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Impact of the Financial Transaction Tax on Europe's Securities Lending Market

In February 2013 the European Commission proposed a Directive that will introduce a Financial Transaction Tax (FTT) for 11 participating EU Members States ("EU11"). Unlike similar transaction taxes imposed in other jurisdictions, the Commission proposes that the FTT would apply to securities lending transactions, with both borrower and lender paying 10 basis points on the value of the securities lent. As currently drafted, the FTT would effectively close down the securities lending markets across the EU11 with considerable implications for long term investors and the mobility of collateral.

Securities lending is used by long term investors such as pension funds, insurance companies and mutual funds as a means of generating incremental returns on their securities portfolios. The loans that they make are fully collateralised and conducted within a well-established legal framework. Investment banks and asset managers borrow their securities for a variety of reasons, including facilitating market making, covering settlement failures and supporting risk management (hedging) strategies. Securities lending provides important liquidity to the secondary markets for both bonds and equities and in the year to May 2013 long term investors in the European markets generated incremental revenues of EUR3bn through securities lending. More information on this market is available in "Securities Lending: An Introductory Guide"[1].

Our analysis shows that over 65% of the securities lending market in Europe would be directly impacted by this tax with key markets, such as in Germany and France, all but disappearing. This would directly lower the returns that long term investors earn from these markets and would have further implications for both the economy and financial stability.

Key findings from our analysis[2]

- At least 65% of the European securities lending market would disappear as a result of the FTT.
- France and Germany would be the markets most impacted, and EU 11 Government Bonds the asset most impacted.
- Over Euro 2bn of revenues would be lost to long term investors.
- Approaching Euro 500bn of Euro Government Bonds would be removed from the lending/ collateral markets.
- Shorter dated transactions would be disproportionately impacted, increasing the risk of settlement fails by possibly as much as 100%
- Securities lending fee levels would need to increase by over 400% just to maintain current revenue streams for long term institutional investors.

[1] http://www.isla.co.uk/images/PDF/Publications/sl_intro_guide_9_10.pdf

[2] See Annexe: FTT Securities Lending Impact Analysis and data Methodology

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Consequences for the European Economy

- In excess of Euro 2 billion of revenues would be lost to long term investors every year as the rental income derived from lending would be far outweighed by the proposed FTT making practically all in scope lending uneconomic.
- The loss of this revenue stream will directly impact pension funds, insurance policy holders and a wide array of institutional investors.
- This loss will represent an additional cost to investors of 'holding' EU 11 securities and this may change long term investor behaviour. All other things being equal investors will prefer to buy non-EU11 securities.
- The cost of sourcing high quality collateral will rise for all market participants. For banks, this will have the effect of shrinking balance sheets and reduce their capacity to lend to the wider economy.
- Equity and bond markets will see reduced liquidity and wider bid-offer spreads for all participants.
- The cost of raising finance for EU 11 corporates and governments will consequently rise as investors demand a higher premium for these poorer secondary market conditions.

For the long term investors who participate in this market, securities lending is regarded as a valuable source of low risk incremental returns. In the past year, securities lending transactions generated 18 basis points of return on average per loan[3]. *The proposed flat rate structure of the FTT, set at a minimum 20 basis points per transaction[4], will make 65% of securities lending activity relating to the EU11 unsustainable*. We estimate that securities lending fee levels would need to increase by over 400% just to maintain current revenue streams for long term institutional investors.

The growing demand to borrow high quality collateral for the purposes of collateralising centrally cleared and other derivative transactions will be substantially undermined by the FTT with pools of potentially eligible collateral effectively left immobilised by the tax. *As the cost of accessing this collateral becomes prohibitive and collateralised business disappears, banks will be forced to shrink their balance sheets, reducing their capacity to support the wider economy*.

[3] Using data from Markit Securities Finance.
[4] It is not clear whether FTT is chargeable on substitutions or mark to market movements of collateral (received by investors when they lend securities). Should this be the case the situation would be dramatically worse.

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Consequences for Financial Market Stability

- The FTT will virtually eliminate availability of high quality eligible collateral issued within the EU 11 to the financial system. This is inconsistent with developing G20 regulatory regimes such as EMIR and Basle III
- Settlement failure rates will increase, leading to greater costs and risks within system
- Market volatility will increase and liquidity fall as market makers have less access to securities lending and repo markets.
- Hedging techniques will become more expensive.

The proposed FTT on securities lending and repo within the EU11 looks inconsistent with globally agreed regulatory initiatives. Both the developing Basel III regime for banks and the drive towards central clearing and margining of derivative transactions (as being implemented in the EU through EMIR) place reliance upon the collateralisation of financial transactions and exposures. Both will require a ready supply of eligible and appropriately priced collateral to enable the markets to function efficiently but without a functioning securities lending and repo market this will not be possible.

The proposed flat rate structure of FTT will impact shorter dated transactions disproportionately, and this will have severe negative implications for coverage of settlement failures and market making activities. Central Securities Depositories rely on the securities lending market to cover imminent settlement fails*. If this market is closed, settlement fail rates will increase, possibly by as much as 100%, thereby increasing overall systemic risk. If 'market makers' do not have ready access to a securities lending market they will be obliged to widen their spreads to cover their increased market risk to the detriment of underlying investors.*

Institutional investors and fund managers regularly use derivative products to better manage risk, express stock or market sentiment and match long term assets and liabilities. Many of these products require access to deep and liquid securities lending and repo markets to allow investment banks to hedge these risks on their own balance sheets. *The absence of the ability to borrow securities will incentivise funds and banks to reduce hedging, thereby increasing market instability and volatility for underlying investors.*

The pivotal role played by securities lending in the context of the broader money markets has been acknowledged in recent domestic FTTs. Both the French and Italian measures include exceptions for securities lending and repo, and long standing exemptions for temporary transfers of securities are also present in other markets with similar tax regimes.