CONGRESSIONAL BUDGET OFFICE
U.S. Congress
Washington, DC 20515

Douglas W. Elmendorf, Director

March 4, 2010

Honorable Charles E. Grassley
Ranking Member
Committee on Finance
United States Senate
Washington, DC 20510

Dear Senator:

This letter responds to questions you posed about the President's proposal for a "Financial Crisis Responsibility Fee":

- Who would pay the fee?

- What would be the impact of the fee on the stability of financial institutions and government outlays to cover future losses of those institutions?

- What would be the impact of the fee on the availability of credit in general and for small businesses in particular?

- What would be the impact of the fee on economic growth?

- What are the estimated costs to the federal government of the Troubled Asset Relief Program (TARP) and the Federal Reserve's activities related to the financial crisis?

- What is the overlap between firms that would pay the proposed fee and firms that generated losses for the TARP?

The Congressional Budget Office (CBO) is working with the staff of the Joint Committee on Taxation (JCT) to analyze the proposal. Although the Administration has laid out the broad outlines of the proposal, it has not specified how comprehensive the definitions of assets and liabilities would be for the purpose of assessing the fee. Those definitions would affect which institutions were covered, how institutions would react to the fee, and what its incidence would be.

The proposal

The President proposes to assess an annual fee on liabilities of banks, thrifts, bank and thrift holding companies, brokers, and security dealers, as well as U.S. holding companies controlling such entities. The fee, which would apply to firms with consolidated assets of more than $50 billion, would be approximately 0.15 percent of a firm's total liabilities—excluding deposits subject to assessments by the Federal Deposit Insurance Corporation (in the case of banks) and certain liabilities related to insurance policies (in the case of insurance companies).[1] The Administration estimates that the fee would generate revenues totaling about $90 billion from 2011 to 2020.

Who would pay the fee?

Preliminary estimates by JCT identified approximately 60 bank holding and insurance companies with assets in excess of the $50 billion threshold, which include most of the institutions that are likely to pay the fee. A small number of very large firms would account for most of the payments. However, the ultimate cost of a tax or fee is not necessarily borne by the entity that writes the check to the government. The cost of the proposed fee would ultimately be borne to varying degrees by an institution's customers, employees, and investors, but the precise incidence among those groups is uncertain. Customers would probably absorb some of the cost in the form of higher borrowing rates and other charges, although competition from financial institutions not subject to the fee would limit the extent to which the cost could be passed through to borrowers. Employees might bear some of the cost by accepting some reduction in their compensation, including income from bonuses, if they did not have better employment opportunities available to them. Investors could bear some of the cost in the form of lower prices of their stock if the fee reduced the institution's future profits.

What would be the impact of the fee on the stability of financial institutions and future government outlays to cover future losses?

In general, the effect of a 0.15 percent fee would be small because the fee is small—for instance, it represents a small fraction of the rate charged on an average bank loan to businesses, which currently is in excess of 3 percent. Because the proposed fee does not appear to be high enough to cause financial institutions to significantly change their financial structures or activities, it would not have a significant impact on the stability of financial institutions or

[1] Financial reporting done on a consolidated basis includes a wider range of assets and liabilities than that done on an unconsolidated basis; consolidated obligations of a parent company generally include the assets and liabilities of its subsidiaries. It is uncertain how comprehensive the definition of consolidation would be under the proposal—whether, for instance, the obligations of "special-purpose vehicles" controlled by the affected companies would be included. For some financial companies, assets and liabilities on a fully consolidated basis are many times larger than those carried on their balance sheets.

significantly alter the risk that government outlays will be needed to cover future losses.

The fee would provide incentives that might either increase or decrease institutions' risk taking, and CBO cannot predict whether the net impact would be to raise or lower the federal government's costs in the future. On the one hand, the fee could reduce the profitability of larger institutions, which might create an incentive for them to take greater risks in pursuit of higher returns to offset their higher costs.[2] On the other hand, the fee would provide an incentive for larger financial institutions to reduce their dependence on liabilities subject to the fee. To the extent that institutions increased their reliance on equity, the risk of future losses would be reduced. However, financial institutions consider equity capital to be expensive, and introducing a fee of this size would probably not induce much of a substitution of equity for debt.[3] More generally, whether a particular institution would have an incentive to change its investment or financing mix in a way that altered its risk profile would depend on a number of factors, including the relative cost of financing options and regulatory constraints.

Imposing a fee on the largest banks would improve the competitive position of small- and medium-size banks, probably leading to some increase in their share of the loan market. How that development would affect the government's costs and risk exposure is unclear. Smaller banks have experienced higher failure rates historically, but their failures are less costly to resolve and less likely to pose a systemic risk to the economy.[4]

What would be the impact of the fee on the availability of credit in general and for small businesses in particular?

The fee would probably lower the total supply of credit in the financial system to a slight degree. It would also probably slightly decrease the availability of credit for small businesses. Small businesses often rely on smaller financial institutions for their credit needs, and those institutions would not be affected by the fee.

---

[2] Federally insured institutions have an incentive to take more risk than they otherwise would because their shareholders reap all of any gains but are partly protected from any losses. The expected gain from risk-taking is higher for less profitable institutions, which gain more from the downside protection of insurance. Because the fee could reduce profitability, it could increase the propensity to take risk. (The value of insurance accrues to equity holders rather than depositors because it allows banks to pay lower interest rates on deposits.)

[3] Large institutions might shift to funding sources not included among the liabilities covered by the fee—for example, by increasing their reliance on deposits. An increase in the total volume of insured deposits would increase the amount of liabilities bearing explicit federal insurance, but a substantial additional reliance on deposits would probably involve large uninsured deposits. Large institutions might also fund more loans by securitizing them—bundling them into securities and selling the securities to investors—if those securities would not be covered by the fee.

[4] The Federal Deposit Insurance Corporation is responsible for resolving bank failures. Under current law, its costs are covered by premiums charged to insured financial institutions and not by taxes or other federal revenues.

However, larger financial institutions also supply funding for small business loans, and that lending would probably be diminished a bit by the fee.

What would be the impact of the fee on the economic growth?
Because of its modest size, the fee would probably not have a measurable impact on the growth of gross domestic product.

What are the federal government's costs from the TARP and the activities of the Federal Reserve related to the financial crisis?
CBO estimates that the full cost of the TARP will be $99 billion (including realized losses and the present value of expected future losses on funds already disbursed and projected future disbursements), plus about $200 million a year for administrative costs.[5] In your letter, you asked whether receipts from the proposed fee would repay all of the TARP's losses by 2013. Although JCT does not yet have enough detail about the proposal to estimate expected revenues, the Administration's budget shows only $25 billion in receipts from the proposed fee through fiscal year 2013; moreover, CBO does not expect all of the TARP's transactions to be resolved by then.

The Federal Reserve has purchased a substantial amount of longer-term and riskier securities in support of the housing market and the broader economy. Those securities have a significantly higher expected return than the rate that the Federal Reserve pays on the reserves used to finance them. Consequently, CBO expects that, over the next several years, the Federal Reserve's remittances to the Treasury will be higher than previous levels.[6] A forthcoming report by CBO will provide an estimate of the cost of the Federal Reserve's activities in response to the financial crisis.

What is the overlap between firms that would pay the proposed fee and firms that generated losses for the TARP?
For the most part, the firms paying the fee would not be those that are directly responsible for losses realized by the TARP. Some firms subject to the fee are expected to generate such losses, including the American International Group, GMAC Financial Services, and CIT Group (which filed for bankruptcy protection on November 1, 2009). However, the fee would not apply to firms in the automotive industry, which account for $47 billion of the program's estimated total cost of $99 billion. Other firms that would be subject to the fee have either paid back all of the funds received from the TARP or are current on their repayment schedule and unlikely to generate losses from their participation in the program. However, all of the institutions that might be covered by the fee

---

[5] See Congressional Budget Office, *The Budget* and *Economic Outlook: Fiscal Years 2010 to 2020* (January 2010), Box 1-2, pp. 12–13.

[6] See Congressional Budget Office, *The Budget* and *Economic Outlook: Fiscal Years 2010 to 2020*, Chapter 4.

benefited to varying degrees from the program's contribution toward stabilizing the nation's financial system and overall economy.

I hope that you find this information helpful. If you have any further questions, please contact me or my staff. The primary staff contact is Deborah Lucas.

Sincerely,

Douglas W. Elmendorf

Douglas W. Elmendorf
Director

cc: Honorable Max Baucus
Chairman

Honorable Christopher J. Dodd
Chairman, Senate Committee on
Banking, Housing, and Urban Affairs

Honorable Richard C. Shelby
Ranking Member, Senate Committee on
Banking, Housing, and Urban Affairs

Honorable Sander M. Levin
Acting Chairman, House Committee on
Ways and Means

Honorable Dave Camp
Ranking Member, House Committee on
Ways and Means

Honorable Barney Frank
Chairman, House Committee on
Financial Services

Honorable Spencer Bachus
Ranking Member, House Committee on
Financial Services