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2024 Regulatory Outlook: One Step Forward, One Step Back and One Step in a New Direction

> "The state – the machinery and power of the state – is a potential resource or threat to every industry in the society. With its power to prohibit or compel, to take or give money, the state can and does selectively help or hurt a vast number of industries…. "
>
> -- George Stigler[1]

This outlook provides an analysis of forthcoming legislative and regulatory changes, highlighting the risks and opportunities for investors from these evolving landscapes. It examines the Inflation Reduction Act of 2022, Basel III Endgame, and the US Supreme Court's anticipated paradigmatic shift in the interpretation of federal statutes by administrative agencies.

We delve into the transformative potential of the Inflation Reduction Act of 2022. The Act is a strategic move by the United States to boost its competitiveness in the global renewable energy sector, with broader implications for international relations and trade dynamics. This significant legislative milestone mirrors the scale and impact of the 1930s New Deal, offering unprecedented opportunity modifying, extending, and creating various tax credits for renewable energy and other environmental efforts, that are now transferable in a new legislative innovation.

We also explore the implications of the Basel III Endgame's heightened capital requirements, presenting a unique investment landscape, especially for smaller banks. Finally, we briefly discuss the shifting judicial landscape with potential US Supreme Court decisions that could redefine regulatory interpretation, adding another layer of complexity and opportunity in the regulatory state.

EJF Capital specializes in regulatory event-driven investing, particularly in the financial and real estate sectors. Our approach involves combining investment expertise across the capital structure with a corporate finance focus, aiming to identify creative solutions for investing in complex securities and fiscal stimulus tools that can be harnessed to generate attractive returns. This approach is underpinned by our focus on regulatory change and its potential to create investment opportunities.

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[1] , "The Theory of Economic Regulation", The Bell Journal of Economics and Management Science, Vol. 2, No. 1 (Spring 1971), p. 3.

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Executive Summary

- The Step Forward: The Inflation Reduction Act of 2022 ("IRA") presents a generational opportunity to take advantage of the impact of tax credits the magnitude and scope of which echo the New Deal legislation of the 1930s.
    - The IRA has been estimated to provide somewhere between $369 billion and $500 billion in tax incentives over ten years[2], spurring some $3 trillion investment in renewable energy technology that could double the amount of energy produced by the shale revolution 15 years ago.
    - EJF believes that the IRA presents interesting opportunities from both an investment angle and a tax credit perspective.
    - The IRA's legislative innovation of transferable tax credits will amplify the usage of such credits and investments in renewable projects and components.
- The Step Backward: EJF believes that a much-anticipated step backward in banking regulation – known as the "Basel III Endgame" heightened capital requirements - also presents an investment opportunity.
    - After the spring 2023 collapse in succession of Silicon Valley Bank, Signature Bank and First Republic Bank, members of Congress and bank regulators have sought to "fix the problem" by imposing new capital and other requirements.
    - The anticipated regulations will most likely only affect banks in the US with assets $100 billion and greater and thus provide a very clear investment case for small banks and some non-bank financials.
    - Smaller banks are beginning to enter into Credit Risk Transfer ("CRT") transactions; CRTs are designed to transfer the risk of all or a tranche of a group of financial assets, principally portfolios of mortgages, corporate loans, or other assets, to outside investors in a manner that "frees up" capital for banks.
    - It has been estimated that the potential market size for CRT transactions by the US banks could be up to $400 billion, based on the assumption that 10% of the risk-weighted assets of the US banks could be transferred through CRTs.[3]
    - EJF believes that CRT transactions offer attractive credit investment opportunities for investors.
- The Step in a New Direction: Although not specifically actionable as an investment thesis, EJF believes that investors should be aware that there will be a paradigm shift in the interpretation of federal statutes by courts after a series of US Supreme Court decisions are announced in the spring.

[2] Scheinert, Christian, "EU's Response to the US Inflation Reduction Act: Think Tank: European Parliament", Jun. 6, 2023
https://www.europarl.europa.eu/thinktank/en/document/IPOL_IDA(2023)740087#:~:text=Although%20hailed%20in%20the%20EU,to%20relocate%20to%20the%20US

[3] Mondaq, "United States: Regulation Q And You: Capital Relief Trades For U.S. Banks", Jun. 14, 2022
https://www.mondaq.com/unitedstates/securitization-amp-structured-finance/1201432/regulation-q-and-you-capital-relief-trades-for-us-banks

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- In the future, Congress will have to be clearer in its delegation authority language in statutes, which will likely make the struggles within Congress to pass statutes even more contentious.
- There will likely be more challenges to regulatory actions by federal agencies on the grounds that such actions exceed statutory authority.
- The net effect will be less regulatory reach by the administrative state and less fluctuation of regulatory action as presidential administrations change.

Professor Stigler's observation in the introduction is as notable for its clarity as its insight. The importance of economic regulations to society, and to investors, is undeniable. Governmental authority established through legislation and regulation has been an historical feature of every society since the dawn of mankind. Perhaps the quintessential example in early history of a government effectively using regulation as a tool to maintain authority was the Roman Empire. In Roman times, salt was the most important commodity in society and a critical element to sustaining human life: for maintaining agriculture and livestock, for making bread, for preserving food. According to Andreas Viestad in his book, <u>Dinner in Rome: A History of the World in One Meal</u>, leaders of Rome in 508 B.C. instituted a monopoly on the salt flats near the Tyrrhenian Sea, controlling the movement of salt collected from the pools of sea water in the flats to Rome on Via Salaria (literally, "salt road"), one of the oldest paths to the ancient city. The regulatory tool of choice for the leaders of Rome was taxing salt usage. The Empire sought to influence behavior by taxing different salt usages at different rates. The Roman regulatory regime was not atypical; as Viestad asserts, "Salt tax is probably the oldest tax there is, and historically the most unpopular".[4] As evidence, Viestad serves a smorgasbord of salt tax vignettes. The popular revolt against King Louis XVI's salt tax -- la gabelle du sel (from which the nobility and clergy were notably exempted) – was a contributing cause of the French Revolution in 1789. The gabelle du sel, which was the largest source of revenue for the French state throughout the 18th century, met a guillotine-like demise the next year. During the Han Dynasty in China, the government's salt tax accounted for more than half of the Empire's revenues and largely underwrote the construction of the Great Wall. Britain's colonial rule over India was, in part, buttressed by its control of local salt sources and the imposition of high taxes on imported British salt. The salt tax was such a stirring symbol of unfairness that Mahatma Gandhi highlighted it during his 1930 "salt protest march" which culminated in the boiling of seawater and collecting of salt lumps in the town of Dandi on the Arabian Sea coast.

<u>One Step Forward</u>

Thankfully, modern democratic capitalist-based economies and societies do not suffer egregious and authoritarian salt taxes. But investors do need to understand and be aware of the impacts of new legislation and regulatory changes and the opportunities they create. In the first two years of

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[4] Viestad (Reakton Books Ltd. 2022), p. 77.

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his administration, President Joseph Biden passed with bipartisan support three substantial pieces of legislation directed at the domestic US market: in 2021, the Infrastructure Investment and Jobs Act, which provides $1.2 trillion for domestic projects to update infrastructure as far ranging as broadband internet, rail, bridges, clean water and electric vehicle charging stations[5]; in 2022, the CHIPS and Science Act, which incentivizes the manufacture of semiconductors in the US[6], and the IRA which incentivizes the manufacture of renewable projects and components in the US. The CHIPS Act and the IRA represent seminal political and financial commitments to decrease America's integration with the world economy. Although these Acts apply narrowly to the manufacturing of semiconductors and renewable energy plants and components, they represent strategic and bipartisan steps to disengage meaningfully from global supply chains and dependence on foreign energy and goods.

From EJF's perspective, the IRA in particular presents a generational opportunity to take advantage of the impact of tax credits the magnitude and scope of which echo the New Deal legislation of the 1930s. The IRA provides tax incentives for US companies to invest in manufacturing wind, solar, energy storage and other renewable energy projects. The subsidies are substantial. The Investment Tax Credits ("ITC") provide up to a 30% tax credit for investing in renewable energy projects, and those credits can be increased if the investments are made in "low income communities" or in "energy communities" that have experienced closures of coal mines or retirement of a coal-fired electric generating unit.[7] The IRA's Production Tax Credits ("PTC") are in many ways more actionable as the Act provides an exact formula based on how much solar, wind or other renewable energy components – such as nuts, bolts, clamps and wind towers – are produced.

The IRA's provisions can potentially make U.S. electricity from renewable sources like solar and wind the cheapest globally in the near future giving rise to implications for the global market; for example affecting the European Union's ambitions to become a leader in green hydrogen. The EU may be unable to compete with the United States' heavy subsidization of green and blue hydrogen and instead become an importer.[8]

Most importantly, both PTC and ITC tax credits are transferable, a legislative innovation that will maximize their usage. The IRA allows for the transfer of ITC and PTC to corporations and individuals that have passive income to reduce their tax liabilities dollar for dollar. The IRA has

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[5] White House Fact Sheet: The Bipartisan Infrastructure Deal, Nov. 6, 2021 https://www.whitehouse.gov/briefing-room/statements-releases/2021/11/06/fact-sheet-the-bipartisan-infrastructure-deal/

[6] White House Fact Sheet: The CHIPS and Science Act, Aug. 9, 2022 https://www.whitehouse.gov/briefing-room/statements-releases/2022/08/09/fact-sheet-chips-and-science-act-will-lower-costs-create-jobs-strengthen-supply-chains-and-counter-china/

[7] US Treasury Fact Sheet: "How the Inflation Reduction Act's Tax Incentives Are Ensuring All Americans Benefit from the Growth of the Clean Energy Economy", Oct. 20, 2023 https://home.treasury.gov/news/press-releases/jy1830#:~:text=The%20Inflation%20Reduction%20Act%20modifies%20and%20extends%20the%20Renewable%20Energy,meet%20prevailing%20wage%20standards%20and

[8] Elcano Royal Institute, Key transatlantic implications of the Inflation Reduction Act, Apr. 11, 2023 https://www.realinstitutoelcano.org/en/analyses/key-transatlantic-implications-of-the-inflation-reduction-act/

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been estimated to provide somewhere between $369 billion and $500 billion in tax incentives over ten years.[9] Some have even argued that the IRA ultimately could "spur about $3 trillion investment in renewable energy technology that could double the amount of energy produced by the shale revolution 15 years ago."[10] Although there is certainly a risk that a new Republican President and Congress could curtail these tax credits, the domestic nature and location of America's manufacturing base in swing political districts make this possibility, in our view, unlikely. For example, of the estimated $128 billion of investments in domestic EV and battery manufacturing that have been announced since the passage of the IRA, $48 billion (or 38%) are located in Georgia, Arizona, Nevada and Michigan.[11]

Prior to the passage of the IRA, investment tax credits generated by renewable energy projects could not be transferred. To "transfer" credits, developers had to enter into joint venture arrangements with companies with a sufficient tax liability. Such "tax equity" transactions are relatively complex financing structures and have five-year exposure to the project as well as the credit. Given the complexity of such structures, large financial institutions such as money center banks with project financing underwriting capabilities dominated the "tax equity" market. By contrast, the IRA allows businesses to transfer all or a portion of any of 11 clean energy ITC or PTC to a third party in exchange for tax-free immediate funds. This allows businesses to take advantage of tax incentives even if they do not have sufficient tax liability to utilize the credits themselves. Because of the transferability of the tax credits, renewable energy project developers and component manufacturers can become profitable, or more profitable, almost immediately, can lower the cost of energy produced to consumers, and can finance projects more expeditiously --- all impacts which have a multiplier effect. Transferability creates a more efficient use of capital as ITC and PTC sellers get capital back quicker and buyers are able to apply the tax credits to their returns almost immediately.

Although EJF believes that investments in renewable energy developers can be compelling because of the IRA, the manufacturers of renewable energy related components and the tax credits they produce are even more compelling because they reduce "look back" risk because of their immediate nature. We therefore think that the IRA presents interesting opportunities from both an investment angle and a tax credit perspective.

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[9] Scheinert, Christian, "EU's Response to the US Inflation Reduction Act: Think Tank: European Parliament", Jun. 6, 2023
https://www.europarl.europa.eu/thinktank/en/document/IPOL_IDA(2023)740087#:~:text=Although%20hailed%20in%20the%20EU,to%20relocate%20to%20the%20US

[10] Goldman Sachs, "The US is poised for an energy revolution", Apr. 17, 2023
https://www.goldmansachs.com/intelligence/pages/the-us-is-poised-for-an-energy-revolution.html

[11] Reuters, "In 2024, Republican EV attacks may fall short as swing states reap investment", Nov. 27, 2023
https://www.reuters.com/world/us/2024-republican-ev-attacks-may-fall-short-swing-states-reap-investment-2023-11-27/

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One Step Backward

EJF believes that a much-anticipated step backward in banking regulation also presents an investment opportunity. After the spring 2023 collapse in succession of Silicon Valley Bank, Signature Bank and First Republic Bank, members of Congress and bank regulators have sought to "fix the problem" by imposing higher capital requirements and other regulatory "fixes". Although they will do anything but address "the problem" banks face (e.g., mismanaged securities portfolio risk, deposit flight risk), they will create investment opportunities. The regulations, popularly known as "Basel III Endgame" will most likely only affect banks in the US with assets $100 billion and greater and thus provide a very clear investment case for small banks and some non-bank financials.

In our experience observing the regulatory state in action, the more push-and-pull you see from opposing sides on a specific regulation change, the closer it is to being implemented. Over the course of the past six months, the largest 37 banks in the U.S. most impacted by the Basel III Endgame proposals have argued that the potential regulation will make them less competitive versus both international institutions and 'shadow banks', i.e. non-bank lending entities such as private credit firms, REITs and alternative asset management entities. Given the expected 10%-30% increase in capital requirements for banks under the Basel III Endgame regulations, the banks have begun an extremely active lobby against the rule changes. Recently, a group of 39 Senate Republicans called on the regulatory agencies to withdraw the proposals. They referenced limited access to credit for millions of Americans as a result of these potential rules. In early December, CEOs of the largest banks spoke on Capitol Hill and urged Congress to push for watered-down regulations in order to prevent a credit shift to non-bank financial companies that do not face the same rules. Finally, on December 19, 2023, the head of the American Bankers Association, Rob Nichols, made public a letter addressed to President Biden urging him to intervene and slow a barrage of regulations pending for the largest US lenders.[12] Through its spokesperson, Michael Kikukawa, the White House responded with the following statement which portends regulatory action: "Without commenting on specific proposed regulations, President Biden supports common-sense reforms to reverse Trump-era weakening of the supervision of large regional banks in order to strengthen our banking system to avoid future crises like the collapse of Silicon Valley Bank…. A safe and diversified banking sector — including healthy community and regional banks — is a source of strength for our economy. As is common practice, independent regulators are currently in the process of taking comment from industry, businesses and other stakeholders on specific aspects of their proposed rules."[13]

[12] Rob Nichols, ABA Letter to President Biden re Impact of Regulations, Dec. 19, 2023
https://www.aba.com/advocacy/policy-analysis/letter-to-president-biden-re-impact-of-regulations
[13] American Banker, "Banks ask Biden to Rethink More Stringent Regulation," Dec. 21, 2023
https://www.americanbanker.com/news/banks-ask-biden-to-rethink-more-stringent-regulation

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EJF believes that small banks, which will have effectively no new regulations as a result of the impending Basel III Endgame regulations, will take market share from larger regional and money center banks if the proposed rules were to become finalized in 2024, and we believe they will given the political pressures on the White House and its framing of the issue as an anti-Trump measure. We believe that the end of rate hikes likely reduces the tail risk of a deep recession and greater than expected credit quality deterioration for the banking sector. As a result, we are optimistic that investors in 2024 will begin to more appropriately value small and medium sized banks based upon fundamentals; their earnings and return on average tangible common equity progressions instead of fear emanating from the wake of the regional bank crisis of March 2023. Small banks enjoy attractive valuations, healthy credit conditions, strong earnings power, lower capital requirements and regulatory/political hurdles than money center banks, and robust through-the-cycle M&A activity. We see small banks taking market share, particularly as it relates to serving small businesses. Over the past 15 years, small banks have improved operating leverage by reducing physical branches and improving systems/technology utilization. EJF believes that both sides of the political spectrum are committed to community and small banks given their role in serving an estimated 30 million small businesses and originating approximately half of all US small business loans annually. In short, EJF sees meaningful upside in small bank equities and debt.

Although small banks will not be subject to new Basel III Endgame capital requirements, EJF has seen a growing interest in such banks taking affirmative steps to address the heightened regulatory landscape after the regional banking crisis. One of the ways in which these institutions are able to generate regulatory capital relief and mitigate concentration and liquidity risk has been through Credit Risk Transfer ("CRT") transactions. This is an area we expect will continue to grow in popularity as balance sheet management and regulatory thresholds becoming increasingly challenging. CRT transactions are designed to transfer all or a tranche of a group of financial assets, principally portfolios of mortgages, corporate loans, or other assets. The originator and holder of the assets seeks to buy protection on the assets from a bank, insurance company, trust, or other capital market investor seeking to take on the risk. We have seen fewer than a dozen transactions by banks in the US, all of which have occurred in the last few years. A report by the Structured Finance Association estimated the total outstanding CRT issuance by the US banks as of June 2021 at about $32 billion, with $25 billion from the largest money center banks and $7 billion from the midsize regional banks.[14] The report also estimated that the potential market size for CRT transactions by the US banks could be up to $400 billion, based on the assumption that 10% of the risk-weighted assets of the US banks could be transferred through CRTs.[15] Given the current macroeconomic and capital market landscape we believe this is a tool which had largely been overlooked, but one which can prove to be an effective innovative solution for small banks, which need to find a way to work within capital thresholds on particular sections of their loan

[14] Structured Finance Association, "Economics of Freddie Mac and Fannie Mae Credit Risk Transfer", Sep. 2021, https://structuredfinance.org/wp-content/uploads/2021/09/SFA-CRT-White-Paper-FINAL-FORMAT.pdf

[15] Mondaq, "United States: Regulation Q And You: Capital Relief Trades For U.S. Banks", Jun. 14, 2022 https://www.mondaq.com/unitedstates/securitization-amp-structured-finance/1201432/regulation-q-and-you-capital-relief-trades-for-us-banks

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portfolios. EJF believes that CRT transactions offer attractive credit investment opportunities for investors.

One Step in a New Direction

Although not specifically actionable as an investment thesis, investors should be aware that EJF believes that there will be a paradigm shift in the interpretation of federal statutes by courts after a series of US Supreme Court decisions are announced in the spring. This shift is important in predicting the impact of regulatory action in specific cases and in application of legislative mandates more broadly. In 2023, the US Supreme Court heard two cases, *Loper Bright* and *Relentless*, that call into question the historically broad deference given to administrative agencies when they are interpreting acts of Congress and implementing regulations. Prior to the appointment of three Justices to the Supreme Court by President Donald Trump during his administration, the prevailing legal doctrine that operated when reviewing challenges to administrative agency actions was the "Chevron Doctrine", named for a 1984 case involving a challenge to EPA regulations by the oil company, Chevron.[16] The Supreme Court determined that the EPA, and by implication other federal agencies, should be given deference in their interpretation of a statute as long as the interpretation is reasonable, even in the absence of explicit delegation to the agency in question. The Chevron Doctrine is now in question and likely will be overturned or materially narrowed. This has several implications. The first is that Congress will have to be clearer in its delegation authority language in statutes, which will likely make the struggles within Congress to pass statutes even more contentious. The second is that there will likely be more legal challenges to regulatory actions on the grounds that such actions exceed statutory authority. The net effect will be less regulatory reach by the administrative state and less fluctuation of regulatory action as presidential administrations change.[17]

Not coincidentally, it is worth noting that the paradigm shift away from deference to federal agencies is coupled by pending attacks against the independent agency, the Consumer Finance Protection Bureau (CFPB), and the administrative law judge enforcement apparatus of the Securities and Exchange Commission (SEC) and Federal Trade Commission (FTC). All of these attacks on federal agencies have been on the grounds that they are unconstitutional in conflict with the Appropriations Clause (CFPB) or Article III (SEC and FTC).[18] The thematic point is that the multi-decade growth and power of the administrative state is facing resistance and, ultimately, new limits.

[16] Bloomberg, "Expect Narrowing of Chevron Doctrine, High Court Watchers Say", Oct. 10, 2023
https://news.bloomberglaw.com/us-law-week/expect-narrowing-of-chevron-doctrine-high-court-watchers-say
[17] Eugene Scalia, "Chevron Deference Was Fund While it Lasted", WSJ, Jan. 9, 2024
https://www.wsj.com/articles/chevron-deference-was-fun-while-it-lasted-legal-scotus-partisan-regulation-changes-bddbfe27
[18] "Consumer Financial Protection Bureau on Trial", Harvard Law Today, Sep. 29, 2023
https://hls.harvard.edu/today/supreme-court-preview-consumer-financial-protection-bureau-v-community-financial-services-association-of-america/#:~:text=But%20somewhat%20surprisingly%20and%20in,lending%20rule%20was%20itself%20unlawful.

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Conclusion

EJF believes that 2024 presents two very clear investment opportunities created by the IRA and the impending increase in capital requirements for money center banks. The IRA is historic in its scope and implications for the renewable energy space. Its legislative innovation of transferable tax credits will amplify the usage of such credits and have a multiplier effect on investments in renewable projects and components. Although EJF believes, unlike the IRA provisions, that the impending Basel III Endgame regulations do not constitute good policy, they present a clear investment thesis: invest in the equity and debt of small banks. Such institutions enjoy attractive valuations, healthy credit conditions, strong earnings power, lower capital requirements and regulatory/political hurdles than money center banks, and robust through-the-cycle M&A activity. We see small banks taking market share over the next few years, particularly as it relates to serving small businesses.

Have a great 2024 … and please don't take our observations with a grain (or pinch) of salt!

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