Are European banks abnormally profitable in tax havens? Why EU Tax Observatory's study is misleading

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Executive summary

EU Tax Observatory claims that European banks are abnormally profitable in tax havens. However, their data does not provide evidence of significant profit shifting by banks. By comparing country-by-country reports to other data, we find that

- HSBC in Hong Kong alone generates 43% of the total tax haven profits of 36 major European banks
- EU Tax Observatory does not correct for the differences in GDP per capita between tax havens and other countries
- Economies of scale are a better explanation for bank profitability than tax rates

Introduction

EU Tax Observatory recently published a report titled *Have European banks left tax havens? Evidence from country-by-country data*[1]. The authors analyzed the profits of 36 systemic European banks over the period 2014-2020. Banks have to publish their turnover, number of employees, profits, and corporate income taxes paid per country[2]. Using these *country-by-country reports*, EU Tax Observatory identified 17 "tax havens". These havens are jurisdictions where banks booked a high profit per employee and paid an effective tax rate below 15%.

They find that

> *"The main European banks book EUR 20 billion (or 14% of their total profits) in tax havens each year. This percentage has been stable since 2014 despite the introduction of mandatory information disclosure.* ***Bank profitability in tax havens is abnormally high: EUR 238 000 per employee, as opposed to around EUR 65 000 in non-haven countries.*** *This suggests that the profits booked in tax havens are primarily shifted out of other countries where service production occurs."*
>
> (EU Tax Observatory[1], page 3, emphasis added by Finrestra)

In this report, we show that **while these aggregate numbers are correct, they are also misleading**. Banks' annual reports do not support EU Tax Observatory's implication "that the profits booked in tax havens are primarily shifted out of other countries where service production occurs." Rather, banks are most profitable in high-income countries where they can keep costs low.

Like the authors of the EU Tax Observatory study, we look in depth at two banks: UK-based HSBC and French Société Générale.

Case study 1: HSBC

HSBC accounts for about 10% of the turnover, profits, and employees of the 36 banks (EU Tax Observatory[1], page 24). Over the period 2014-2020, HSBC made on average EUR 8.6 billion[3] profit per year in Hong Kong (Figure 1). **HSBC's Hong Kong profits account for 43% of the EUR 20 billion annual profits in tax havens** reported by EU Tax Observatory.

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[1] Giulia Aliprandi, Mona Barake, Paul-Emmanuel Chouc, [EU-Tax-Observatory-Report-n°2-Have-European-banks-left-tax-havens-Evidence-from-country-by-country-data.pdf (taxobservatory.eu)]() (September 2021)

[2] See [Article 89 of the Capital Requirements Directive IV]()

[3] Source: HSBC Holding plc Country-by-country reports. Amounts in USD were converted to EUR using the end-of-year FX rates according to the [ECB](). On average, HSBC made an annual pre-tax profit of EUR 287,151 per employee in Hong Kong.

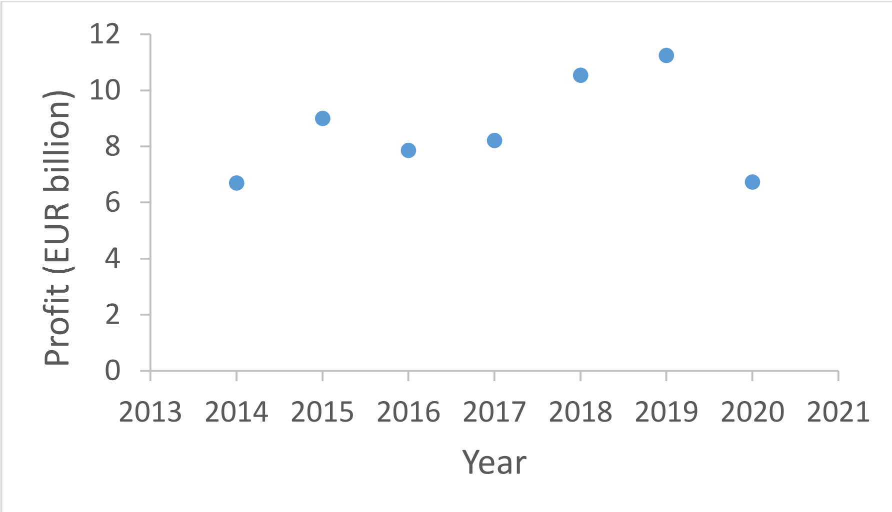

Figure 1: Pre-tax profit of HSBC in Hong Kong from 2014 to 2020. Average annual profit was €8.6 billion.

How can the activities of HSBC in Hong Kong be so profitable? Profits come from turnover minus costs. Figure 2 shows HSBC's turnover per employee in the five countries where it has most employees. There is a **positive correlation between GDP per capita and turnover per employee.** High-income countries have productive, capital intensive economies with a high demand for financial services. **Tax havens** like Hong Kong **have a higher GDP per capita** than most non-tax havens. **Therefore, banks are more profitable in tax havens**, assuming similar cost ratios.

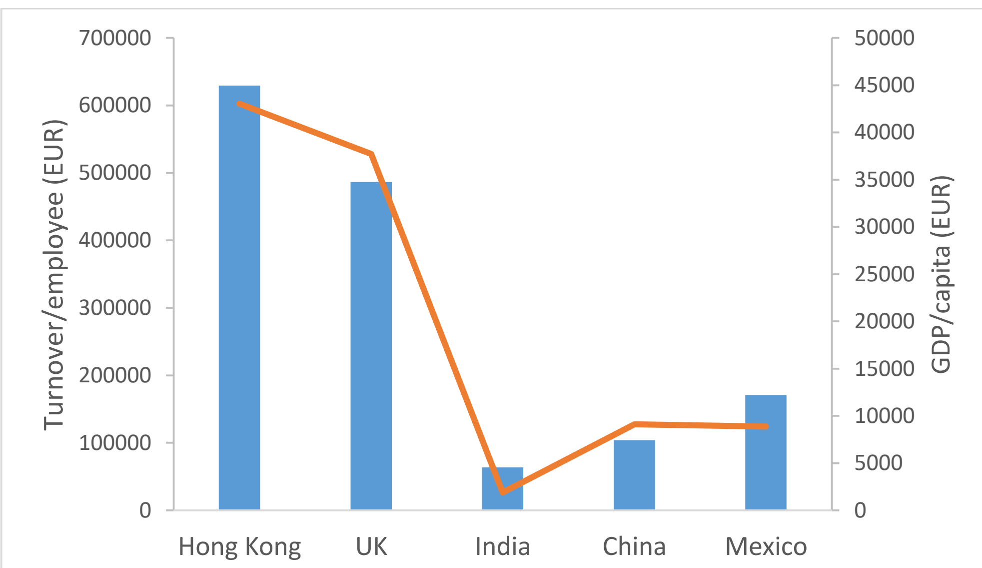

Figure 2: Turnover/employee (blue bars) and GDP/capita (orange line) in Hong Kong and the four other countries where HSBC has most employees. Data: HSBC 2019 country-by-country report, World Bank.

Moreover, HSBC's subsidiaries have a 28% market share for loans, 45% for credit cards and 54% for mutual funds[4] in Hong Kong. The bank therefore likely benefits from significant economies of scale, keeping its operating costs low.

Case study 2: Société Générale

Société Générale (SocGen) also illustrates the fact that multinational banks tend to have lower turnover per employee in lower-income countries (Figure 3).

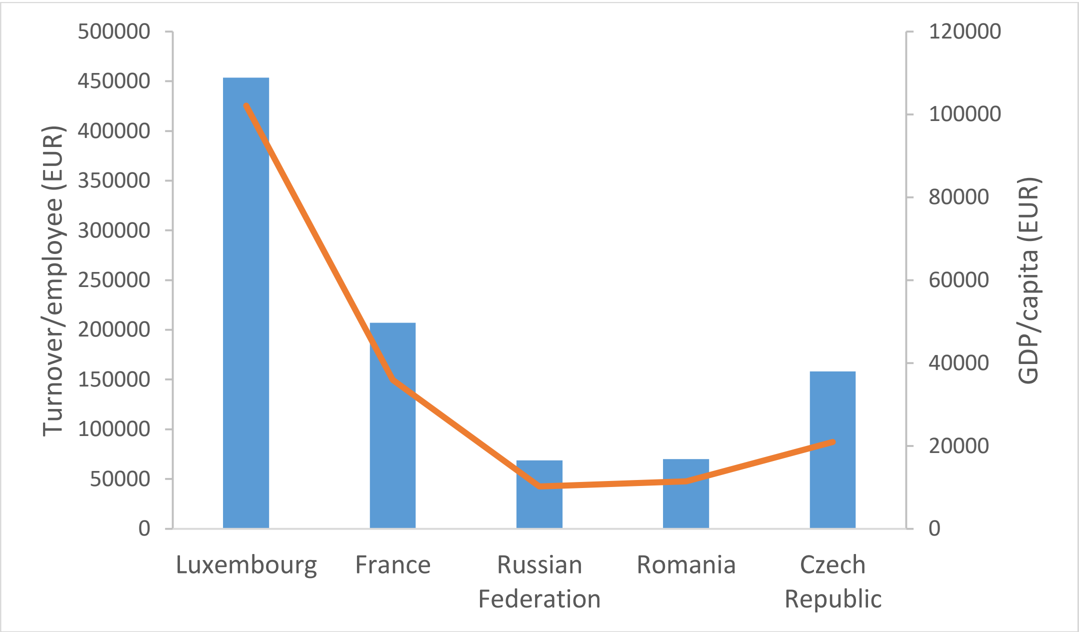

Figure 3: Turnover/employee (blue bars) and GDP/capita (orange line) in Luxembourg and the four[5] countries where SocGen has most employees. Data: Société Générale 2019 annual report, World Bank.

EU Tax Observatory remarks that Société Générale has far more employees in France than in the Czech Republic or in Luxembourg (EU Tax Observatory[1], page 30). Yet SocGen's total profits over the period 2014-2020 in these three countries are in the same order of magnitude (Figure 3). In fact, if EU Tax Observatory had not excluded years with negative profits, the total profits in France would have been lower than those in the Czech Republic and Luxembourg.

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[4] https://www.hsbc.com/-/files/hsbc/investors/hsbc-results/2019/annual/pdfs/hsbc-holdings-plc/200330-asia-factbook-fy19.pdf

[5] Société Générale has more employees in India than in the Czech Republic. However, most of the Indian staff is assigned to a shared services center. The income of this shared services center is not booked as net banking income in the country-by-country report.

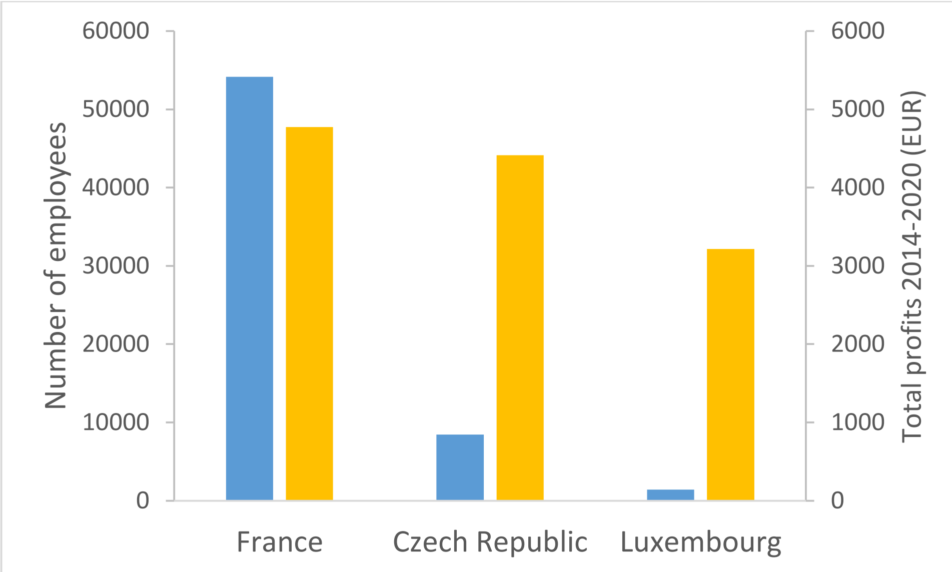

Figure 4: Average number of employees (blue) and total profits (yellow) of SocGen over the period 2014-2020 in France, the Czech Republic and Luxembourg. Negative profits (=losses) were excluded, similar to figure 3.4.6 in the report of EU Tax Observatory.

Why are Luxembourg and the Czech Republic far more profitable than France?

In Luxembourg, Société Générale offers financial services to corporate clients, institutional investors and high-net-worth individuals. Bank can generate more profit per employee from these activities than from retail banking. The **tax havens** in the report of EU Tax Observatory **are also international financial centers where banks offer high-value-added services**.

However, the Czech Republic is no international financial center. Similar to France, SocGen's Czech subsidiary Komerční banka serves retail clients. According to EU Tax Observatory,

> *"The use of the Czech Republic as a tax destination in the case of Société Générale, indicates that banks might take advantage of other European countries with a relatively low corporate taxation, beyond the usual list of tax haven countries, in order to shift their profits and resources accordingly."*
>
> (EU Tax Observatory[1], page 29)

But they do not present any evidence that profits are shifted to the Czech Republic. In fact, the annual report of Komerční banka explicitly states that its "income is primarily – more than 98% (2019: more than 98%) – generated on the territory of the Czech Republic."[6]

So what does explain the higher profitability of the SocGen in the Czech Republic, although it has a lower income than in France (Figure 3, Figure 4)?

The answer is lower costs.

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[6] KB 2020 Annual Report, page 128

This fits a general pattern. European countries with **low profits per employee** in the study of EU Tax Observatory (Figure 2.3.1, page 8) also tend to have many bank branches per inhabitants (Figure 5). A high density of branches indicates **overcapacity in the banking market**.

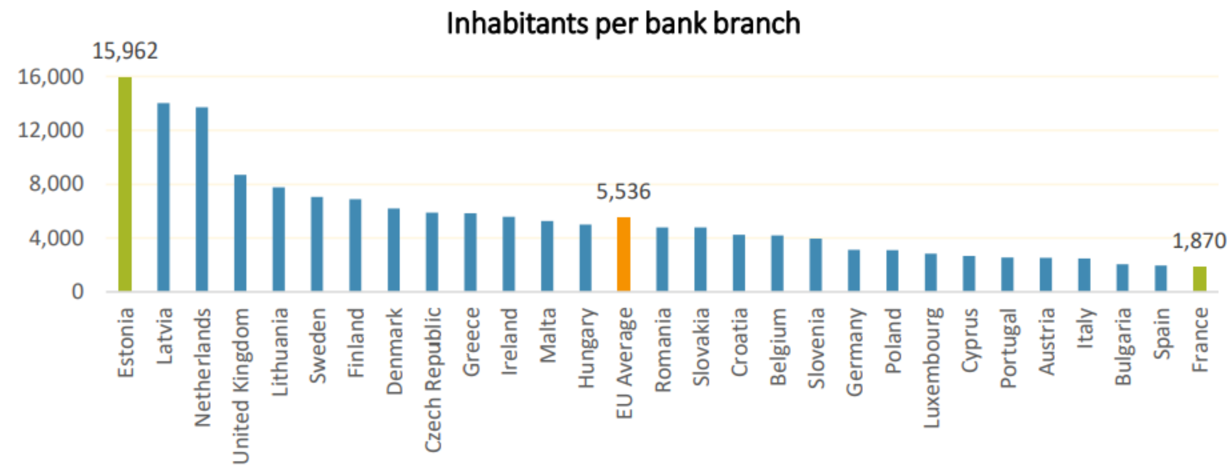

Figure 5: Number of inhabitants per bank branch. Source: European Banking Federation.

Banks in countries like Sweden and the Czech Republic are cost-efficient (Figure 5). For example, Swedish Handelsbanken reported an average annual profit per employee of EUR 213,108 in its home country[7]. This profitability cannot be explained by taxes, as Handelsbanken paid an effective tax rate of 24% in Sweden.

In contrast, France, Spain, Italy and Germany are much less cost-efficient[8] (Figure 5). The latter four countries are home to 19 of the 36 banks in the study of EU Tax Observatory. These 19 banks employ 61% of the total labor force of the 36 banks (EU Tax Observatory[1], pages 39-40).

Rather than exposing an abnormally high profitability in tax havens, the study of EU Tax Observatory illustrates the **low profitability of European banks due to overcapacity**.

[7] Calculation based on the country-by-country reports of Handelsbanken in the period 2014-2020.
[8] Profits in the headquarter country are also affected by impairments in investments in foreign subsidiaries. For example, while HSBC UK Bank plc is profitable, HSBC's country-by-country reports indicated losses in the United Kingdom for all years in the period 2014-2020.

Conclusion

EU Tax Observatory claims that “bank profitability in tax havens is abnormally high” and suggests “that the profits booked in tax havens are primarily shifted out of other countries where service production occurs” (EU Tax Observatory[1], page 3).

These claims are misleading.

The study does not take into account that banks have a lower profitability in non-tax havens because

- turnover and profit per employee is lower in poorer countries
- many high-income European markets are overbanked
- tax havens are high-income economies with high-added-value financial services

Furthermore, of the EUR 20 billion profit in tax havens, 43% is due to HSBC in Hong Kong.

About Finrestra

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