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Anni Podimata

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Dear Ms Podimata,

Re: EU Proposal for a Council Directive on a common system of financial transaction tax (FTT)

To begin with, we would like to point out that we are presently unable to make any conclusive assessment of all the related effects owing to the complexity of the "Council Directive implementing enhanced cooperation in the area of financial transaction tax" as currently proposed by the EU Commission. Please find below an initial evaluation of the proposal.

General remarks

In a European comparison, the banking industry in Austria already has a sizable burden to bear on account of the bank levy (which generates approx. EUR 625 million). Should the FTT be introduced, whose purpose according to the Commission is to get the financial sector to contribute to the costs of the crisis, the bank levy would have to be abolished completely.

At any rate, an implementation of the proposed Council Directive would raise transaction costs, increase the costs of raising capital for the real economy, put added pressure on savers and private households and especially pension plans and entail a reduction in overall economic growth.

Furthermore, the cited objectives (avoidance of distortion of competition on account of uncoordinated national bank taxes, removal of the double taxation burden on financial transactions that fail to promote efficiency in the financial markets) will not be achieved by means of the proposed Council Directive.

Moreover, the present Directive fails to create incentives for market participants to invest in less risky and in transparent transactions. The proposed Directive imposes a flat tax on all financial transactions and therefore in no way regulates market conduct.

This is apparent in the fact that risk-hedging as well as internal group transactions are treated just like other financial transactions.

On account of the envisaged financial transaction tax, suppliers in the participating Member States will experience massive competitive disadvantages and delocalisation effects as well as negative location effects:

- As the tax is to be introduced in only eleven Member States, a massive relocation of securities and derivative trading to non-participating countries (especially Great Britain) is likely to occur. Austrian financial institutions will no longer be able to offer customers from non-participating FTT countries (e.g. Poland, Czech Republic, UK) competitive terms for securities and derivatives from non-participating FTT countries.
At any rate, customers will make a circle around financial institutions from countries with an FTT in order to avoid additional costs.
- Austrian fund providers established in one of the eleven participating FTT countries will be forced out of the market for international fund management on account of the present proposal for a Council Directive. In future, pension funds and insurance undertakings established in Asia or the US will not assign any fund management contracts to the providers in any of the eleven participating countries (including Austria). The Austrian investment fund management companies established in the CEE area in recent years would be particularly affected.

Furthermore, the following aspects should be given special consideration:

- consideration of transactions within groups and sectors;
- consideration of transactions for the purpose of controlling liquidity in the interbank market (asset/liability management);
- exemption of transactions carried out to hedge interest rate, liquidity or currency positions;
- exemption of repurchase agreements;
- exemption for market making and customer-oriented trading in bonds and shares to ensure lower-cost refinancing of issuers (public sector, real economy and banks).

Further material remarks

The draft provided by the Commission will have serious effects on the following areas:

Risk-hedging transactions

Legal transactions to hedge against interest rate, liquidity or currency risk must be exempted from the new tax. To ensure financial market stability across Europe, incentives for the conclusion of risk-mitigating transactions need to be provided. Imposing taxes on precisely those who responsibly hedge risk positions is the wrong approach to take.

It will cause a move from secured transactions to unsecured transactions, which in turn will lead to a rise in risk positions. Placing an additional burden on risk-hedging transactions would also have negative effects for Austrian businesses, e.g. in exports.

There are various reasons for the financial crisis, which cannot be attributed alone to transaction-based risk (e.g. derivatives) What should likewise be kept in mind is that regional taxation will not be able to eliminate all the risk inherent in a highly developed and globally integrated economy.

When it comes to preventing undesired speculation, we need to emphasise that derivative transactions, too, represent an essential risk control tool for Austrian businesses. The current proposal will not only make the financial instruments acquired in order to reduce corporate risk more expensive but also cause business to suffer a competitive disadvantage vis-à-vis companies in non-participating EU Member States.

In detail

The introduction of an FTT as envisaged will entail a general taxation of derivatives, irrespective of their actual purpose. As a result, high risk and risk-hedging transactions will receive the same tax treatment and this would run counter to the original objective of the present Directive, which is to keep market participants from undertaking speculative transactions. With respect to derivatives, at any rate, the specific functions of the various types and groups of derivatives need to be taken into account.

According to the draft, a bank that uses derivatives solely for the purpose of interest rate hedging with little effect on liquidity would, for instance, be particularly severely affected. In any event, transactions that do not constitute speculation would have to be exempted.

Banking book derivatives should be subject to a general exemption since, of all derivatives, banking book derivatives are not associated with any trading intent.

Repurchase agreements (repos):

In economic terms, these transactions are comparable to secured loans (free of EU FTT); repurchase agreements involve the sale of securities (collateral element) for a consideration (credit element) as well as the later repurchase of the same securities and simultaneous return of the consideration.

In the course of the financial crisis, unsecured money market transactions have for the most part been replaced by secured repurchase agreements and securities lending. This has led to a considerable risk reduction in interbank business and, along with the ECB tenders, has contributed to the smooth implementation of bank refinancing. Owing to their fine-tuning effect, repurchase agreements are implemented on a daily basis as an indispensable means of cash pooling.

Consequence

Imposing FTT on the purchase or sale of securities leads to direct costs and thus to an increase in refinancing costs. Repurchase agreements would no longer be available as safe and inexpensive sources of refinancing. As a result, repurchase agreements can be expected to generate only very small tax revenues; in addition, refinancing will become considerably more expensive for all banks.

The rise in refinancing costs would also affect the real economy and ultimately reduce the credit volume and increase credit costs.

Repurchase agreements are also one of the main incentives for banks to buy high-quality government bonds.

Furthermore, the FTT would thwart efforts undertaken by the ECB to boost liquidity trading in the interbank market and maintain the high dependence on Central Bank facilities. This would also prevent Target 2 imbalances from being reduced in future. Today, repurchase agreements represent a modern form of secured money market trading and constitute a vital part of the refinancing mix in the banking landscape. In this context, securities lending is used in combination with repurchase agreements to fund activities (for the procurement of ECB-eligible securities through collateral upgrade transactions).

What needs to be kept in mind as well is that national banks in third countries are not included in the exemption set forth in Article 3 (4) of the proposed Directive and therefore financial transactions with partners that are vital for Austrian businesses, such as the Swiss National Bank, would be subject to the financial transaction tax.

Since these transactions will become more expensive on account of the EU's FTT, it can further be assumed that (unsecured) "normal" money market transactions will become more attractive. This would run counter to the objectives of previous regulatory initiatives (e.g. EMIR, CRD IV) in that a shift would be promoted from low-risk secured to high-risk unsecured forms of refinancing.

Short-term transactions versus high frequency trading:

The objective of the present proposal for a directive is to curb high-frequency trading, but fails to take into account the maturity of the financial transactions that are to be taxed. It therefore appears crucial to work out the difference between high frequency trading and short-term transactions.

Whereas the term of any financial transaction is based on the maturity of the underlying transaction and the term can actually be as short as one day, we understand high frequency trading to consist of multiple turnovers in one and the same transaction within a short period of time. The maturity of the underlying security can be considerably longer or not defined at all, as with some instruments such as shares.

Repurchase agreements should generally be exempted from the envisaged tax, since they are transactions that are secured by securities and constitute instruments needed for effective cash pooling between the banks. Therefore, a tax burden would likewise prove counterproductive.

Group and internal network transactions

In any case, transactions within groups of banks should be exempted from paying FTT. Transactions within a group serve to manage liquidity and ensure that all banks in a group have sufficient liquidity in order to be able to provide customers with adequate funds. It lies in the interest of the general public and businesses to provide the banks within groups with sufficient liquidity, otherwise bottlenecks are likely to occur. Therefore, internal group transactions should be excluded from the tax burden.

The cash pooling prescribed by the law and the general services provided by central institutions in the network and in decentralised structures would be massively impacted by the new tax and should therefore be exempted from taxation just as internal group transactions. This cash pooling is not only ensured by deposits but also by bonds.

Cash pooling ensures that a bank's surplus liquidity is made available to the central institution. The central institution holds these liquid funds and makes them available to other institutions whenever they are required. This cash pooling virtually takes place on a daily basis.

Cash pooling within a network is necessary in order to ensure that the bank can continue to provide customers with money. It thus serves to ensure a sufficient supply of money for customers. These transactions within a network also have positive effects on the financial markets and help to reduce the liquidity risk since they improve the safety of the financial market as a whole. They should be exempted from the new tax in any event.

Whenever two financial institutions are party to one and the same transaction, the problem of internal transactions within decentralised networks is further exacerbated by the envisaged double tax burden. This arrangement will give rise to multiple burdens and prevent any meaningful control.

"Reasonable contribution to the costs of the financial crisis"

First, we would like to point out that the financial sector is committed to drawing the lessons from the crisis.

The approach by which banks are to participate in bearing the costs of the financial crisis has already been implemented in Austria in the form of a bank levy that, by European standards, is very high (EUR 625 million per year). What should be taken into account as well is that Austrian banks incur enormous costs owing to the extensive regulatory measures at European level.

FX swaps as liquidity management tool:

FX swaps in investment books do not involve speculation, but aim to hedge refinancing in a currency other than the lead currency. . With FX swaps, investors do not speculate on future FX performance but merely wishes to remedy the liquidity imbalance of different currencies. A burden would therefore be counterproductive.

The financial industry defines an FX swap as an agreement to exchange two currencies immediately (spot) and to re-exchange these two currencies at an agreed future point in time, taking into account the interest rate differential. Technically, this transaction is similar to two reciprocal custody transactions in different currencies, but the business partner's default risk is substantially lower (bank A lends bank B EUR 100 for one week and at the same time borrows USD 130 from bank B for a week).

FX swaps represent an important tool in banking control and help to efficiently equalise any short-term liquidity gaps in a foreign currency.

Example:

A company asks bank A for a short-term loan (with a 1-week maturity) in USD in order to bridge the time period between the purchase and sale of a commodity. Bank A is established in the eurozone and therefore has sufficient euro liquidity but no or only limited access to USD

liquidity. By entering an FX swap with a 1-week maturity, the available EUR liquidity is switched to USD liquidity for a period of 1 week in order to cater to the customer's needs.

The envisaged financial tax arrangement provides for a 0.01% transaction tax on the FX swap. Due to the short maturity of one week, this corresponds to a tax rate of 0.52% per annum and the loan can be expected to become more expensive.

In day-to-day business, investors enter into FX swaps with a maturity of only one day; the tax rate for these would increase up to 3.65% p.a.

Considering the turnover of liquidity providers (market makers) in the tax assessment basis

Market makers at the stock exchange and in OTC markets are vital for ensuring that capital markets operate efficiently. Market makers provide the markets with liquidity, ensure low volatility through their willingness to set purchase and selling prices at any time and thus warrant the market's attractiveness.

Owing to the substantial liquidity decrease in the Austrian securities market, a functioning secondary market without market makers would no longer appear feasible with many of the Austrian shares. The market receives an essential supply of liquidity from certificate market making as well.

In return for their support in maintaining the stability of the financial market, market makers at the Vienna Stock Exchange pay highly reduced or no transaction costs.

Consequence

If market maker turnover were subject to a 0.1% tax, trading fees for share market makers would increase tenfold. With an estimated market maker turnover at the Vienna Stock Exchange of EUR 3 billion in 2012, this would result in additional costs to the tune of EUR 3 million. For institutions, these costs would make market making a loss-making business, which could prompt market makers to relinquish their mandates.

Market segmentation in the Vienna Stock Exchanges ensures that at least one market maker sets prices for all shares in continuous trading.

The most liquid segments in the Vienna Stock Exchange would disappear, resulting in even lower stock exchange turnover and thus in greater volatility and higher liquidity premiums and, consequently, leading to higher capital costs for Austrian businesses.

For liquidity providers offering bonds, derivatives and certificates, any taxation of turnover would significantly increase transaction costs, causing them to relinquish their roles. Without a healthy secondary market for bonds, which plays an essential role for market makers, bond issuers would have to pay higher primary market premiums. The resulting increase in refinancing costs would hit the real economy twofold. First via the higher costs of issue in the capital market and then again in borrowing due to the banks' higher refinancing costs.

Small economies, like Austria, would be disproportionately more severely affected by the disappearance of market making than large economies whose overall economic importance guarantees sufficient liquidity. This would lead to competitive distortion even within the 11 participating countries.

Effects on the real economy

There are various reasons for the financial crisis, which cannot be attributed alone to transaction-based risk (e.g. to derivatives, which are already subject to taxation). What should likewise be kept in mind is that regional taxation will not be able to eliminate all the risk inherent in a highly developed and globally integrated economy.

When it comes to preventing undesired speculation, we need to emphasise that derivative transactions, too, represent an essential risk control tool for Austrian businesses. The current proposal will not only make the financial instruments acquired in order to reduce corporate risk more expensive but also cause business to suffer a competitive disadvantage vis-à-vis companies in non-participating EU Member States and thus ultimately lead to competitive distortion in the internal market. At any rate, a distinction needs to be made between speculative derivative transactions and derivative transactions for hedging purposes.

Liquidity coverage ratio (LCR)

In this context, we refer to the CRR provisions relating to the LCR: in future, banks will be required by the law to buy and sell a specific share of their liquid funds in order to test the bank's liquidity in the market. This statutory obligation will lead to a substantial additional load for banks in participating Member States. From now on, however, every single transaction will be taxed not only once but twice, because the counterparties are usually banks as well. The liquidity of the funds depends on the sales and purchase activities. Taxation could give rise to analogous feedback processes in that the liquid funds could no longer be represented as required by the LCR.

LCR funds should therefore be exempted from taxation in any event.

Negative tax cascade effect:

Article 10(2) of the proposal for a Council Directive provides that the other financial institution owes the FTT of the EU only when a financial institution trades in the name and for the account of another financial institution. This does not completely exclude the possibility of a negative tax cascade effect in a financial transaction.

Customer orders in financial instruments usually follow a chain of execution. The order of an end customer usually involves several transactions between financial intermediaries. A single economic transaction often produces six controllable business events (customer A - house bank A - clearing broker - central counterparty - market maker - customer B). Products traded over the counter and centrally cleared like swaps, in particular, will become substantially more expensive. Due to the bilateral derivative relationship between banks and customers that is exposed to credit risk, the execution chain can be shortened. In part, these chain relations are induced by regulation, e.g. by EMIR (Derivative Regulation), which requires a clearing member that is not directly connected to trade exclusively through such a member via the CCP.

Consequence

Individual financial market transactions are taxed at least fourfold. For every participating financial institution, the tax would become payable twice, i.e. by the clearing broker / the central counterparty during execution and by the customer during execution as well. It is

expected that financial institution will have to pass on to customers at least part of the tax payable on account of customer orders. Depending on the financial instrument and place of performance, such a tax burden of at least 4 or 40 basis points is "cascaded upward" and this would then have to be passed on to the customer. This would directly increase trading costs for institutional customer threefold and entail corresponding direct effects on all investors (also in retail) and particularly on old-age pension products.

In share, bond and OTC derivative trading, this significant increase in trading costs will lead to a massive decline in turnover. The decline in liquidity in the secondary market will be reflected directly in higher refinancing costs for issuers.

Previously, the introduction of capital gains tax on Austrian securities had caused a marked decline in the turnover of retail investors who were then presumably completely pushed out of the market. This would again result in declining stock exchange turnover, which could lead to higher capital costs for Austrian businesses and/or prompt business, particularly large Austrian companies, to move away.

Double taxation of financial transactions

The plan is obviously to tax every financial transaction involving two financial institutions twice (Article 10). A clarification would be necessary in this respect to specify that the financial transaction tax is imposed/levied only once on the end beneficiary.

Exemption for clearing brokers

In addition to central counterparties (CCPs), clearing brokers should also be exempted from the application of this Directive provided they serve as client clearers.

With central counterparties, this would prevent any discrimination against indirect membership and preferential treatment of direct membership.

Insurance undertakings

Insurance undertakings should be exempted from the scope of the financial transaction tax, since the products they offer serve to protect against risk and prevent risk. The introduction of a financial transaction tax would add a financial load on all insurance sectors; this is true particularly for old-age pension products.

Life insurance policies are taken out particularly to secure additionally available liquid funds for a period of incapacity for work. This is applicable not only to state-promoted old-age pension products and corporate group insurance, but also to endowment and death insurance products.

The framework conditions of pillars 2 and 3 of old-age insurance will deteriorate once the financial transaction tax is introduced. These effects run counter to the political intention of further developing private old-age pension schemes alongside state pensions. The White Paper "Agenda for adequate, safe and sustainable pensions" of the European Commission shows which efforts are needed in order to secure the first pillar of old-age pension. However, arrangements to strengthen the second and third pillar are also mentioned, which, if successfully implemented, would be prejudiced by the introduction of the financial transaction tax.

Institutional financial intermediaries are increasingly required when making investments. The process often involves several stages. The resulting cascade could lead to an accumulation of the payable financial transaction tax.

Pension funds and special credit institutions

Pension funds play an essential role in the development of old-age pension schemes. It would therefore be counterproductive to include pension fund business in the scope of the financial transaction tax. Pension funds, too, should therefore be exempted from the scope of the Regulation (Article 3). France, where pension funds are already exempt from the financial transaction tax, could serve as a role model.

Special Austrian credit institutions should likewise be exempted - including subsidised corporate pension funds, since they provide financial services that the state qualifies as services in the general public interest. To ensure consistent legislation, it would be expedient to exempt these companies from any financial transaction tax.

Negative effects of the financial transaction tax on investment funds

Investment funds are savings option available to retail investors. Unit certificates can be acquired even for small amounts; through these the (retail) investors get to participate in widely diversified fund assets consisting of bonds and/or shares. Fund assets are actively managed by a licensed credit institution. Investing in funds is also particularly suitable for long-term old-age provision.

The financial transaction tax is paid by the financial institutions, but it is imposed as a direct burden on the fund assets owned by retail investors. Insofar, this too represents a further burden on the real economy.

The introduction of the transaction tax in the eleven participating countries would move transactions into jurisdictions that have no such tax, i.e. to non-participating EU countries and third countries. This will cause massive predatory competition to the detriment of fund providers in the eleven participating countries (including Austria), destroying jobs in the eleven EU countries participating in the FTT and substantially decreasing the total amount of tax revenues generated.

We fear that the introduction of a financial transaction tax in the eleven participating countries will

- massively displace the investment fund products available to Luxembourg, Great Britain, Switzerland, the US and Asia and thus discriminate against the Austrian investment fund sector. All financial instruments issued in the eleven participating countries (e.g. US shares and Polish shares, etc.) will not be subject to any financial transaction tax when bought and sold by financial institutions (including funds) in non-FTT countries.
- In particular, the introduction of the tax will lead to the dissolution of domestic low-risk funds (especially money market funds and near-market-money funds), since their efficient management will no longer be possible.
- Fund accounts will be moved from FTT-participating countries to countries not participating in the FTT scheme and third countries.
- It is unclear why investment funds should be subject to multiple taxation, making the previously described competitive disadvantage even more pronounced. The transaction tax will affect both the level of unit certificates (return) and the fund level.

The present proposal for a Council Directive, including the so-called "issuance principle", will in no way be able to prevent migration to funds in other EU countries (non-participating countries) and third countries.

Joint and several liability:

According to Article 10(3) of the proposal each party to a transaction, including persons other than financial institutions, shall be jointly and severally liable for the payment of the tax due by a financial institution on account of that transaction where this financial institution has not paid the tax due within the time limit set out in Article 11(5).

This requirement will also affect commercial enterprises and individuals whenever they serve as the counterparty in a financial transaction and, being jointly and severally liable, are obligated to pay financial transaction tax to the tax authorities when the institution participating in the financial transaction fails to do so. In addition, financial institutions from third countries are presented as spurious EU financial institutions in Article 3(1). Legally, this seems rather dubious due to the associated extraterritorial link. Particularly in connection with the liability of commercial enterprises and individuals, which also applies to such "spurious EU financial institutions", joint and several liability threatens to transgress the limits of what is legally admissible.

But the requirement also bears a considerable risk for financial institutions if these transactions are carried out with financial institutions and/or parties to the transaction established in third countries. In these cases, the financial institutions would be liable for the tax, even though it is owed by the counterparty established in the third country which will most likely not pay due to the lack of any possibility to legally enforce payment. In such transactions, the tax burden will double for institutions established in participating countries.

Harmonisation of laws

The line of arguments put forward in the proposal is not applicable here. Since, so far, a national financial transaction tax has been introduced only in two EU Member States, there is no need for harmonisation, particularly since, in substance, the laws in France and Italy are very similar. The proposed Council Directive fails to avoid the fragmentation of tax treatment in the internal market for financial services mentioned by the EU Commission.

In addition, the issuance principle gives rise to extraterritorial repercussions of the EU's FTT, which had previously been criticised when the French and Italian financial transaction tax was introduced on account of the problem issues it raised with respect to international law (insufficient domestic orientation). Furthermore, initial analyses of the French financial transaction tax have revealed a marked decline in the trading volume of French shares.

Transposition:

At all events, the transposition period provided for in Article 20 of the proposed Directive is much too short.

From publication of the Austrian transposition requirements, at least 18 months are needed for the transposition in the affected institutions on account of the high IT- and project-related effort required.

Kindly give our remarks due consideration.

Yours sincerely,

Dr. Franz Rudorfer
Managing Director
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Annex: Distinguishing between HFT and short-term transactions

The daily roll-over of a transaction with a one-day maturity therefore does not constitute high-frequency trading, since a new transaction is concluded every day and thus 1 trade is executed.

Example:

Bank A invests its surplus liquidity on a daily basis (note: from payable-on-demand savings deposits and deposits repayable on demand), with a maturity of 1 day with bank B. In order to reduce the counterparty risk to a minimum, a reverse repurchase agreement is purchased (bank A places funds with bank B and bank B provides collateral for these funds by assigning securities).

According to the proposal, taxes in the amount of 0.10% would be payable for repurchase transactions. For a transaction with a maturity of 1 day this corresponds to an interest rate of 36.5% p.a. and makes these kinds of transactions economically absurd (the price for 1-day repurchase agreements is currently between 0.01% to 0.07% p.a., depending on the quality of the collateral provided). The effective tax rate (p.a.) exceeds the value of the transaction itself by a factor of 1000!

For the sake of comparison, the taxation of high-frequency trading in long-term government bonds (with an assumed maturity of 10 years) is comparably low. Overall, a five-fold turnover within one trading day (5 x purchase, 5 x sale) would account for $10 \times 0.10\% = 1\%$. Calculated for the maturity of the underlying instrument, this corresponds to a tax rate of 0.10% p.a.

While trading in government bonds is a business field and cessation due to a change in the general conditions would presumably have an impact on the revenue of companies but not jeopardise bank control in its essence, such prohibitive taxation of transactions that serve to manage liquidity constitutes a substantial intervention in the bank's management.