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Cozen Currents: Banking on a Crisis

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The Cozen Lens

- This past weekend's fast-moving banking crisis was an abrupt reminder that the era of easy money is over. While regulators were able to avoid broader contagion (at least for now), this crisis has far-reaching implications going forward for regulation of the banking sector writ large, the Fed's monetary policy, and President Biden's re-election campaign.
- President Biden released his FY24 budget last week. As the saying goes, "the president proposes and Congress disposes," and Biden's budget request stands little chance of making it into law. It will have implications for the impending debt ceiling fight and the 2024 presidential election though.

The Politics of a Banking Crisis

Bailouts are Off the Table. "Bailout" has become the political equivalent of Voldemort in the wake of the 2008 financial crisis and the 2020 pandemic, so when the Biden administration was facing an imminent banking crisis this weekend as a result of the collapse of Silicon Valley Bank (SVB), preventing their actions from being characterized as a bailout was front of mind.

- Due to the speed with which SVB failed and then quickly posed a contagion risk, federal regulators had a financial and economic imperative to halt the incipient banking crisis before Asian financial markets opened on Sunday evening.
- But while avoiding a cascade of bank failures was a necessary condition, it was not a sufficient one. The Biden administration also had a political imperative to avoid providing a bailout. But what's considered a bailout is in the eye of the beholder, or in this case, the voter. Ultimately, the administration drew the line on bailing out depositors but not bank executives or investors.
- Some of Biden's top appointed banking regulators, such as Fed Vice Chair for Supervision Michael Barr and Federal Deposit Insurance Corporation (FDIC) Chairman Martin Gruenberg, were intimately involved in the Obama administration's collaboration with Congress to pass the Dodd-Frank Act. Among the core principles enshrined into that seminal law is that the largest banks should not be allowed to get larger. Thus, while facilitating the sale of SVB to one of the largest systemically important financial institutions (SIFIs), i.e., big banks, would have been the most expedient resolution from a financial perspective, it was not a politically acceptable option for them.

Banks Traded Relief Today for Higher Regulatory Bar(r) Tomorrow. Last week was the high-water mark of post-crisis banking deregulation.

- As a result of the Dodd-Frank Act, the banking sector was effectively split into two tiers – SIFIs and non-SIFIs. Although the big banks were not a cause of the SVB and Signature Bank failures, they nevertheless will bear a large part of the burden of the regulatory reaction. President Biden said on Sunday evening that he was going to continue, "to strengthen oversight and regulation of larger banks so that we are not in this position again."
- Fed Vice Chair for Supervision Barr said in his first speech after his 2022 confirmation that he was undertaking a "holistic" review of banks' capital requirements "to understand how they are supporting the resilience of the financial system, individually and in combination." As a result of this review, Barr had already been expected to impose more stringent capital requirements on SIFIs by rolling back the deregulation that occurred under the Trump administration. However, Barr is now likely to go even further. The affected banks and some of their Republican champions on Capitol Hill have lobbied the Fed to avoid such changes, but

their pleas will fall on deaf ears in the new political environment.

- Despite the avoidance of a broader banking crisis, non-SIFIs, including regional and community banks, remain in an existential crisis that must be solved before the Fed, FDIC, and Treasury can allow the temporary facility they established on Sunday to backstop all uninsured deposits across the banking system to come to an end. The Fed announced yesterday that Barr will also lead a review of the central bank's supervision and regulation of SVB with the final report due for public release on May 1st. Barr is likely to seek to apply some of the regulatory tools already used on the bigger banks to non-SIFIs, such as higher capital and liquidity standards, stress test scenarios to measure for concentration risk, and lending standards.
- There is little chance of any legislative response in the foreseeable future given the divided and hyper-partisan nature of Congress, so repeal of the 2018 bipartisan law that sought to limit the applicable SIFI regulatory requirements to a smaller subset of banks and to provide regulatory relief to regional banks is off the table. But there is still considerable discretion in that statute for the Fed to regulate regional banks more aggressively than they have been in practice.

Nobody is Letting a Good Crisis Go to Waste Politically. House Financial Services Committee Chairman Patrick McHenry (R-NC) stated that this was the first Twitter-induced banking crisis. To that end, the various factions in Washington have already been using social media to twist these events to their own worldview and political advantage.

- MAGA Republicans have seized on the so-called "woke" business practices and values of SVB to further their line of attack that when businesses and financial institutions stray from their traditional goal of creating shareholder value, they risk "going broke."
- Progressives have also been out in force decrying their moderate Democratic peers, such as Senator Mark Warner (D-VA), who supported the 2018 regulatory reform law. Senators Bernie Sanders (I-VT) and Elizabeth Warren (D-MA) are calling for further wholesale de-risking of the financial sector and repeal of any deregulation from the Trump era.
- Then there is the Biden administration and federal regulators who know that the crisis was a byproduct of the Fed's aggressive interest rate tightening. There is now palpable fear in the private sector about other hidden risks from operating in a restrictive interest rate environment. Even if the system stabilizes as regulators hope, the impending capital increases will mean less money available to lend and businesses reining in their risk-taking. These factors all have the potential to chill economic activity further, which creates complications for the Biden reelection campaign as well as for Barr's colleagues on the Fed who had indicated a desire and willingness to continue to increase interest rates higher and for longer, at least before this weekend's crisis hit.

The Proposal (and Disposal) of Biden's FY24 Budget

What Biden's Budget Means for FY24 Appropriations. Last week's budget request from the White House is the first step in funding the government for FY24.

- President Biden's budget includes a return of some proposals from his Build Back Better agenda, including raising the corporate tax rate from 21 to 28 percent, raising the tax on foreign corporate profits from 10.5 to 21 percent, raising the stock buyback tax from 1 to 4 percent, and raising the top individual and capital gains rates on high-income individuals.
- There is a zero percent chance any of these policies see the light of day as long as Republicans hold at least one chamber of Congress. Biden's budget is a political and messaging document to show Democrats can reduce the deficit without cutting spending on entitlement and discretionary programs. It's meant to contrast with Republicans looking to cut spending.
- House Republicans want to return to the $1.5 trillion spending level of FY22 for FY24. That would be a cut of about $124 billion or 7.6 percent from FY23 levels. Some MAGA Republicans and libertarians, like Rep. Jim Jordan (R-OH) and Senator Rand Paul (R-KY), have signaled openness to defense cuts. But there's a big defense hawk contingency in the GOP, which includes Senate Minority Leader Mitch McConnell (R-KY).
- There was a larger plus up in defense spending compared to non-defense spending in FY23, but that reflected the fact that Democrats got a lot of nondefense spending done in

separate legislation. Democrats will likely aim for parity between increases to defense and nondefense spending in FY24. They are not going to agree to a cut of over $124 billion in nondefense spending as defense spending rises to keep within the FY22 spending limit of the House GOP.

- In the end, appropriators may split the baby in half for FY24, leaving defense and nondefense toplines at FY23 levels, perhaps with an effective yearlong continuing resolution.

What Biden's Budget Means for the Debt Ceiling. Biden's budget also stakes out his negotiating position for the upcoming debt ceiling battle.

- Republicans are seeking some "fiscal reforms" as a condition of supporting an increase in the debt ceiling. Biden's budget includes $3 trillion in deficit reduction over 10 years, and it's now on Republicans to formulate a proposal that can get 218 votes in the House.
- As Dan Meyer, the chief of staff to House Speaker Kevin McCarthy (R-CA), noted per a Washington Post report, Republicans are in a "nearly impossible bind." That's because as a condition for being elected speaker, McCarthy promised to push discretionary spending to FY22 levels, not touch Social Security and Medicare spending, not raise taxes, and balance the budget in 10 years (i.e., no annual deficit). Republican defense hawks will also push hard to not trim the defense budget. This means Republicans will be looking to make deep cuts to non-defense discretionary spending and entitlement programs for the poor, like Medicaid and food stamps. This scenario is just as unrealistic as the tax increases in Biden's budget.
- We will likely not get greater clarity on the GOP's debt ceiling position until the House Budget Committee releases its budget, which will likely not be until this spring. The Republican Study Committee, a broad group of House conservatives, may also release its own proposal.
- The Congressional Budget Office estimates the X-date will come between July and September, with a chance it arrives in June if tax receipts are lighter than expected. With a firmer X-date estimate after tax season, the pressure could ramp up.

What Biden's Budget Means for Politics. The president's budget also has implications for the 2024 presidential race.

- Biden's FY24 budget is the precursor to his formal re-election announcement, perhaps as soon as next month. It lays out a vision of what another Biden term would look like, showing how he can make government work for the average person, funded by greater taxes on corporations and the wealthy. Biden's budget also seeks to paint a contrast between the president and Republicans.
- While Biden's path to the Democratic nomination is secure, Republicans likely have a fight on their hands. How Republican presidential contenders respond to Biden's budget and the budgetary battles this year will influence the direction of the GOP in DC.
- Florida Governor Ron DeSantis delivered his annual State of the State address last week as the Florida legislative session opened. It was heavy on fighting the culture wars, not budgets. As the race to lead the Republican Party is still unsettled, former President Trump and DeSantis may see the budget as a means to fighting the culture war. Russ Vought, Trump's former budget director, has proposed a budget to decrease government spending by taking on the "woke" government. This includes trillions of cuts to Medicaid and healthcare for the poor and reducing agencies like the State Department and Labor Department by half.
- Other Republicans do not subscribe to this viewpoint. Former Vice President Mike Pence has called for cuts to entitlement spending, while former UN Ambassador Nikki Haley published a USA Today op-ed portraying herself as a fiscal hawk. However, if the next GOP leader is Trump or DeSantis, this could be the leading voice for budget policy moving forward.