



Global regulation and the FTT

A concern surrounding the FTT currently proposed by the European Commission is that it offers economic incentives that conflict with existing international efforts at financial market reform.

Because the FTT is imposed at every stage of a financial transaction it discourages financial intermediation. Mandatory clearing rules introduced by the Dodd Frank Act in the US and EMIR in Europe aim to reduce counterparty credit risk by migrating OTC bilateral transactions to clearing houses. This has the effect of increasing transaction intermediation in cases where trades were bilaterally executed.

Central clearing is designed to reduce systemic risks in the financial system. The central counterparty (CCP) acts as buyer to every seller and seller to every buyer. In so doing, it is designed to centralize financial risks that were previously dispersed between multiple counterparties. Central clearing reduces counterparty credit risk by requiring firms to post collateral against potential future losses on trades (initial margin) and the mark to market value of the same trades (variation margin). Basel III rules are similarly designed to encourage greater collateralization of OTC trades by imposing higher capital requirements on banks for trades which are not collateralized.¹⁴

Many financial firms will be required to clear derivative transactions using CCPs. Most non-financial corporations, however, will not. The FTT, therefore, may discourage non-financial entities from centrally clearing derivative transactions as doing so would incur higher transaction costs.

Under the current European Commission proposal, it is unclear whether the FTT is to be applied to the exchange of collateral. If it were applied, this would clash with efforts to reduce counterparty credit risk. Again, financial corporations are likely to be subject to prudential margin standards which will require them to collateralize trades even when they are not cleared. Non-financial corporations will likely not be subject to the same standards.

In the case of non-financial institutions that are not subject to prudential margin requirements, a number of factors will determine whether they choose to bilaterally margin uncleared derivative transactions, or trade via a credit value adjustment (CVA) approach where credit charges are incurred. These include the cost of credit charges, the availability of high quality collateral that can be used as margin and the sensitivity to cash flow risk arising from margining. If it were to tax the exchange of collateral, the FTT would provide an incentive for non-financial institutions to choose the CVA approach.

Other market efforts at reducing risk may be impacted by the FTT. For example, portfolio compression trades, where offsetting positions are netted by counterparties in order to minimize counterparty risk, may be subject to the tax.

The FTT would have broad implications for all major trading centers of foreign exchange. Many international dealers provide liquidity to clients based in participating member states. For example, London, which provides the world's largest trading hub of foreign exchange, would be particularly adversely impacted.

¹⁴ We examine the impact of OTC derivative regulation on FX markets in more detail in our report: *Exchange Rate Perspectives How Regulation will Reshape FX Markets, Part 2*, 31st July 2012