EU law.

The residency principle is likely to make EU-11 countries unviable as a location for many types of mutual fund and separate accounts, penalising funds or investors domiciled in those countries. A mutual fund located in an EU-11 country would face an FTT liability with regards to all its transactions (whereas mutual funds located elsewhere would have a liability limited to FTT-zone securities). In addition, economically, it is likely that a counterparty located in an EU-11 territory would be required to pick up both sides of the FTT liability: unless separate pools of liquidity arise (with differential pricing), the non-EU-11 counterparty would otherwise choose not to transact with them. If their liability cannot be passed on to the EU-11 investor, a non-EU mutual fund may even choose to exclude EU-11 residents from being eligible investors.

Funds are likely to be re-domiciled outside the EU-11 and institutional clients are likely to move their segregated mandates to the non EU-11 zone. This could mean the end of the local funds industry, except for a core of funds investing in local assets, where the FTT burden (high because of the nature of the assets) will be the same as for a fund outside the EU-11. The end-investor's opportunity to invest will be narrowed and distorted by the FTT at a time when funding Europeans' longevity has never been a more pressing public policy priority.

The future of the FTT Directive – what happens next?

Despite the controversy surrounding the Directive, and its tortuous progress to date, considerable political capital remains committed to it. Any talk of the demise of the proposal is premature.

The lack of consensus at the EU-28 level has forced the core group of 11 countries to fall back upon the Enhanced Cooperation Procedure, which greatly complicates the picture for the Directive. The use of the ECP imposes three main procedural constraints on the group of 11:

1. The detail of the eventual tax needs to be agreed unanimously in all respects between the eleven participating countries;
2. The proposal must be substantially similar to the one that the 28 EU countries initially failed to agree upon; and
3. The proposal must not impinge unduly on the other 17 countries of the EU.

It is a huge challenge for the EU-11 countries to design a tax that meets the above constraints while, on one hand, respecting the competencies of the other member states in relation to tax and, on the other, avoiding discrimination or harm to the Single European Market. Furthermore, all this must be done in a manner that reduces the risk of migration of economic activity from either the EU-11 or the EU as a whole.

While we do appreciate the rationale for the policy goals of proponents of the tax, as set out in this *ViewPoint*, regrettably we believe that the proposal will not deliver on these objectives. Further, the incompatibility of the proposed FTT with the principles underpinning the EU and the Single European Market should be of concern to all parties, including the EU-11 countries. While BlackRock's main concern is to avoid harm to end-investors – savers and pensioners as well as the 'real economy' in the form of corporates – the proposal risks missing its stated policy goals while harming the cohesion of the EU, to the ultimate detriment of all concerned.

to this argument is that the burden of such taxes always falls disproportionately on less sophisticated savers or investors. For example, pension funds, insurance companies, individuals and mutual funds bore two-thirds of the UK stamp duty in 2005.¹¹ **A tax that is presented by proponents as a ‘Robin Hood tax’ (that would be paid by the financial sector and be used for the benefit of the wider community) is of course no such thing – it will chiefly impact savers and investors, whether applied to a wide range of instruments or only to equities.**

Conclusion

Our objections, like those of other stakeholders from across the EU and elsewhere, are founded on a number of key concerns. In our view, the proposed FTT:

- ▶ Fails to meet the stated objective of being a targeted measure through which the financial sector contributes towards the cost of the financial crisis. Instead, we believe it will significantly erode investment returns for end-investors – pensioners, savers and corporates – through both the direct cost of the FTT itself and higher trading costs as a result of market restructuring.
- ▶ Applies extraterritorially. While the FTT will affect investors in the EU-11 the most, it will also destroy value in

portfolios held by end-investors outside the EU-11, without passing on to them any of the revenues it raises, making it inherently discriminatory.

- ▶ Undermines the cohesion of the EU by being applied unevenly across the Single European Market. If the tax is implemented, asset managers are likely to prefer to invest in companies based outside the EU-11 and many mutual funds and separate accounts are likely to relocate outside the EU-11.
- ▶ Increases financial instability and by doing so erodes the benefits made by five years of regulatory reform in Europe. There will also be an increase in dependence on bank funding. Bank deposits will not be subject to the FTT but financial market transactions will be. This will work against the greater balance between bank funding and market finance that policymakers are trying to achieve.

Acting as our clients’ agent by representing their best interests in this debate, we are compelled to conclude that we oppose the current proposal for FTT in Europe, as we would all forms of additional taxation that would be borne by taxpayers and the ‘real economy’, especially at a time when the longevity and economic growth challenges for Europe are becoming intense. Since the proposal risks much more harm to Europe than good, we would encourage the EC to withdraw it without further delay.

¹¹ Oxera, ‘Stamp duty: its impact and the benefits of its abolition’, May 2007.

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