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LEGAL ALERT

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Obama Administration Proposes Financial Crisis Responsibility Fee

Perhaps the biggest news in the financial world this week, overshadowing the announcements of exceptional bank profits, is the Financial Crisis Responsibility Fee (the "FCR Fee") proposed yesterday by President Obama. In this Alert, we provide a description of the President's proposal for the FCR Fee, a preliminary list of aspects of the proposed fee that require clarification and some potential reactions to the FCR Fee.

Overview of the FCR Fee

The FCR Fee will work as follows:

- *Covered Institutions*. It will apply to institutions with assets of more than $50 billion. Covered institutions are those that were on January 14, 2010 (or thereafter became) insurance or other companies owning insured depository institutions; insured depository institutions; bank holding companies; thrift holding companies; and securities broker-dealers. *The Economist* estimates that the FCR Fee will be imposed on approximately 50 banks and insurers, which would include 35 American institutions and approximately 15 domestic subsidiaries of foreign companies.[1] The Obama Administration has indicated a desire to have other G-20 countries adopt "comparable approaches."

- *Calculation of the FCR Fee*. The FCR Fee could be viewed as a leverage tax in that the amount of the FCR Fee a covered institution will pay "will be based on its size and exposure to debt," as President Obama stated in his speech on January 14. He added that one aspect of the FCR Fee would be "promoting reform of the banking practices that contributed" to the financial crisis.

  The FCR Fee will be fifteen basis points (15 bps, or 0.15%) of Covered Liabilities, which are calculated as follows:

  Covered Liabilities = Assets – Tier 1 capital – FDIC-assessed deposits (and/or insurance policy reserves, as appropriate)

  For U.S. institutions, the FCR Fee would be applied to assets on a global basis.

  In plain English this generally means, for applicable insurers, starting with all assets, then backing out assets that the insurer owns as a result of (a) selling common stock (usually the par of the issued and outstanding common stock), (b) making a profit doing business and not distributing profits to shareholders (*i.e.*, retained earnings), (c) collecting premiums and holding them as reserves and (d) collecting deposits in FDIC-insured depository subsidiaries.

- *Timing*. The FCR Fee would be in effect from June 30, 2010 until at least June 20, 2020. The FCR Fee would continue to be imposed if TARP losses have not been recouped by then. In 2014,

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[1] "America's Banks: Turning the Tables," *The Economist* (January 14, 2010), http://www.economist.com/opinion/displayStory.cfm?story_id=15293383&source=features_box2

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the Treasury Department will report on the effectiveness and progress of the FCR Fee in repaying projected TARP losses. There is the implication that the FCR Fee could be changed (*i.e.*,. increased) if it is not effective. TARP losses are currently estimated at $177 billion.

Issues Requiring Clarification

Since the proposal is only one day old, it is inevitable that there will be aspects that will need clarification. The following are selected items for clarification that we find interesting.

- *Asset Valuation*. How should assets be valued? Should GAAP book value be used, or should market value be determined in accordance with Statement of Financial Accounting Standards No. 157, Fair Value Measurements, commonly known as FAS 157. Since FAS 157 allows the use of internal models by the reporting company, it may allow more discretion on the part of the tax-payer than the White House would prefer.

  In addition, if a goal of the FCR Fee is to provide an incentive to decrease leverage, then use of market values for assets could have unintended consequences. The Covered Liabilities formula backs out retained earnings. If a covered institution has assets whose market values appreciated, then retained earnings may not reflect this appreciation, and the "Covered Liabilities" would include market appreciation instead of just leverage. The result is that institutions are taxed on successful investment results rather than risky leverage.

- Perhaps the White House may view market value appreciation as the result of the taxpayer support that helped the economy. If that is the case, increases in market value should be limited to those since the financial crisis began.

- *Accounting Basis for Determining Reserves*. Will insurance policy reserves be determined on a GAAP basis or under statutory insurance accounting rules? Statutory reserves are often higher than GAAP reserves, so the former may be preferred by insurers in calculating the FCR Fee, as higher reserves translate to lower Covered Liabilities and a lower FCR fee.

- *Principle-Based Reserves*. How will principles-based reserving (PBR) affect the determination of insurance reserves for the purpose of calculating the FCR Fee? Insurers will have an incentive, for FCR Fee purposes at least, to establish higher reserves. Since PBR gives insurers a degree of discretion, there may be a tendency to establish reserves at the high end of an acceptable range.

- *Transition to IFRS*. The SEC's consideration of transitioning from GAAP reporting to reporting under International Financial Reporting Standards (IFRS) adds another layer of complexity. How would that affect the calculation of Covered Liabilities and, therefore, the amount of FCR Fee to be paid? Grandfathering GAAP (*i.e.*, permitting or requiring a U.S. SEC reporting company to keep GAAP books for purposes of calculating the FCR Fee) would seem expensive, but there may be times where a company feels this added expense would be justified.

- *Influence of IFRS on Statutory Accounting*. The National Association of Insurance Commissioners (NAIC) has been wrestling with how and to what extent statutory insurance accounting ought to reflect a change by the SEC to IFRS. If statutory accounting is used for purposes of determining reserves, any changes implemented by the NAIC adopting IFRS principles may also affect the calculation of Covered Liabilities.

- *Surplus Notes*. Will surplus notes be treated as Tier 1 capital and be used to reduce the FCR Fee? For statutory accounting purposes, surplus notes are treated as capital. By that reasoning, perhaps they should be treated as Tier 1 capital for purposes of determining Covered Liabilities.

  Assuming surplus notes are Tier 1 capital, the FCR Fee may be viewed as treating stock insurers unfairly vis a vis mutuals. For example, if an insurance holding company issues bonds at a lower interest rate than surplus notes, the bonds would be subject to the FCR Fee but not the surplus notes. The stock insurer, in effect, could be viewed as being penalized for having lower cost access to the capital markets. A demutualized stock insurer would face a particular predicament, because it became a stock company for the lower cost capital and then would taxed for taking advantage of it.

- *Adverse Impacts Depending on Corporate Form or Industry*. Is there any tendency for the FCR Fee to be different when applied to mutual insurers as opposed to over stock companies? When should it be applied to life insurers as opposed to property/casualty insurers.

- *Early Termination*. Will the FCR Fee be discontinued if TARP losses are paid off earlier than 2020?

- *Tax Deductibility*. Will the FCR Fee be tax deductible? It seems unlikely, because this will offset the goal of "repaying the American people."

Potential Actions in Response to the FCR Fee

The following are some actions that may occur as a result of adoption of the FCR Fee –

- *M&A Activity*. There may be increased M&A activity as foreign covered institutions seek to reduce the assets held by their U.S. subsidiaries to below $50 billion. The same may be true for U.S. covered institutions that are close to the $50 billion threshold. By the same token, there may be fewer very large financial institution M&A deals. For example, two companies with assets under $50 billion would be reluctant to combine and become subject to the FCR Fee, in addition to the potential scrutiny or regulation if viewed as systemically important.

- *Spin-offs*. Boards of directors may find themselves in the uncomfortable position of having to decide whether a spin-off of part of their company in order to eliminate the burden of the FCR Fee (e.g., to create two institutions, each of which has assets below $50 Billion) would be preferable to maintaining a single company subject to the FCR Fee.

- *Redomestications*. The offshore structure used by some insurers may be adopted by banks and old line insurers. For example, a U.S. covered institution may consider forming a Cayman Islands holding company with subsidiaries organized throughout the world. In light of potential tax haven legislation, Ireland or Switzerland could impose no such fee (or a lower fee) to compete for this business.

- *Increased Issuance of Tier 1 Capital Instruments*. Covered institutions may seek to raise funds via Tier 1 eligible instruments.

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Additional Resources

The White House Press Release on the FCR Fee is available here.

The White House Fact Sheet on the FCR Fee is available here.

President Obama's speech on the FCR Fee is available here.

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If you have any questions about this development, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

Bert Adams	212.389.5004	bert.adams@sutherland.com
Eric A. Arnold	202.383.0741	eric.arnold@sutherland.com
B. Scott Burton	404.853.8217	scott.burton@sutherland.com
James M. Cain	202.383.0180	james.cain@sutherland.com
W. Thomas Conner	202.383.0590	thomas.conner@sutherland.com
Susan S. Krawczyk	202.383.0197	susan.krawczyk@sutherland.com
Cynthia M. Krus	202.383.0218	cynthia.krus@sutherland.com
David A. Massey	202.383.0201	david.massey@sutherland.com
Stephen E. Roth	202.383.0158	steve.roth@sutherland.com
Holly H. Smith	202.383.0245	holly.smith@sutherland.com
Annette L. Tripp	713.470.6133	annette.tripp@sutherland.com
Mary Jane Wilson-Bilik	202.383.0660	mj.wilson-bilik@sutherland.com
Earl Zimmerman	212.389.5024	earl.zimmerman@sutherland.com