ICI VIEWPOINTS

NOVEMBER 27, 2023

The SEC Is Kicking Bank Loan Funds to the Curb

By Matt Thornton

Bank loan mutual funds and ETFs play a key role in capital markets, facilitating financing for American companies and offering unique benefits to fund investors. These funds invest primarily in loans made by banks to other businesses—loans that often have stronger lender protections than other forms of debt. And amid a sharp rise in interest rates, the floating-rate nature of bank loans has helped make these funds standout performers in 2023.[1]

> **"Bank loan funds have weathered several periods of market stress over the past 20 years without incident. To date, *no* fund investing primarily in bank loans has suspended redemptions."**

Yet despite their benefits to investors and importance to the financial system, bank loan funds are squarely in the crosshairs of the Securities and Exchange Commission (SEC). If the Commission adopts its proposed rule amendments to the industry's current liquidity risk management requirements, it would drive bank loan funds out of business, sending fund investors to the sidelines and disrupting access to capital for growing companies.

Upending an Important Market

By arbitrarily expanding the definition of an *illiquid* investment, the SEC's proposal would cause a wide variety of funds to exceed the 15 percent cap on illiquid assets. No type of fund is more vulnerable to that change than bank loan funds, as they typically invest at least 80 percent of their assets in loans that would be deemed illiquid under the SEC's proposal.

While loans typically can be *sold* within seven days, they can take somewhat longer to *settle in cash* after trade execution, making them generally less liquid than ordinary stocks and bonds. [2]

However, because of loans' longer settlement times, bank loan funds prudently mitigate liquidity risk by maintaining a buffer allocation to assets that can be quickly converted to cash. They also have lines of credit, lending arrangements with other funds in the same complex, and contractual provisions to expedite settlement, all of which aids their ability to navigate challenging conditions.

The fact is that bank loan funds have weathered several periods of market stress over the past 20 years without incident. To date, no fund investing primarily in bank loans has suspended redemptions. Based on that track record, the SEC's concerns are exaggerated, and its proposed prohibition on bank loan funds is unwarranted.

Take a Closer Look

Bank loans enable companies to undertake a host of activities, such as:

- Expanding operations
- Merging with or acquiring other companies
- Recapitalizing their balance sheet
- Refinancing their debt

As buyers of these loans, bank loan funds facilitate capital flows to an array of companies, including many smaller businesses that might not otherwise have access to capital. They also have invested in loans from household names that include: [3]

- American Airlines
- Harbor Freight Tools
- Uber
- Bass Pro Shops
- iHeartMedia

A Better Way Forward

While opposing the Commission's extreme approach, ICI supports sensible, tailored measures that would further mitigate the liquidity risks of bank loan funds. For instance, while the SEC's proposed 10 percent *highly liquid investment minimum* requirement is inappropriate for other types of funds, it makes sense for bank loan funds given their holdings of longer-settling assets.

Additionally, ICI supports amending the rule's liquidity risk factors to expressly address longer-settling investments. The SEC could pair this new language with guidance setting forth its expectations about funds' use of liquidity risk mitigants, including credit lines. We also support examining and improving the bank loan market itself to reduce settlement times generally.

The Bottom Line

Loan settlement can be further improved, and liquidity risk for bank loan funds can be further mitigated in a sensible way. But the SEC's idea of reform would be a fatal blow to these funds that poses real-world harm to shareholders as well as businesses in need of capital. The SEC should instead pursue the policy recommendations put forth by ICI and others to deliver genuine reform and preserve the viability of bank loan funds for the benefit of investors.

Notes

[1] The S&P/LSTA US Leveraged Loan Index gained 9.6% over the year-to-date period ended October 31, 2023, which represented meaningful outperformance versus fixed income markets broadly. For instance, the S&P US Aggregate Bond Index Total Return declined 1.8% over the same period.

Sources: ICI calculations of Refinitiv data.

[2] According to LSTA's comment letter to the SEC, "The long-term median buyside settlement time is nine days and it is shorter in times of market stress in light of the inherently higher settlement urgency. For example, in March 2020, the median buyside sale settlement time was seven days."

[3] Based on ICI analysis of fund holdings.

Matt Thornton is an Associate General Counsel, Securities Regulation at ICI.