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January 16, 2024

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, D.C. 20551
Attention: Ann E. Misback, Secretary

Federal Deposit Insurance Corporation
550 17th Street NW
Washington, D.C. 20429
Attention: James P. Sheesley, Assistant Executive Secretary, Comments/Legal OES

Office of the Comptroller of the Currency
400 7th Street, SW, Suite 3E-218
Washington, D.C. 20219
Attention: Chief Counsel's Office, Comment Processing

Re: Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity (Federal Reserve Docket No. R-1813, RIN 7100-AG64; FDIC RIN 3064-AF29; Docket ID OCC-2023-0008)

Ladies and Gentlemen:

On behalf of the Investment Company Institute,[1] we submit the following comment on potential market impacts stemming from the proposed rulemaking by the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), and the

[1] The Investment Company Institute (ICI) is the leading association representing regulated investment funds. ICI's mission is to strengthen the foundation of the asset management industry for the ultimate benefit of the long-term individual investor. ICI's members include mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and UCITS and similar funds offered to investors in other jurisdictions. Its members manage $31.9 trillion invested in funds registered under the US Investment Company Act of 1940, serving more than 100 million investors. Members manage an additional $8.5 trillion in regulated fund assets managed outside the United States. ICI also represents its members in their capacity as investment advisers to certain collective investment trusts (CITs) and retail separately managed accounts (SMAs). ICI has offices in Washington DC, Brussels, and London and carries out its international work through ICI Global.

Office of the Comptroller of the Currency (collectively, the Agencies) to amend the capital requirements applicable to certain banking organizations (Proposal).[2]

In its advocacy and educational efforts, ICI represents the interests of US registered investment companies (RICs), business development companies, and similar funds organized outside the United States (which we refer to collectively as regulated funds). We also represent the interests of the investment advisers that manage regulated funds and other investment products intended for the benefit of individual investors including collective investment trusts that are offered in defined contribution plans (CITs).

We have significant concerns as to how this Proposal may impact regulated funds and CITs, their advisers, and the over 120 million Americans that invest in regulated funds and CITs to save for retirement and other important financial goals.

In this letter, we want to underscore a key point: *market liquidity and market-making are fundamental to the efficient operation of financial markets*. We are very concerned that this Proposal, in its rush to impose Basel III on US banks, has failed to explore in-depth — let alone pay more than even lip-service to — the potentially detrimental consequences to market liquidity and market-making of imposing higher or ill-conceived capital standards on banks, which in turn could harm funds and their millions of shareholders.

Banks should be well-capitalized, but capital is costly. Because market-making requires bank capital, raising capital requirements can limit banks' ability (or their dealer subsidiaries) to make markets. Thus, the "right" level of regulatory bank capital requires a careful balancing act. Capital standards that are set too high or are ill-structured are likely to raise trading costs, especially in the fixed income markets. This can result — especially during crises — in a rise in costs of trading bonds (e.g., wider bid-ask spreads on Treasuries, wider credit spreads on corporate bonds and/or sharply higher yields in funding markets) or, potentially even more serious, an outright reduction in trading irrespective of quoted prices.

ICI has long been concerned that inappropriate or too-high capital standards have *already* degraded market-making and thus market liquidity.[3] Most prominently, we saw these kinds of effects play out in March 2020, when the settings of the supplementary leverage ratio (SLR) limited the ability of banks to engage in principal trades, contributing to and amplifying stresses in the US Treasury markets.

We are not alone in this view. The FRB, in temporarily loosening the parameters of the SLR in April 2020, explicitly acknowledged that the SLR had added to stresses in the Treasury market.[4]

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[2] *See* Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity, 88 Fed. Reg. 64,028 (Sept. 18, 2023). A separate letter detailing ICI's views on several aspects of the Proposal is available here.

[3] *See, e.g.,* Eric Pan, "Liquidity strains in markets need structural fixes," *Financial Times*, July 5, 2022.

[4] *See* "Federal Reserve Board announces temporary change to its supplementary leverage ratio rule to ease strains in the Treasury market resulting from the coronavirus and increase banking organizations' ability to provide credit to households and businesses," April 1, 2020 ("Liquidity conditions in Treasury markets have deteriorated rapidly, and

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Individually, FRB officials (or past FRB officials) have pointed to the SLR as creating problems in March 2020, arguing that the Agencies should consider recalibrating the SLR so as to avoid similar problems in the future.[5]

The Agencies have not done that. Instead, they now seek to impose *higher* levels of bank capital, along with more onerous provisions about how capital standards will apply (the so-called "Fundamental Review of Trading Book (FRTB)" provisions). Many industry participants, on both the sell- and buy-sides,[6] have voiced strong concerns that the Proposal would degrade market liquidity and the capital markets more generally.[7]

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financial institutions are receiving significant inflows of customer deposits along with increased reserve levels. The regulatory restrictions that accompany this balance sheet growth may constrain the firms' ability to continue to serve as financial intermediaries and to provide credit to households and businesses. The change to the supplementary leverage ratio will mitigate the effects of those restrictions and better enable firms to support the economy.").

[5] *See* Randal K. Quarles, "Between the Hither and the Farther Shore: Thoughts on Unfinished Business," speech at American Enterprise Institute, Dec. 2, 2021 ("While a leverage ratio is an important backstop, it can result in perverse incentives if it becomes the primary constraint on a bank's investment decisions. Because a leverage ratio is not sensitive to risk, a firm that is "bound" by such a ratio has an incentive to avoid adding safe assets to its portfolio. During times of stress in the financial system, when it is most important for banks to be able to continue serving businesses and households, or intermediating transactions, a binding leverage constraint—or even one that threatens to become binding—may discourage banks from engaging in safe activities, such as those involving U.S. Treasury securities … During the onset of the COVID event, regulators took emergency action to exclude U.S. Treasury securities and deposits at Federal Reserve Banks from the supplementary leverage ratio to provide banks with additional flexibility to act as financial intermediaries in that period of financial stress. That exclusion expired as scheduled on March 31, 2021. I supported that expiration, *with the commitment that the Fed develop a longer-term solution to the perverse implications of the current calibration of the SLR*.") (emphasis added). *See also* Daniel K. Tarullo, "Capital Regulation and the Treasury Market," Brookings Institution, March 2023 ("The Biden administration, policy groups, and academics have all included changes in capital regulations in menus of possible reforms to improve the functioning of the Treasury market. Specifically, changes have been proposed to the Enhanced Supplementary Leverage Ratio (eSLR) and G-SIB (Global Systemically Important Bank) capital surcharge.").

[6] On the buy-side, *see, e.g.,* comments filed by Franklin Templeton and Invesco (Jan. 16, 2024) ("In general, as we consider the effect of the Proposal on the financial markets in which we invest our respective clients' assets, we believe that the Proposal will make it more difficult for asset managers like Franklin and Invesco to meet our clients' investment goals, and also more difficult to mitigate risks in their portfolios as banks - as liquidity providers - abandon products, services or markets that are no longer viable.) and comments filed by Allspring (Jan. 16, 2024) ("Allspring is particularly concerned about the Proposal's potential negative impact on liquidity in the fixed income markets. Banking organizations have long served as key providers of liquidity in these markets. While many factors affect liquidity in the fixed income markets, insufficiently tailored regulatory requirements can influence the ways in which banking organizations participate in these markets. In some critical markets—such as corporate bonds and U.S. Treasuries—recent past regulatory changes already have led banking organizations to hold fewer bonds in inventory and make markets more frequently in an agency capacity, which at times has presented registered funds with increased liquidity challenges"). On the sell-side, see "BPI Basel Endgame Research Recap" ("Because of the complexity and severity of the requirements and tests, the FRTB will raise market risk capital requirements of large banks over 60 percent, and the capital requirements of the largest banks, mostly financial institutions in the U.S., by almost 70 percent … [B]anks can create a natural hedge during market volatility by generating additional revenues from trading, and capital requirements that make trading activity more costly may reduce this buffer effect.").

[7] *See* Dr. Guowei Zhang, Dr. Peter Ryan and Mr. Carter McDowell, "Identifying an Optimal Level of Capital and Evaluating the Impact of Higher Bank Capital Requirements on US Capital Markets," May 15, 2023, SIFMA

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Furthermore, we think the Proposal is flawed not only by what the Agencies are choosing to do, but also what they have chosen not to do. For example, we think the Agencies are mistaken in failing to re-examine the SLR in this Proposal.[8]

In this Proposal, the Agencies are being inconsistent in a way that is of deep concern to our industry, which will be a victim of the Agencies' decisions. The FRB, the FDIC, the Financial Stability Oversight Council, and the Securities and Exchange Commission have argued vociferously since March 2020 that open-end RICs supposedly amplified market shocks that month by allegedly having too little liquidity to meet redemptions.[9] We believe such claims lack merit, and we have backed our view with hard data.[10] Nevertheless, if US policymakers insist on sticking to the narrative that open-end RICs hold insufficient liquidity, it makes no sense, at the same time, to impose on market-makers new capital standards that more than likely will reduce overall market liquidity, *making it harder for these same RICs to access liquidity during market stress.*

Instead of issuing this sweeping Proposal, the Agencies should have first conducted a comprehensive and public review of current capital standards. On the one hand, this would have allowed market participants to air their concerns, react to provisions, and help the Agencies improve any potential rule provisions, in turn helping promote balance between regulatory concerns with the need for our financial markets to function efficiently. On the other hand, this would have allowed the Agencies to air convincingly any concerns they have about why current capital standards are insufficient. Indeed, it seems entirely inconsistent for the Agencies to insist that this Proposal is time-critical[11] and at the same time argue, as they have repeatedly since the

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comment, stating that the "reduction in banks' ability to support capital market activities likely will lead to diminished liquidity, more frequent flash crashes, and heightened financial stability risk, especially during market stresses."

[8] Speech by Federal Reserve Vice Chair for Supervision Michael S. Barr, "Holistic Capital Review," Jul. 10, 2023 ("With respect to the enhanced supplementary leverage ratio (eSLR), I am not recommending changes to the calibration at this time. With the revisions in risk-based capital requirements I mentioned above, the eSLR generally would not act as the binding constraint at the holding company level, where Treasury market intermediation occurs. We will carefully monitor Treasury market intermediation, and if problems arise, will consider appropriate policy responses.").

[9] *See* Financial Stability Oversight Council, "Statement on Nonbank Financial Intermediation," Feb. 4, 2021 (stating that its "interagency staff-level Open-end Fund Working Group "evaluated the role of open-end funds in the market stress that occurred during the early stages of the COVID-19 pandemic" and that "[o]pen-end funds were not the sole or primary cause of market stress—there was no single, primary cause—but the size of their asset liquidations indicates that they were one of the significant contributors to this stress.").

[10] *See* Shelly Antoniewicz & Sean Collins, "ICI Bond Mutual Fund Survey Brings Facts to the Debate". *ICI Viewpoints*, Feb. 24, 2022; "Setting the Record Straight on Bond Mutual Funds' Sales of Treasuries," *ICI Viewpoints*, Feb. 24, 2022; "Policymakers Say Bond Mutual Funds Contributed Significantly to Treasury Market Stress but…," *ICI Viewpoints*, Mar. 24, 2022.

[11] Testimony by Federal Reserve Vice Chair for Supervision Michael S. Barr, "Supervision and Regulation," before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Nov. 14, 2023 ("Most aspects of this proposal have been under development *for many years,*" which is curiously juxtaposed against the statement that "The comment period is an important part of the rulemaking process. I want to reiterate that we are interested in public input. We have recently announced an extension of the comment period. With this extension, we are providing the public *nearly six months* to review the proposal.") (emphasis added).

March 2023 collapse of Silicon Valley Bank, that banks are well-capitalized.[12] We believe that banks are in fact well-capitalized, which thus begs the question of why the Agencies seem set on forcing through this Proposal so quickly.

In sum, we urge the Agencies to consider a re-proposal, one key feature of which must be to contemplate (both qualitatively and quantitively) how to appropriately balance the need for well-capitalized banks with the societal need for banks to be able to undertake, among other things, critical market functions.

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We appreciate the opportunity to comment on this significant proposal. If you have any questions, please contact Eric Pan (eric.pan@ici.org) or Sean Collins (scollins@ici.org). We also can be reached by phone at 202-326-5800.

Regards,

/s/ Eric J. Pan

Eric J. Pan
President and CEO

/s/ Sean Collins

Sean Collins
Chief Economist

[12] *Id.* ("Our banking system is sound and resilient. The acute stress that occurred in March has receded, and banking organizations continue to report capital and liquidity ratios above minimum regulatory levels. Earnings performance has remained solid and in line with pre-pandemic levels, despite recent pressure on net interest margins. Regulatory capital ratios increased during the first half of 2023. While liquidity levels have come down from their peak in 2021, they remain above pre-pandemic levels and, as applicable, above minimum regulatory levels, leaving the banking system well positioned to mitigate liquidity pressures that may arise.").