

May 4, 2010

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*Testimony of*

**James Chessen, Ph.D.**

*On Behalf of the*

**AMERICAN BANKERS ASSOCIATION**

*Before the*

**Committee on Finance**

**United States Senate**



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Chairman Baucus, Ranking Member Grassley, and members of the Committee, my name is James Chessen. I am the Chief Economist for the American Bankers Association (ABA). I am pleased to be here today representing ABA to discuss the Administration’s proposed “Financial Crisis Responsibility Fee” (or “bank tax”). The American Bankers Association represents banks of all sizes and charters and is the voice for the nation’s \$13 trillion banking industry and its two million employees.

There is no question that the banking industry – indeed, the entire country – benefited from the extraordinary actions taken by policy makers in the fall of 2008. It was a time of considerable stress and required decisive action to stop the growing anxiety and uncertainties in markets worldwide. Unfortunately, the purpose of the programs implemented to deal with the crisis were not well articulated, and often changed as new issues arose. This was particularly the case ever since the Troubled Asset Relief Program (TARP) was authorized under the Emergency Economic Stabilization Act (EESA). Originally, the TARP, as the name implies, was for the purchase of troubled assets. Then in a matter of days after enactment, everything changed and the policy shifted to putting capital in healthy, viable banks (under the Capital Purchase Program). The fact that this was a program for generally healthy banks – ***and one that promised a significant return to the government*** – was lost on the public, and worse, often completely mischaracterized as a bailout.

As the economic recession took hold, the use of TARP funds expanded well ***beyond*** providing capital to the banking industry. ***It became a ready source of funds for dealing with the bankruptcies of non-banks, including General Motors, Chrysler, and AIG.*** And yet, while the program was expanded to non-bank firms – and is where the losses are concentrated – the EESA requirement that losses be recouped from the financial industry remained. ***Had the TARP been***

*limited to the banking industry, there would be no losses on that program.* In fact, President Obama said in a speech at the Brookings Institution last December that “...assistance to banks, once thought to cost the taxpayers untold billions is on track to actually reap billions in profit for the taxpaying public.”<sup>1</sup> According to Herb Allison Jr., Assistant Secretary for Financial Stability, as of April 16, 2010, “TARP has received \$19 billion in dividends and warrant proceeds from banks.”<sup>2</sup> Moreover, according to SNL Financial, the bank-TARP programs have earned an estimated 8.5 percent profit for taxpayers – a very good return by any measure.<sup>3</sup>

Besides the unfairness to pay for losses outside the banking industry, the bank tax proposed would have significant unintended consequences. Payments of \$90 billion to \$117 billion (as proposed) mean that \$90 billion to \$117 billion cannot be used directly for lending. But even that does not begin to capture the impact on lending as \$1 dollar in capital supports up to \$10 dollars of new loans – thus the total impact could well be nearly \$1 trillion in foregone credit.

Finally, while the bank tax has direct, and severe, consequences for large institutions, it has a broader impact on the smaller banks as well. Because the proposed tax covers non-deposit liabilities, it will affect how large banks fund themselves. This will inevitably alter the economics of *all* bank-funding markets, including the deposit market, the federal funds market, the pricing of Federal Home Loan Bank advances, and the short-term Repo (repurchase) market – which will raise the cost of funding loans for community banks. Thus, the tax burden will not be limited to the largest banks, but will be felt by smaller banks as well. Ultimately, it is the owners and borrowers, particularly small business borrowers who are often financed by local community banks, that end up paying for the tax.

It is for these reasons that the ABA is opposed to this bank tax or any other fee targeted at the financial services industry. In the remainder of this testimony, I would like to elaborate on three key points:

- Taxpayers will make a profit on every bank-TARP program;
- The bank tax will have significant unintended consequences; and
- Large banks are directly affected, but smaller banks will also feel the ripple effects.

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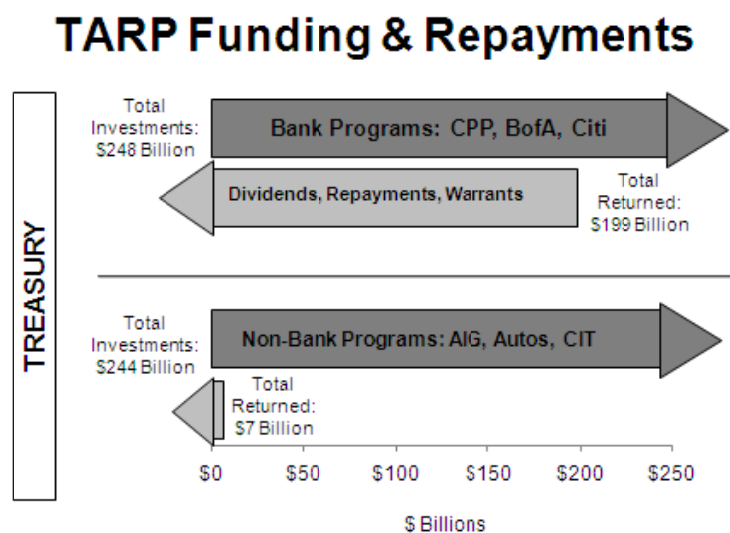
<sup>1</sup> Speech at the Brookings Institution, December 8, 2009, <http://www.whitehouse.gov/the-press-office/remarks-president-job-creation-and-economic-growth>

<sup>2</sup> Testimony of Herbert M. Allison Jr., Assistant Secretary for Financial Stability, before the U.S. House of Representatives Committee on Appropriations Subcommittee on Financial Services and General Government, April 22, 2010 <http://www.treas.gov/press/releases/tg653.htm>

<sup>3</sup> SNL Financial, “Treasury Reaps 8.5% from TARP,” April 1, 2010.

## I. Taxpayers Will Make a Profit on Every Bank-TARP Program

“Treasury now expects to *make* – not lose – money on the \$245 billion of investments in banks made through TARP programs,” said Herb Allison, Assistant Secretary for Financial Stability, before Congress just two weeks ago. He continued: “This is in sharp contrast to the original 2010 President's budget estimate that Treasury's investments in the banks would cost taxpayers \$79 billion. In fact, Treasury is being repaid at a very substantial rate.”<sup>4</sup> As the chart below shows, the real costs have come from non-bank firms.



Source: US Treasury, SIGTARP.  
Investment data through 4/8/2010 report. Dividends through 3/17/2010 report.

The Congressional Budget Office (CBO), in response to your questions Ranking Member Grassley, acknowledged that “For the most part, the firms paying the fee would not be those that are directly responsible for losses realized by the TARP.” The CBO went on to say that non-banks, such as AIG would be subject to the fee, but that “the fee would not apply to the automotive industry, which account for \$47 billion of the program’s estimated total cost of \$99 billion.”

The bank tax is an arbitrary tax on institutions of a certain size without regard to where the losses actually occurred or the payments made by banks which have provided a significant return to taxpayers. Moreover, setting a new tax to target an individual industry or set of firms within an industry sets a very bad precedent and violates the principle of fair taxation.

It is also noteworthy that the estimates of losses on TARP continue to decline every quarter. This is the reason why the EESA required a report on net TARP losses in **2013**, so that there would be

<sup>4</sup> April 22, 2010, Op. cit.

a clearer picture of the magnitude of losses and the source of those losses. It is certainly too soon to know the extent of losses from the auto companies or AIG, which is where the current losses are concentrated. Given the continual downward revisions in expected losses, any discussion of repayment is premature, and in fact, implementing such a tax now would likely lead to a greater withdrawal of resources in a shorter period of time than is appropriate or prudent, particularly given the anemic state of the economy.

## II. There are Negative Unintended Consequences of the Bank Tax

A tax of any kind on banks has consequences. The current proposal would apply a tax of approximately 15 basis points on non-deposit liabilities (except Tier 1 capital) of banks over \$50 billion in assets. This is expected to generate \$90 billion over 10 years and \$117 billion over 12 years.<sup>5,6</sup> This means that all non-deposit sources of funds (which many large banks rely on) – such as repurchase agreements, Federal Home Loan Bank advances, federal funds, and types of secondary capital, such as subordinated debt, would be relatively more expensive. The magnitude of the proposed bank tax – \$90 billion to \$117 billion – has both direct consequences, particularly on credit availability, and indirect impacts as banks alter their funding strategy to less costly sources.

### ➤ *The Bank Tax Will Reduce Credit Availability*

The most immediate – and clearly the most important – impact of the tax is that it immediately reduces the amount of funds available for lending. A \$90 billion to \$117 billion tax means a \$90 billion to \$117 billion reduction in credit. But the impact on credit goes far beyond this, as the tax drives investor dollars away from banks (to industries and firms with lower tax burdens). This is important because \$1 of capital supports up to \$10 dollars of loans. Therefore, with \$90 billion to \$117 billion in taxes sent to Washington over the next decade, ***it can mean up to \$1 trillion of loans not made.*** Moreover, this is more likely to impact small businesses – and the jobs they create – as they have fewer alternatives than large firms for funding their operations. Such a bank tax is completely counter to efforts to stimulate job creation in this tepid economy.

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<sup>5</sup> Banks already pay significant premiums to the FDIC on total domestic deposits.

<sup>6</sup> [http://www.whitehouse.gov/sites/default/files/financial\\_responsibility\\_fee\\_fact\\_sheet.pdf](http://www.whitehouse.gov/sites/default/files/financial_responsibility_fee_fact_sheet.pdf)

➤ ***The Bank Tax Drives Capital Out of the Banking Industry***

This impact on investors was dramatically illustrated when investor reaction to the announcement of the tax on January 12, 2010 destroyed \$18 billion in market capitalization of the largest banks.

Investors are keenly aware of the government's efforts to impose greater costs or regulations on banks and they react quickly to any news, moving money to other industries.

Moreover, the administration argues that a bank tax will be “deterrent against excessive leverage.”<sup>7</sup> Excessive leverage is a concern that is best met through direct and targeted means and not through a blunt instrument like the tax code. Even the mere suggestion of a bank tax has already driven capital away from banks, thereby hurting, not helping the ability of banks to raise capital levels. Moreover, because the tax applies to other forms of capital, such as subordinated debt and other Tier 2 capital instruments, investors will shun these instruments as well. This further hurts the ability of banks to attract capital to backstop their operations.

➤ ***The Bank Tax Will Severely Impact Short-term, Low-Risk Repo Market***

A very important and flexible market for managing liquidity is the repo, or repurchase, market. In repo transactions, securities are exchanged for cash with an agreement to repurchase the securities at a future date. The securities serve as collateral for what is essentially a cash loan and, conversely, the cash serves as collateral for a securities loan. Because repos are short-maturity collateralized instruments, they have strong linkages with securities markets. It is a low credit risk transaction, which means it trades with extremely small spreads. The 15 basis point bank tax would severely damage this market as it would represent a significant percentage increase in the cost. The artificially high bid-asked spreads would make cash instruments uncompetitive as trading vehicles and hedging tools. Driving activity away from cash trading would damage the liquidity of the Treasury and agency securities market and is clearly counter to assuring a steady market in traditional credit delivery channels.

➤ ***The Bank Tax Will Hinder the Federal Reserve's Monetary Policy Strategy***

Negative impacts for the repo market has serious consequences for the conduct of monetary policy as it will hinder the Federal Reserve's ability to use reverse repos as a monetary policy tool. The Fed will have to pay 15 bps higher for the transactions to offset the tax these covered banks would pay to entice them to participate. Federal Reserve Chairman, Ben Bernanke, noted this

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<sup>7</sup> <http://www.ustreas.gov/press/releases/tg506.htm>

concern in testimony on February 24, 2010: “And one issue which has arisen is that imposing the tax on nondeposit liabilities could have some negative consequences for the repo market.”<sup>8</sup>

➤ ***The Bank Tax Will Disrupt the Fed Funds Market***

The fed funds market is the primary interbank market, with transactions flowing from banks of all sizes. Large banks, often the purchaser of funds from smaller banks, would be far less willing to buy funds if the tax were applied to the purchase. They would only be willing to pay 15 basis points **less** than normal, reflecting the full cost of the bank tax they would have to pay. In this low-interest rate environment, such a reduction makes these transactions uneconomical and thereby unlikely to occur. Simply put, the bank tax will virtually kill fed fund sales from small to large banks, thereby disadvantaging both sized banks and hurting liquidity options.

➤ ***The Bank Tax Means That Banks with Better Credit Will Pay More***

The proposed tax would increase funding costs more for banks with better credit. On a relative basis, the tax will increase costs of funding more for banks with high credit ratings than those with lower credit ratings. For example, a higher-rated bank that is able to borrow overnight at 20 basis points will suffer a 75 percent increase in costs from a 15 basis points tax; in contrast, a lower-rated bank that can only borrow overnight at 50 basis points would suffer a 30 percent increase in cost. Thus, the bank tax is likely to stop any short-term transactions, particularly the lowest risk ones, leaving a greater share of short-term funding with higher-risk credits.

➤ ***The Bank Tax Will Increase the Cost of Mortgage Finance, as Large Banks and Insurance Companies Use Fewer Federal Home Loan Bank Advances***

Banks, large and small, use the advances from the Federal Home Loan Banks (FHLBs) to make housing-related loans. The business model for FHLBs depends on serving institutions of all sizes, and if large banks withdraw, advance costs for smaller banks will rise. Adding additional costs of 15 basis points on these funds for large banks will reduce the use of advances. This means less mortgage liquidity that would be available, and what is available would cost more. The result is a decrease in the level of credit ultimately available to homeowners.

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<sup>8</sup> Transcript of Testimony before the House Committee on Financial Services, February 24, 2010.

Moreover, this also has important implications for the financial stability of the FHLBs themselves (which would have less income and less capital as a consequence), and would impact the availability and cost of advances for smaller banks (as well as hurt the investments those smaller banks have in the FHLBs). It could lead to a downward spiral for the FHLBs and their members, because as borrowing from the FHLBs becomes more expensive, fewer advances will be made. As fewer advances are made, members will reduce their holdings of the FHLB stock required to borrow, thus shrinking the System and its ability to provide liquidity to all members.

➤ ***The Bank Tax Shifts Business to Foreign Competitors***

The proposed bank tax must be considered in a larger, global context. First, it is unclear what action will be actually be taken by other countries. While there is considerable discussion on the topic, there is no consensus on what, if anything, needs to be done (let alone, whether it can realistically be implemented consistently across many countries).

Second, if there are inconsistencies, which seem inevitable, it will lead to competitive issues. For example, as noted above, the tax squeezes the already tight spreads on many wholesale products supported by non-deposit liabilities. The 15 basis point tax would make U.S. firms uncompetitive in low-margin money market and foreign exchange products, which would leave these markets in the hands of foreign competitors, whose prices are not constrained by the bank tax. While regional and community banks are not subject to the tax, it is unreasonable to assume that they could create and replace the large-scale, low-risk, repo markets that are being disrupted by the tax. Thus, this leaves foreign banks to take market share from U.S. institutions. It may also encourage U.S. banks with multi-national operations to shift operations from the U.S. to countries with more favorable tax treatments.

### **III. Large Banks are Directly Affected by the Bank Tax, But Smaller Banks Will Also Feel the Ripple Affects**

Large banks with over \$50 billion in assets are, of course, directly impacted by this large bank tax. The tax reduces capital to support loans, raises the cost of funding loans, and disrupts short-term liquidity markets. But the implications of this tax do not stop with the largest banks. In fact, the costs and consequences will ripple through the financial services system, imposing costs on all banks and their customers.



The previous section discussed the negative consequences on many short-term funding markets. These impacts raise the cost of funding for smaller banks and, in turn, affect the pricing of loans that they extend. For example, as large banks seek to minimize the financial burden of non-deposit funding sources, they will increase competition for deposits. Community banks, which largely raise deposits from local sources, have fewer alternatives to raise funds to finance local loans. As the competition for deposits increase due to the bank tax on non-deposit funding sources, it will be even more difficult, and certainly more expensive, to finance loans for community banks. This inevitably will lead to higher costs for borrowers.

Community banks often sell fed funds to larger banks, facilitating effective management of liquidity and promoting efficient flows of short-term funding. As large banks would have to pay 15 basis points for any such borrowing, the price they are willing to pay for such funds – if they are willing, given these spreads – is reduced by an equivalent amount. This disadvantages both parties, but particularly limits the ability of community banks to benefit from this short-term market.

Community banks also utilize FHLB advances. While these advances would still be available, the increased costs for using advances by large banks means that the income to the FHLBs is reduced and could impair viability of some of these FHLBs. Since all banks that borrow from the FHLBs must also hold capital in the system, any impairment of income to the system has consequences to all FHLB-stockholding banks. It also has consequences for how the advances that are made available are priced. Thus, the combination of reduced usage of advances by the largest banks, the reduction in income that reduces the value of the stock owned, and the likely increase in the cost of advances all will make funding of loans – which generally supports housing market loans – more difficult and expensive for community banks

There is a broader issue than just the likely ripple effects that will impair community banks' ability to meet the needs of their communities. Many small banks believe that once the precedent is set to assess an additional tax on large banks, it is only a matter of time before the tax is spread to other banks. It also sets precedents to arbitrarily raise taxes on any specific sector or any specific firm or group of firms. Thus, an industry-specific tax is not appropriate and sets a precedent that will affect all industries, not just the banking industry. It will inevitably affect healthy, well-run firms – whether banks or other healthy businesses and whether they are large or small.

## Conclusion

The banking industry appreciates the extraordinary actions taken by the government to address the financial crisis. Unfortunately, there continues to be considerable confusion about those programs, including the expansion of support to non-banks and even non-financial companies. There has also been a failure to recognize the significant returns already provided by the banking industry to taxpayers and the unfairness created when banks are asked to pay for the losses created by non-banks. Large banks will clearly bear the brunt should any bank tax be applied, but the consequences go well beyond the largest banks and will likely affect community banks' funding costs and the ultimate borrowing costs for their customers. The ABA, therefore, must oppose such a tax.