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It's Payback Time:
The United States and Germany are Debating a Financial Institution Fee

By Stormy-Annika Mildner

How do the German and American fee proposals differ?

What political challenges does a fee face in either country?

Is transatlantic cooperation appropriate in determining a Financial Stability Fee?

"*My commitment is to recover every single dime the American people are owed. […] That's why I'm proposing a Financial Crisis Responsibility Fee to be imposed on major financial firms until the American people are fully compensated for the extraordinary assistance they provided to Wall Street.*"[1] *(U.S. President Barack Obama)*

"The experience of the crisis has demonstrated the importance of a well designed legal framework for effective bank resolution. The German government has just decided to implement such a framework, complemented by a levy in the shape of a 'banking fee'."[2]
(German Finance Minister Wolfgang Schäuble)

When Senate Finance Chairman Max Baucus opened the Committee's hearing on 4 May 2010 by quoting Thomas Jefferson in saying that "banking institutions are more dangerous […] than standing armies" he sounded almost like German Federal President Horst Köhler, who repeatedly called the financial markets a "monster." The governments of both countries, Germany and the United States, are currently discussing how best to recover the costs of the financial crisis and how to reduce excessive risk taking behavior in the financial sector. While the Obama administration and the Merkel government agree that financial institutions should be held responsible, paying their due share in getting the economy (and public finance) back on its feet, there are considerable differences in their approaches. And while both support a financial institution responsibility fee, the devil, as so often, lies in the detail.

At the G20 summit in Pittsburgh in September 2009, President Barack Obama and German Chancellor Angela Merkel, together with the other G20 leaders, asked the IMF to "[…] prepare a report for our next meeting [June 2010] with regard to the range of options countries have adopted or are considering as to how the financial sector could make a fair and substantial contribution toward paying for any burden associated with government interventions to repair the banking system."[3] In response, the IMF proposed two bank taxes in late April 2010. Under the Financial Stability Contribution, all institutions would initially pay a flat-rate bank levy. Over time, this "backward-looking" fee is to become more "forward-looking" by reflecting riskiness and systemicness, meaning that those who pose a greater danger to the financial system should also pay more. The proceeds of this levy could either finance a resolution fund or feed into general revenues. The Financial Activities Tax would be levied on the profits of financial institutions.[4] The goals of these proposals are two-fold: first, to ensure that the financial sector pays for the expected net fiscal costs of direct support during the financial crisis and, second, to reduce the probability and costliness of future crises by inducing less risky behavior and funding possible bail-outs.

At the G20 meeting of Finance Ministers and Central Bank Governors on 23 April 2010, the leaders were not able to find a consensus on whether a financial institution tax was an appropriate element of regulatory reform as Canada, Australia, and Japan are decidedly opposed to a bank fee. Likewise, major emerging economies such as China, India, and Brazil are less than thrilled about the idea of burdening their financial institutions with a new tax.[5] The G20 only called upon the IMF to "further work on options to ensure domestic financial institutions bear the burden of any extraordinary government interventions where they occur."[6] However, two countries have already put forward proposals for a fee on banks: the United States and Germany. But, the approaches have remarkable differences: the U.S.

Financial Crisis Responsibility Fee is decidedly backward-looking while Germany is much more set on a forward-looking tax. The proposals differ with regard to the institutions subjected to the fee, the determinants of the fee (risk, income, and bonuses), the goals of the levy, as well as the appropriate use of the fee revenues. They do, however, have two important things in common: first, they are to a certain extent populist measures, their timing coming not entirely as a surprise—important state elections took place in early May in Germany and the U.S. Congress faces midterm elections in November of this year. Second, the proposals have run up against strong opposition; so far, their implementation is anything but certain.

The U.S. Financial Crisis Responsibility Fee

Earlier this year, on January 14, the Obama administration proposed a Financial Crisis Responsibility Fee (FCR) to recover intervention costs incurred during the financial crisis under the $700 billion Troubled Assets Relief Program (TARP). The fee is to be in place for ten years, longer if necessary, until the costs of TARP are fully recovered.

Only the largest firms (banks, thrifts, insurance companies, and U.S. holding companies of those entities) with assets of more than $50 billion and that profited from TARP would be subject to an annual levy. U.S. companies would be taxed based on their worldwide consolidated assets, foreign entities only on their U.S. assets. Covered liabilities would be reported by regulators, the fee would be collected by the IRS, and revenues would be used to reduce the federal budget deficit.[7] About 60 entities currently qualify for taxation under the FCR, according to the Treasury, thus 99 percent of the banking sector would be unaffected. Furthermore, 60 percent of the revenues would come from the ten largest financial firms. Secretary of the Treasury Timothy Geithner wants to achieve two goals with the fee: putting a premium on risk-taking behavior and reducing the government deficit. The FCR fee is estimated to raise $90 to $117 billion over a 10 to 12 year period. Contrary to the IMF's proposal, the administration does not propose a rainy day fund for future financial crises as such a fund could amplify the "too big to fail" problem and promote rather than prevent taxpayer bailouts of failed financial institutions (moral hazard). Such a provision was also dropped from the regulatory overhaul bill, the Restoring American Financial Stability Act of 2010, which is currently debated on the floor of the Senate. Likewise not on the administration's agenda are a profits tax and a financial transaction tax.

The administration's proposal ran into strong opposition from lawmakers, particularly Republicans.[8] Backed by the financial industry, their argument is threefold. Their first criticism concerns the timing of the measure. The legislation that created TARP, the Emergency Economic Stabilization Act of 2008 (EESA), calls on the president to put forward a plan "that recoups from the financial industry an amount equal to the shortfall in order to ensure that the Troubled Asset Relief Program does not add to the deficit or national debt" by 2013. Given this date, some Republican Senators, such as Jim Bunning, called the measure "suspicious,"[9] merely a political stunt shortly before the upcoming Congressional midterm elections. Opponents to the tax argue that the full costs of TARP cannot yet be measured sufficiently and that the fee would just be a "stab in the dark," as Democratic Senator Maria Cantwell put it. Building on the timing argument, the rate at which financial institutions will have paid back rescue money and interest could mean that TARP might even run profits. This would render a bank fee unnecessary by 2013. Finally, they argue that the measure is a backdoor regulatory scheme as it tries to influence financial institutions' behavior. To this, Geithner has offered a counterargument that time is of the essence. TARP alone does not capture all the costs of the financial crisis as well as the damage done to the economy and the government's budget, and he fears that by 2013 he will lose his chance to get any meaningful legislation through Congress to recuperate these costs. If he wants to capitalize on the fast fading reform impetus of the financial crisis, he needs to act quickly. Last but not least, he believes that the United States needs to send a signal to the international community that it is tackling the shortcomings of its financial regulatory system, which will also reassure markets.

A second criticism voiced by Republicans is the fairness of the measure. Some institutions that contributed to the financial crisis and benefited considerably from the government's rescues, like the two mortgage companies Fannie Mae and Freddie Mac as well as automobile companies such as General Motors, would not be subject to the levy. Geithner countered this argument by pointing out that Fannie and Freddie are currently still under conservatorship by the U.S. government; taxing these institutions would simply mean "one hand of the government paying another."[10] With regard to the auto industry, Geithner argues that it has not caused the financial crisis but suffered tremendously from it. Countering the argument that the majority of financial institutions subjected to the levy either did not participate in TARP or have repaid their TARP loans, Geithner points out that all financial institutions benefited generally from the financial support provided by the bailouts.

Another issue that concerns policymakers, Democrats and Republicans alike, is the effect of the fee on small business lending and the still fragile economic recovery. Financial institutions are fuelling this fear, warning that they might be forced to pass their costs along to the consumer. In this case, not the companies but their employees and/or shareholders would bear the cost of the tax. In addition, credits could become more expensive and less available. Geithner refutes these arguments, highlighting that competition from entities not subject to the levy would prevent them passing along the costs.

While the Treasury Secretary eloquently lobbied for the administration's proposal at the Senate Finance Hearing on 4 May, skepticism remained strong. And as the proposal is not included in the financial regulatory bill, the fate of the proposed Financial Crisis Responsibility Fee is uncertain at best.

Germany's Banking Fee

At the end of March 2010, finance minister Wolfgang Schäuble announced that he would put forward a legislative proposal by fall this year to improve the country's ability to deal with failing financial institutions. Unlike in the United States, the systemic risk adjustment levy is very much more "forward oriented." While all banks would be subject to the fee, its amount would vary according to the systemic risk an individual bank poses to the financial system. Systemic risk would be determined on the basis of the size of bank's liabilities (excluding capital and deposits) and its interconnectedness with other financial market participants, among other factors. Thus, according to the government's initial proposal, banks with a higher systemic risk would have to pay more than, for example, credit unions and savings banks.[11] While the CDU was first critical of the IMF's second proposal, it changed course in early May, broadening the base of the tax to bank's profits and manager bonuses.

The levy is designed to be a corrective on financial institution's behavior and likely to be permanent. The receipts are to feed into a stability fund to finance the restructuring and resolution of systemically relevant banks in the future. This would entail that financial supervisors obtain expanded powers to intervene in banks. The fund and the resolution mechanism would be supervised and managed by the Federal Agency for Financial-Market Stabilization (*Bundesanstalt für Finanzmarktstabilisierung*, FMSA), created in 2008.[12] The government also discussed a tax on international financial transactions. In his speech at the IX Munich Economic summit, Horst Köhler called this the best instrument to get the financial sector to pay its due share in restoring (and keeping up) financial stability. Chancellor Merkel, however, has removed the transaction tax from the government's agenda due to expected technical implementation problems and broad political opposition.

Whether the CDU's coalition partner, the liberal FDP, will back the proposal is yet uncertain, one of the preconditions being the exclusion of saving banks. Volker Wissing (FDP), the Chairman of the Bundestag's Finance Committee, cautioned that it might be too early for such a levy as banks are not yet in the clear. He also warned against a unilateral approach, strongly supporting an international coordinated bank levy.[13] However, it is likely that some compromise will be reached within the coalition.

The Social Democratic Party (SPD), on the other hand, calls for a more radical approach such as a financial transaction tax and more regulation. Furthermore, Sigmar Gabriel, leader of the SPD, warned about the effects on small and medium business lending. The Left Party criticized the tax as window dressing and political bait for the state elections in North Rhine-Westphalia. Also members of the *Wirtschaftsweisen Rat*, a council similar to the U.S. Council of Economic Advisors, are skeptical about the tax.[14] Beatrice Weder di Mauro, for example, argues that not just banks but also other financial institutions such as insurance companies and hedge funds should be subject to the tax. But there is also a lot of skepticism and outright opposition. Bundesbank President Axel Weber concedes, the levy could be used to making banks contribute to cost sharing. However, in comparison to capital requirements, it was less well equipped to reduce risk taking behavior.[15]

Surprisingly, the Association of German Banks, which represents private sector banks including Deutsche Bank AG and Commerzbank AG, supports a privately financed, state-controlled stabilization fund that could intervene to rescue or wind up troubled lenders. Its support of the levy is not unconditional, however. In April 2010, it published a document that offered several concerns about the current plan, many of which sound like the Republican's fears in the U.S.[16] First, if all financial institutions are going to profit from the stabilization fund, then they should all be responsible for contributing to it. Second, if only certain institutions are labeled as "systemically risky" by the government, by virtue of the fact that certain institutions must pay a levy and not others, then there will be adverse effects on their businesses. A third concern is how the amount of the fund should be determined and how to keep it so that it does not "place excessive strain on a company's ability to perform."[17] Finally, the last concern is perhaps the largest. That is, how can a reform be instituted and regulated universally, so as to avoid regulatory arbitrage.

The Federation of German Industries (BDI) agrees that it was legitimate for the government to seek to involve banks in the costs of saving and stabilizing financial institutions. The big questions, however, concern the extent of the fee, its base, and its target. Just as in the United States, there are worriers about the effect on small and medium business lending. "However, this [the tax] must not be to the detriment of the real economy in that credit conditions are worsened. […] That would be counterproductive in view of a looming credit squeeze for industrial companies," warned senior BDI official Werner Schnappauf.[18] Likewise, savings and cooperative banks argued that their loans to the real economy should be excluded from the balance sheets when determining its contribution. The *Bundesverband Freier Immobilien- und Wohnungsunternehmen*, the federation of the German real estate industry, also warned about a credit squeeze, pointing out that the levy was not a sensible step while the financial markets and economic recovery were still fragile.[19]

There is also debate on a financial stability levy on the European level. Michel Barnier, EU Commissioner for Internal Market and Services, emphasized: "The financial sector needs to contribute to the costs of financial stability. This should be one of the building blocks in our effort to set up a crisis management framework in Europe."[20] The European Commission put forward a proposal in early April. The Commission's report argued that a financial stability fee would have a "double dividend," meaning that it would raise revenues (between €13 and 50 billion depending on the rate of tax imposed) and improve market stability by putting a price on risk taking behavior.[21] But the EU bank fee is unlikely to be implemented in the near future due to strong opposition of several member states. Thus Schäuble already announced that Germany would not wait for a broader European regulation before enforcing its own levy.

Conclusion: Much Need for Transatlantic Cooperation

Does a fee to recuperate the costs of the financial crisis make sense? Certainly—if properly structured. But there are many questions that have yet to be answered more thoroughly: Which institutions should be subjected to the fee (and why)? What is the best way to structure the tax? Should the fee be calculated on the basis of systemic risk only, or take profits and bonuses into account? Should the money be used to balance the government budget or be a down payment for future crises? And how will this fee fit in with other regulatory reform efforts such as capital requirements? The chairman of the Financial Stability Board rightly cautioned "[…] proposed reforms will need to be carefully considered, in order to lessen the risk of unintended consequences and to counter financial industry claims that the reforms could derail economic and financial recovery."[22]

Does it make sense to implement such a fee unilaterally? Certainly not. Rather, international coordination is necessary as, due to the globalized nature of the financial sector, unilaterally imposed regulations and taxes would have substantial international spillovers and create the risk of regulatory arbitrage and multiple taxation of financial firms. Along these lines, the IMF warned, "effectiveness of possible measures is likely to depend on the extent of international cooperation in their design and enforcement."[23]

Geithner's deliberations on regulatory cooperation, however, are not very reassuring: "They [rules] are negotiated in an international context. [But] In the United States, we decide what makes sense in our country. And then we negotiate with other countries around the world, which have institutions which compete with our banks in their markets and around the world, to try to bring the world to those standards we apply in the United States."[24]

Albeit, there is much to gain from transatlantic cooperation in an early stage: Through a transatlantic dialogue, the United States and Germany could address many of the aforementioned concerns with regard to the scope, design, and goals of the fee. They could also better analyze the (unintended) consequences of such a fee on the international level. And by finding a common approach, the risk of regulatory arbitrage and double taxation would be minimized. A joint approach would also set an example for other countries due to the leading position of the U.S. and the EU in global finance. Of the global total, the U.S. and the EU make up, for example, 65 percent of global banking assets, 72 percent in private and public debt securities outstanding, 58 percent global stock market capitalization, and 74 percent in global insurance in terms of premia collected.[25]

There are several excellent transatlantic institutions that could be used to discuss the financial stability levy: the Transatlantic Economic Council (TEC), the Transatlantic Business Dialogue (TABD), and the U.S.-EU Financial Markets Regulatory Dialogue. In preparation of the TEC Meeting on 27 October 2009 in Washington, the U.S.-EU Financial Markets Regulatory Dialogue agreed to work on a whole range of financial issues, including supervision, capital standards, rating agencies, over the counter derivatives, and accounting. The report emphasized: "As their respective regulatory reform roadmaps continue to unfold, the members of the U.S.–EU regulatory dialogue will continue to hold regular exchanges of information at all levels and monitor closely regulatory developments on both sides of the Atlantic."[26] Earlier this year, the Transatlantic Business Dialogue released its report "EU-U.S. Financial Markets—need for cooperation in difficult times" that calls on policymakers to intensify transatlantic cooperation on financial market regulation.

Unfortunately, after President Obama cancelled his participation at the annual EU-U.S. summit this spring, the summit, and with it the scheduled Transatlantic Economic Council meeting, were postponed. The Obama administration felt that it had more pressing issues to attend to, foremost the unemployment situation. With the Greece crisis unfolding, there is also little interest from the Merkel government to set up a new meeting soon. The next TEC meeting should not be expected before late fall this year. This is a shame, as there are many financial regulatory issues to discuss, the Financial Stability Fee being one of these.

NOTES

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AICGS
1755 Massachusetts Ave. NW
Suite 700
Washington, DC 20036
www.aicgs.org

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Dr. Stormy-Annika Mildner is a DAAD/AICGS Fellow in May and June 2010 and a senior researcher at the German Institute for International and Security Affairs (SWP).

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