PENSIONS EUROPE

Position Paper on the negative effects of a Financial Transaction Tax on pension provision

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Introduction

PensionsEurope welcomes the EU institutions' commitment to get Europe growing again, foster investments and create jobs. PensionsEurope supports the Capital Markets Union initiative as well as the Better Regulation agenda. PensionsEurope however feels that the Financial Transaction Tax (FTT) will be contra-productive in this respect.

Pension funds and other IORPs play a crucial role in pension provision throughout the EU. Pension funds constitute a major part of the second pillar of pension systems in EU Member States, both in those that form part of the FTT11 and in those not participating therein. Their sole aim is to to provide and secure pension income to employees.

The FTT is widely known as a tax on financial services. That is a misapprehension – it actually is a tax on savings and retirement incomes. The FTT will ultimately be paid by pension funds' members and beneficiaries. To serve as an example: an investment manager acts as an agent on its client's behalf. If that client is a pension fund, the costs are ultimately passed to it. A pension fund acts on behalf of its members, i.e. individual savers that contribute to the pension fund to safeguard their financial future when retired. In case of pension funds being the beneficial owners of UCITS and AIFs[1], any FTT applied to such investment funds' assets in fact taxes the pension funds' investments and thus ultimately the end-investors' savings. This seems inconsistent with the objectives of the many tax incentivised savings and investment schemes that exist across Europe. An FTT will affect the retirement income of people in Europe and the capital allocation by pension funds to the real economy.

1. The FTT would negatively impact the real economy and pensioners would bear the costs

People in Europe still feel the impact of the financial and sovereign crises of recent years. Meanwhile they are living longer and are expected to take greater control of their own financial well-being, especially when it comes to their financial security into retirement. The impact of the proposed FTT will make more difficult.

In general, pension funds can play an important role in fostering long-term investment and economic growth, due to the match between the long duration of their liabilities on the one hand, and long-term financing on the other. Pension funds need to invest in the interests of their members and beneficiaries in order to generate pension income, but at the same time are large providers of capital to the real economy. The FTT would lower returns on pension investments. It would also increase the funding costs of sponsoring companies.

As the voice of European pension funds, we are concerned that the FTT, as currently negotiated would:

1. Increase the costs, lower the returns and reduce the efficiency of the investment strategies of pension funds which will ultimately lead to lower benefits for pensioners;

[1] Undertakings for Collective Investment in Transferable Securities and Alternative Investment Funds

2. significantly reduce hedging activities of Europe's pension funds and companies, impacting pension returns;

3. increase the cost of capital for FTT-zone issuers. FTT-zone member states would become less attractive and the movement of capital, particularly between the FTT-zone and the rest of the EU, would be impaired.

Our Members are concerned that the FTT contradicts the EU strategy to create growth and foster investment in the EU, as it would severely affect pension funds in their roles as investors. The FTT would consequently have a negative effect on pension funds' ability to contribute to the Capital Markets Union (CMU) objectives. We firmly believe that the FTT would be detrimental to retirement savings and to the real economy.

2. The FTT initiative should be withdrawn or otherwise at least pension funds should be exempt from its scope

The Members of PensionsEurope call on the FTT11 governments not to hinder pension provision in the EU, and hence to withdraw the FTT initiative or, otherwise, at least exempt pension funds from its scope.

2.1 The FTT should not hinder pension provision in the EU

Due to demographic challenges, public pensions are under pressure and more workplace pensions are needed. The 2012 Commission's White Paper on Pensions[2] advocates for a stronger role for supplementary pensions. Pension funds are first and foremost social, not-for-profit institutions that are active in financial markets. There is a contradiction if the Commission explicitly intends to promote supplementary pensions on the one hand and some Member States introduce a new tax also applicable for pension institutions on the other hand, as the FTT would have a negative impact on these pensions. In addition, introducing an FTT will be not in line with the Commission recommendation on EET taxation[3] for supplementary pensions. The FTT should not unjustifiably punish pension funds.

The FTT would lower investment returns, and this would put pressure on employers' contributions in DB schemes and decrease the benefits in DC schemes.

2.2. The FTT should avoid impacting the investment strategies of pension funds

Pension institutions have to cover long-term risks and they are often long-term investors. The notion that retirement savings and occupational pensions – given their long term investment horizon – are only insignificantly affected by the financial transaction tax is not accurate. This is due to their increasing risk management needs (i.e. overlay structures, hedging) and prudential requirements. The pending IORP II proposal aims to increasing the risk management requirements for IORPs. As a consequence, pension

[2] http://ec.europa.eu/social/main.jsp?catId=752
[3] EET = **E**xempt contributions – **E**xempt capital gains – **T**axed benefits

funds will need to use even increasingly financial instruments to comply with them, including OTC derivatives which play an important role in risk management.

Pension funds often invest in a broad variety of investment strategies and styles (such as active or passive, fundamental or quantitative) to allow for another dimension of **investment strategy diversification** in addition to diversification over assets, regions, etc. Some investment strategies would be affected more than others by the FTT. In fact a large number of pension funds opt for active management strategies. The investment process of a pension fund is based on elements such as financial market expectations, the fund's liability structure and the risk appetite of the pension fund. The negative impact of the FTT would likely be to prevent pension funds from using different investments strategies to the benefit of beneficiaries and employees. Especially within fund investments it is necessary for **risk mitigation reasons** as well as to **generate adequate returns** to have portfolio turnovers in the course of the year and not to solely follow buy-and-hold strategies with respect to neither equities nor fixed income. Especially with respect to the current **low interest rate environment**, that is reducing the returns of safe long-term bonds, more financial transactions will be necessary in order to get the returns needed for pensions.

For example, pension funds use OTC derivative contracts for risk management purposes, to manage their risks in their balance sheet and liabilities by hedging – among others – their interest rate, inflation or currency risks. The IORP Directive[4] explicitly allows pension funds to use derivatives for mitigating investment risks and for efficient portfolio management. The FTT would make this more expensive and thus in practice it would limit the ability of pension funds to hedge risks. Ultimately, this will negatively affect pensioners who will receive reduced benefits if and when the unhedged risks materialise.

Due to the volatility in financial markets, the limits of the strategic asset allocation are often reached and thus financial transactions are necessary for the purpose of rebalancing. That's why the FTT also significantly affects pension funds as long term investors.

To make it even clearer, pension funds need to engage in short term transactions. Pension funds need to enter into transactions for various reasons, the most important of which are **(i) to control risks that vary over time, (ii) to accommodate for cash flows and mitigate risk and (iii) to make attractive investments in order to realise adequate returns for their beneficiaries.**

The FTT would penalise the substantial transaction volumes of pension funds which are a result of the size of their assets under management, the need to match assets and liabilities and to mitigate risks, and not as a result of excessive search for return or risk-taking. The FTT would penalise all these activities, including regular (maintenance) transaction in index replication strategies.

Last but not least, even if they are exempt from the FTT, pension funds as end users will be affected by the FTT if it is levied in the preceding transactions, due to the cascading effect.

For these reasons PensionsEurope call on the 11 Member States participating in the enhanced cooperation on the FTT to withdraw the initiative. Pension funds would at least need to be exempt in case that the withdrawal of the FTT proposal will prove to be unfeasible.

[4] Article 18 of **Directive 2003/41/EC** http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32003L0041:EN:HTML