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AXA INVESTMENT MANAGERS

Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

29th May, 2001

Dear Sirs

The New Basel Capital Accord

This submission is made on behalf of AXA Investment Managers in response to the consultation documents issued by the Basel Committee on Banking Supervision in January 2001, and by the European Commission in February 2001, on which comments have been requested by 31 May 2001.

AXA Investment Managers is an autonomously managed investment management business which manages assets of €255 billion from four European countries (France, UK, Germany and Netherlands), the USA and Asia, and also has offices in Belgium, Italy and Spain. It is part of the AXA group, one of the world's largest insurance and asset management businesses.

We are members of the European Asset Management Association, and national trade bodies, and have provided input into their deliberations and submissions. Our own views are set out in the attached paper. We would be pleased to discuss or explain these with you further if this would be helpful.

Yours sincerely

Donald Brydon

Donald Brydon
Chairman and Chief Executive

46, Avenue de la Grande Armée 75017 Paris, Téléphone : 01 55 37 50 00
AXA Investment Managers, Société Anonyme au Capital de 42 962 284,75 Euros, SIREN 393 051 826 RCS Paris

INVESTMENT
MANAGERS

REVIEW OF REGULATORY CAPITAL REQUIREMENTS
SUBMISSION BY AXA INVESTMENT MANAGERS

Principle concerns

We have four principle concerns about the current proposals in relation to their impact on investment management businesses, whose risk profiles are different to those of banks and other investment businesses, and closer to those of UCITS management companies.

1. **Regulatory capital for operational risk:** We do not believe that regulatory capital is the most appropriate regulatory tool for managing operational risk. However, we do accept the need for investment managers to maintain a minimum level of regulatory capital.

2. **Appropriate measures:** If there is to be a regulatory capital charge in respect of operational risk, we do not believe that a simple measure such as one based solely on income or assets under management (as proposed in the Basic Indicator Approach and the Standardised Approach) represents an appropriate measure of that risk.

3. **Calibration:** If there is to be a regulatory capital charge in respect of operation risk based on income or assets under management, we believe that the magnitudes of the ß factors currently proposed are much too large, and would lead to unacceptably large increases in regulatory capital requirements for investment managers. These ß factors must be reduced, and further work must be done to assess the impact of any replacements on a wide cross section of firms.

4. **Consistency between CAD and UCITS Directives:** Investment management firms and UCITS management companies face similar operational risks, although UCITS management companies are also subject to additional risks in connection with the incorrect valuation and pricing of funds. Greater consistency should therefore be introduced to reflect these similarities in the regulatory capital requirements proposed for these two types of business, which are currently very different in nature and magnitude.

Despite these misgivings, we recognise the desire to develop a new approach to regulatory capital for investment managers, and we therefore suggest below an approach which we would regard as acceptable.

Regulatory capital for operational risk

We accept that investment managers should hold a minimum level of capital in order to carry on business, and recognise that investment managers are subject to certain operational risks. However we do not believe that regulatory capital based on some measure of operational risk is the most appropriate measure to safeguard and control against those risks.

We consider that an expenditure-based requirement should be retained as an important safeguard of last resort, since it is ultimately expenditure (and not income or assets under management) that leads to financial insolvency. The existing capital requirements based on 25% of annual expenditure have worked well in containing the number of financial failures by investment managers, therefore there is no reason to increase the level of regulatory capital required by investment managers.

This view is supported by the findings of the EAMA study[1]:

- "most losses are financed out of internal profits" (p18); and
- only 10 out of 1,321 firms declared in default by the UK Investors Compensation Scheme from 1998 – 2000 were investment managers regulated by IMRO, and total losses in respect of these firms were less than £4 million (p153).

Appropriate measures

The EAMA Study identifies the main operational risks facing investment managers as:

- Misdealing
- Breach of client guidelines (investment restrictions)
- Settlement problems
- Failure to collect all income (including all corporate action failures)

It also identifies fund mispricing as a major risk, but this risk is faced by UCITS managers rather than investment managers generally.

We are not in favour of the use of income as an indicator for asset management in the basic indicator approach because:

- it is not closely correlated with the main operational risks faced by asset managers;
- it does not reflect a comparable indication of the level of operational risk faced by other types of business;
- it is not consistently correlated with assets under management.

Across the investment management industry as a whole there is not a close correlation between AUM and income because fee levels vary according to asset class (eg equity or fixed income), management style (eg active or index) and markets. There is also a trend towards lower basic fees with performance fees where a performance benchmark is exceeded.

The effect of moving from a basic indicator approach base on income to a standard indicator approach based on assets under management will therefore have a very different effect on different firms according to the types of accounts they manage.

1. "Risk and regulation in European asset management: is there a role for capital requirements", by Professor J Franks and Professor C Mayer and OXERA, January 2001, commissioned by the European Asset Management Association

This can be demonstrated by a simple hypothetical example:

Example	30% of income	0.18% of AUM	Change
€1bn retail funds at 50 bp	€1.5m	€1.8m	+20%
€1bn institutional funds at 20bp	€0.6m	€1.8m	+200%
€1bn institutional funds at 10bp with 20% performance fee on 4% outperformance	€2.7m	€1.8m	-33%

To avoid the perversities highlighted in the example above, we suggest using assets under management as the basis of both the basic and the standardised indicator approaches, with a lower ß for the latter to ensure that an improved control environment is consistently rewarded by a lower capital charge. Alternatively, we suggest that the use of the basic indicator approach is excluded for investment management firms.

Of the simple indicators available (income, expenditure, assets under management, and value of transactions (turnover)), the measure which is intuitively the most closely related to the first three of the risks above is turnover. For corporate action failures it is assets under management. In none of these examples is it income or expenditure.

We have therefore considered whether a measure based on turnover would be more appropriate as a determinant of regulatory capital for operational risk than one based on income or assets under management. We have concluded that it would not, because the volatility of turnover could lead to unacceptably large fluctuations in regulatory capital requirements. An investment manager should not be prevented from undertaking a transaction that is in the best interests of its client solely because of regulatory capital constraints.

We have also considered whether there is likely to be sufficient correlation to regard AUM as a reasonable proxy for turnover. We believe there is not a close correlation because:

- turnover on some portfolios may be restricted to avoid crystallising tax liabilities on realised capital gains;
- turnover will vary greatly between equity, bond and money market funds;
- portfolios such as pension funds and insurance companies may buy and hold fixed income investments until maturity for asset / liability matching purposes.

We consider that any reliable methodology for determining capital requirements in respect of operational risk must be inevitably be more complex than those currently proposed, but we also recognise the need for a simple approach at the present time. We would therefore support the use of assets under management as a basis for regulatory capital requirements for investment management activities

Calibration

We have estimated the impact of the current proposals on the regulatory capital of our European businesses.:

- The effect of a regulatory capital charge of 30% of income is to increase the required capital by between 35% and 400%, with total additional capital required of €40 million.
- The effect of a regulatory capital charge of 0.18% of assets under management is to increase the required capital by between 5 and 20 times, with total additional capital required of €380 million.

These levels of capital would severely damage the profitability of the investment management industry, and would be seriously anti-competitive,. They would be impossible for many firms to meet, they would greatly increase barriers to entry, and they would further distort competition between firms in Europe and those elsewhere (notably in the USA) which do not face similar requirements,.

If a basic indicator approach based on income is retained, the ß factor for such business must be set at an acceptable level. The average margin on revenue in the 2000 PriceWaterhouse Coopers Investment Management Survey is 29.2%. This implies that a ß of 30% will on average lead to a 69% increase in regulatory capital charge over the current level of 25% of expenditure, and that to be neutral in its effect ß should be set at.17.7%.

In the case of our own businesses in Europe, a ß of 17% would result in a 10% (€5m) increase in the total of their capital requirements, with an increase of 180% (€12m) for one particular business.

We therefore suggest that if a capital charge based on income is retained, the appropriate calibration for asset management activities should be around 15%, and that the regulators should carry out a detailed impact analysis if they intend to introduce such a requirement.

Aggregate figures for UK investment managers released by the UK's Financial Services Authority imply average expenses for investment managers of 8.7 bp of assets under management. This implies that to maintain regulatory capital at an aggregate level of 25% of expenditure, ß should be calibrated at 2.2 bp. This is a different order of magnitude to that currently envisaged, although it is consistent with the 2bp currently proposed for UCITS management companies.

Consistency between CAD and UCITS Directives
We understand that the current regulatory capital proposals for UCITS managers are the higher of :

- 25% of annual expenditure; and
- €125,000, plus 0.02% of Assets under Management above €250 million;

subject to an overall cap of € 10 million capital.

Most UCITS managers are part of investment management groups that also include investment managers subject to the ISD and CAD. UCITS managers face all the operational risks faced by investment managers, plus additional risks in relation to their dealings in units of the fund and pricing the fund based on underlying net asset value. It is illogical and inappropriate for the EC to propose regulatory capital requirement s for ISD investment managers that are (a) inconsistent with, and (b) greater than, those proposed for UCITS managers.

We believe that these proposals represent a practical approach for investment managers generally, at least until further work is undertaken. In particular:

- it applies a simple model;
- it is consistent between UCITS managers and investment management firms;
- it retains a link with the existing expenditure based requirement;
- the calibration of ß is at a more acceptable level, both in terms of its likely impact on investment management firms and having regard to aggregate industry data;
- the introduction of a floor and a cap recognises that operational risk is not a wholly linear function, and should prevent extreme distortions arising.

If applied to our own European businesses, these proposals would lead to an overall increase in capital of 13% (€6m), with some businesses not affected and other facing increases of between 50% and 120%. Even these proposals should therefore be subject to extensive impact analysis before their introduction is advocated.
