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CONGRESSIONAL TESTIMONY

The Financial Crisis Responsibility Fee: The Wrong "Solution"

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Good morning. I am David C. John, the Senior Research Fellow in Retirement Security and Financial institutions at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

First allow me to clarify a bit of terminology. The proposed “Financial Crisis Responsibility Fee” is a tax on major financial entities, pure and simple. If it were a fee, it would be assessed on those who caused the losses to the TARP program. As I will discuss in a moment, CBO estimates show that losses from the TARP program for the most part come from other programs and industries. It is also important to remember that while the top banks all received money from TARP, the largest of them received it under duress at the insistence of former Secretary Hank Paulson. There is a bit or irony that certain banks were forced to take taxpayer dollars and are now taxed for taking it.

The “fee” is about revenue raising today

Willie Sutton would be proud. When President Obama announced the details of the original version of his Administration’s plan, he said, “We want our money back, and we are going to get it.” The Treasury desperately needs revenue to reduce the nation’s massive budget deficits. If the Administration wanted to be candid about their reasoning for placing a “fee” on big banks, they would quote famed bank robber Willie Sutton, who, when asked why he robbed banks, purportedly answered, “Because that’s where the money is.”

Taxpayers can be justifiably angry with financial institutions that took huge amounts of taxpayer dollars and are paying huge bonuses for some of the very behavior that contributed to the 2008 financial crisis. However, this new tax has nothing to do with that situation, and its enactment would not discourage such bonuses in the future. Nor would it change the way that financial institutions operate.

The case for believing that the proposed tax has more to do with raising revenue than for having anything to do with TARP is reinforced by its timing. Section 134 of the Emergency Economic Stabilization Act of 2008 required the president to propose a way to repay TARP’s losses in 2013, and not in 2010. Obviously, we will have a better idea of those losses then than now, and the major companies that caused those losses, may be able to repay their share of the losses.

How the “fee” would work

The structure of the proposed “fee” has changed since it was first announced back in January. As announced, the new bank “fee” would apply to all financial institutions with more than $50 billion in assets. This includes about 50 firms that either own insured depository institutions or are broker-dealers. About half are banks, with the rest being insurance companies and other types of financial institutions. About 10–15 are U.S. subsidiaries of foreign firms, the rest being domestic financial institutions. A key factor

is that the tax would apply to only the US assets of foreign firms, but it would apply to worldwide assets of US firms.

The original structure would have required each affected financial institution to pay an annual fee equal to 0.15 percent of its liabilities. This would be calculated by taking the firm's total assets and subtracting both its Tier 1 capital and any deposits that are insured by the FDIC. Thus, firms that have high levels of insured deposits, such as those with extensive bank branch networks, would pay less than those that rely largely upon borrowed money and other assets. About 60 percent of the revenue from the fee is expected to come from the 10 largest financial institutions.

Now, however, the Administration proposes a sliding scale whereby riskier assets would result in a higher fee, while lower risk assets would cause a lower fee. A financial institution would pay a fee that reflects a blend of its asset portfolio rather than a flat fee. This could cause some interesting problems.

First, since commercial loans have a higher risk weighting than other types of assets, this fee appears to contradict Treasury Secretary Geithner's May 4 statement that "This fee is designed to limit the risk of any adverse impact on lending." Quite the contrary, the fee may have the result of discouraging certain commercial loan activity if the transaction is marginally profitable. Although smaller banks do make significant loans to large and small business, the result is likely to be a slight reduction in the supply of loans to commercial borrowers.

Second, the proposed structure only seems to apply to the way that banks are regulated, as there is no comparable standard that applies to insurance companies and other types of financial institutions. Further, it would make little sense to tax what is effectively another arm of the government, Fannie Mae and Freddie Mac, unless and until they or substantial portions of them are privatized. Otherwise, the net result appears to be nothing less than increasing the federal bailouts that both have received.

Third, and most important, the new structure clashes with the inevitable new capital standards that are to be applied to financial institutions. Given that for banks, the same structure for determining the proposed tax payments will also be used to determine increased capital standards, there is a very real question about how the tax will interact with capital requirement.

Will the combination of the two serve to over increase the impact of the two on certain asset classes? Will there be any coordination of the two at all, or will two separate agencies determine tax levels and capital? If there is coordination and tax payments are subtracted from the new capital standards, the net result would be to take money that could be used to provide a higher safety margin for the bank, and transfer it to the Treasury, thus reducing the safety level and making future bailouts more likely.

Details are very important. These are questions that can be answered, but not until the details of how this tax will be set and collected are released and studied. Until then, the committee should delay taking any action.

Additional problems with the proposed "fee."

Although the Treasury Department claims that the new "Financial Crisis Responsibility Fee" is intended to recapture losses from the TARP bailout fund, the reality is very different:

1. First, with one exception, the tax does not apply to the entities that caused most of TARP's losses. As of March 2010, CBO estimates that TARP will lose money on its bailout of AIG, auto companies GM and Chrysler, and the Administration's program to help people refinance mortgages. TARP's other programs actually showed a small profit. Together, CBO estimates that these three will result in $92 billion of the program's total $109 billion loss. (Programs benefiting Citibank and other banks are likely to result in a $7 billion profit to the government.) It is possible that other TARP programs aimed at the financial sector will sustain losses in the future, but that is far from certain. Congress is certainly not going to make those individuals who benefitted from the mortgage refinancing plan repay the losses of that program. The fee would not apply to Chrysler or GM, either. The only entity that caused a loss that will be taxed is AIG, but the fee would just make it harder for the firm to repay its bailout. Until that firm has turned around, taxpayers will get no benefit from AIG being taxed.
2. Second, the new tax is not designed just to recapture some of the profits that financial institutions made last year. Since it is styled as a "fee," it would apply to both profitable and unprofitable financial institutions. This structure would make it even harder for undercapitalized financial institutions to rebuild their financial strength and increase the risk of failure if the economy goes back into recession.
3. Third, despite claims that the tax would be collected only until TARP deficits are "paid for" (about 10 years), history suggests that the fee will become a permanent tax upon large financial institutions.

"Because that's where the money is"

When Congress passed the TARP bill in 2008, it required the Treasury to find a way to recoup any losses by 2013. The time lag was designed to allow Treasury the opportunity to see how the program had performed and to assess those who caused the losses. While the Obama Administration claims that it is fulfilling this requirement three years early, it is really just seeking a new revenue source to try to pay for some of the massive deficits caused by their spending programs.

On balance, the new "fee" bears a striking resemblance to the old motivational technique that called for the beatings to continue until the morale improves. While Administration officials urge banks and other firms to start lending again, the new tax would discourage them from taking risks. The "fee" would apply regardless of a firm's

profitability and would make it even harder for firms recovering from earlier losses to rebuild the capital needed to back up lending.

This is the wrong approach to reducing the swollen deficit and would inevitably cause more problems than it solves. It is a bad idea being used to score political points and should be dropped.

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