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1 May 2001

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

Dear Sirs

THE NEW BASEL CAPITAL ACCORD

The European Asset Management Association ("EAMA") represents the European asset management industry. We enclose a list of our members.

Reasons for concern

We are deeply concerned about the provisions of the proposed new Basel Capital Accord insofar as they relate to the asset management industry, in particular the provisions relating to a capital requirement for operational risk which are described in the Consultative Document on "Operational Risk" issued in January.

A significant proportion of our members are owned by internationally active banks and will therefore be affected by the new Basel Accord because their parents will be obliged to hold capital to cover operational risk in respect of their asset management subsidiaries.

We believe that the proposal that internationally active banks should be required to hold a high level of regulatory capital to cover operational risk in their asset management subsidiaries is based on a misconception about the nature of the asset management business and its relationship to systemic risk.

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Supposed justification of capital requirement for asset management businesses of banks to cover operational risk

We presume that the reasoning leading banking regulators to consider requiring internationally active banks to hold a high level of regulatory capital to cover operational risk in their asset management subsidiaries runs as follows:

1) Asset management firms make operational errors which give rise to liabilities to third parties.

2) These liabilities could be so large that they make the asset management firm insolvent.

3) Systematic risk would then be generated by one of the following three mechanisms:

    a) The insolvency of the asset management subsidiary would generate systemic risk because it is a counterparty

    b) The insolvency of the asset management subsidiary would cause one or more of their clients to become insolvent and the insolvency of their client(s) would generate systemic risk.

    c) The insolvency of the asset management subsidiary would cause the parent bank to inject funds into the asset management subsidiary thereby jeopardising the solvency of the bank owning the asset management subsidiary.

Errors in supposed justification of capital requirement for asset management businesses of banks to cover operational risk

Assuming this is your reasoning we would like to make the following points in respect of the above propositions:

1) We agree that asset management firms make operational errors. These give rise to financial liabilities to their clients. It is extremely unlikely for liabilities to arise in respect of any other third party as asset management firms do not generally trade on their own account. The only significant liability that is likely to arise is to clients.

2) Most operational errors giving rise to liabilities to clients are very small in relation to the size of the operation as measured by assets under management.

    Last year EAMA commissioned an independent report into the nature and extent of operational risk in the European asset management industry and the appropriate regulatory response. The research was carried out by Professor Julian Franks and Professor Colin Mayer and Oxford Economic Research Associates Ltd. Their conclusions were based on a confidential survey of 39 European asset management companies, nearly half of which were owned by

banks. Their report, "Risks and Regulation in European Asset Management: Is there a Role for Capital Requirements?", was published in January. Their report found that the largest operational loss for the sample represented less than one basis point (0.01 %) of assets under management (Table 7.13) and the largest potential operational loss in any one particular year was thought by large asset management firms questioned to be about 1 basis point (0.01 %) of assets under management (Table 7.14).

Very occasionally much larger operational losses arise. These may be associated with fraud. We believe, however, that such rare eventualities can be covered through effective insurance and need not lead to the insolvency of the asset management company.

We therefore believe that operational losses are generally too small to make asset management firms insolvent and, where they are large, insolvency can be prevented through insurance.

3) If an asset management firm does become insolvent we do not believe that its insolvency gives rise to any significant systemic risk because:

a) the asset management firm itself is not a counterparty to transactions so will not itself owe substantial amounts to banks or other key capital market participants such as investment banks, brokers, dealers, market makers and central counterparties.

b) The insolvency of an asset management firm is unlikely to lead to the insolvency of their clients because the great majority of substantial clients of asset management firms employ a custodian to keep their assets so that their assets are legally and effectively completely separate from those of the asset management company and are safe in the event of the asset management company becoming insolvent.

In this context we would like to point out that custody is a completely separate business from asset management. When an asset management company is part of a banking group that also offers custody services to its asset management subsidiary's clients, the custody function is usually carried out by a completely separate company within the banking group. We make no comment on the appropriate level of regulatory capital for companies offering custody services.

c) A parent bank might inject capital into a failing asset management subsidiary in order to maintain its reputation in the market place or the value of its brand name. Indeed there have recently been rare but important instances of such injections. But a parent bank would not make such transfers if they jeopardised its own solvency unless there were a legally binding requirement, such as a guarantee, for it to do so, or unless required so to do by regulators. Such legally binding or regulatory requirements are not common practice and, in our view, this legal distinction between parent and subsidiary enhances systemic stability and should be encouraged. In short, the parent bank is able to

walk away from an insolvent asset management, as from any other, subsidiary and is not obliged to meet its subsidiary's liabilities so the insolvency of an asset management subsidiary should not, in the final analysis, lead to the insolvency of its parent and does not give rise to systemic risk.

Conclusion

We have demonstrated that the low level of operational risk in the asset management business is unlikely to lead to asset management firms becoming insolvent but that, even if they do become insolvent, this will not lead to systemic risk either directly or by causing the insolvency of their clients or their parent bank.

We therefore believe that requiring internationally active banks to hold a high level of regulatory capital to cover operational risk in their asset management subsidiaries would not significantly diminish systemic risk.

Role of asset management industry in reducing systemic risk

Indeed we believe that requiring internationally active banks to hold a high level of regulatory capital to cover operational risk in their asset management subsidiaries could lead to an increase in systemic risk by inhibiting the development of the asset management industry by increasing its costs.

This would reduce the ability of the asset management industry to reduce global financial systemic risk in the ways that it currently does so by:

a) investing savings in equities on which there is no guaranteed return and therefore no risk of default. This contrasts sharply with the potential for default presented by the lack of matching in term of currency and maturity of the loans and deposits of most internationally active banks.

b) distributing market risk (i.e. loss on investments) among a wide variety of unconnected savers which is in marked contrast to the interbank deposit system the interlocking nature of which enables the domino effect to jeopardise systemic stability.

c) investing savings in securitised bank loans thereby enabling banks to reduce the risk to which they are exposed by unmatched loans and deposits on their balance sheet.

Enclosures

We enclose a copy of our response to the European Commission's second consultative paper on proposed changes to the Capital Adequacy Directive. This

response covers many of the points which we have raised in this letter but also focuses on investor protection issues as well as systemic risk.

We also enclose under separate cover a copy of the independent report commissioned by EAMA on operational risk in the European asset management industry and the appropriate regulatory response.

If there are any points arising from this response, or other issues relating to the effects of the proposed new Basel Accord on the European asset management industry, we would be pleased to assist.

Yours sincerely

Donald Brydon
President

Enc.