EU Financial Transactions Tax and Securities Lending

We understand that the EU Financial Transactions Tax continues to be discussed and the 11 member states involved in the negotiations are making progress in their desire to implement the tax. Press reports suggest that the member states are considering certain options in the design of the FTT. These include potential provisions which would lessen the impact of the tax on pension funds, and possible exemptions for certain instruments (such as government bonds) and transactions that are considered to provide liquidity to markets, such as market making and sale and repurchase agreements (repo).

In 2013 ISLA published a paper[1] that highlighted some concerns about the application of a financial transactions tax to securities lending transactions. Our research and analysis concluded that:-

- At least 65% of European securities lending market would be directly impacted by the FTT.
- The proposed FTT would make securities lending markets prohibitively expensive across the participating Member States including the significant markets in France and Germany.
- Over Euro 2bn of revenues will be lost to long term investors including pension funds.
- Approaching Euro 500bn of Euro Government Bonds would be removed from the securities lending and collateral market.

The securities lending market is used by institutional investors (such as pension funds) and banks provides valuable liquidity to markets in bonds (both government and corporate) and equities in the same way that repo does.

As noted in our previous paper applying an FTT to securities lending transactions would result in a large reduction in securities lending activity in the countries affected as the economics of these short term, low risk and return transactions, would be dwarfed by the tax.

This would have very negative implications for the functioning of the wider financial markets, and for the successful delivery of a European Capital Markets Union:--

[1] http://www.isla.co.uk/wp-content/uploads/2015/08/ISLA_FTT_Overview_May2013.pdf

1. Securities lending and pension funds' investments.

Pension funds are major players in the securities lending markets. They and mutual funds (in which pension plans are significant investors) represent 45% of the market. However, these investors consider securities lending as an ancillary activity and would simply not do it if the costs largely outweighed the benefits. In 2013, institutional investors in Europe earned approximately EUR3bn of revenue[2] from lending their securities. It is estimated that EUR 2bn of revenue would be seriously at risk if the FTT is implemented on securities lending transactions.

> ***A tax on securities lending will reduce returns to institutional investors including pension funds by EUR 2bn pa.***

2. Securities lending and government debt financing.

As found in our 2013 research, the introduction of an FTT as per the Commission proposal would wipe out Euro 500bn worth Euro Government Bonds from the securities lending and collateral market, and thus reduce secondary liquidity in those instruments.

> ***A tax on securities lending will contribute to increase FTT 11 Governments' cost of funding via capital markets.***

3. Securities lending and market making

Market makers must be able to borrow securities in order to provide reliable and efficient two-way prices to their customers. Market makers are expected to quote prices to investors without knowing whether those investors are looking to buy or sell securities. It is not feasible for market makers to hold sufficient securities to cover any purchases their customers may wish to make. Therefore to enable them to quote prices and be confident of being able to deliver the securities, they need the ability to borrow securities.

> ***A tax on securities lending transactions will make the provision of market making more risky and expensive. This will result in fewer market makers and wider bid-offer spreads being quoted (raising costs for all investors).***

4. Securities lending and collateral

Securities lending is playing an increasingly important role in the mobility of collateral. It is commonly acknowledged that demand for collateral in the financial system will continue to rise as a result of general good risk management practice and also due to the growing body of regulation that drives its use (in particular Basel 3 and EMIR). In order for the markets to continue functioning well, market participants need to source collateral from investors that are natural holders of eligible securities. Securities lending and repo provide efficient and safe mechanisms which enable the transfer of collateral to where it is needed whilst providing for the original holder of the security to be compensated for its use.

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[2] ISLA Estimate from data from Markit Securities Finance (see

A tax on securities lending will seriously inhibit the flow of collateral securities, including high quality collateral, thus threatening the success of Basel 3 and EMIR as well as the objective of the CMU of encouraging deeper cross-border collateral markets.

5. Securities lending and safe and efficient settlement

The Central Securities Depository Regulation (CSDR) will implement settlement disciplines for transactions that fail to settle on their intended settlement date. There is concern in the market that the penalties imposed may be disruptive to normal market activity. The CSDR itself assumes that transactions that are due to fail can be remedied by market participants borrowing securities temporarily.[3]

A tax on securities lending will reduce the supply of securities that market participants will be able to borrow to cure settlement fails. This will increase operational risk in the system and could therefore defeat one of the main objectives of the CSDR.

6. Securities lending and repos

Legally and economically the transactions are virtually identical[4], and as a consequence both transactions are documented and regulated in the same way[5], as well as treated the same from an accounting point of view. In the same manner, it is important that any repo exemption from an FTT extends to securities financing transactions.

A tax on securities lending will create regulatory arbitrage opportunity within the markets for securities financing.

7. Securities lending and the wider market

Securities lending transactions exist to support other transactions (such as for trading, effecting timely settlement, collateral management, and market making). In countries where transactions taxes exist, it is commonplace for securities lending to be exempt whilst resultant trading activity is subject to the tax.

An FTT on securities lending would not only significantly reduce the volume of lending, it would also have a corresponding reduction in other potentially taxable transactions.

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[3] See for example: http://www.esma.europa.eu/system/files/2015-esma-1219_-_final_report_csdr_ta_incl_cba_for_ec.pdf

[4] The main master agreements securities lending and repo (the GMSLA and GMRA) both use title transfer collateral arrangements and are closely modelled on each other. The securities lending market tends to involve an institutional investors lending securities, whereas the dominant players in the repo market are banks

[5] For example see the Securities Financing Transactions Regulation and Central Securities Depository Regulation