Global FX Division

Briefing Note

June 2013

The Proposed EU FTT – Impact on the Foreign Exchange Markets

Executive Summary

The Foreign Exchange (FX) market **underpins international commerce and investment** by allowing governments, businesses, investors and individuals to convert one currency to another. In addition to FX Spot transactions, other **FX Products** (FX forwards, NDFs, FX swaps, FX options) enable participants to transact with certainty over the exchange rate and therefore the value of the transaction, whether for issuing a bond to international investors, purchasing raw materials abroad, exporting goods overseas, or protecting the value of pension investments made in other currencies.

Europe is focused on **restarting economic growth**. The **ability of European companies of all sizes to remain active on the global scene** - by exporting European goods while securing a stable income at home despite volatility in currency markets - is crucial to this economic growth. **FX Products are central to that ability**.

To preserve the usefulness of FX markets, the proposed Financial Transaction Tax (FTT) should not create barriers or prevent European companies and investors from being active in international commerce and investment. **The inclusion of these FX Products in the scope of any FTT would significantly raise the cost for end-users if they are to remain active in international commerce.** Our analysis[1] shows:

- For **EU corporates**, **their FX transaction costs will rise by up to 700%.** With just a single dealer a corporate based in the tax zone could see its annual FX transactions costs rise from \$2.4m to \$20.4m.[2]
- For a **pension fund or fund manager,** the impact is even greater, due to the double-sided nature of the proposed tax. These users could see their **transaction costs rise by around 1,500% and possibly by as much as 4,700%.** For a pension fund manager whose annual FX transaction costs with a single dealer are currently \$1.6m, this will mean that, once taxed, transaction costs would exceed \$75m.

Imposing an FTT on these FX Products (FX forwards, NDF, FX swaps, FX options) may well cause companies and investors to move away from hedging the risk of their international activities, **increasing their earnings volatility and business risk or pushing up costs that will reduce returns for investors.** It risks discouraging them from being active in international commerce or creating costs that are a drain on firms' financial resources that they could otherwise have deployed to fund their growth plans.

The European Commission[3] has already recognised that including FX spot transactions in the FTT would infringe the movement of capital under The Treaty on the Functioning of the European Union and in 2011 raised concerns with regards including other FX Products. Given these other FX Products are used for the same purposes as spot transactions - for payments, investing and funding - **we suggest that these FX Products – FX swaps, forwards, options and NDFs - should, as is already the case in relation to FX spot transactions, be excluded from the scope of any FTT proposal.**

[1] See Table 1 for further details. GFMA Global FX Division analysis based on 2012 trade data – impact assessment of FTT on client transaction costs applied to actual FX transactions of corporates & fund managers.

[2] Note also examples provided by EACT ("Comments concerning the Proposal for a Council Directive implementing enhanced cooperation in the area of a financial transaction tax (May 2013)"). For corporate FX users they calculate increases in FX forwards and swaps costs of €16.6m and €27.3m.

[3] European Commission Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax Brussels 14.2.2013 COM(2013) 71 Final [Memorandum page 9]

Foreign Exchange Markets – at the heart of international commerce and investment

- FX constitutes the **largest and most liquid financial market** in the world. It forms the basis for international trade and supports the functioning of the global payments system. **Corporates and asset managers** regularly participate in the market for real operational needs, for example:
    - Import/export payments
    - Repatriation of earnings
    - Cross border investment
    - M&A activity
    - Hedging currency of foreign assets and liabilities
    - Portfolio balancing and cash flow management

- The FX market's **importance in effecting monetary policy** has long been established and as such has been **historically subject to central bank oversight**. **Central banks** utilise the FX markets, adjusting currency reserves, influencing exchange rates and handling FX transactions for government and public sector enterprises.

- According to the Bank for International Settlements 2010 survey, the FX market has a daily turnover of close to $4 trillion per day.[4] Outside of **FX Spot**[5] trading (38% of daily volume), the vast majority (45%) are traded as **FX swaps**[6], a further 12% as **FX forwards**[7] and 5% as **options** [8] - all are products are used by end-users to manage currency fluctuations and invest internationally.

Instrument	1998	%	2001	%	2004	%	2007	%	2010	%
Spot	568	*37%*	386	*31%*	631	*33%*	1,005	*31%*	1,490	*38%*
Outright forwards	128	*8%*	130	*11%*	209	*11%*	362	*11%*	475	*12%*
Swaps	734	*48%*	656	*53%*	954	*50%*	1,714	*52%*	1,765	*45%*
Options and other	87	*6%*	60	*5%*	119	*6%*	212	*6%*	207	*5%*
Total	**1,517**	***100%***	**1,232**	***100%***	**1,913**	***100%***	**3,293**	***100%***	**3,938**	***100%***

Figure 2 - Source: BIS Triennial Central Bank Survey Report on global foreign exchange market activity in 2010 (excludes cross currency swaps)

- The FX market is also characterised by being extremely **short term**. Further analysis of BIS and central bank survey data[9] shows a market where:
    - 75% of FX swaps transactions are under 1 week, 97% under 6 months
    - 69% of FX forwards are under 1 month, with 96% under 6 months
    - 39% of FX options are under 1 month, 81% under 6 months

Maturity	<1wk	1wk-1m	1m-6m	6m-1yr	>1yr
FX Swaps	75%	9%	13%	2%	1%
FX Forwards	49%	20%	27%	2%	2%
FX Options	16%	23%	42%	12%	7%

Looking at overall volumes of these products, **65% of FX swap, forwards and options are being transacted in tenors under 1 week**, 77% being of maturities under 1 month and 98% under 12 months. Whilst the market is characterised by short tenors, it is worth noting corporates and investors do also look to fix longer dated payments e.g. out to 1-2+ years, to negate any exchange rate fluctuations. Artificially bifurcating the market by tenor should not be a consideration.

[4] According to the Bank for International Settlements 2010 survey
[5] **FX Spot** – being contracts for the sale or purchase of a given amount of currency for another at a pre-agreed exchange rate with duration typically of 2 days
[6] **FX Swaps**- FX swaps, being a two part simultaneous purchase and sale transaction for two different dates, comprising either a spot FX transaction and an offsetting FX forward or two offsetting FX forwards.
[7] **FX forwards**- FX forwards, being contracts providing for the sale or purchase of a given amount of currency for another at a pre-agreed exchange rate on an agreed future date, typically greater than 2 days
[8] **FX options**- a contract providing the owner a right, but not an obligation to exchange money from one currency into another currency at a pre-agreed exchange rate.
[9] Oliver Wyman analysis of central bank FX surveys and BIS Triennial FX Survey 2010

- **FX pricing is driven by market makers** who provide continual two-way pricing. Dealers in the market act as principal. The bid-offer reflects the dealer's principal risk and the client transaction costs are calculated as a proportion of the bid-offer prices they are offered.

- The FX market is highly liquid and competitive and has been **at the forefront of the development of electronic trading**. Price data is widely available from a number of sources which has resulted in tight spreads allowing for highly cost-effective hedging for users.

- **Clients benefit from these tight spreads.** For example in FX spot markets such as Euro/USD these are typically measured to 5 decimal places (0.0000*n*). In the FX forwards and swaps market, these spreads are even tighter.

- The **electronic nature of the FX market** has driven further industry initiatives in straight-through processing. This, in turn, has improved the operational efficiency of the market resulting in continual product improvements for end-users. Dealers have sought to reduce their operational costs to a minimum – by 2008 Z/Yen[10] reported that operations costs per trade across the FX market had fallen to between £0.20 and £2.60.

- Given bid offer spreads have continued to tighten, dealers have sought to reduce their operating costs further in an effort to provide ever more cost effective FX Products to their clients. They are **continually seeking to shave *cents* off their costs per trade**

Who uses FX Products and for what purpose?

- **Pharmaceutical company seeks to sell its products globally** – A corporate treasury department for a large pharmaceutical company supplying products globally has multiple income and payments streams in different currencies. This is likely to result in a mismatch in their currency needs and will require that they convert these balances into other currencies using FX swaps to avoid borrowing costs and to optimise interest earned. If they are unable to hedge cost effectively, the result will be increased business costs or they may decide not to hedge – which in itself risks increased volatility in their earnings.

- **Multinational engineering company with its order book in many currencies but its cost base is in Euros** – A large multinational engineering company has a multi-year order book in multiple currencies but with a cost base in Euros. A large movement in currencies over the period would place volatility into its earnings and it therefore needs to hedge as efficiently as possible and will use FX options to facilitate this hedge. A lack of a cost-effective FX options market may well reduce the company's appetite to hedge and reintroduce the currency risk that it was hoping to avoid, pushing up operational costs.

- **Pension fund invest globally but needs to convert the various currency flows to a single balance every week** – A large pension fund manager investing globally has multiple cash flows in different currencies on various pension portfolios – flowing from redemptions, dividends, investments – and needs to be able to convert all the different currency flows into a single balance on a weekly basis. This allows the pension fund to then undertake FX transactions to meet liabilities in different currencies as required through an efficient process. For positive balances this also allows the pension fund manager to gain the most attractive interest rates. Access to cost effective, short-dated FX swaps allows it to carry out this function for the benefit of its investors. Any increases in pension fund costs are ultimately passed on to the underlying funds and hence reduce fund performance.

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[10] Z/Yen Cost Per Trade and STP Benchmarking
http://www.wallstreetsystems.com/documents/Cost%20per%20Trade%20and%20STP%20Benchmarking.pdf

- **Global company seeks to hedge cash flows and carry out overseas acquisitions** - A global corporation uses FX Products to hedge their FX exposures, mostly receivables and costs linked to their underlying commercial activities. High transaction volumes are a result of daily monitoring of cash exposures – mitigated by using short-dated FX swaps to match long and short cash positions in various currencies. In addition, some of the corporate's FX needs are linked to more strategic transactions such as acquisitions / disposals and some financing requirements – intercompany loans and capital injections in foreign currencies.

  As European policymakers are exploring ways to **restart economic growth**, the ability – to which a well-functioning FX market is central - of **European companies of all sizes to remain active on the global scene** will be a crucial element of Europe's path to economic growth.

FTT impact on FX markets

We have sought to analyse the impact of the proposed FTT on the cost of using FX Products for end-users

Methodology for calculating the impact of the proposed FTT on transaction costs

- Our results (in Table 1) are based on the analysis of actual 2012 FX transactions between dealers and clients;
- 2012 client transactions covering FX Products (FX forwards, NDFs, FX swaps, FX options but excluding FX spot) have been identified for both corporate and asset manager clients – where either one or both counterparties are based in the tax zone (therefore those would be transactions caught by the proposed FTT);
- Pre-FTT client transaction costs are calculated as a proportion of the bid-offer spread offered by the liquidity provider (i.e. the dealer);
- To calculate the FTT payable, the total of the notional amounts traded by the client for 2012 are multiplied by the proposed EU tax rate of either 0.01% for corporates or 0.02% for fund manager examples (transactions between financial institutions and dealers are taxed at 0.01% on both sides of the trade);
- The resulting Financial Transaction Tax payable on the trades is calculated as an absolute amount and then displayed as a percentage increase over and above the transaction costs that the client experienced pre-FTT;
- For corporates this assumes that the organisation is not also caught by the "financial institution" classification by virtue of its corporate structure – hence only one charge to FTT at 0.01% is levied on the notional value;
- The assumption made is that due to the scale of the tax in relation to any income the dealers make that there is likely to be no option for the dealer but to pass this tax onto the end-user.
- The increase displayed only takes into account the FTT on the primary transaction. It does not take into account any additional FTT applied to the dealer's subsequent hedging costs or the impact of liquidity reduction in the market. A reasonable assumption is that in most cases this could at least *double* the cost increase percentages shown.

Worked example: Multinational Corporation in Tax Zone

A multi-national corporation has weekly cashflows of approximately $2,000,000,000 ($2bn) in multiple currencies, which it seeks to convert into a single currency for cash management purposes and then swap back again to meet outgoing requirements.

It uses short term FX swaps for this purpose, converting the various currency streams into dollars before swapping them back again. This gives rise to $4,000,000,000 ($4bn) in notional value of FX swaps on a weekly basis, which amounts to $200,000,000,000 ($200bn) on an annual basis (assume 50 weeks * $4bn). These short-dated swaps are competitively priced in the market (given that they can be seen as a short term collateralised loan of one currency for another and then reversal of that position) and the transaction costs (calculated through the bid-offer spread) for the annual amount to $2,500,000.

The FTT when applied to the notional values of the transactions for the year amount to $200,000,000,000 * 0.01% = $20,000,000. Given that the dealer will need to pass on these costs, for this straightforward and cost effective service, the corporate sees its transaction costs rise from $2.5m to $22.5m – an 800% increase.

FTT Impact on Client Transaction Costs – Results

- Analysis has been conducted by the Global FX Division to assess the transaction cost impact, not simply on a single trade, but also when applied to the actual annual FX forward, FX swap, FX option and NDF transactions of corporates and fund managers. FX Spot has been excluded.
- This provides estimates of the actual increase in their transaction costs for their trades in different currencies and tenors, executed over a 12 month period – i.e. during 2012.

Table 1- Increase in client transaction costs resulting from FTT application to FX Products (excluding Spot transactions)

End-User Type and Location	Dealer Location	2012 FX Products traded	Increase in Direct Transaction Cost from FTT
Corporate, in Tax Zone	Tax zone	FX Swaps	**738%**
Corporate Non Tax Zone	Tax Zone	FX Forwards, Swaps, Options	**326%**
Corporate Non Tax Zone	Tax Zone	FX Forwards, Swaps, Options	**216%**
Corporate, Tax Zone	Tax Zone	FX Swaps	**706%**
Fund manager, Tax Zone	Non Tax Zone	FX Swaps	**1489%**
Fund manager, Tax Zone	Non Tax Zone	FX Swaps	**163%**
Fund manager, Tax Zone	Non Tax Zone	FX Swaps and Options	**1027%**
Fund Manager, non Tax Zone	Tax Zone	FX Swaps, fwds, Options	**4722%**
Corporate, Tax Zone	Tax Zone	FX Swaps, fwds, Options	**484%**
Fund Manager, Tax Zone	Tax Zone	FX Swaps, fwds	**751%**
Corporate, Tax Zone	Tax Zone	FX Swaps	**768%**
Corporate Non Tax Zone	Tax Zone	FX Forwards, Swaps, Options	**191%**
Fund Manager, Tax Zone	Tax Zone	FX Swaps, fwds	**675%**
Corporate, Tax Zone	Tax Zone	FX Swaps, fwds	**241%**
Corporate, Tax Zone	Tax Zone	FX Swaps, fwds	**333%**

Conclusion

Given the short-dated nature of the majority of the FX market, with its extremely tight and transparent pricing, coupled with the large notional values and short tenors of the transactions, the **FTT will have a major impact on the users of these FX Products**[11]. As shown in the results table, this **ranges from several hundred to several thousands of percent increases in client transaction costs**.

A Financial Transaction Tax levied on FX Products (FX forwards, NDF, FX swaps, FX options) could result in companies and investors moving away from hedging their international activities' risks with a **subsequent increase in earnings volatility and business risk or an increase in costs that will reduce returns for investors**. Not only would this **discourage them from being active in international commerce**, but this could also create a drain on their financial resources that would otherwise have been be deployed to fund growth plans.

The European Commission has already stated[12] **that FX spot transactions are excluded** from the proposed FTT so as not to restrict the free movement of capital under The Treaty on the Functioning of the European Union (TFEU). In its own 2011 impact assessment in connection with the FTT, the Commission itself recognised that a tax on currency transactions such as FX Spot transactions and these FX Products (a Currency Transaction Tax) would be incompatible with the TFEU[13]. For this reason, FX spot transactions are outside the scope of the current FTT proposal. **For the same reason, the FTT should also not apply to these FX Products – FX forwards, FX swaps, FX options and NDFs.**

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[11]See also Oliver Wyman "Proposed EU Commission Financial Transaction Tax Impact Analysis on Foreign Exchange Markets" January 2012 showing typical increases in transaction costs of between 3-7x and up to 18x for the most liquid transactions

[12] European Commission Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax Brussels 14.2.2013 COM(2013) 71 Final [Memorandum page 9]

[13] Commission Impact Assessment SEC/2011/1102 volume 8, pages 13,14