TECHNICAL FICHE[1]
RELOCATION, SUBSTITUTION AND OTHER MARKET REACTIONS

The application of an indirect tax bears the intrinsic risk of agents "relocating" their activities to reduce the fiscal burden. "Relocation" might take place by (i) moving the relevant activities to jurisdictions where they are taxed less, (ii) by shifting to products/suppliers outside the scope of taxation within the same jurisdiction e.g. by changing the business model or contract design, or (iii) abandoning the taxable activity altogether. In principle, this latter might even lead some products/markets to disappear in the medium and longer run. Obviously, the risk of physical relocation of markets/market players and migration to non-taxed products decreases the more widespread is the adoption of the taxes and the broader their scope. Thus, the concrete design of a tax in combination with the transaction costs of relocation will largely impact on the actual extent of relocation. The cases of Sweden and the UK, which both introduced a tax on financial transactions with different relocation effects, provide some evidence for this.

The responsiveness of traded volumes to taxes (and transaction costs in general) varies across products and markets, as it is heavily influenced by available substitution possibilities and the characteristics of the relevant trading platforms. Thus, the design of the tax will be as important as its rate or change in the rate.

The risks of geographical relocation, as well as those arising from potential migration towards untaxed substitute products, could be minimised by (i) not taxing certain activities at all, by (ii) extending the geographical coverage of the tax and by (iii) including a wide range of financial products and markets (exchange and over-the-counter) in its scope. It can also be reduced by linking the FTT with some form of registration. Clearly, coordination in terms of products covered by the tax as well as of applicable tax rates is a prerequisite for lowering the incentives to relocation across jurisdictions.

1. GEOGRAPHICAL RELOCATION

So as to effectively avoid having to pay FTT it would not suffice that a financial institution

[1] This technical fiche should be considered as a non-paper that commits only the Commission's services involved in its preparation.

simply moves its seat outside the EU. This is, because for as long as a financial institution intends to either undertake transactions in the EU or to serve a European client base it would be deemed to be established in the territory of a Member State (Article 3.1 of the FTT proposal). Thus, a financial institution would have to both abandon to trade on European trading platforms (this would also hold for the remote access to European trading platforms from outside Europe) and to abandon all its European clients if it wanted to avoid paying the tax.

European client base

Example1:

An American bank sells a derivative via a Swedish retail bank to a Swedish local authority. The Swedish retail bank acts for the account of the local authority.

- FTT is due twice in Sweden at the Swedish rate as both banks are deemed to be established in Sweden.
- If the notional value of this derivative was EUR 10 mn. and Sweden applied the minimum rate of 0.01% each financial institution would have to pay EUR 1.000.

Example 2:

A German bank asks its American-based Investment Bank subsidiary (AS) to hedge a currency risk in its name. For this, the American subsidiary (AS) enters into a derivative agreement in the name of the German bank with another American bank (AB) having no link to the territory of a Member State.

- FTT is due twice in Germany at the German rate as the German bank is established in that Member State and the second American bank (AB) is equally deemed to be established in that State (Article 3.1).
- If the notional value of this derivative agreement was EUR 10 mn. and Germany applied the minimum rate of 0.01% the German bank itself and the American bank would each have to pay EUR 1.000. The American subsidiary would not have to pay FTT as it was acting in the name of the German parent company.

This very broadly defined residence principle distinguishes the actual design of the FTT as proposed by the Commission from the design typically analysed in studies preceding the Commission proposal, and highlighting the relocation risk in case an FTT was introduced at a sub-global level.

Also, certain transactions most prone for geographical relocation, i.e. those not involving an

EU party at all, fall outside the scope of the proposed tax[2]. Thus, there would be no incentive to relocate the so-called "booking centre" services.

"Booking centre" services

Example:

A Spanish bank concludes in the name and for the account of an Argentinean pension fund an interest-rate swap with a Portuguese bank that acts in the name and for the account of a Brazilian pension fund. Neither the Argentinean nor the Brazilian pension fund is deemed to be established in a Member State. The swap agreement runs over five years and its notional value is EUR 10 mn.

- This transaction is out of scope of the directive (Art. 1.2) as none of the parties to the transaction (neither the Argentinean nor the Brazilian pension fund) is (deemed to be) established in a Member State.

Thus, the risk of geographical relocation remains rather limited. So do the benefits of relocation.

2. SUBSTITUTION AND CHANGING BUSINESS MODELS

The Commission proposal is characterised by a very broad definition of transactions, instruments and institutions, as defined in Article 2 of the proposal. This approach to cover all markets (regulated and over-the-counter), all actors (from traditional banks via the so-called "shadow-banking sector" to big non-financial companies that undertake significant financial transactions) and all products (from shares and bonds to derivatives and structured products) was inspired by the invariable strive of market participants to minimize their tax burden and engage in economic activities that are either not taxed or less taxed. By the same token, it was also inspired by the need for preserving "tax neutrality" and not to discriminate against or to privilege certain actors, markets or products.

A significant share of the market reactions triggered by the introduction of this tax is assumed to be the result of actors replacing taxable events with (new) un-taxed business models. For example, the traditional way of brokering (where brokers buy and sell in the name or on account of other financial institutions) might replace the current practice of trading in ones own name and on ones own account (e.g. by broker/market-makers) as this would relieve

[2] Art. 1.2 reads: "*This transaction shall apply to all financial transactions, on condition that at least one party to the transaction is established in a Member State …*"

them from paying the tax (see Art. 9.2 of the proposal[3]). In the present business model of transaction chains being dominated by proprietary trading by all actors, each transaction would show up (in the statistics of market turnover) as a buying and selling transaction, i.e. a single purchase/sale operation triggered from outside the financial sector might (statistically) show up as two, three or even four trades at each side of the transaction. Once such proprietary trading will turn into taxable events the trading might be replaced by "intermediation". So, while "trading" turnovers will decline, the initiating underlying economic substance (one actor wants to buy and one other wants to sell) remains unchanged, and the potential cascading effect of the tax within a single transaction chain can be avoided.

Brokerage and market making services

Example 1:

A Belgian and a French private household use respectively their Belgian and French retail banks and order them to buy/sell on the Paris stock exchange, in the name or for the account of the respective households, shares of a French joint-stock company in the value of EUR 10.000. The retail banks pass on these orders to their wholesale banks and those to their brokers on the Paris stock exchange. All three intermediate only, without buying or selling for their own account.

- Both retail banks are liable to pay the FTT due in their country of establishment (Belgium and France respectively) (Art. 9.1). Neither the wholesale banks nor the brokers are liable to pay FTT (Art. 9.2).
- The retail banks would have to pay EUR 10 each for this transaction in France and Belgium respectively. The effective tax rate for the whole transaction is 0.2%.

Example 2:

Same case as in example 1, but, this time, the shares are passed on through five successive sales and purchase: Apart from the two retail banks, who act in the name or for the account of the respective households, all other participants act in their own name and for their own account as well.

- All six financial institutions are liable to pay FTT in France and in Belgium respectively. Both brokers and both wholesale banks have to pay FTT twice, while the retail banks have to pay only once.
- The brokers and wholesale banks would each have to pay EUR 20 and the retail banks each EUR 10. The effective tax rate for the whole transaction is 1.0%.

[3] Art. 9.2 reads: "Where a financial institution acts in the name or for the account of another financial institution only that other financial institution shall be liable to pay FTT."

An alternative to the provision of Article 9.2 would have been to exempt professional dealers from the scope of the tax in first place. However, this would then also have put out of scope those trades between financial institutions that are not a rent-seeking complement to intermediation but also those that are genuine trades between financial institutions. This, in turn, could have significant negative revenue implications as well.

Closely related to avoiding cascading effects in a transaction chain by going for intermediation instead of proprietary trading, is a substitution effect where untaxed business models are used in general. For example, bonds (the trading of which would be taxed) could be replaced by untaxed loans, or RePo agreements (where bonds are sold and repurchased) could be replaced by economically similar transactions where such bonds were only serving as collateral for outright lending and borrowing of central bank money.

Repurchase agreements

Example 1:

A bank established in France lends "over-night" EUR 10 mn. to a bank in Italy (possibly backed up by securities as collateral).

- No FTT is due as outright lending and borrowing is out of scope of the FTT.

Example 2:

A bank established in France buys "over-night" EUR 10 mn. of French government bonds from a bank established in Italy and sells them back the next day (repo transaction):

- FTT is due both in France and in Italy for each transaction (Art. 2.1).
- As the market price of the transaction is EUR 10 mn., and as there are two transactions, each bank has to pay EUR 20.000 FTT in their country of establishment if both countries applied the minimum rate.

Example 3:

A bank established in France lends shares (with a market value of EUR 10 mn.) of an Italian listed-stock company to a bank in Italy. In accordance with the agreement, the shares are returned to the lender after three months. The lending fee is EUR 10.000..

- FTT is due both in France and Italy (Art. 2.1).
- As the market value of the shares is EUR 10 mn., both the French and the Italian bank would have to pay EUR 10.000 FTT in case both France and Italy applied the minimum tax rate.

It is assumed that financial institutions will not ignore the tax when developing and implementing their business strategies.

The main reason for the assumed decrease in derivatives turnover is that the notional value is the tax base for the taxation of the derivative, mainly for reasons of administrative ease and cash-flow considerations. However, the notional value does not always reflect the economic value of a derivative contract. A tax levied on the notional value looks to target a very large tax base, compared to which the economic value of the transaction appears significantly smaller. Given this large difference it is reasonable to expect that turnover measured in notional values could shrink significantly.

Risk hedging volumes

Example:

A trader exposes himself to a high nominal risk (e.g. EUR 50 mn.) and then hedges the biggest part of this risk accordingly by also taking the opposite risk (e.g. in the order of EUR 40 mn), so that the net risk exposure would effectively be limited to the difference between these two positions (EUR 10 mn. in this case).

- The introduction of a tax on the notional value of the underlying would provide incentives to go for the net risk only, i.e. EUR 10 mn., as this institution would then not have to pay an FTT of EUR 9.000 (for a notional value of EUR 50 mn. + EUR 40 mn.) but only EUR 1.000 (for a notional value of EUR 10 mn.)
- Statistically, the turnover volumes would have declined by almost 90% as the new turnover would only be EUR 10 mn. instead of the previous EUR 90 mn.

Investing in derivatives and investing in the underlying asset are to a certain extent different activities, especially with respect to the leverage effect of the capital invested. It was thus proposed to set the tax rate for derivatives at a tenth of the rate for securities. As a consequence, the tax rate for derivatives renders derivative agreements with a leverage factor of less than ten relatively attractive, i.e. where the capital to be invested will be more than 10% of the notional value of the underlying. By contrast those contracts where this ratio falls below 10% will be less attractive. Thus, derivatives implying a hedging of very small and tiny risks (that means, the premiums to be paid are very small as compared to the notional value) will be discouraged. So will be transactions which are "speculative", i.e. where the actor invested little money so as to gain a lot, but with a small likelihood.

In the economic analysis it is also assumed that the reduction in market volumes is partly the result of the rolling back of certain high frequency but low-margin transactions which would

no longer be attractive for the transaction partners once a tax of 0.1% or 0.01% is levied. Thus, it is assumed that in some market segments the tax will create a structural break in the sense that business models change (e.g. in the field of automated High Frequency Trading) which leads to fewer transactions and potentially other ways of trading assets and risks.