22nd May 2001.

Irish Association of Investment Managers

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

Dear Sirs,

Re: The New Basel Capital Accord

The Irish Association of Investment Managers (IAIM) represents the Irish Investment Management industry.

The Association is 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.

As our response to the proposed Accord, we enclose a copy of a letter which we have sent to Commissioner Bolkestein of the European Commission. This sets out our concerns in relation to both the Basel Committee and EU Commission's proposals.

Yours Sincerely,

Ann Fitzgerald
Secretary General.

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Commissioner Bolkestein
European Commission
Rue de la Loi 200
1049 Brussels
Belgium

Dear Commissioner,

Review of Regulatory Capital for Credit Institutions and Investment Firms.

The Irish Association of Investment Managers (IAIM) represents the Irish Investment Management industry. The IAIM is a founding member of the European Asset Management Association (EAMA). The IAIM welcomes the opportunity to comment on the Commissioner's Consultative Paper on Capital Adequacy for Credit Institutions and Investment firms. In doing so, we would refer you to the report by Franks & Mayer on the Operational Risk Profile of the European Asset Management industry which was commissioned by EAMA and which has been made available to your office.

Differences between banking and asset management industry

The Commission's Second Consultative paper seems to be based on the premise that the European asset management industry is a subdivision of the European banking industry and has much in common with it in terms of operational risk despite the criticisms made of this approach in the Villiers report which were endorsed by the European Parliament.

Although a number of Irish asset management companies are owned by banks most are not and there is no legal reason why they should be. Furthermore, many of the asset management companies which are owned by banks operate autonomously, have their own management hierarchy and internal control system and are required to satisfy return on capital criteria in respect of the capital employed in the asset management business.

Limited role of capital requirements in asset management industry

It is generally accepted that prudential capital requirements for banking are justified on grounds of (1) mitigation of systemic risk and (2) investor protection.

The Irish asset management industry is very different from the Irish banking industry because:

1 **Systemic risk**

Irish asset management firms pose no significant threat from a systemic risk perspective:

a) They do not generally trade on their own account and so are not counterparties to trades

b) They do not provide guarantees of transactions effected on behalf of clients.

2 **Investor protection**

Operational failures may give rise to liabilities to clients but these liabilities are generally on a small scale and the impact of any operational failure is generally mitigated as:

a) Client assets are legally separate from the asset management company's own assets.

b) Asset management companies do not generally provide any guarantee as to the performance of funds under management.

Size of operational losses in asset management industry normally low

The Franks/Mayer Report indicates that

i) the typical size of operational loss sustained within the European asset management industry is far lower than the amount of capital required under the current capital adequacy regime

ii) the only type of operational loss that is likely to exceed the capital required under the current capital adequacy regime are losses occasioned by fraud. The level of capital that would be required to combat the effect of possible fraud would "seriously limit competition within Europe and make the industry uncompetitive with the USA"

Damage caused to the Irish asset management industry by high capital requirements

Our concerns about the damage that may be done to the Irish asset management industry by high capital requirements are as follows:

1 Damage to competition within Irish/European asset management industry

The Irish/European asset management industry is a highly competitive industry both in terms of level of fees and quality of service provided. The high degree of competition between asset management firms is a source of strength for the industry and encourages serious investment research and the development of new investment tools and techniques.

One of the reasons for the high degree of competition is the low entry barriers into the industry. It is possible for skilled asset managers to establish new firms and compete for business against longer established firms, provided that they receive the

appropriate authorisation from the supervisory authority. The imposition of a high capital requirement would constitute an entry barrier.

2 Damage to competitive position of Irish/European asset management industry

The Irish/European asset management industry has to compete with asset management firms based outside the European Union both for business within the European Union and business outside the European Union. A high capital requirement increases the cost base of carrying on business and this higher cost has to be reflected in fees charged to customers. In many markets the main competition comes from US based asset management firms. As most of these are not owned by banks they are not subject to the Basel Accord capital requirements even at consolidated level. US regulators do not impose significant capital requirements on asset management firms not owned by banks. Such firms would therefore have a lower cost base than their European counterparts and would enjoy a significant competitive advantage when trying to win new business or retain existing customers.

Inappropriateness of assets under management as risk indicator

We believe that using funds under management as an indicator of operational risk, as provided by the Standardised Approach in the Basel Consultative Document, has serious drawbacks and does not correctly or even approximately reflect the distribution of operational risk within the Irish and European asset management industry.

The Franks/Mayer Report found that the maximum operational loss for the sample examined as a proportion of total assets under management is 0.0094%. The report suggests that even under very pessimistic assumptions the financial impact of the potential largest loss for large asset management companies would be less than 0.06% of assets under management. This data suggests that a beta of tenths of a percent would be excessive and that a beta of between 1 and 5 basis points would be more appropriate.

Validity of expenditure based capital requirement

It is not at all clear to the IAIM what is wrong with the current expenditure based capital requirement. This regime has worked satisfactorily since its inception, affording adequate protection for investors without damaging the asset management industry.

It has been suggested that the current regime discourages asset management companies from spending enough on internal control systems and thereby encourages the taking of operational risk. This is a completely unrealistic suggestion as there are other very significant factors which give asset management companies the strongest possible incentive to spend money on sound internal control systems including the risk of legal liability to clients and third parties for errors and the potential loss of business and damage to reputation arising from errors. These factors far outweigh any disincentive arising from the current expenditure based capital requirement.

We believe that there is no theoretical or empirical justification for the replacement of the current expenditure based requirement by a new regime.

Need for an interim solution for the Irish/European asset management industry

We fully appreciate the reasons for the wish for the punctual implementation of the revised Basel Accord at European Union level. It would, however, in our members' view, be deeply regrettable if the Commission's desire not to put the Irish/European banking industry at a competitive disadvantage with the banking industry based in other parts of the world, especially the USA, were to lead to the Irish/European asset management industry being placed at a competitive disadvantage to the asset management industry based in other parts of the world, especially the USA.

Irish Association of Investment Managers

Rather than replace a tried, tested and generally accepted capital adequacy regime by one that has no theoretical justification and for which the data necessary for its implementation are not yet available and unlikely to be available for some time, we urge the European Commission to exclude asset management firms from the scope of this revised Capital Adequacy Directive at both solo and consolidated levels and to require asset management firms to continue to meet the requirements of the existing Capital Adequacy Directive until a more appropriate regime based on real understanding of operational risk within the European asset management industry can be drawn up.

Such an interim solution should not present any problem of unlevel playing field between the asset management business (whether owned by banks or not) and other services provided by banks because they are by definition competing in different markets.

Merits of alternative approaches

In the meantime, IAIM through EAMA would be pleased to co-operate with the European Commission to arrive at an appropriate long term solution that reconciles the need for investor protection with that of a strong competitive European asset management industry. Such a solution might well build on the Franks/Mayer Report, which indicated that the market failures that occur in asset management should be corrected by a combination of disclosure, auditing, enforcement, insurance, custody and trustees, rather than indirectly through capital requirements.

Yours Sincerely

Ann Fitzgerald
Secretary General