

NO EXEMPTION

The Financial Transaction Tax and Pension Funds

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A report by...

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Introduction

Pension funds *must not be exempted* from the Financial Transaction Tax (FTT) to be implemented by at least 11 European countries.

Significant progress has been made toward a multinational FTT in Europe since 2011 when the European Commission adopted a proposal for a common FTT system. Though an EU-27 FTT was not possible due to the unwillingness of a few countries, a coalition of willing nations agreed to develop a common FTT. Subsequently the European Commission announced that a group of at least 9 EU nations would invoke the Lisbon Treaty's enhanced co-operation procedure and implement their own FTT by the end of 2012.

As some (France, Italy and Portugal) are planning their own FTTs this year, the broad thrust is clearly to implement the tax, one that should reduce speculative activity and raise considerable revenue. A recent DIW report indicated that an 11 nation enhanced cooperation FTT would raise €37bn per year but *only if* 'FTT coverage is as broad as possible.'¹ That report also argues that pension funds should not be exempt. It is the issues of coverage and non-exemption that this paper addresses.

FTT Benefits

The FTT will help secure pensioners' investments through reducing short-term speculative activity and encouraging their funds to invest over longer horizons. It will benefit both European pensioners and the pension fund industry.

Historically pension funds favoured a valuation based low turnover approach to investing so a low-rate FTT

levied at points of entry and exit from the market would have minimal impact on returns. While a significant proportion still adopt such strategies, in recent years a variety of forces including low interest rates have encouraged increased turnover of assets which is contributing to a significant percentage of pension funds' high costs (estimates vary from 2% to as high as 20%). It is such costs rather than a 0.1% FTT, that are a major drag on returns. Wider reforms such as greater cost transparency and re-structuring of asset-based and performance fees that would reduce total costs should go hand in hand with an effective FTT.²

No loopholes, no exemptions for pension funds

Although a European Parliamentary non-binding vote overwhelmingly endorsed the EC's original proposals, liberal and conservative groups in Parliament requested exemptions for pension funds.

Experience shows that exclusions and exemptions of any type will be exploited to the detriment of the tax's effectiveness.³ If pension funds are exempt avoidance may occur through re-routing trades, re-casting themselves as pension funds, or other forms of creative accounting. This would reduce both revenue and the FTT's 'sand in the wheels' benefit that contributes to a more stable, less short-term focused market.

Of Europe's two pension systems, those funded by public transfers (pay-as-you-go, tax-financed) and those pre-funded by capital investments, *only* the latter would be affected by a FTT as the former are

1 DIW – the German Institute of Economic Research, http://www.diw.de/sixcms/detail.php?id=diw_01.c.405814.de

2 Reforms reviewing the fiduciary duty of fund trustees to their beneficiaries, and to facilitate better governance, have also been subject to much discussion of late.

3 The EU definition (Directive 2003/41/EC) of a pension fund – 'institutions which are completely separate from any sponsoring undertaking and which operate on a funded basis for the sole purpose of providing retirement' – at first glance seems to offer a relatively watertight way of ring-fencing pension funds from being mis-used. However, it is best to err on the side of caution. Given an opportunity to increase profits, financial institutions have been remarkably adept at creative accounting to lower tax liabilities.

http://eur-ex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexplus!prod!CELEXnumdoc&lg=EN&numdoc=32003L0041

not invested in financial markets.⁴ Importantly, public transfers account for well over 50% of retirees' income in European countries (with the notable exceptions of the Netherlands, the UK and Finland), and would not be affected by an FTT. Pre-funded schemes account for less than 10% in 11 EU countries (France, Greece, Belgium, Spain, Portugal, Italy, Hungary, Austria, Poland, Slovakia, Czech Republic), 15% in Germany, and are a substantial source of income (above 20%) in only 6 countries (Denmark, Ireland, Sweden, Finland, Netherlands, UK). Unsurprisingly it is in the latter countries where exemptions were raised by business groups, lobbyists for the financial sector and some pension funds.

The UK has Europe's largest pre-funded pension sector. It has been estimated that UK private sector pension scheme values declined by 30% as a result of the 2007/8 crash. At the same time, losses in the various individual funds that make up the collective £143bn local government pension scheme were as high as 28%.⁵ Though this paper does not address the UK context in great detail (due to the reluctance of the UK government to join the enhanced co-operation FTT), such data indicates that its pension funds too would have much to gain from a broad based FTT which reduces levels of risky high frequency trading, and encourages funds to move further towards long term investment models, such as infrastructure.⁶ The effects of £375bn of Quantitative Easing from the Bank of England together with a historically low interest rate of 0.5% since March 2009 have, we show, had a far greater impact on pension funds than any hypothetical introduction of a broad based FTT.

In Finland and the Netherlands over 20% of pension fund capital is invested in asset classes such as cash and deposits that will not attract an FTT.⁷ Under EC legislation government and corporate bonds would also not attract an FTT in the primary market, and

any one-off 0.1% levy paid on bonds in the secondary market would have minimal impact given long holding periods.⁸ Defined Benefit (DB) schemes in both the Netherlands and Finland invest significantly in bonds (67% in the Netherlands, 42% in Finland) indicating that the FTT's impact may well be less than often thought.⁹ While the percentage of DB and Defined Contribution (DC) funds varies across countries, the Netherlands (82%) and Finland (65%) have predominantly DB schemes, traditionally the more conservative of the two. Even in an environment where equities are traded more frequently than before, long-term investing in bonds remains a major feature of those country's pension funds.¹⁰ For clarity at the outset, this analysis primarily addresses the impact on DB schemes.

Perhaps because of the size of the Dutch pension sector (€783bn, 129% of GDP), the most vocal criticisms of an FTT for pension funds have come from the Centraal Plan Bureau (CPB) – the Netherlands' Bureau for Economic Policy Analysis. It claims that an FTT 'raises transaction costs that will increase funding costs for firms and therefore reduce returns for pensioners.'¹¹ It quotes, but 'cannot verify' the estimate of large Dutch pension providers that the FTT would cost Dutch funds some €3bn per year. We will respond to this later but by comparison, it is worth noting that brokers and other intermediaries contribute to, according to one recent study, an estimated total of €5bn–€6bn of annual costs faced by pension funds, figures which equate to roughly 20% of annual employee and employer contributions. Though this paper's main thrust is claims made against the FTT, it also raises wider questions and areas of reform around total costs that would benefit pensioners.

4 http://ec.europa.eu/taxation_customs/resources/documents/taxation/other_taxes/financial_sector/fact_sheet/pension-funds.pdf

5 For the UK context, see http://www.localis.org.uk/images/LOC1358_Infrastructure_report_WEB.pdf

6 We note too, the arguments in favour of fund amalgamation (particularly in the UK local government pension scheme) which may lower transaction costs. This might include infrastructure investment, though this must of course have a sound business case.

7 http://www.tuac.org/en/public/e-docs/00/00/0B/C3/document_doc.phtml

8 http://www.pensionprotectionfund.org.uk/DocumentLibrary/Documents/Purple%20Book_2011_Chapter1.pdf

9 Defined Benefit (DB) schemes specify the amount that will be paid out in retirement according to a pre-determined formula, often based on final salary and years in employment. They are often job specific, thus reducing the potential for investors to move elsewhere. Defined Contribution (DC) schemes specify the amount paid in by employees, but then invest this money to maximise returns (the payout in retirement thus depends on the amount raised through these investments). As DB schemes know in advance the amount they will have to accrue, they can afford to take a longer term view of their investments. DC schemes look to attract business through their annual profits, and are regarded as more 'portable' – allowing potential contributors to move their money with greater ease/lower cost.

10 For the statistics in this paragraph see <http://www.mercer.com/articles/1462945>

11 <http://www.cpb.nl/en/publication/financial-transaction-tax-review-and-assessment>

Why the FTT will not hurt pensioners

First, any cost borne by pensioners will be minimal because pension funds are significantly longer-term investors so a micro-tax applied at entry and exit from the market will be negligible.¹²

The key consideration is the holding period. The cost of a FTT is disproportionately high for short term periods (minutes-months), marginal for medium term periods (1–2 years), and negligible for long term periods (5+ years).¹³ As Andy Haldane, Executive Director for Financial Stability at the Bank of England has recently stated, '[the FTT] will catch anyone, in principle, who transacts – obviously if you're transacting once every ten years, it catches you rather less often than if you're transacting every ten milliseconds. So it will be felt disproportionately by those who transact more often and therefore the High Frequency Trading community.'¹⁴

The economist Stephany Griffith-Jones and former trader and current head of financial think tank Intelligence Capital, Avinash Persaud, highlight the different effects this will have:

‘The average pension fund holds a stock on average for 2 years (so it turns over 50% of its portfolio a year). Assuming a 0.1% FTT ... a pension fund ... would pay transaction taxes equivalent to 0.05%. A high frequency trader turning over its entire portfolio in a day, would pay transaction taxes of 50%, or 1,000 times more than an average pension fund. What is likely to happen therefore is that high-frequency trading falls off dramatically.'¹⁵

Another common criticism is to hypothesise a long investment chain where at each stage of the purchase of a financial instrument an FTT is paid, which could make the effective FTT rate as high as 1% rather than the 0.1% in the Commission's proposals. Such assumptions are at the root of many of the extreme figures such as CPB's estimated cost of €3bn. But the FTT is not innately a cascading tax. Of the two broad types of investors, asset owners (those, including pension funds, that purchase assets) and asset managers (those, such as market funds, which manage the purchase of such assets) the latter don't purchase assets for themselves. They are intermediaries acting on behalf of pension fund clients, and as the EC points out,

‘... actors [such as brokers, would look to] replace 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 one's own name and on one's own account (e.g. by broker/market-makers) as this would relieve them of [paying the tax].'¹⁶

Once it became clear that an FTT would apply to transactions that intermediaries are not liable for (e.g. procuring an asset and then selling it on to clients, rather than simply channeling client's money) they would likely return to their traditional role as intermediaries. The FTT would therefore not innately cascade because brokers and other intermediaries would have strong incentives to pursue untaxed transactions. The chain would not be as long as critics hypothesise. As Pierre Habbard (Trade Union Advisory Committee to the OECD) has noted, 'opponents [of the FTT] believe that costs...will be transferred to pension funds. But there is no evidence that this will happen, rather [costs] will be shared all along the investment chain. There is competition in the market place and asset managers will want to keep their clients.'¹⁷ Reforms to make pension fund costs more

12 <http://harr123et.files.wordpress.com/2010/07/futureoffinance-chapter31.pdf>

13 The EC technical fiche on pension funds includes an excellent illustration of the modest effects of the FTT on a cautious, low trading more buy-and-hold fund compared to one with a more active strategy. While the cautious fund (70% of its portfolio invested in bonds which it holds until maturity, and only 20% of total assets turned once every year) would see the FTT at 0.08% over 20 years, the more active fund (turning over 90% of its assets twice a year) would end up facing an FTT of nearly 8% over the same period. Estimates depend heavily on the nature of the investment.

14 Andy Haldane speaking in a personal capacity at Occupy Economics' 'Socially Useful Banking?' Event, 29 October 2012, <http://occupylondon.org.uk/archives/17783>

15 <http://www.europarl.europa.eu/document/activities/cont/201202/20120208ATT37596/20120208ATT37596EN.pdf>

16 http://ec.europa.eu/taxation_customs/resources/documents/taxation/other_taxes/financial_sector/fact_sheet/relocation.pdf

17 http://www.tuac.org/en/public/e-docs/00/00/0B/C3/document_doc.phtml

transparent and open to scrutiny would help ensure this does actually occur. The taxation of derivatives has been made possible by legislation on mandatory central reporting. Similar directives on the reporting of transaction costs are necessary.

On balance claims that the FTT will cost pension funds billions of euros a year do not stack up. In short, pensioners will not be 'hurt' by an FTT because:

- For pension funds with a long term investment approach the FTT will add a negligible cost (a small fraction of transaction costs).
- The extent to which an FTT moves funds toward lower turnover in the markets should benefit pensioners.
- The (negligible) costs will largely be absorbed further up the investment chain as asset managers offer competitive rates to their pension fund clients.

If the FTT had no beneficial effects on the wider market, pensioners would theoretically have to live with a tiny additional cost, orders of magnitude far smaller than the CPB's alleged €3bn. Further, it's probable that an FTT would not cost pensioners at all because of the general benefits it and subsequent reforms would make to the pension fund sector.

Management costs, not an FTT, is the problem

Andreas Botsch (European Trade Union Institute) notes that 'annual operating costs and management fees of 1.2% to 2.4% average six to twelve times any FTT',¹⁸ while the UK Royal Society of Arts, Manufacturing and Commerce

estimates that transaction costs for UK pension funds may be as high as 3%.¹⁹

One recent study, the annual survey published by the actuary and consultancy firm LCP, estimates Dutch total costs are between €5bn and €6bn, up to 20% of total contributions from employers and employees.²⁰ High transaction costs should not be used as a smokescreen to avoid the FTT, as they have by Finnish commentators.²¹

For pension funds wanting to increase longer term future dividend flows, many commentators such as Paul Woolley of the London School of Economics²² have suggested a cap on turnover, a re-structuring of performance fees, and greater transparency of management costs and how they are delineated. An FTT would complement such moves towards a fairer market place.

Historically low interest rates too have a far greater cost impact on pension funds than an FTT. With nations such as Finland (0.5%), the Netherlands (0.75%), and the UK (0.5%) offering extremely low returns on savings, pension funds are pressed to adopt more high turnover strategies, to the evident advantage of intermediaries who are paid for trades regardless of quality or effectiveness. As Woolley points out, much of this increased trading occurs between pension funds themselves which are exchanging assets 25 times in the life of the average liability for no collective advantage but at a cost that reduces the end-value of pensions by around 30%. Estimates vary, but recent surveys find that Dutch and British pension funds turn over their portfolios every 9–12 months.²³ Unless increased turnover fulfills the hope of increased returns, a 100% annual turnover for example costs 1% per annum. To that extent, by lowering turnover, an FTT would lower transaction costs and so increase returns to pensioners.²⁴

Wider central bank monetary policy has also eroded pension fund savings far more than any FTT. For instance, by buying government gilts quantitative easing (QE) pushes up their price and hence lowers expected returns. Thus QE reduces the propensity

18 <http://www.etui.org/Publications2/Policy-Briefs/European-Economic-Employment-and-Social-Policy/Financial-transaction-taxes-in-the-EU>

19 http://www.thersa.org/___data/assets/pdf_file/0004/635917/Seeing_Through_British_Pensions_-_How_to_Increase_Cost_Transparency_in_UK_Pension_Schemes.PDF

20 <http://www.lcpnl.com/en/news-and-publications/publications/2012/work-in-progress-at-pension-funds-2012>

21 <http://www.taloussanomat.fi/tyomarkkinat/2012/03/15/arvio-eun-markkinavero-nipistaisi-suomalaisten-palkkoja/201225358/12>

22 <http://harr123et.files.wordpress.com/2010/07/futureoffinance-chapter31.pdf>

23 http://www.qass.org.uk/2011-May_Brunel-conference/Rubbaniy.pdf; <http://www.moneywise.co.uk/news/2011-11-21/3-billion-pension-fund-costs-hidden-investors>

24 See 'Future of Finance' chapter, above.

for pension funds to invest in bonds which nudges them towards more active financial assets and trading strategies.

Because an FTT would reduce the frequency and amplitude of crashes (see the analysis below of Griffith-Jones and Persaud) and substantially reduce the volume of high frequency trades it would lessen the likelihood of lower interest rates and of QE both of which undermine long-term savings. The financial services sector has benefitted from cheap money as low returns on savings and cheaper costs of borrowing leads to greater turnover and more revenue in commission and associated costs. Therein lies the real drain on pensioners' returns, not a micro tax on transactions.

An FTT is good for the pension fund sector

Research by financial services analysts TowersWatson shows that during 2005–2010 nations with FTTs experienced the largest growth in pension funds.

The 22% growth in Brazilian funds was closely followed by Australia's at 19% and Taiwan's at 13%. These nations have FTTs that go beyond taxing only stocks and include other assets such as bonds and, in the Taiwanese case, derivatives. Though other factors such as the strong recent growth in these economies dominate causal explanations, this correlation at least casts doubt on the accusation that an FTT is intrinsically associated with low growth in pension funds. That accusation also ignores FTT's positive contribution to pension fund revenues through market stabilisation and improved patterns of investing. As Griffith-Jones and Persaud show, it is important to factor in the effect of crashes on any cost-benefit analysis because FTTs have market shaping as well as revenue raising functions:

“*Stock value declines in crashes are in the region of 33% to 50% and crashes occur on average within every 10 years... If a transaction tax of 0.1% reduced the role of “noise traders” which reduced the size of misalignments in markets, which reduced the incidence of financial crashes by just 5%, then the increased expected return of pension funds would be higher than the 0.05% cost of the tax... The essential point is that the cost of [any FTT] will fall least on pension funds, would be marginal compared with returns and if the tax brought benefits in terms of financial stability these benefits are likely to offset these slight costs, boosting pensions.*”²⁵

Greater financial stability reduces the frequency of crashes and so reduces the number and duration of sustained periods of mass redundancies and increased unemployment. An FTT would therefore also make an indirect contribution to keeping people in work and paying into pension funds, capital which could be invested into future profits for funds and pensioners alike. An FTT would re-enforce pension funds' strategy of greater allocations to long-term asset classes, potentially including infrastructure where the investment conditions are right.²⁶

A tax that helps curb the excesses of High Frequency Trading (HFT) would benefit the pension fund sector. A 2011 survey for the UK Government's Department of Business Innovation and Skills (BIS) found that:

“*No traditional investors (pension funds, asset managers and insurance companies) employ HFT, though a few acknowledge that their brokers might ... HFT does not fit the long-only investment strategies of the asset managers, pension funds and insurers we interviewed.*”²⁷

Survey responses were uniformly negative, and contained comments such as, 'we do not like that more than half the market is traded like this, in short time frames...' and 'we do not churn stocks, we are long-term [investors]. I do not think [HFT] would merit the investment it would take to get into the business.'

25 <http://www.europarl.europa.eu/document/activities/cont/201202/20120208ATT37596/20120208ATT37596EN.pdf>

26 The pressing need for infrastructure may support nudging funds in that direction where, of course, such investments are prudent (and no conflicts of interest occur).

27 <http://www.bis.gov.uk/assets/foresight/docs/computer-trading/12-679-end-user-perspectives-on-computerised-trading>

Critics of the FTT sometimes conflate its undoubted reduction in investment activity in certain areas with potential harm for pension funds, particularly in relation to hedging activities. Yet this fundamentally misrepresents both the way pension funds use derivatives, and the type of high frequency investor who would be most affected. The EC proposal points to a significant reduction in trading volumes in the over-the-counter derivatives market upon the introduction of an FTT, but this is likely to come from HFT rather than from pension funds. As Hubbard notes, ‘pension funds buy [derivatives] because they have a legitimate need for insurance, not for speculation. Accordingly they hold OTC derivatives until they reach maturity, which can span over several years.’²⁸ A small tax on entry and exit would scarcely impact such long term investments. By contrast, much HFT is of no long term benefit. As Botsch argues in relation to the foreign exchange market, ‘90% of financial market turnover can justifiably be regarded as “hot air” or speculation.’ Removing short term speculators from the market will *inter alia* reduce the likelihood of flash crashes. Some allege that this will damage liquidity. Not so according to Persaud, who points out that the relationship of HFT to liquidity is hardly entirely beneficial:

“*Having lost the feasibility argument [on the FTT], bankers have started to raise the liquidity argument – an evocative point when we are still so close to the financial meltdown of 2008. High-frequency traders argue that all that turnover is not just hot air as it provides critical liquidity and price-discovery to markets. But this is deceptive. During calm times, when markets are already liquid, high-frequency traders are contrarian and support liquidity, but during times of crisis, they try to run ahead of the trend, draining liquidity just when it is needed most, as we saw with the Flash Crash on 6 May 2010. If a transaction tax limits High Frequency Trading it may even provide a bonus in improving systemic resilience.*”²⁹

As for transaction costs, according to the New York financial services firm Pragmatrading, HFT may be raising, rather than reducing the already high costs faced by pension funds:

“*Given that High Frequency Traders are very short-term intermediaries between the directional traders who are actually trying to accumulate or unwind a position, it is hard to see how they can simultaneously be saving investors’ money and pulling billions out of the markets in trading profits... By competing to earn spreads and rebates by providing liquidity, High Frequency Traders crowd out directional traders’ passive orders, force them to cross the spread more often, and result in higher trading costs for investors.*”³⁰

The ‘excessive competition’ engendered by HFT essentially leads to a backlog of demand for certain high volume stocks, making it more expensive for patient investors to acquire them as part of a long-term strategy.

Conclusion

This paper has argued that an FTT would not materially affect pensioners and that it has broader benefits. An FTT, which nudges funds further in the direction of longer-term strategies and which reduces de-stabilising elements such as high frequency traders while not significantly harming liquidity, is of real benefit to the sector.

The FTT fits with responsible investment over longer-term horizons by discouraging funds from ‘inappropriate’ turnover in favour of more traditional and stable forms of long-term management. It would help reduce the likelihood of crashes and associated ‘credit crunches’ and increase capital flows to the real economy. It would materially benefit pension funds and the wider economy alike.

A 0.1% FTT is extremely modest compared to the 2% and upwards of pension fund contributions absorbed by costs, and its impact is likely to be felt high up the investment chain, not by pensioners. Nonetheless, further reform is needed to address these two points. To ensure the most effective FTT possible, it is vital that pension funds are not excluded from its remit.

28 See TUAC paper, above.

29 <http://www.cepweb.org/why-a-financial-transaction-tax-is-good-for-your-pension/>

30 http://www.pragmatrading.com/sites/default/files/pragma_commentary_hft_and_cost_of_deep_liquidity.pdf

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