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WASHINGTON POLICY STRATEGY

Potomac Perspective

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A House hearing with the banking regulators did not provide any groundbreaking news on the Basel III Endgame proposal. It did, however, reinforce our view that the proposal could be significantly altered or even scrapped. A revised rule could be capital neutral.

The announcement of two presidential debates signaled the Biden campaign sees the race similarly to what public polls have shown – a steady lead for Donald Trump that the Biden campaign has been unable to dent, and the Biden team needs to change the campaign's trajectory sooner rather than later. We note the risks the debates pose to both campaigns but, counterintuitively, the Trump campaign might face more downside on net.

BASEL III ENDGAME

On Wednesday, federal banking regulators testified before the House Financial Services Committee, and the Basel III Endgame (B3) was among the topics that were discussed. The regulators did not reveal significantly new information when asked about the proposed rule. However, the prepared testimony of Federal Reserve (Fed) Vice Chairman for Supervision, Michael Barr, and Federal Deposit Insurance Corporation (FDIC) Chairman, Martin Gruenberg, provided more evidence that the proposal is likely to be significantly altered when and if it is finalized.

In his written testimony, Vice Chairman Barr said of the B3 proposal (emphasis added):

*We are closely analyzing this information, and **I expect we will have a set of broad, material changes to the proposal** that allow us to have a broad consensus in moving the proposal forward.*

FDIC Chairman Gruenberg wrote:

The comments have been very helpful in identifying areas of the proposal that may warrant changes in a final rule. For example, concerns have been raised related to the proposed treatment for residential mortgage exposures, certain tax credit equity investments, trading activities, and banking activities that generate large amounts of fee-based revenue. The FDIC continues to consider the comments and engage with our fellow regulators in developing a final rule.

The comments from Mr. Barr and Mr. Gruenberg are consistent with earlier comments from Fed Chairman Jerome Powell, underscoring the likelihood the B3 proposal will be significantly revised before it is finalized, or possibly re-proposed, by year-end.

These comments support our long-held thesis that the presidential election will have an impact on B3. If Donald Trump wins the November election, the leadership of two of the three agencies involved in the B3 rulemaking would change on Inauguration Day. This could lead to the rule being scrapped altogether.

In our view, if elected, Mr. Trump would replace the Comptroller of the Currency immediately. A Trump-appointed Comptroller would probably kill the proposal at that agency. Also, Mr. Trump would likely replace the Director of the Consumer Financial Protection Bureau who, like the Comptroller, is a FDIC Board member. While a president cannot fire the head of the FDIC without cause, FDIC Chairman Gruenberg would lose effective control of the Board and be unable to approve the B3 proposal if Mr. Trump wins. While the Fed's Board of Governors would not be impacted by the election, two Fed Governors (Michelle Bowman and Christopher Waller) previously voted against the original proposal. Chairman Powell and Vice Chairman Philip Jefferson also expressed concerns with the initial proposal. It seems evident from these actions that there is some pressure within the Fed to make changes to the rule.

The possibility of a Trump win, which creates the potential for the possible scrapping of the entire B3 proposal, provides a powerful incentive for regulators to make significant changes to finish it. Coordinating multiple agencies involved in rulemaking is never easy. It is possible that the Office of the Comptroller of the Currency, FDIC, and Fed will be unable to agree to a final rule before the election, but we think it is in the agencies' interests to scale back the proposal and finish it before the election. The heads of the three agencies can read polls, and they realize a Trump win and the scrapping of B3 is a realistic scenario, so the chances of revisions to B3 that result in a capital-neutral rule are quite good.

PRESIDENTIAL DEBATE

Wednesday's announcement of two debates between President Joe Biden and former President Donald Trump signaled that the Biden campaign recognizes Mr. Trump's lead in public polling is real and stable, and Mr. Biden needs to shake up the race sooner rather than later. According to the RealClearPolitics polling averages, Mr. Trump holds a small but consistent lead nationally over Mr. Biden. Mr. Trump has also led Mr. Biden in all of the key battleground states, and in some of those states (Arizona, Georgia, Nevada, and North Carolina), the Trump lead is sizable. We think the Biden campaign also realizes that voters are already familiar with both candidates, and it is unlikely that late developments, such as a September or October debate, will alter the race. An earlier debate might stand a better chance of altering the race's trajectory. Also, the June debate will occur before any early voting takes place, which could make it more impactful.

The debates pose risks for both candidates but, contrary to popular opinion, we think Mr. Trump might have more to lose. He and his campaign have set expectations so low for Mr. Biden that the current President could surprise voters with even a mediocre performance. Also, the rules of no audience and mics possibly being cut off when a speaker's time has expired could work against Mr. Trump, who thrives on an audience's energy. On the flip side, the debates pose some risk for Mr. Biden, too. There is history of incumbent presidents performing poorly in a first debate (Ronald Reagan in 1984, George H.W. Bush in 1992, George W. Bush in 2004, and Barack Obama in 2012). A weak debate by Mr. Biden could reinforce the perception among some voters that he is too old for the job. Despite the fact the June date is intended to allow the debate loser time to recover, Mr. Biden might be unable to recover from gaffes or senior moments.

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