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NEWS ANALYSIS

The Financial Transactions Tax Is Coming

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This article is an expanded and better-organized version of remarks delivered January 11 to the New York State Society of Certified Public Accountants conference on taxation of financial instruments and transactions.

Of the thinning ranks of presidential hopefuls, only Jon Huntsman talked constructively about the unresolved problems in the banking system. Rep. Ron Paul, R-Texas, is also talking about these things, and any man who hates the Fed can't be all bad, but going back to the gold standard is not constructive. (The president's new chief of staff does not believe that deregulation was a contributing factor to the meltdown.)

Huntsman wanted to break up the six largest U.S. banks, which collectively report assets equal to 66 percent of GDP. He would have capped bank asset size as a percentage of GDP. He wanted to cap permitted leverage, and he also advocated what appears to be a fee on excess leverage. Mitt Romney, the likely Republican nominee, supports the bank bailouts but not enhanced regulation.

> ***The recent announcements of mass firings and lower earnings for the former investment banks indicate that the casino part of the financial sector is shrinking.***

Let's get one thing out of the way: The big banks caused the meltdown. They created mortgages for trading and shorting purposes far beyond the housing needs of the country. They were aided and abetted by the Fed's low interest rates (which are now propping up their profits at the expense of savers).

The Community Reinvestment Act did not cause the meltdown. Most subprime mortgages were made by specialized lenders not subject to that law, which only covered banks.

Fannie Mae did not cause the meltdown. It was left holding a big bag of junky mortgages that it bought for its portfolio late in the game. But it did have a big role in creating MERS, an extralegal end run around the statutory mortgage recording system, designed to facilitate trading in mortgages.

The financial sector needs to shrink. And the recent announcements of mass firings and lower earnings for the former investment banks indicate that the casino part of the financial sector is shrinking.

Oh, no, not the clients! You all are professionals, and you can roll with the punches. When the finance sector shrinks, you can move on to the next big sector or the next gimmick. Don't be like lawyers and get attached to one client or one way of doing business.

Today's topic is the financial transactions tax (FTT) — a behavioral device designed to shrink the speculative side of the financial sector.

The City of London

The City of London is very important to the meltdown picture because it is where American and European banks go to make mischief that their home country laws would not permit. The City — so named because it is the oldest part of the ancient Roman city — is a little patch of ground in southeast London.

The City is a self-governing regulatory haven within the borders of the United Kingdom. It has no meaningful financial regulation and a codependent relationship with Wall Street. A lot of money sloshes through the City, some of which gets paid in tax to the British government, causing misguided souls to think it is doing the United Kingdom some good.

The Economist thinks we should stop bashing bankers/traders because they're doing something productive. Its recent cover story bleated, ''Save the City'' from FTTs and European regulation (*The Economist,* Jan. 7, 2012, p. 19).

Even Prime Minister David Cameron understands that the finance sector in the United Kingdom is too large. He recently bemoaned the market failure represented by excessive growth in executive pay, advocating binding shareholder votes. When a toffee-nosed conservative like Cameron thinks traders are paying themselves too much, you know that opinions are changing.

"Finance — the funneling of savings to their best use — is a vital industry," said *The Economist*. Yes, indeed it is, but that is not what London's derivatives traders and high-frequency traders do. It is not what London's hedge funds do. It is not even what London's private equity funds do most days of the week.

What they do instead is gamble with other people's money, which the magazine euphemistically refers to as "a freewheeling international market for global capital."

It gets sillier. *The Economist* maintains that "Britain is very good at it, leading the world in various financial markets, including foreign exchange and over-the-counter derivatives."

Uh-huh. Neither of those activities is remotely productive or necessary. Moreover, most of the banks in London have foreign parents, so it's hard to identify the British contribution.

What do London bankers do?

Foreign currency trading. That is why the United Kingdom did not go on the euro. The strong pound policy works to the benefit of financiers and to the detriment of British manufacturing. London accounts for 40 percent of the world's currency trading.

Rehypothecation churning. Rehypothecation is when a prime broker uses collateral posted by a hedge fund or other securities lender as collateral for its own borrowing. Every prime brokerage agreement permits rehypothecation of collateral. "Excess" collateral — the value that exceeds the loan amount — can be reused as collateral for the bank's own purposes.

U.S. law limits rehypothecation to 140 percent of loan balances when a broker/dealer uses customer collateral to finance its own business. A broker/dealer cannot rehypothecate customer collateral to finance proprietary trading.

But there is no limit on rehypothecation in the United Kingdom. U.S. banks got a lot of collateral from British hedge funds, which they rehypothecated. Continuous rehypothecation of the same collateral is called churning. The financial meltdown featured a good deal of collateral churning through London.

The IMF found that $1 trillion of hedge fund collateral was used for $4 trillion of borrowing by big banks. Even worse, sometimes rehypothecation took the form of a U.S. broker transferring client securities to a British affiliate, which then rehypothecated them. (This is the very definition of a Minsky moment.)

Derivatives. London accounts for 46 percent of over-the-counter derivatives. It is where AIG's derivatives operation was located, as well as the derivatives operations of most large American former investment banks.

The Economist bases its claim for City importance on the amount of income the foreign banks choose to book in the United Kingdom, arguing that this is the result of some Ricardian competitive advantage and not lax regulation.

I'm often asked why American hedge fund managers don't decamp to London. The answer is that a millionaire in London lives less well than a middle-class American.

European Plan

The balance sheets of Europe's too-big-to-fail universal banks make the balance sheets of the largest American banks look pretty. European banks still have not come clean about all the mortgage-backed garbage the Americans sold them, and now the sovereign debt meltdown is dealing them a second blow. Bank shares on both sides of the Atlantic are trading at option prices.

European leaders are dithering on measures that would enable members of Club Med to borrow at Germany's rates, and to allow investors, principally the European universal banks, to report higher values for Club Med sovereign debt on their balance sheets. Investors ought to take hits, because they were perfectly capable of analyzing the problems of Club Med. It is not as though Italian and Greek fiscal problems were a secret (Spain and Portugal have too much private debt).

Having failed to prevent the rot from spreading to Italy, European leaders are now desperate to prevent it from spreading to France (whose rating was cut as this article was being written). This is a fool's errand, but the governments are serious about an FTT to stock a European rescue fund, the minimum credible size for which would have to be €2 trillion. The shadow banking system betting against the euro and Club Med sovereign debt is estimated to be $60 trillion.

> ***An EU FTT of 10 basis points could produce revenue of €20 billion per annum, even assuming a 70 percent decrease in the volume of trading.***

Last March the European Parliament passed a resolution endorsing an FTT. The planned effective date is January 2014. German Chancellor Angela Merkel, the world's most powerful woman, wants plans for an EU FTT to be developed by the end of March. French President Nicolas Sarkozy said he intends to introduce an FTT in France by the end of January.

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The European Commission has a draft EU directive for an FTT (*Doc 2011-20607*). The draft directive suggests a minimum rate that each member would separately adopt.

An EU FTT of 10 basis points could produce revenue of €20 billion per annum, even assuming a 70 percent decrease in the volume of trading. Roughly 90 percent of the revenue from an EU FTT imposed on all types of financial assets would come from taxing derivatives on their notional values at a lower rate of 1 basis point. (For the commission's impact assessment, see *Doc 2011-20606*.)

Roughly 71 percent of the revenue in a European base would be in the United Kingdom, even assuming a reduction in trading volumes. In essence, an EU FTT would be a British subsidy to the other 26 members.

Cameron has definitively stated that the United Kingdom will use its veto to prevent adoption of an FTT for the entire EU. Article 113 of the Treaty on the Functioning of the European Union (TFEU) requires unanimity for EU taxes. But a group of at least nine EU members could agree to impose one among themselves. The plan now appears to be for the 17 euro area members to have an FTT, using a process called enhanced cooperation, the same process being used for the euro bailout (article 326 of the TFEU).

That would redirect trading to London or to other financial hubs. The commission recognized this potential. According to the draft directive, a transaction would be taxable if one of the parties were European, even if it was closed in London or New York.

This jurisdiction would mean that a London dealer would have to collect the FTT on behalf of a French customer, which would be jointly and severally liable. Likewise, an American dealer would have to collect the FTT when dealing with a French customer. If a London dealer was a branch of a continental bank — as many are — it would have to collect tax on behalf of customers. So would a continental branch of a British or American bank.

Alternatively, the draft directive states that a bank will not be subject to the FTT if there is no link between the economic substance of the transaction and any EU member. This would encourage banks that wanted to wall off their transactions from the FTT to sever all European ties. This would be no bad thing if it meant that European governments would not have to bail out these players when they fail.

Oh, but isn't Europe irrelevant? Europe has more influence than you may think. Credit default swaps have lost credibility since the decision by the International Swaps and Derivatives Association not to trigger them on Greek sovereign debt. ISDA's apparent restraint in a clear case of default demonstrates the influence of European governments on finance. Alternatively, ISDA may merely be protecting some dealers who sold credit default swaps on Greek debt.

Stamp Duty

Despite its indulgence of the financial sector, the United Kingdom has a special tax that is instructive for the mechanics of an FTT. The British stamp duty works quite well and shows that an FTT could work. (If the United Kingdom agreed to introduce an FTT, it would replace the stamp duty. The draft directive forbids competing taxes.)

The British stamp duty is imposed on issuance of shares, as well as secondary market transactions. Stamp duty is collected on foreign transactions when the shares are registered as depositary receipts.

The stamp duty exception for dealer trading is so broad that it excuses bank proprietary trading. If there were no dealer exemption, an FTT would cascade when a financial asset is frequently transferred. The EU draft directive has no dealer exemption.

British stamp duty is imposed on futures contracts that call for delivery of shares but not on contracts for difference, which are primitive cash-settled derivatives. London share speculation, not surprisingly, largely takes the form of contracts for difference.

No transfer of a security is legally enforceable until duty has been paid, regardless of whether the transfer occurred on an exchange. The British electronic securities settlement system (CREST) collects and remits the stamp duty upon settlement. The stamp duty has very low administrative costs.

Financial Transactions Tax

What would an FTT do? It would slow trading.

Economist James Tobin, who first suggested it, wanted to throw a monkey wrench into excessive speculation. Like a cigarette tax, an FTT would discourage the activity being taxed. So it should be looked at as only partially a revenue raiser and primarily as a behavioral device.

What would an FTT do? It would slow trading.

An FTT would kill off high-frequency trading. The SEC is dithering on doing anything about this parasitic activity that is making the securities markets unsafe for all but algorithm traders.

An FTT could reduce the use of derivatives and repo finance by raising the costs of these forms of borrowing and liability creation.

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The problem with an FTT for accountants is that it does not require compliance or planning. It is automatically levied by the clearing body, if the transaction is cleared. The draft directive contemplates taxation at the bank level — and two taxes when banks trade with each other.

The base of an FTT is the transactional amount. It could be consideration, strike price, or option premium. The base could be accruals for deferred payment contracts.

For OTC derivatives, the draft directive calls for the sell side to remit and pay tax, with secondary liability on the customer. Derivatives modification would also be taxable under the draft directive.

The FTT envisioned by the draft directive would reach repos and currency trading, but the commission appears to have cold feet about taxing spot currency trading. The draft directive would tax structured products, that is, the tradable result of securitizations.

The FTT would not apply to IPOs of equity or debt. But issuance of equity interests in hedge funds or UCITS would be subject to FTT. The FTT would not apply to retail transactions like mutual fund shares, mortgages, insurance, and credit cards. These services are exempt from VAT in Europe. Otherwise, policymakers see the FTT as a way to compensate for the VAT exemption of financial services generally.

High-Frequency Trading

Stock picking is becoming irrelevant. Unless a company has 90 percent of the market, it is not going to outperform its peers. When the industry goes up, it goes up; when the industry goes down, everyone goes down together.

High-frequency trading makes stock picking beside the point. The prices offered on exchanges and trading platforms have nothing to do with fundamentals.

Oh, gee, doesn't the market magically assign the right price to everything? The 2008 meltdown proved that the efficient market hypothesis is piffle.

High-frequency traders benefit from teensy little price discrepancies that they pick up by having their computers right next to exchange order-matching computers. That co-location is a privilege they pay the exchanges to enjoy. The exchanges are for-profit companies.

Co-location essentially permits high-tech front-running. High-frequency traders have the ability to see other participants' prices early, and they use proprietary computer algorithms to predict price movements using the data.

Unless the traders are market makers, there are no restrictions on how they can use the information gleaned from the exchange's computers.

High-frequency trading now accounts for more than half the volume on U.S. exchanges and 40 percent of the volume on European exchanges. The average holding period of a share is a mere 22 seconds — that's these guys' microseconds averaged with the day traders.

The margins in high-frequency trading are so small that even a tiny FTT would eat them up. The typical spread for a high-frequency trader is less than one basis point.

Don't high-frequency traders provide liquidity? No, they vanish in a downdraft — which is what some observers think caused the flash crash. The Commodity Futures Trading Commission studied the flash crash and concluded that high-frequency traders exacerbated volatility, because they move in the direction of price changes. ■

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