

## A fair and substantial contribution? – Taxing the financial sector to cover the costs of the financial stability objective

*Ash Saluja, Partner at CMS Cameron McKenna, analyses the IMF's proposals for taxing the financial sector in the name of financial stability. This article first appeared on Complinet and has been reproduced with the kind permission of the publisher.*

In the post-crisis clamour to cure the ills of the financial system, governments have administered an onerous cocktail of increased regulation and higher capital and financial requirements for financial institutions. In the latest 'twist in the tale', last month's leaked IMF interim report to G20 ministers, entitled 'A fair and substantial contribution by the financial sector', highlighted that taxes and levies on the financial sector will be an additional burden. In this new era of 'disaster mode' thinking and 'planning for failure', the IMF's report reflects the current priority that the financial sector – as opposed to governments and taxpayers – should cover the costs incurred when financial institutions fail or have to be rescued by the state. It is now becoming clear that there will be a heavy price to pay; financial institutions will have to fund reserves for the 'worst-case' scenarios haunting governments and regulatory authorities. Insurers are rightly concerned that the substantial contribution the IMF proposes for the financial sector as a whole impacts unfairly on the insurance industry.

Of course, taxing financial institutions to promote greater financial stability is not a new concept. The debate has, however, moved a long way since 2008 when economists began digging out forgotten theses on the so-called 'Tobin tax'. Recent months have witnessed a number of governments press ahead with levies on financial institutions to recoup the costs of crisis bailouts, despite the lack of international consensus. These range from one-off taxes on bankers' bonuses in the UK and France, to the US FCR fee – a 0.15% levy to recover TARP costs. The IMF report was, in some measure, a response to the actions already taken by national governments, which recognises the need for international co-ordination of a substantive, systemic levy on the financial sector.

The call for an internationally co-ordinated tax on financial institutions has been lent considerable support by the IMF's interim report. Whilst the IMF rejected the idea of an internationally co-ordinated *ex-post* tax to recover the cost of support already provided during the recent crisis, it recommended to G20 ministers an internationally co-ordinated *ex-ante* levy on financial institutions to build a reserve to finance support to these institutions that may be required in a future crisis. According to IMF proposals, this levy, or 'Financial Stability Contribution' (FSC), would not take the form of a financial transaction tax – as proposed by Tobin. It would be levied on the balance sheets of all financial institutions to cover the net fiscal costs of direct support that it is imagined financial institutions might require in a future downturn.

The FSC is based on the assumption that a fund will be required, despite tighter regulation and other steps (for example to break up banks that are 'too big to fail'). It also assumes that - as in the recent crisis- industry funded insurance schemes (such as the UK's FSCS) will not be sufficient, despite increased capacity and better and faster resolution regimes. The European Parliament's Economic Affairs Committee has proposed that systemically important cross-border financial institutions – whom the committee advocates should be directly supervised at EU level – should be obliged to contribute *both* to a European deposit guarantee fund and a European stability fund. The latter would be presumably funded by some sort of FSC levy and would be used to finance future bailouts of financial institutions. The FSC might also be seen as contributing to broader costs - for example the state's role in supporting the financial sector on a going concern basis (as distinct from insurance and costs for resolving or winding up institutions); these broader roles are sometimes broken down into 3 areas - the lender of last resort (LOLR), market maker of last resort (MMLR) and the provider of capital of last resort (COLR). The establishment of an FSC could put pressure on states to define precisely who can benefit from these facilities and to what extent.

With the rates currently under discussion for the FSC ranging between 1% (according to US proposals) to 2.5% (proposed by Sweden) of GDP, the potential revenue generated is huge, and this raises the question of how to use the money. Revenue raised by the FSC could be hypothecated into a special resolution fund or alternatively taken by the state into its general revenue. HSBC advocate that this money should be used for venture capital funding. Yet, this discussion rather pre-empt the policy process. IMF's interim report met with fierce opposition among G20 ministers. Countries such as Canada are reluctant to impose a costly and as they see it unnecessary levy on their respective financial sectors. Whilst, it is easy to propose an internationally co-ordinated tax, there will be huge difficulties in defining and agreeing how the raising of the levy and the responsibility for deploying funds in a future crisis will be shared between different countries, although co-ordination of this type should (in theory) be easier within the EU single market.

In the political melee surrounding an internationally co-ordinated systemic tax, many of the details of the IMF's plan risk being overlooked. Most concerning for the insurance sector, is the IMF's support for a broad-scope levy, which would apply to *all* financial institutions including insurers, funds and asset managers of all types, despite the broad acknowledgement that the failure of banks was more likely and more expensive during the recent crisis and that these institutions continue to

pose a greater systemic risk than other firms. The IMF's report grants some concession to the differences between insurance and banking business models, favouring an FSC levy on balance sheets on a differentiated basis according to institution type. This would only be an interim measure, as ideally IMF supports an FSC levy based on the level of risk, particularly systemic risk, posed by individual financial institutions. The Geneva Association has already undertaken important work to demonstrate that insurance differs from banking and that insurers do not pose the same systemic risks to financial stability that banking firms can. The worrying implication of the IMF's interim report is that, should these proposals gain traction with international policy makers, levies on financial institutions would be formulated on a broad basis that would capture insurance firms despite the fact that they do not pose the same systemic risks as banks.

In addition to an FSC levy, the IMF report endorsed a further measure - a Financial Activities tax (FAT) to be levied on the sum of profits and remuneration at financial institutions. Whereas the FSC levy has a direct purpose, the proposed tax on financial activities would be levied in the name of broader systemic objectives. Taxing profits and remuneration could offset the risk of the financial sector growing too large on the back of VAT exemption. If levied above a specific profit threshold, the FAT could discourage excessive risk-taking by disincentivising risks taken to achieve excessive rewards.

Evidently, this is yet another front on which the insurance industry needs to defend itself against the march of intrusive and ill-considered regulatory policy, and clearly the sector will want to voice its concerns about an unfair levy on insurers at an international level. Insurers in the UK will want to keep a careful watch on the levy on banks that the UK coalition government announced on its first day in office and any steps it may take to implement an *ex-ante* levy.

## Contacts



### **Ash Saluja**

Partner, Financial Services  
CMS Cameron McKenna LLP  
T: +44 (0) 20 7367 2734  
E: ash.saluja@cms-cmck.com