

MEMO# 35587

January 17, 2024

ICI Files Two Letters Responding to Basel III Endgame Proposal

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TO: ICI Members
Bank-Affiliated Member Advisory Committee
SEC Rules Committee SUBJECTS: Bank Regulation
Closed-End Funds
Derivatives
Exchange-Traded Funds (ETFs)
Fixed Income Securities
Investment Advisers
Municipal Securities
Trading and Markets RE: ICI Files Two Letters Responding to Basel III Endgame Proposal

ICI has filed two letters in response to the joint notice of proposed rulemaking issued by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (collectively, the Agencies) to amend the capital requirements applicable to certain banking organizations (Proposal).[\[1\]](#) Commonly referred to as the Basel III endgame, the Proposal would implement the final components of the Basel III framework and apply a broader set of capital requirements to more banking organizations, in response to the March 2023 collapse of several regional banks.

ICI Comment Letter

The comment letter[\[2\]](#) observes at the outset that ICI typically does not weigh in on matters of banking regulation, particularly the setting of capital requirements, but will do so when ICI has significant concerns as to how a banking proposal may impact regulated funds and collective investment trusts (CITs), their advisers, and the millions of American households that invest in regulated funds and CITs to save for retirement and other important financial goals. The comment letter then discusses several aspects of the Proposal, as highlighted in this summary of comments:

Regulated funds and CITs play a major role in the US economy and financial markets. By law, they are required to operate under robust regulatory frameworks intended to protect investors. They are significant "buy side" participants in US and international financial

markets and rely on efficient and resilient markets across all major financial asset classes. Banking organizations long have been key providers of liquidity across many markets, promoting the orderly functioning of the markets through the commitment of capital to facilitate market making.

It is essential for the Agencies to consider how the Proposal could be revised to achieve necessary policy objectives without creating unnecessary "friction" to market liquidity. It likewise is important for the Agencies to be cognizant of how the Proposal may intersect with other recently completed or pending rulemakings that may impact financial markets and liquidity provision, including the GSIB surcharge proposal.

ICI's letter also outlines specific concerns regarding several elements of the Proposal.

- Highly regulated entities, including US registered investment companies (RICs), foreign public funds (as defined by the Agencies in the Volcker Rule context), and business development companies (BDCs), should be eligible for the lower 65% risk weight for investment-grade corporate exposures regardless of whether they have (or have a parent company that has) publicly traded securities outstanding.
- The Agencies should reconsider the significant over-calibration of the proposed operational risk capital requirement, particularly as it relates to fee-based business, potential implications for its impact on key services such as custody and lines of credit, and the competitive impact on bank-affiliated investment advisers.
- Banking organizations should be permitted to elect the use of banking book rules to measure their equity exposures to RICs and similar funds organized outside of the United States, provided they can demonstrate and document the lack of any trading intent.
- The Agencies should provide an explicit exclusion from the definition of "subordinated debt instrument" for closed-end RIC preferred stock. In the alternative, the definition of "subordinated debt instrument" should exclude any preferred stock that is not subordinated to any other material liabilities of the issuer. Additionally, the Agencies should assign preferred stock issued by closed-end RICs a lower risk weight than operating company preferred stock and the closed-end RIC's own common stock.
- We support the proposed exclusions from the minimum haircut floors for securities financing transactions (SFTs) with RICs and foreign public funds, and likewise urge the Agencies to exclude SFTs with CITs that hold ERISA plan assets and with BDCs.
- Given the robust regulatory protections to which RICs' use of derivatives are subject, ICI: (1) urges the Agencies to allow for a more calibrated risk weight for RICs in the calculation of capital associated with credit valuation adjustment (CVA) risk; (2) that similar treatment be afforded for BDCs, whose use of derivatives likewise is subject to Investment Company Act Rule 18f-4; and (3) that the Agencies exempt the client-facing leg of a cleared derivative transactions from CVA capital requirements.

Supplemental Letter on Potential Market Impacts

A second letter filed by ICI emphasizes that market liquidity and market-making are fundamental to the efficient operation of financial markets.^[3] The letter expresses deep concern that the Proposal fails to explore 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 ICI members and their millions of shareholders. The letter urges the Agencies to consider a re-proposal that contemplates (both qualitatively and quantitatively) 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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Notes

[1] [Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity](#), 88 Fed. Reg. 64,028 (Sept. 18, 2023).

[2] ICI's comment letter is available [here](#).

[3] The letter on potential market impacts is available [here](#).

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