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CAPITAL ADVISORS

September 26, 2023

Ann E. Misback, Secretary
Board of Governors of the Federal Reserve System
Docket No. R-1537
20th Street and Constitution Avenue NW
Washington, DC 20551

James P. Sheesley, Assistant Executive Secretary
Federal Deposit Insurance Corporation
Attention: Comments/Legal OES
RIN 3064-AF86
550 17th Street, NW
Washington, DC 20429

Chief Counsel's Office
Office of the Controller of the Currency
Attention: Comment Processing
Docket ID: OCC-2023-0011 | RIN 557-AF21
400 7th Street, SW, Suite 3E-218
Washington, DC 20219

Comment Re: Long-term Debt Requirements for Large Bank Holding Companies, Certain Intermediate Holding Companies Foreign Banking Organizations, and Large Insured Depository Institutions

Dear Ms. Misback, Mr. Sheesley and Chief Counsel's Office,

Breckinridge Capital Advisors is a Boston-based fixed income manager that invests funds on behalf of sophisticated retail and institutional clients. These clients hold over $1 billion of exposure to the long-term debt of banking organizations with more than $100 billion in total consolidated assets. Many of them hold their exposure in minimum denomination sizes well below $400,000.

Breckinridge *opposes* a recent proposal that would require such banks to issue external long-term debt in minimum denomination sizes of $400,000. Instead, we recommend that regulators (a) propose a far lower threshold for minimum denominations (no higher than $100,000) or (b) replace the proposed minimum denomination size rule with an established accredited investor standard.

Rule & Rationale:

On 8/29/23, the Federal Reserve (Fed), Office of the Comptroller of the Currency (OCC), and Department of the Treasury (Treasury), Federal Deposit Insurance Corporation (FDIC) proposed regulations that would, among other things, establish a minimum denomination requirement of $400,000 for the external long-term debt of banking organizations with more than $100 billion in total consolidated assets. Current minimum denominations are as low as $1,000.

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Regulators promulgated the rule to:

(a) Disincentivize retail investors from directly investing in long-term bank debt.
(b) Ensure that bank insolvencies result in losses mostly for sophisticated investors, as opposed to retail investors.
(c) Promote market discipline and oversight by ensuring that long-term bank debt holders are sophisticated investors.[1]

Regulators grounded their rationale in data from the 2019 Survey of Consumer Finances (SCF) which showed that half of households owning at least one bond had a bond portfolio of $121,000.

The rule is unlikely to achieve any of goals listed above:

First, the rule is likely to *reduce* the ability of mid-size institutional investors to directly hold long-term bank debt and to construct diversified fixed income portfolios. This may result from regulators' use of the Survey of Consumer Finances to conclude that a $400,000 minimum denomination makes sense. The SCF surveys 6,500 *families* every three years.[2] It excludes any analysis of the many mid-size institutional investors that directly invest in long-term bank debt.

For perspective: among endowments & foundations with assets between $50 million and $250 million, the median allocation to fixed income was 21 percent, as of June 30, 2023.[3] The average endowment size for this cohort is $110 million. This implies an average fixed income allocation of $23 million, and an average corporate bond allocation of $5.8 million.[4] Within the corporate bond index, 23% represents long-term bank debt. This suggests that a foundation or endowment with $110 million in assets would ideally hold around $1.3 million in bank debt (23% x $5.8 million). Under a $400,000 minimum denomination threshold this would limit the institution to three individual bank positions ($400,000 x 3 = $1.2 million) each with a 7% position size ($400,000 / $5.8 million = 7%). Very few bond portfolio managers, institutional or retail, are comfortable with concentrated positions of this size.

Note that many institutions have *less* than $110 million in assets. The rule would impact these institutional investors even more negatively. Endowments with less than $50 million in assets typically have a larger fixed income allocation compared to peers (28 percent as opposed to 25 percent).[5]

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[1] https://www.fdic.gov/news/board-matters/2023/2023-08-29-notice-dis-a-fr.pdf, page 53.
[2] https://www.federalreserve.gov/econres/aboutscf.htm.
[3] Per SEI and Investment Metrics, LLC, based on 223 observations.
[4] The IG corporate component of the Bloomberg Aggregate Bond Index is 25 percent. This implies that a fixed income allocation of $23 million would have $5.8 million in corporate bond exposure if the allocation were designed to be index weighted.
[5] SEI, Investment Metrics, LLC, data as of 6/30/23. The Universe is a custom universe created by Investment Metrics, LLC for all endowments & foundations (E&F) less than $50 million. Of 305 observations among endowments & foundations below $50 million, the median allocation to fixed income was 28% as of 6/30/23. The average endowment size for this cohort is $14 million, implying a median fixed income allocation of about $4 million. In the U.S., an accredited investor must have assets over $1 million, which this cohort exceeds. A Qualified Institutional Buyer (QIB) typically has $100 million in investable assets, which may exclude this cohort unless fixed assets are included. At $25 trillion in market value, the Bloomberg U.S. Aggregate Bond Index (Agg) is the most widely used benchmark in U.S. fixed income markets. The investment-grade corporate bond component of the Agg is about 25 percent of total value. So, for a fixed income allocation of $4 million, an Index-weighting of corporate bonds would be $1 million. The largest two issuers in the Bloomberg U.S. Corporate Bond Index are BAC and JPM at slightly over 2-percent each. Applying a 2-percent market value per position, a large overweight to all issuers in the Index, implies fifty positions of $20,000 each in a diverse $1 million bond portfolio across issuers and sectors. Should a $400,000 minimum apply to banks, the portfolio would have the option of investing in

To hammer home this point: imagine if the $400,000 minimum denomination rule were in place when Silicon Valley Bank (SVB) and First Republic Bank (FRCB) bank bonds lost 95 percent or more of their value. Boosting the bank bond minimum denomination size from $2,000 to $400,000 could have the unintended consequence of reducing individual and institutional investors' ability to diversify away default risk across an IG fixed income allocation in the Banking sector.

<u>Second</u>, the rule is likely to create new investment risks for mid-sized institutional and retail investors who own bonds directly. These investors will be more likely to seek diversified bank debt exposure through a commingled investment account, mutual fund, or ETF. Investment vehicles of this sort are sometimes misaligned with the interests of smaller investors.

Commingled structures like ETFs may be less tax-advantaged and offer fewer customization options to certain bond investors than when bonds are owned in a separately managed account (SMA).[6]

There is also concern that commingled structures like mutual funds and ETFs have outgrown the capacity of the market to provide the liquidity needed to support redemptions during an extended period of market volatility or dislocation.[7] It would be ironic if regulators passed a minimum bank denomination rule to force retail investors into bond funds – and a subsequent recession or monetary crisis caused a run of outflows from those same funds.

Forcing more bond investors into commingled structures is also likely to inhibit investors' ability to customize their accounts. Bond investors who own their securities directly can tailor a portfolio's structure to align with liquidity needs, risk tolerance, and personal values.

<u>Third</u>, the rule does not apply to higher-risk investments such as speculative-grade bonds[8] and equities that may trade in lots as small as $2,000 or in fractional shares, respectively. In this case, an accredited individual investor could buy a deeply speculative-grade company but would be unable to purchase investment-grade debt of large U.S. banks. Per Moody's since 1983, issuer-weighted speculative-grade default rates have averaged 4.75% annually, compared to 0.09% for investment-grade default rates.[9]

An accredited investor standard would achieve the same ends without limiting investors' access to long-term bank debt.

On page 55 of Docket ID *OCC-2023-0011*, Question 28 asks, *"What minimum denomination amount is most appropriate in the range of $100,000 to $1 million and should the agencies require the debt instrument for eligible LTD to expressly prohibit their exchange into smaller denominations?"* [10]

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one, one or two bank bonds that would represent 0-percent, 40-percent, and 80-percent of corporate market value, respectively and in the case of BAC and JPM exceed Index weightings by 20-40 times each.

[6] Portfolios Made Personal: Separately Managed Accounts Offer You More Control Over Your Investments and Taxes, J.P. Morgan Asset Management. © 2023 JPMorgan Chase & Co. All rights reserved.

[7] How Illiquid Open-End Funds Can Amplify Shocks and Destabilize Asset Prices. Chapter 3 of the October 2022 Global Financial Stability Report, "Asset Price Fragility in Times of Stress: The Role of Open-End Investment Funds."

[8] Note: VIASET Inc., on 9/21/23, a Caa1/B rated Cable-Satellite company, issued and priced 7.5% notes due 2031 in a private placement under rule 144A. The minimum denomination size for the issuance was $2,000.

[9] Corporate Defaults and Recovery Rates, 1920-2010, Moody's Investors Service, pages 30-31.

[10] https://www.fdic.gov/news/board-matters/2023/2023-08-29-notice-dis-a-fr.pdf, page 55.

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Breckinridge supports regulators' aims to create a more resilient banking system. However, given the above, we strongly urge regulators to reduce the proposed minimum denomination threshold to $100,000 and not to expressly prohibit their exchange into smaller denominations or, even better, replace the proposal with an accredited investor standard. We reiterate our belief that a $400,000 minimum denomination size for future bank bond issuance could drive high position concentrations in retail and institutional bond portfolios, reduce diversification opportunities, and impair effective asset allocation among investors who prefer to own bonds in a separate account versus a commingled fund.

The goal of the regulation is to protect retail investors from the risk of insolvency and incent better oversight of banks. This can be achieved by adopting the Securities and Exchange Commission's (SEC's) existing accredited investor standard for individuals. This requires an individual to have net worth over $1 million (excluding her primary residence) and income over $200,000 (individually) in two consecutive years.[11]

Notably, these thresholds should protect most of the families that the rule is designed to help – based on the SCF data that regulators used to craft it. Per the SCF, in 2019, almost no households in the 0-90%ile held any bonds. Of those families in 90-100%ile income, only 5% had bond exposure. The 90-100% cohort starts with households with income exceeding $85,000.[1] It makes sense that only the most affluent, sophisticated retail investors will hold many corporate bonds, let alone long-term bank debt. This finding is buttressed by IRS data which shows that 84% of taxable interest payments were claimed by taxpayers with more than $200,000 in income in tax year 2020.[12]

In short, regulators should reconsider their approach to protecting small investors from perceived bank insolvency risks and recognize that their $400,000 minimum denomination rule is more likely to harm small retail investors and institutions than help them.

Sincerely,

Peter B. Coffin

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[11] https://www.sec.gov/education/capitalraising/building-blocks/accredited-investor
[1] https://www.federalreserve.gov/econres/scfindex.htm
[12] https://www.irs.gov/statistics/soi-tax-stats-individual-statistical-tables-by-size-of-adjusted-gross-income