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Brian Gardner
Chief Washington Policy Strategist
bgardner@stifel.com

WASHINGTON POLICY STRATEGY

Potomac Perspective

Despite positive rhetoric following Secretary Janet Yellen's trip to China, tensions between the two countries are likely to remain elevated, as the U.S. is unlikely to significantly reduce tariffs on Chinese exports and might, instead, create a new vetting process for outbound investments in China. A bipartisan hawkishness towards China is likely to prevent much of a thaw in bilateral relations, especially ahead of the 2024 elections.

On Monday, a key banking regulator will give a speech that could outline proposals to increase bank capital requirements.

Congress returns to Washington with a busy agenda which could include cannabis-related legislation as well as hearings on Environmental, Social, and Governance (ESG) policy and cryptocurrency. A busy month in the policy world is on tap ahead of Congress's August recess.

YELLEN GOES TO CHINA – WHAT'S NEXT

Following Treasury Secretary Janet Yellen's meetings in China, American and Chinese officials gave positive assessments of the trip. **Investors, however, should not expect major policy changes in the wake of the trip.** Tensions between the U.S. and China have recently escalated as western countries limited exports of semiconductors to China. China retaliated by restricting the export of gallium and germanium, key elements used in the manufacture of computer chips. Trade tensions could further escalate in the coming weeks despite efforts by the U.S. (and China) to lower the temperature.

China has been pushing to repeal of reduce tariffs on exports that the U.S. imposed in 2018, but a repeal or widescale reduction is unlikely. The Biden administration continues its review of 2018 tariffs. This review is mandated under the law the Trump administration used to impose them, so the review should not be interpreted as a sign that the U.S is likely to change its policy. Our baseline expectation is that most of the 2018 tariffs will be extended and only a small number of tariffs might be either reduced or revoked.

Furthermore, **the administration has been considering a new process to vet outbound investment by U.S. companies in China.** The Biden administration's potential Executive Order, which would create this new vetting process, has been under consideration for some time and would probably be limited to sectors closely linked to national security such as quantum computing.

Even if the administration decided to change course and not issue an Executive Order, a bipartisan group in Congress has signaled its intent to go farther than the administration and subject a wider array of outbound investments to U.S. government scrutiny. While some free market conservatives in Congress want to limit the scope of any outbound vetting process, there seems to be a bipartisan consensus to implement it.

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In the end, the ongoing bipartisan competition in Congress for who can look toughest against China means investors should not expect a thawing of U.S.-China relations anytime soon. **The looming 2024 election will only intensify the desire of lawmakers to maintain a tough stance vis-à-vis China.**

Expect an announcement of an outbound investment vetting process in the coming months as well as an extension of most China tariffs.

BANK CAPITAL

On Monday, Federal Reserve (Fed) Vice Chairman for Supervision Michael Barr is scheduled to deliver a speech in Washington that could outline proposals to change bank capital requirements. The potential changes could come in two separate proposals.

The first proposal could be released as soon as the week of July 17 and would likely comprise the Basel III Endgame proposal. It is expected that the proposal will address four issues. The common themes of each part of the proposal are standardization and less reliance on banks' internal models.

1. **Credit risk** – Introduce a standardized approach for credit risk in lieu of the current model-based approach.
2. **Market risk** – A) Require a more robust methodology to capitalize for potential tail risks as well as market liquidity risk under stressed conditions, B) Set out more stringent requirements for the use of internal models for calculating capital requirements, and) Possibly introduce a new standardized measurement for market risk that provides a more consistent approach to calculating capital requirements.
3. **Operational risk** – Move away from internal models for operational risk and replace the current model-based approach with a standardized approach that is adjusted for banks' own historical loss experience.
4. **Financial derivatives** – Improve the estimation of credit valuation adjustment risk by introducing new frameworks that would be consistent with the more robust methodology under the revised market risk framework.

The Basel II Endgame proposal is likely to increase bank capital requirements but will likely be targeted at banks with over $100 billion in assets. The proposal could be finalized in mid-2024, but regulators acknowledge they will give banks several years to implement the new requirements.

Vice Chairman Barr might also discuss the comprehensive review of bank capital rules that he announced in late 2022. In December, Mr. Barr said the Fed would conduct a holistic review of bank capital standards. While he did not say what changes might be made to bank capital requirements, his speech cited studies which found that U.S. bank capital requirements are insufficient. This suggests the Fed could be working on a broad proposal to increase capital requirements. Monday's speech could shed new light on what changes the regulators might propose, as well as the potential timing of such a proposal.

SAFE BANKING ACT

The Senate Banking Committee could schedule a markup of the SAFE Banking Act sometime in July. The bill would allow financial institutions to serve the cannabis industry in states where the product has been legalized. While cannabis is legal in several states, it remains illegal under federal law, and financial service companies that do business with cannabis firms could be prosecuted under federal anti-money laundering laws.

Supporters of SAFE would like to pass the bill through the Banking Committee and add it to a year-end bill such as the National Defense Authorization Act (NDAA). The headlines of scheduling a markup could be positive for the sector, but we note that the strategy of adding SAFE to the NDAA has been unsuccessfully tried before. **Despite some potentially positive headlines in the coming week, SAFE still faces significant political opposition, especially from some key congressional Republicans.**

CRYPTOCURRENCY LEGISLATION

The House Financial Services Committee could markup cryptocurrency legislation later this month. Committee Chairman Patrick McHenry (R-North Carolina) has been working on two bills – one bill on crypto market structure that would clarify the regulatory framework for digital assets and a second bill regarding stablecoins. No markup has been scheduled yet and a markup might not happen until after Labor Day, but investors could see headlines regarding a markup shortly.

In the Senate, Senators Kristen Gillibrand (D-New York) and Cynthia Lummis (R-Wyoming) could release soon an updated version of the cryptocurrency bill they drafted in 2022.

In the wake of the collapse of FTX, any traction for crypto legislation has been lost, so investors should discount headlines regarding crypto legislation. For the foreseeable future, policy action, which is the purview of the Securities and Exchange Commission (SEC), will be the mechanism by which the government seeks to assert control over the industry.

ESG HEARINGS

The House Financial Services Committee will hold a series of hearing this week regarding Environmental, Social, and Governance (ESG) policy. The hearings could shine a spotlight on the issue, but most action regarding ESG continues to be done by the SEC and the states. The SEC proposed climate risk disclosure rules last year, but that proposal has been criticized by observers, especially issuers. The SEC has been working through the public comments, and it is unclear when a final rule might be released.

As we also noted in our 2023 outlook, much of the ESG policy debate is at the state level, where state-funded pension funds (especially in red states) continue to push back against ESG policies which these states view as harmful to both their pension plans as well as some home state industries. Congressional action is unlikely – investors should continue to monitor the SEC and the states.

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