



The voice of banking
& financial services

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Dear Mr Plowgian, Mr Eggert and Mr Sweeney

Follow up Submission from the British Bankers' Association to NOTICE 2011-34

1. The British Bankers' Association (BBA) is the leading association for banking and financial services in the UK. We represent 230 banking organisations from 60 countries and have 40 professional service firms within our associate membership.
2. Further to the BBA submission of 7th June 2011 (the BBA Submission) and the videoconference of 6th July 2011, the BBA is writing to IRS and US Treasury to provide the additional information promised in relation to the subject matters set out below.
3. The comments and suggestions contained in this paper are provided subject to the issues that the BBA previously identified relating to the legal tensions between FATCA and UK/European law being satisfactorily resolved.

Summary:

4. The BBA welcomes the confirmation provided in Notice 2011-53 that US Treasury and the IRS are working with foreign governments to understand the specific administrative and legal challenges that must be addressed.
5. The BBA does not believe that, as currently proposed, the withholding and passthru payment requirements are practically capable of being implemented. To avoid serious disruption to global financial markets, the BBA would strongly urge a multilateral solution. See paragraphs 8 to 13 and the Annexes to this submission.
6. The BBA supports the principle of distinguishing between 'private banking' and other (retail) accounts. However, the BBA believes that further refinement is necessary. See paragraphs 16 to 20.
7. The BBA welcomes the principle of phased implementation contained in Notice 2011-53. However, the BBA reiterates its previous assertions that commencement has to be tied to the issuance of final regulations and guidance. See paragraphs 31 to 37.

Impact of passthru payment requirements, with particular reference to securities settlements and inter-bank payment systems (Paragraphs 7 and 52 of the BBA Submission)

8. The BBA's further research has reaffirmed its initial concerns about the impact of the FATCA passthru payment requirements on securities settlements and inter-bank payment systems. The BBA expands upon these in the Annexes to this submission.
9. The BBA believes that the sheer magnitude of the potential impact on such systems, as well as the other complexities and concerns noted in the BBA Submission at paragraphs 44 to 51, raise very serious questions as to whether the present concept of passthru payment can be practically implemented in a proportionate or workable manner.
10. It not immediately apparent to the BBA what moderating actions could be taken to resolve the issues attached to the current passthru payment requirement. After considerable discussion between members, the BBA has set out two possible approaches at paragraphs 11 and 13 below, which might be considered in isolation or combination. The BBA has discussed, and discounted, the possibility of applying a uniform passthru payment percentage (PPP) rate to banks and other financial institutions which was discussed during our videoconference as, although it may provide for a far more simplified determination of PPP, it would not resolve the impact to wider market systems covered in the Annexes to this submission. Nor would it resolve the myriad legal obstacles that are particular to the potential application of US withholding tax on payments that would generally be regarded outside of the US as not having a US source.
11. In the short term, and subject to the BBA's comments at paragraph 3 above, consideration might be given to legislating for a targeted form of passthru payment concept, which is restricted to payments attributable to income and sale proceeds from US securities (other than those securities that fall under the grandfathering provisions). In the case of fund events, and subject to any alternative view put forward by fund representative bodies, this would involve an asset based approach as envisaged by Notice 2011-34. In other (non-fund) situations this would involve a 'directly attributable' approach, following the principles laid out in section 1 of the BBA letter dated 10 March 2011.
12. Notwithstanding the above comments, no withholding should be required on passthru payments (other than withholdable payments) until the treatment of participating Foreign Financial Institutions (FFIs) and US Financial Institutions (USFIs) are aligned. The current inconsistency is unacceptable and would lead to a position where USFIs could act as 'blockers', whilst simultaneously creating a substantial competitive disadvantage for participating FFIs.
13. Ultimately, the BBA believes that the passthru payment issue, like many other primary issues attached to FATCA, can only be addressed by resolving the generic problem of potential recalcitrant accounts. The BBA again reiterates the need for a multilateral solution that would provide financial institutions with a solid domestic legal basis for reporting all relevant account holders. This could potentially be based on an expansion of existing domestic reporting obligations and exchange of information arrangements between the US and other competent authorities; see also our further comments at paragraphs 33 to 36 below. While the BBA appreciates that

there may be some lead time involved in establishing such a multilateral solution, the BBA believes that it would take far longer to give effect to the existing passthru payment proposals, if indeed it would ever be possible for these to be given effect.

Documentary Requirements (Paragraphs 14 and 15 of the BBA Submission)

14. In paragraph 14 of the BBA Submission, the BBA commented that it "does not believe that condition at Section I A 1 (3) C can be conclusively applied as a primary test to define a private banking department". IRS and US Treasury had asked the BBA to explain this comment in more detail. Accordingly, the rationale for this comment is that the UK Joint Money Laundering Steering Group guidance 'Prevention of money laundering/combating terrorist financing'¹ under which UK financial institutions operate, does not specifically define private banking. Therefore, in the BBA's opinion this test is superfluous to the others outlined in Section I A 1 (3).
15. Paragraph 15 of the BBA Submission noted the need to explore documentary requirements in more detail, to take into account existing AML standards applicable in various jurisdictions. In the intervening period the BBA notes that the submission by the Canadian Bankers' Association (CBA), dated 7th June 2011, covers this point at pages 4 and 5, under the heading *Documentary Evidence*. The BBA has subsequently established that the position set out by the CBA matches that of the United Kingdom. In addition, the BBA proposes that FFIs be permitted to rely on another institution for customer identification and due diligence to the extent permissible by applicable local law. This would be in line with the US where one US Patriot Act 2001–regulated institution can rely on another for customer identification and verification.

Private Banking (Paragraph 11 of the BBA Submission)

16. As noted in the BBA Submission, the BBA supports the principle of distinguishing between 'private banking' and other (retail) accounts on a risk-based approach. However, the BBA believes that the scope of private banking does need to be addressed for the reasons set out below.
17. As noted in the BBA submission, under certain business models it is possible for an enhanced level of service (in comparison to retail accounts) to be provided to some customers, nominally involving a 'relationship manager' service, but where the close relationship that one would expect between a private banking customer and his relationship manager does not exist. Typically such customers would be portfolio managed. The BBA submission suggested that such customer relationships should not fall within the intended scope of the private banking proposals. IRS and US Treasury had asked for further clarification on this point.
18. Accordingly, the BBA sets out below why it considers that these types of customer relationships should not be treated as private banking accounts.
 - The ratio of customers to relationship managers is so great that the relationship manager cannot be expected to have the detailed knowledge of his customers that would be necessary for a meaningful diligent review to be carried out;

¹ <http://www.jmlsg.org.uk/industry-guidance/article/part-i-part-ii-part-iii-and-treasury-ministal-approval>

- This high ratio would also make it impractical for a relationship manager to carry out a diligent review of his entire customer pool within the time limits specified in Notice 2011-34;
 - Additionally such customers may not be allocated a named relationship manager but will instead be assigned a pool of staff at the financial institution to whom they may speak;
 - The average value of accounts tends to be inversely proportional to the ratio of customers to relationship managers. This is logical as a financial institution would typically devote more and closer attention to those customers with the highest account balances
19. As a practical and systemic matter, the BBA considers that it would be more appropriate to simply distinguish between accounts with an aggregate value of USD \$1,000,000 or more (which would be regarded as private banking accounts) and other accounts. The BBA notes that a similar rationale has been applied with regard to the identification of a private banking account under the US Patriot Act 2001, Section 312, 31 U.S.C 5318(i). The BBA strongly believes that the treatment for US and non-US institutions should be aligned.
20. The BBA welcomes the amended approach reflected at II A 2 b iv in Notice 2011-53, whereby the review of account files may be completed by any person designated by the participating FFI.

Identification requirements for pre-existing private banking accounts (to supplement the original comments made in the BBA Submission at Paragraphs 19 to 25)

21. The BBA notes that Notice 2011-53 essentially preserves the arrangements set out in Notice 2011-34 in relation to pre-existing accounts.
22. It is the BBA's view that any pre-existing private banking account (\$1,000,000 or more) that is documented (either with an IRS Form W-8BEN or with documentary evidence described in Notice 2011-34) should be subject only to an electronic search for indicia of U.S. status. Pre-existing private banking accounts would thus be subject to a manual review only if such accounts are undocumented or if the electronic search reveals US indicia.

Alternative transition method and Passthru Payment percentage (Paragraph 55 of the BBA Submission)

23. On further reflection, the BBA has nothing to add beyond the comments covered at paragraphs 8 to 13 of this submission.

Grandfathered obligations and Passthru Payment percentage (Paragraph 68 of the BBA Submission)

24. Subject to the BBA's earlier comments at paragraphs 8 to 13 of this submission, the BBA notes that for grandfathering provisions to have practical effect, it will necessary for information regarding the grandfathered status (or lack of it) to be generally available to those parties responsible for applying the passthru payment provisions. The BBA believes that the issuers of grandfathered obligations and market information providers will have a critical role to play in this regard.

Local FFI members of participating FFI groups (Paragraph 73 of the BBA Submission)

25. Having given this matter further consideration, the BBA's initial comments at paragraph 73 of the BBA submission stand, as in practice it is thought that a participating FFI's underlying affiliates would be active outside of their jurisdiction.

Deemed compliance status for categories of certain FFIs (Paragraphs 73 and 77 of the BBA Submission)

26. BBA members have further reflected on the arrangements that would potentially except certain categories of FFI from FATCA requirements.
27. With regard to the proposals contained within Notice 2011-34 to except certain local banks and certain FFI members of participating FFI groups, the BBA Submission had identified important limiting factors at paragraphs 70 and 73. The BBA has concluded that the provisions attached to deemed compliance status as set out under Section III would provide marginal benefit in comparison to full participating FFI status, and would therefore be of limited attractiveness to such FFIs, even assuming that these limitations could be overcome.
28. With regard to other categories of deemed compliant FFIs, the BBA considers that the most appropriate option for those entities which pose a low risk of becoming vehicles for U.S. tax evasion, is to be excepted from the FATCA requirements. The BBA would envisage that the majority of such FFIs would satisfy (fall under) a threshold of USD \$1,000,000 as proposed at paragraph 19 of this submission and would question the cost-benefit (to both the U.S. authorities and affected entities) of their registration under FATCA.
29. The BBA Submission, outlined at paragraph 71 the possibility of excepting or deeming compliant certain FFIs with low value business or where it would be inappropriate to introduce burdensome requirements. The BBA would additionally propose that participating FFIs which consolidate U.S. customers under one or more legal entities within the participating FFI-group could administer all other FFIs within the group as deemed compliant, subject to the FFI's periodic verification that due process has been followed.

Impact of FATCA on QI agreements (Paragraph 84 of the BBA Submission)

30. The BBA considers that the requirements of current QI agreements should stand alone from FATCA. This would prevent the requirement to have an external auditor perform Agreed Upon Procedures on non-designated QI accounts.

Transitional Arrangements

31. In our videoconference, IRS and US Treasury suggested that it would be useful for the BBA to provide an indicative critical path of deliverables which would be likely to enable participating FFIs to make the necessary systems changes needed to achieve compliance with the various requirements of FATCA. Recognising the ongoing governmental discussions, with respect to multilateral or bilateral treaty/information exchange solutions and uncertainty in relation to other variables, the BBA considers that such an analysis, at this time, would be unhelpful and potentially counterproductive.

32. In our videoconference, IRS and US Treasury asked the BBA to consider the possibility of adapting existing systems to deal with some of the immediate challenges arising from the FATCA requirements. IRS and US Treasury also asked about the possible lead times for conducting initial searches (but not reporting or withholding) on account holders.
33. The BBA has subsequently discussed possible options following an in-depth analysis of the range of current UK reporting obligations. The BBA's conclusion is that reporting systems, and associated customer documentation requirements, currently applied in relation to the EU Savings Directive might provide an initial basis for discharging obligations under FATCA. UK banks and other financial institutions have existing systems and administrative routines to handle EU Savings Directive obligations. Developing a mirror system for reporting US payees would be relatively straight-forward, certainly in contrast to developing an entirely new system. It could also be developed far more quickly. However, further consideration would be required as to the ease with which such arrangements could be extended to branches and subsidiaries located in countries outside the EU.
34. The BBA believes that it would be highly beneficial for such a system to be based, at least initially, on existing EU Savings Directive customer identification and documentation requirements. The benefit of such an approach would be that banks would be in a position to quickly commence the identification and documentation process, as the requirements are already known and in day to day operation. This would also allow a period of reflection in order to subsequently put in place optimal identification/documentation requirements.
35. The BBA would further propose that the initial focus should be on individual account holders rather than entity account holders. The BBA believes that such a focus is justified on the basis that there are great number of open issues currently impacting entity account holders under FATCA, such as the possibility of certain types of entity being excepted from FATCA reporting and the level of underlying ownership that should trigger the entity 'look through' provisions.
36. The BBA would stress that the comments and suggestions at paragraphs 33 to 35 above are subject to the current legal tensions noted at paragraph 3 being resolved. Consistent with the BBA's earlier submissions and comments at paragraph 13 above, the BBA would urge IRS and US Treasury to work with other governments to develop a multilateral solution that would address those tensions. The BBA has previously suggested the potential application of the EU Savings Directive in this regard. If it were possible to reach a multilateral agreement in this respect the BBA believes that it would be hugely beneficial in terms of UK banks' ability to provide reporting with the minimum of delay and cost and the maximum of efficiency.
37. While the BBA welcomes the phased implementation timeline contained in Notice 2011-53, the BBA reiterates its previous assertions that commencement has to be tied to the issuance of final regulations and guidance. The BBA would consider a period of 18 months as a minimum transition period from the issuance of Final Regulations and Guidance to participating FFI implementation. BBA members are anxious that the significant compliance costs of FATCA should not be increased by unnecessary, speculative and abortive preparatory work and systems build prior to Final Regulations and Guidance being issued. The BBA believes that the proposals made in paragraphs 33 to 35 above would minimise this possibility.

Conclusion

38. The BBA hopes that the above information provides further clarification in relation to the covered subject matters and remain at your disposal to provide any further assistance or explanation that IRS and US Treasury require.
39. The BBA would tentatively suggest a follow up videoconference towards the end of August to discuss the contents of this letter.
40. The BBA also believes that a discussion ahead of Commissioner Shulman's visit to London in October is necessary to agree a suitable agenda and ensure that all of the meeting participants are satisfactorily prepared. The BBA will be liaising directly with Jonathan Davis to facilitate this and will keep IRS and US Treasury informed of developments.

Yours sincerely,



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Pass Thru Payments and international security settlement systems

In Notice 2011-34, preliminary guidance has been provided on the application of the passthru payment rules together with a working example of the calculation methodology.

This Annex outlines the fundamentals of the international securities settlements systems and contemplates how the application of the current passthru payment rules will affect these systems.

Overview of risk in relation to securities clearance and settlement systems

By far the largest financial risk in securities clearance and settlement occurs during the settlement process, that is, the process by which a securities trade transaction is completed by final, unconditional, transfer of securities from the seller to the buyer (delivery) and final transfer of funds from the buyer to the seller (payment): otherwise referred to as delivery versus payment (DVP).

If DVP does not take place counterparties to a trade are exposed to principal risk, that is, the risk that the seller of a security could deliver but not receive full payment or that the buyer of a security could make full payment but not receive full delivery.

The securities clearance and settlement systems are a major component of a country's financial sector infrastructure. As such they are closely integrated with the national payment systems. Accordingly to ensure a stable financial sector it is essential that safety, soundness and certainty of the system are achieved.

Any interruption to the flow of instructions associated with the transfer of ownership, order of payments, and confirmation of receipt can lead to market instability causing significant liquidity pressures and losses.

Liquidity risk includes the risk that the seller of a security that does not receive full payment when due, may have to borrow funds or liquidate assets to complete other payments. It also includes the risk that the buyer of the security does not receive delivery when due and may have to borrow the security in order to complete its own delivery obligation. Failures to meet obligations, when due, are likely to create concerns about the solvency of counterparties. In the current environment, markets are particularly sensitised to liquidity risk, which could be further heightened in a market where securities prices are changing rapidly.

Where the potential of the loss of the full principal value of securities or funds exists some participants will likely deny deliveries and payments, which, in turn, may prevent other participants from meeting their obligations.

What follows is a general overview of the settlements participants and transaction process. Slight differences may occur in national systems and not all participants will be found in all markets.

Overview of market participants

Investor – the beneficial owner of the security

Broker/Dealers – Intermediaries in the securities trade, matching buyers with sellers. In this process a broker can act as agent for an Investor or as principal (i.e. it is the Investor).

Central Securities Depository (CSD) - Holds and administers securities. Under the CSD, there is no physical delivery of shares. Instead, the CSD uses a book entry system to keep track of the movement of shares arising from trades. Moreover, it manages the provision of dividends and interest payment services, as well as the settlement process. CSDs are normally private firms and are constituted as a 'self regulatory organization' under the oversight of securities market regulators. There is often, but not always, only one CSD in a country.

International Central Securities Depository (ICSD) - Clears and settles international securities or cross-border transactions through direct access to the local CSD or through indirect access – partnership with a local agent.

Custodians – Provide a range of services including safekeeping of securities, arranging settlement of any purchases and sales, and collecting income from such securities on behalf of their clients. Custodians will generally have direct access to the CSD.

Global custodians - Also responsible, *inter alia*, for safekeeping and administrative services as outlined for custodians above. However, global custodians generally provide these services to clients in multiple jurisdictions around the world. They will use either their own local branches or other local custodian banks with which they contract so as to form a 'global network' covering each market to hold securities for their clients.

Clearing House (CH) - Is a department of an exchange or a separate entity which facilitates the clearing and settlement of securities and associated payments.

Central Counterparty (CCP) - A CCP interposes itself to both legal parts of the transaction, becoming the buyer and the seller of every security. It offers two advantages, the multilateral netting that reduces the costs of cross-border transactions and effective collateral management, which is achieved with the concentration of required collateral in a single entity.

Clearing Agent (a generic term which may represent a CSD, CH or CCP depending on the market)

Transaction process

A transaction starts with an order given by a client to his broker to buy (or sell) a specified number of shares of a company at a specified price. Typically, the order is then keyed into the stock exchange's central computers. The order for buying and selling is matched automatically by the system, with prices determined by the market forces of supply and demand through a process of bids and offers. Once matched, confirmation¹ is immediately routed back to the broker and sent to the clearing agent to facilitate settlement.

There are other trade execution platforms, such as an electronic trading system, a brokered market, or a matching system where buyers and sellers trade directly. Regardless of the trade execution platform used, trading details must thereafter be sent to the clearing agent on the trade date.

¹ Confirmation refers to the terms agreed on the price, quantity, and other details of the securities transaction. It also identifies the parties to the trade, to which the security and payment should be delivered (usually by a custodian bank). Brokers send to the CCP, if available, or to the clearing agent, trade details and deliver to their customers the terms and confirmation of the counterparty. Confirmation takes place via SWIFT messaging, electronic mail or fax. Information flows continue until there are no mistakes in trade details, which should be accomplished by Trade date plus one day

On settlement date the securities must be cleared. This is achieved by a series of transactions which involves the calculation of all the mutual obligations of the market participants. It determines what each counterparty should expect to receive.

Securities and funds must be provided by the custodians or, in some cases, by the brokers prior to settlement. The securities traded are blocked at the clearing agent until settlement date. Meanwhile, the investor authorizes his custodian to receive securities and deliver payment or deliver securities and receive payment. The clearing agent will execute the instructions of securities and payment transfers either on a gross or net basis (see below, for a further explanation on the gross or net basis).

Settlement takes place when the share ownership transfer occurs on the CSD's records, while the cash side of the transaction is usually effected through a banking payment system.

In most developed financial markets, ownership is tracked electronically through a book-entry system maintained by a CSD.

In some markets, large broker-dealers that frequently trade with each other use a CCP to minimize the risks of failure. A CCP stands between inter-dealer trades, and replaces the original bilateral contractual obligation. The CCP lowers the risks to dealers by offsetting, or 'netting', buy and sell trades. In addition, it reduces the number and size of movements on securities and money to be settled.

Most systems adopt a netting process, this is intended to minimise risk, in particular liquidity concerns.

- **Gross settlement** means that each trade is settled individually. In a real-time gross settlement system, each transaction is settled with finality right after trade/settlement date is confirmed.
- **Bilateral netting** occurs when positions of two participants are combined and off-set in pre-defined intervals of time before final settlement. For example: settlement may happen once in a day after trading hours are closed, or every two hours during the trade period.
- **Multilateral netting** means that positions are off-set among all participants before the net transfers of securities and payments take place.
- **Net settlement** occurs at intervals. At this point trades are offset and the net obligations of each counterparty are crystallized.

The practical impact of FATCA withholding on a settlements system

The imposition of FATCA and the potential charge to withholding on settlement proceeds would create two principal considerations from a settlement perspective.

First, there are numerous parties that would potentially be required to withhold and/or enter into an FFI agreement with the IRS, even if there is no obvious reason for them to do so based on their business models. To illustrate, party A, a UK Investor, sells his shares in a UK bank which is a participating FFI using the broking services of a UK broker, party B. Separately party C acquires a matching holding in those shares using the broking services of another UK broker, party D. Party E acts as UK clearing agent between parties B and D. In this 'simple scenario', sales proceeds are moving between four different parties in what is ostensibly one straightforward transaction. These would include parties such as B and D (UK brokers dealing in UK securities) and E (clearing agent dealing with UK securities), whose business models have a pure domestic focus and so no obvious connection with the purpose with which FATCA is concerned and therefore no obvious need to become a

participating FFI. It also includes party A, a UK investor, who would potentially be subject to US withholding on his sale of his UK shares if one or more of parties B, D and E failed to become a participating FFI.

The settlements system provides for anonymous trading, one important element in this chain is the role of the broker acting on behalf of a third party in an agency and or principal capacity but in neither scenario do they have legal title to the securities. FATCA does not seem to contemplate the issues arising from the sale of securities with a Broker executing trades. The Broker is not a client of a custodian, bank or other financial intermediary, this seems to implausibly imply that the clearing agent would therefore be required to monitor the FATCA compliance status of all Brokers operating on its exchange, and apply FATCA withholding to non compliant brokers.

These scenarios are purely illustrative of the difficulties presented by the current rules and are by no means exhaustive. Far more complicated permutations exist.

Second, the settlement systems currently in place generally have no provision for withholding tax to be applied to settlement proceeds. The imposition of such a withholding tax would create significant structural implications. It would also potentially invalidate the possibility of intra-day netting (due to the varied withholding tax rates that would potentially have to be applied) thus creating significant settlement risk and liquidity concerns across the wider market, with the attendant risks for financial stability. The likelihood of failed trades and 'buy ins', covered in more detail below, would increase significantly.

Similar issues to those noted above in relation to settlement systems could also arise where a CSD has an automated system routine to correct dividend payments that have been received by the wrong party due to transactions taking place around the dividend record date. Using the above example, this could happen where A initially receives a dividend to which C is actually entitled or vice versa.

In today's environment, brokers who execute trades on behalf of investors have no knowledge of the investors' FATCA status. As the final settlement will potentially be affected by FATCA withholding, worldwide brokerage firms will potentially need access to the participating FFI status and where applicable PPP information of every FFI around the globe. In order to avoid distortion in the pricing of any securities settlement transaction it will be vital that this information is made available in a single source. If any distortion takes place trade matching cannot take place, trades will fail and the Settlement Discipline Regime (SDR) of the affected market will be implemented.

The SDR is typically run by a CSD whose aim is to achieve the timely matching and settlement of securities transactions. It imposes a framework of sanctions on CSD participants. The sanctions require CSDs to monitor the performance of their participants during the lifecycle of a transaction.

If a trade fails the sanctions are imposed on the CSD participants. Such sanctions vary in each jurisdiction but generally include penalties and fines. Failed trades will generally result in a 'buy-in'.

Buy-ins arise when the buyer gives instructions to a CSD official to 'buy in' the stock required. The official announces the quantity of stock, and the purpose for which it is required, and whoever sells the stock must be prepared to deliver it immediately. The original seller has to pay the difference between the two prices, if the latter is higher than the original contract price.

In an illiquid market the premium will be hugely inflated and the costs unquantifiable.

Conclusions

Many of the parties involved in the settlement process would be unlikely to be in a position to assume participating FFI status, thus exacerbating the incidence of withholding.

To comply with FATCA a complex system would need to be implemented across the global markets to enable identification of the transactions and participants to which FATCA should be applied. Extensive PPP information would need to be gathered by every participating FFI. In the absence of a global reference tool, each would need to employ additional staff dedicated solely to the gathering, updating and maintenance of the PPP data on a rolling basis. This would seem wholly disproportionate to the objectives of FATCA.

Information systems and international messaging systems across markets would require radical modification. Common standards would be essential to minimise the disruptive effects to bank and securities settlement transactions across the globe.

Extensive and expensive changes to existing systems would be required. Tax withholding modules would need to be built to cope with a huge range of potential withholding tax rates.

If tax was applied as a separate payment to avoid disruption to the settlements system this would still create unacceptable market risk.

On a broader scale, the introduction of this tax on settlement proceeds from global securities market trades will ultimately affect the trading behaviour of investment managers and could negatively impact liquidity. This will in turn impact broker and custodian revenues.

This Annex has not touched on the specific legal concerns that may prohibit the application of FATCA withholding in specific circumstances which have been identified in many other comment letters. To the extent it is not clear that an FFI can withhold on passthru payments it makes to a non participating FFI (NPFFI) without risk of challenge, the FFI is exposed to either liability to the NPFFI or a breach of local laws. These concerns together with the interconnectivity of the financial markets give rise to real legal and financial exposure to FFIs and investors.

It is not clear how the various financial institutions, market participants, regulators and their auditors will be able to respond to these issues.

Impact of FATCA on Domestic & International Payment Systems

This Annex outlines the fundamentals of the domestic and international payments arena and contemplates how the application of FATCA rules will affect these systems. Certain terms used in this document are further defined in the end glossary.

Overview of Domestic & International Payment Systems

The domestic and international payments infrastructure is at the heart of each country's financial sector. Typically:

Each country has a real time, typically high value or urgent, payment channel (or system) which handles instant interbank payments. These channels tend to be used for high value purchases or for interbank settlement payments (e.g., Fedwire/CHIPS in the US or CHAPS in the UK) and can be used for domestic or cross-border payments.

These are supplemented by one or more low value payment channels which handle high volume, low value or not urgent domestic payments. Payments are normally settled over a number of days (e.g. ACH payments in the US, or bacs in the UK).

International payments are sent and received via the global SWIFT network to which almost all banks belong.

Each country's central bank facilitates the processing of transactions by providing net settlement position for each bank that allows the banks to aggregate all in flows and out flows to another bank, and settle only the difference (as opposed to every transaction). There are also gross systems which settle each transaction in real time.

With the exception of SWIFT and to a lesser extent SEPA payments, each country's payment systems are proprietary and have no commonality to other countries' payment systems.

Generally, when making a domestic payment across any payment channel, the originator of the payment would simply specify the originating account, the beneficiary name, their bank account number and the bank's sort code or identifier. No additional information is required. A limited narrative field is usually available which may be used if the originator wishes to add any details.

Many payment channels allow originators to submit payments directly into the channel as opposed to through their bank. For example an entity such as a pension fund, which would have a large number of relatively small payments to make on a recurring basis, would connect directly to the channel, thereby gaining operational efficiencies through connecting directly.

The Practical Impact of Implementing FATCA

The impact of FATCA is far reaching throughout most financial institutions.

Most business areas are significantly impacted with major changes required across key technology platforms.

We group the changes into three areas of impact:

Implementing Existing & New Customer System Changes

Implementing FATCA Reporting System Changes

Implementing FATCA Withholding System Changes

Implementing Existing & New Customer System Changes

In order to capture and store the status of a customer with respect to FATCA, client onboarding systems will need to record and hold additional details. For example, if a customer is identified as potentially being 'in scope' for FATCA, the FFI would be looking to hold a copy of their W-9 or W-8BEN form and record information from those forms (e.g. Taxpayer Identification Number) as part of their client record. In addition, the status of FFIs (participating/non-participating) would have to be confirmed.

Holding this extended level of detail, for both retail and business customers will require a significant number of applications to be changed across multiple business lines and across all countries.

A new application will most likely need to be built to manage the identification of potential 'in scope' customers and to then help manage the workflow around the correspondence and follow ups with those customers.

Logistically, this will be challenging due to the large number of applications that are in scope to be changed. These applications will be made up of internally developed as well as third party applications. Third party application changes may prove particularly challenging as vendors will have other regulatory and revenue generating priorities. Relevant changes will not be restricted to the payment systems themselves or even to the financial institutions. In many cases, customers with direct interface to payment systems and their software providers will be similarly impacted.

Implementing FATCA Reporting System Changes

As part of the FATCA requirement, FFI's will be required to provide a number of reports to the IRS. For example, providing the annual report on 'in scope' clients, along with their balance information.

Banks typically have a broad number of products across multiple countries. The client information that resides in these product processors is not usually aggregated at a global level.

As such, banks will have a choice of either creating reports from each of these distributed systems or consolidating this information into one new application that generates the required level of reporting (in an automated and repeatable fashion).

Either way, the changes are significant and will require extensive analysis and development work.

In many countries, providing this type of reporting, will contravene local data privacy laws.

If through a multi-lateral agreement, the US was able to join the European Savings Directive, FFI's could leverage the existing European Savings Directive reporting capability. This would help accelerate implementation and reduce the legal challenges, complexity and effort of building a new reporting solution (at least for EU countries).

Implementing FATCA Withholding System Changes

From a payments perspective, the implementation of a withholding tax is extremely difficult if not impossible for a number of operational reasons (in addition to the legal impediments to which the BBA has previously referred).

To explain the operational difficulties, it is necessary to consider each of the two withholding requirements:

1. Withhold on non participating Foreign Financial Institutions (NPFFIs).
2. Withhold on recalcitrant customer accounts.

1. Withholding on Non Participating Foreign Financial Institutions (NPFFIs).

Withholding on NPFFI's raises a number of challenges that make implementation of the requirement very difficult:

1. In order to assist participating FFIs to determine which FFI's are non participating, the IRS will need to include in the list of NPFFI's it intends to publish, the global payment channel membership and identification details of such NPFFIs.

Each NPFFI will have multiple presences in potentially hundreds of payment channels (such as SWIFT or bacs). Participating FFI's will need to have a reliable source of these details in order to automatically apply withholding.

As an example, a typical FFI is likely to have many legal vehicles spread across multiple countries presenting very complex legal entity relationships. Global financial regulators, including the US Treasury, acknowledge this complexity and are therefore addressing this issue through the work to establish a single global system for uniquely identifying legal entities to financial transactions.

Precise identification of a legal entity using a Legal Entity Identifier (LEI) appears to be central to the effective implementation of any withholding where there is a strong requirement to be able to identify the payment systems and payment channel IDs to each separate LEI.

The logistics of identifying every legal vehicle and in which payment channels the legal vehicles have a presence is an enormous challenge. This would be complicated by the daily change around new legal vehicles joining the payment channels or NPFFI's becoming compliant and therefore being removed from any recalcitrant FFI list.

Considering the complexity of the information required, it would be unrealistic to assume that participating FFI's would be capable of collecting this information. Without a reliable and up-to-date central source of information, participating FFIs are at risk of applying withholding in error. In addition, and particularly in the context of the payment systems, participating FFIs are also likely to have to rely on information contributed by other participants in the payment system, not all of which will be financial institutions. The implications of wrongful withholding could be extremely serious in terms of legal and financial exposure for the participating FFI. The risks of such exposure will have a material impact on the institution's decision of whether or not to become a participating FFI.

2. If the NPFFI information was available, then all payment processing engines would need to be modified so as to screen all outbound payments against the NPFFI list.

This would be highly complex as every payment channel typically offers different products, each of which would need to be changed. This would be an extremely onerous undertaking. In addition, this introduces an additional step in the payment processing life cycle, resulting in increased transaction processing duration, complexity and risk. The increased processing duration, may put a participating FFI outside the payment channel Service Level Agreements and create tensions in terms of the ability to settle all payments within the payment channels' scheme rules, which in turn could cause financial and regulatory issues.

3. As indicated in the payments overview section, many payment channels allow customers to submit payments directly into the payment channel. In this scenario, none of the payments would be screened and payments could be destined for NPFFI's. Without payment channels all over the world making changes to their operating model, it would not be possible to screen these payments.
4. Within the European Economic Area, the Payment Services Directive prohibits banks from applying charges without the customer's agreement. If a participating FFI were to apply the tax to a payment to an NPFFI, then the participating FFI would bear the liability and damage claims.
5. Payment channels allow for return and reject payments due to a number of reasons (e.g., incorrect payment details). In the event of a returned payment that had been withheld against, the FFI would need to credit the originator with the full value.
6. Customer Service and Operations could be overwhelmed by customers querying payments made to NPFFI's, where the full amount has not been received by the beneficiary. The FFI would also most likely receive a significant number of calls from the NPFFI beneficiaries which would add to the burden and create significant reputational risk.

Considering many of these payments to an NPFFI will be for wages, pensions and social security payments, the implications of disruption could be profound and lead to significant political, social and economic consequences for domestic governments.

7. If an FFI is deemed to be non compliant and other banks are compliant and applying withholding on the NPFFI, then it is likely that the NPFFI would get into distress after a short period of time. It would soon become public knowledge that any payments to the NPFFI will be withheld against. This could lead to an erosion of confidence in the NPFFI.

Additionally, the possibility for an erroneous application of the PPP on a

participating FFI and/or the application of an unexpected rate on a NPFFI (due to the difficulties in calculating this outlined above) could increase uncertainty over the ability of a financial institution to meet their obligations.

Exponentially, this could lead to systemic market risk, resulting in an unpredictable cascade effect that is contrary to international efforts to establish financial stability.

In the event that the US enters into a multilateral agreement along the lines of the European Savings Directive, with the European Union, then there would not be any European NPFFI's as they would all be mandated by local law to comply. This is our recommended approach. Similar bilateral agreements are recommended for countries outside of the ambit of the European Savings Directive.

2. Withholding on Recalcitrant Customer Accounts.

Withholding on recalcitrant customers introduces a number of challenges that cannot be easily overcome:

1. Payment messages (e.g., bacs, Chaps and SEPA) do not include any identifier, and in certain cases functionality, to allow for the automated determination whether a payment is US sourced or whether it is an income or capital payment.

In order to allow the payments to be screened, all payment channels, domestic and international, would need to extend their payment messages (they typically have multiple) to include a number of additional fields such as:

If Payment is US Sourced

If Yes – what percentage is US Sourced

Payment Type: e.g., Capital, Interest, Salary, etc

If Withholding has already been applied assuming prior withholding on a single payment chain is creditable (in order to prevent multiple withholding on a single payment)

Ultimate beneficiary

Realistically, it is not practical to change all the global payment channels and make these fields mandatory. Even if implemented, the participants in the system would be reliant upon the originators to correctly convey the relevant data.

2. If the payment channels could make those changes, it would require significant changes for the banks and the operators of payment systems, as their end to end payment transaction flows would be impacted. Typically a transaction will traverse multiple systems as it is being processed. All these systems would need to be upgraded to carry the additional information. This would require extensive development change and testing.
3. The points at 3 to 6 of the previous section would also apply in this context.

Conclusions

The FATCA legislation can be broken down into three broad requirements:

Extending client on-boarding systems to capture the required US indicia

Withholding on recalcitrant customers and non participating FFI's

Reporting to the IRS on US customers and 'in scope' entities

Whilst the client on-boarding changes result in broad technology impact across a large number of applications, it is believed that the actual change can be ultimately delivered. Overall implementation timeframes may need to be extended, depending on the number of customers, and thereby systems, impacted.

Customer withholding is not currently implementable from a payments perspective as structural changes would need to be made to all domestic and international payment channels that would provide the required level of detail to allow the identification of US source income and capital payments and given that many customers can submit directly into payment channels.

Equally, NPFFI withholding would need structural changes to payment channels in order to screen outbound payments as many customers can submit directly into payment channels. Perhaps a greater concern would be the impact to beneficiaries at the NPFFI that would be receiving reduced wages, social security and pension payments. The implications of disruption could be profound and lead to significant political, social and economic consequences for domestic governments. In addition, NPFFI withholding or erroneous withholding on participating FFIs could potentially lead to systemic market liquidity risk.

In the event that the US enters into a multilateral agreement along the lines of the European Savings Directive, with the European Union, then there would not be any European NPFFI's as they would all be mandated by local law to comply. This is our recommended approach. Similar bilateral agreements are recommended for countries outside of the European Savings Directive.

In terms of FATCA reporting, banks typically have a broad number of products across multiple countries. The client information that resides in these product processors is not usually aggregated at a global level. As such, banks will have a choice of either creating reports from each of these distributed systems or consolidating this information into one new application that generates the required level of reporting (in an automated and repeatable fashion).

In many countries, providing this type of reporting, will contravene local data privacy and banking secrecy laws. Again, if a multilateral agreement along the lines of the European Savings Directive was agreed, subject to local legal and regulatory approval, the Savings Directive reporting could be extended to provide the required level of reporting.

Glossary

ACH - Automated Clearing House is an electronic network for financial transactions in the United States.

bacs - Bankers' Automated Clearing Services is a United Kingdom scheme for the electronic processing of financial transactions

CHAPS - Clearing House Automated Payment System offers same-day sterling fund transfers

CHIPS - The Clearing House Interbank Payments System is the main privately held clearing house for large-value transactions in the United States

Fedwire - A Real Time Gross Settlement Funds Transfer system operated by the Federal Reserve Banks that enables financial institutions to electronically transfer funds

SEPA - Single Euro Payments Area is the area in which individuals and businesses can make and receive card and electronic payments in euro, across Europe

SWIFT - Society for Worldwide Interbank Financial Telecommunication operates a worldwide financial messaging network which exchanges messages between banks and other financial institutions