

## Chapter 6<sup>\*</sup>

### Taxing Too-Big-to-Fail Institutions

#### The Current Proposals

Legislation that has been proposed in both the House and the Senate calls for a risk-based systemic fund that would be used to guarantee obligations of certain financial institutions during a crisis.<sup>†</sup> The capital in the fund would in theory be paid for by systemic institutions in the form of a premium tied to “the complexity of operations or organization, interconnectedness, size, and direct or indirect activities of the financial institution.” Both congressional bills agree on this basic framework, though the Senate proposal allows for a two-year implementation period.

Nevertheless, there are several major differences between the House and Senate versions:

- (1) The House specifies the size of the institutions that would potentially face a systemic assessment, namely financial companies that have assets of \$50 billion or more, and hedge funds with over \$10 billion of assets under management. Whether the institution actually pays a levy, however, would still depend on the systemic risk it produces.
- (2) The House bill calls for a special assessment if the Systemic Dissolution Fund cannot cover the losses. This fee is tantamount to an ex post charge on the systemic funds described above.
- (3) The House bill implies that the systemic risk charges will be countercyclical to the extent that the assessments would increase during more favorable economic conditions and decrease during less favorable ones.

In terms of international reforms along these lines, only the Group of Twenty (G20) explicitly addresses the need for a capital surcharge to mitigate the risk of systemic financial institutions.

#### Evaluation of Current Proposals

It is helpful to view the systemic risk of each financial institution as producing an external cost – in effect, pollution – on the financial system. Institutions will continue to produce this cost until they are forced to internalize it. Negative externalities of this sort cannot be solved in the private market. It is well-known that an optimal way to address such a problem is to impose a tax on the externality (often denoted a Pigovian tax in honor of the economist Arthur Pigou, who developed the idea in 1912). In this sense, the idea of charging systemic institutions ex ante for future bailouts is appropriate.

The purpose of a Pigovian tax is to force the institutions to internalize the systemic cost so that the firm will organically want to produce less systemic risk. The legislation is more focused on the revenues produced from the tax. Consider the House bill, which calls for an ex post special assessment on systemic institutions when the Systemic Dissolution Fund falls short of

---

<sup>\*</sup> Working group: Viral Acharya, Thomas Cooley, Matthew Richardson and Ingo Walter.

<sup>†</sup> The House bill, H.R. 4173, Sec. 1609 denotes it as a “Systemic Dissolution Fund,” while the Senate bill, Sec. 115 names it a “Financial Stability Fund.”

funds. This ex post charge is problematic in three ways: this clause should not be used to justify a lower ex ante premium than would otherwise be justified; in a crisis, these same systemic institutions will not be in a position to cover the losses; and more importantly, the charge should be related to the expected losses of the institution conditional on a crisis, not the actual ex post losses. If the crisis is worse than expected or occurs earlier than predicted, it does not make economic sense to charge the firms.

The criteria for the systemic assessment should be the firm's systemic risk. While it is logical to assume that this risk will be related to the amount of assets held by the institution, it is not necessarily so. The House legislation is therefore flawed in highlighting a dollar figure either for financial companies or hedge funds.

It is certainly correct that the "true" systemic assessment is most likely pro-cyclical. The House bill calls for the charge to be adjusted so that it is countercyclical. The problem with procyclicality is that, in the midst of a crisis, charging financial firms already short of capital will worsen their trouble, which in turn will force them to sell assets, causing asset prices to fall, leading to other firms' running aground, and so on. From this perspective, introducing some degree of countercyclicality makes sense.

There are two elements missing from the congressional proposals. First, other than a cursory reference to the level of systemic risk, the most important question has been avoided and perhaps rightly so. That is, what is the appropriate level of assessment on financial institutions? In Chapter 4, we discuss the measurement of systemic risk. It is an important concern, because the risk-based premium approach of the FDIC has not been successful and is not a good model.

It will be difficult for a regulator to get this assessment right. An alternative approach would be to require each financial institution to take out insurance against its own losses during a general crisis. The price of this insurance would be set by the private insurance industry. If losses take place, the payment does not go to the financial institution, but to the systemic fund. Thus, the insurance acts like an assessment in the spirit of the House and Senate legislation. One of the issues is that there may not be enough capital available in the private insurance industry to cover the potential losses from a systemic event. Thus, we advocate that the majority of the insurance (say 90%) is offered by the government. The insurance fees would be paid to the government, and the government would provide self-insurance. There is already a successful program that does something similar, namely the Terrorism Risk Insurance Act of 2002.

Second, while the legislation addresses the systemic risk of too-big-to-fail institutions, it does not address the now-explicit guarantee the institution is afforded in a crisis. While some of these guarantees are muted through the other suggested regulation – capital requirements, contingent capital and some form of receivership -- it raises the question of whether there should be a charge analogous to what FDIC-insured companies pay for their own expected losses upon default, crisis or no crisis. The counter argument may be that any guarantees implied by the resolution authority via the systemic fund (i.e., making whole some creditors) would apply only in a crisis. If this is true, then the systemic charge should take care of that portion.