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Statement of the Shadow Financial Regulatory Committee on
Limiting Systemic Risk and Too-Big-to-Fail

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In the aftermath of the financial crisis, the Dodd-Frank Act was passed in part to end the perception that some institutions were too-big-to-fail and to protect the taxpayer from the associated costs that it entailed. There is a growing concern that too-big-to-fail remains an important problem, and the evidence for this belief most often cited is that many of the large financial institutions that were the beneficiaries of government rescues and interventions have actually become larger in the aftermath of the financial crisis. As a result, the U.S. financial system has become more concentrated. In response, the Obama administration in 2010 and, more recently, Representative Camp (R-MI) have proposed levying what amounts to a prudential tax on systemically important financial institutions (SIFIs) to supplement the existing structure of prudential supervision and regulation.

Those who want to introduce a prudential tax policy favor it for a number of different reasons. The first is to use tax policy as a tool to induce banks to shrink in size, thereby purportedly reducing the potential for systemic risk. The second is simply to punish institutions that were bailed out with taxpayer funds – a motive that has gained popularity as the profits and managerial bonuses reported by rescued banks have increased. The third is to raise tax revenues for the government.

The Shadow Financial Regulatory Committee (Committee) believes that the systemic risk concerns are legitimate. Therefore, we will focus on this in the rest of this statement to the exclusion of consideration of the revenue and punishment objectives.

The key issue is the extent to which a new prudential tax can be a useful and needed supplement to existing prudential supervisory tools and regulations such as leverage constraints, stress tests, risk-based deposit insurance premiums and heightened capital adequacy

requirements. The Shadow Financial Regulatory Committee believes that a prudential tax would be a blunt instrument that would add unnecessarily to the overall complexity of existing prudential and supervisory tools while not significantly mitigating the key sources of systemic risk that proved critical in the financial crisis. Existing tools can accomplish the core objectives of the proposed tax without introducing a new level of complexity.

Like all taxes, the Obama and Camp prudential tax proposals share three components – a base, a structure of tax rates and a series of exemptions, but they also differ in many important ways. For example, the most recent financial institution tax proposal is contained in one small section of US Representative Camp’s proposed omnibus *Tax Reform Act of 2015*. It would levy a quarterly tax of 3.5 basis points (the rate) on consolidated total assets (the tax base) exceeding \$500 billion for “systemically important institutions” (SIFIs) (making under \$500 billion the exempted amount). Thus, smaller institutions would be exempted.

The tax proposal applies not just to banks but to any institution that is designated as a SIFI by the Financial Stability Oversight Committee (FSOC). In this respect the reach of the proposed tax is broad, covering not only banks and bank holding companies, but also other institutions considered to be SIFIs, like GE Capital, AIG and Prudential, to name just three institutions recently added to the FSOC list. Additionally, it would tax not only domestic assets but also the assets held in foreign subsidiaries and affiliates. The inclusion of non-bank financial institutions designated as SIFIs introduces an additional layer of complexity since these institutions would now be subject to oversight by the Federal Reserve and have very different business models from banks. Currently under consideration is whether to include some investment advisors as SIFIs, for whom the definition of assets (advisor v fund) is not clear. Should some mutual funds or other parts of the managed assets business be subsequently designated as SIFIs, the tax would essentially be applied to equity, which is essentially a wealth tax and makes little economic sense. In short, the taxation of institutions as SIFIs, many of which are still undefined, can introduce a host of complications that represent a regulatory Pandora’s box.

While the Camp proposal would tax assets, the 2010 Obama tax scheme would tax the non-deposit liabilities of banks, bank holding companies, thrifts and thrift holding companies, insurance companies that owned insured depository institutions and broker dealers in excess of \$50 billion at a rate of 15 basis points per year. The intent would be to use tax policy to make short term, non-deposit financing and highly leveraged positions costly to incentivize large institutions to curtail the strategy of funding longer term assets with short term (even overnight) debt. The reach of the proposal would cover more institutions, because of the lower size threshold, but would not necessarily include other institutions that had been identified as SIFIs.

The Committee recognizes that to the extent that the proposed tax in either the Obama or Camp proposal would tend to incentivize institutions to reduce their size, there might be some marginal but uncertain impacts on systemic risk. But the tax proposals are not risk-related and may create incentives for institutions to take on more risk to generate additional revenue to offset the cost of the tax. Thus, moral hazard would not be reduced and more likely would be enhanced. On the other hand, the Committee also notes that the tax proposals effectively

offset part of the current tax benefit that generated by the interest expense deduction presently available to financial and other institutions.

It is important to recognize that traditional forms of regulation, for example, in the form of leverage limits, capital adequacy constraints and related prudential supervisory efforts, also function as a form of taxation. But unlike regulation the proposed asset or liability tax, the rate, structure and exemptions would be set statutorily by Congress. In contrast, current regulatory and supervisory efforts are directed more flexibly towards limiting risk and their intensity varies with the perceived riskiness of the individual institutions. In principle, regulation and supervision can be targeted to particular areas within financial institutions where the greatest risks may arise. For this reason, the Committee sees little merit in imposing either an asset or liability tax as an additional tool of prudential policy. Moreover, the proposed taxes, because of their reach to nondepository institutions, essentially guarantee that lobbying efforts will intensify to exempt particular classes of assets or liabilities from the tax base. Lastly, the proposals will only add another layer of complexity to what is already a regulatory system that has become more intrusive, with little or no impact on the increasing complexity of the interrelationships among large financial institutions that because of their opacity proved to be a major source of systemic risk in the recent financial crisis.