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

Ref. 03-2152

30 July 2003

Anticipated by e-mail: BCBS.Capital@bis.org

Dear Sirs,

Subject: Third Consultative Paper on the New Basel Capital Accord

FEFSI[1] welcomes the possibility offered to comment on the Basel Committee's third consultative paper (CP3) on the New Basel Capital Accord (New Accord). Our comments will focus on the proposed regulation of operational risk and banks investing in investment funds.

Regulation of operational risk

The main point we wish to make is that fund management poses low operational risk and should therefore benefit from a lower capital charge, for the reasons presented below, which we hope will receive appropriate recognition in the next version of the New Accord. FEFSI is primarily concerned with the position of managers of authorized investment funds. However, many of our concerns are also relevant for other forms of asset management.

Our starting point is the assumption that the goal of the Committee is to deliver a new capital adequacy framework that, on average, maintains the current overall level of regulatory capital, after accounting for operational risk. Whilst this goal appears quite appropriate at first glance, its implementation, as currently proposed, may in fact penalize the banking institutions that specialize in asset management activities because they would be less able to offset the increase in the capital requirement to reflect operational risk with a reduction in the credit risk capital requirements. The results of the Quantitative Impact Study 3 (QIS3) confirm this view.

In its third Consultation Paper on the implementation of a new capital requirements regime for credit institutions and investment firms in the European Union, the European Commission Services also recognized that the introduction of operational risk charges proposed by the Committee for asset management firms would have a material impact, generating a significant increase in capital requirements. The Commission Services concluded that the proposed

[1] FEFSI (www.fefsi.org), the *Fédération Européenne des Fonds et Sociétés d'Investissement*, represents the interests of the European investment funds industry. Through its members, the national associations of the 15 EU Member States, the Czech Republic, Hungary, Liechtenstein, Norway, Poland, the Slovak Republic and Switzerland, FEFSI represents some 900 management companies and 41,000 investment funds with EUR 4.2 trillion of assets at end-March 2003.

charges could not achieve the objective of capital neutrality and considered that the limited activities and risk profile for asset management firms indicated the need for a modified approach.[2] To overcome this problem, the Commission Services developed a potential way forward that would permit asset management firms to calculate their capital requirements as under the current rules in place in the European Union, i.e. using a Expenditure Based Requirement.

The prospect that banking institutions specialized in fund management may be adversely impacted by the New Accord is a concern for FEFSI. Indeed, there is no justification why the New Accord should require increases in the regulatory capital for institutions that specialize in fund management given their low risk profile.

FEFSI's concerns about the potential adverse consequences of the New Accord for the European fund management industry is supported by empirical evidence, which shows that there are limited risks and operational losses in investment fund management. This is one of the main conclusions of an academic study by Professor Biais from the Toulouse University, which FEFSI commissioned to obtain an independent analysis of the merits of capital regulation to control operational risk in investment fund management.[3] [4]

Against this background, we consider that the proposed approach to operational risk for fund management should be modified as follows: (i) there should be a lower calibration of the operational capital charge for asset management; (ii) the definition of gross income for asset management should reflect the specific sources of revenues in asset management activities; and (iii) insurance should be recognized as an operational risk mitigant under both the Basic Indicator and the Standardised Approaches.

A lower calibration for asset management

There should be a lower alpha for asset management

The proposed capital requirement under the Basic Indicator Approach (BIA) may provide an adequate capital charge for "average" banks engaged in a number of different business lines, but does not for banking institutions that specialize in fund management. The result is an uneven playing field and a competitive advantage for diversified banks.

To overcome this problem, the Committee should consider relaxing its "one size fits all" capital requirement (15%) and accept a lower capital requirement for operational risk under the BIA for the institutions that generate a relatively high level of their gross income from asset management activities.

FEFSI considers that this change is essential to avoid upsetting the competitive balance between institutions that specialize in asset management and diversified banks, especially since smaller banks might opt for the BIA to avoid the complexity of the alternative approaches and the costs of conforming to their requirements.

[2] See Commission Services Third Consultation Paper, Explanatory Document, paragraph 353.
[3] The Toulouse study is available in pdf format on the FEFSI website. Two copies are enclosed.
[4] A summary of the Toulouse Study is provided in annex.

The proposed betas for asset management should be lowered

FEFSI agrees with the Risk Management Group (RMG) of the Committee on the importance of measuring the variability of the value of loss events around their mean values to assess the difference in operational risk across business lines. From this perspective, we have noted with interest that the RMG is undertaking internal analysis of the distribution of loss data.[5] FEFSI believes that the Committee should provide feedback to the industry on the results of this analysis to foster a comprehensive assessment of both frequency and severity of operational risk in asset management.

In the meantime, we would draw the Committee's attention to the data reported in the Toulouse Study, which provides information on the upper tail of the distribution of losses collected from a sample of 46 European fund management companies. This Study demonstrated that the five largest loss events in this sample ranked in terms of absolute amount ranged between EUR 0.32 and 0.95 million, between 0.14 and 4 basis points of assets under management and between 0.1% and 14.2% of capital. The Study also showed that the largest total yearly loss in the sample ranked in terms of fraction of assets under management amounted to 17.31 basis points of the assets managed by the company concerned. The Study further confirmed that most losses could be financed out of internal profits. The existing regulatory requirements applicable to investment funds – notably mandatory holding of investors' assets by a third-party supervised institution; mandatory risk spreading and management process; governance regulation; multi-level controls ranging from internal audit, compliance procedures, external depositaries/trustees to independent auditors; and the active involvement of regulators in establishing and monitoring regulations – all contribute to this lower risk profile.

In view of the empirical evidence of the relatively low risk in fund management, FEFSI considers that the beta for asset management should be lowered below 10%. The fact that the EU Commission Services are now persuaded that the beta they proposed for fund/asset management in their consultation paper of November 2002 (10-11%) was too high confirms the relevance of our standpoint.

<u>Choice of the exposure indicator</u>

FEFSI takes note of the Committee's proposal to introduce a volume-based approach for retail and commercial banking and of the new proposal of the European Commission Services' to calculate capital requirements for asset management firms using an expenditure-based requirement. We fully recognize the difficulty of finding an indicator suitable for all business lines and appreciate the importance given by the Committee and the European Commission to the choice of a proper operational risk exposure indicator.

Against this background, it is our intention to reconsider carefully the pros and cons of all possible exposure indicators for fund/asset management, in particular gross income, assets under management and fixed-overhead, with a view to providing the Committee and the European Commission with our conclusions at a later stage.

[5] See the RMG's paper entitled "The 2002 Loss Data Collection Exercise for Operational Risk: Summary of the Data Collected", March 2003, page 16.

An appropriate definition of gross income

Regarding gross income, we consider it important to already indicate to the Committee that we feel that the definition proposed in paragraph 613, i.e. net interest income plus net non-interest income, is very much a banking definition. Our proposal is that the New Accord explicitly recognize that the "gross income" indicator for "asset management" exclude:

- costs of sales & distributions,
- fees paid to third parties providing custody and agency services, as these activities are considered as a separate business line in the STA.

A recognition of the risk mitigating role of insurance

FEFSI welcomes the proposal to recognize insurance as an operational risk mitigant under the AMAs, but urges the Committee to extend this provision to both the Basic Indicator and Standardised Approaches.

The important role that insurance could use in mitigating operational risk in the fund management industry was highlighted in the Toulouse Study, which notes that *"while this is not frequent currently, insurance companies should insure fund management companies against operational risk. Correspondingly, the moral hazard risk analyse in the present paper would be transferred to the insurance company. In this context, it would be in the interest of the latter to monitor the fund management company, and check that it implements efficient risk control systems. The insurance company would have every incentive to design the optimal combination of monitoring and contracting clauses, such that the fund management company would implement effective control of operational risk."* [6]

FEFSI also shares the viewpoint of Calomiris and Herring that *"if insurance contracts mitigate operational risk for institutions that adopt the Advanced Measurement Approaches, then why do the same products not work as effectively for institutions that adopt the other two approaches?"* [7]

Treatment of Investment Funds in the First Pillar

Banks investing in investment funds

FEFSI expressly welcomes the Committee's view that holdings in funds containing both equity investments and other non-equity types of investments can be treated either as a single investment based on the majority of the fund's holdings or, where possible, as separate and distinct investments in the fund's component holdings using a look-through approach.[8] We would be happy if you could confirm our analysis that the envisaged look- through procedure in the IRB is accepted for the purpose of calculation of capital charges in the bank book. There is a practical necessity to add this measure, as there is already considerable investment

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[6] Toulouse Study, page 38.

[7] See "*The Regulation of Operational Risk in Investment Management Companies*" by Professor Charles W. Calomiris and Professor Richard J. Herring, in Perspective, September 2002, available at www.ici.org/pdf/per08-02.pdf.

[8] See paragraph 330.

in investment funds in some European countries. Furthermore we urge the Committee to allow for a look through approach not only in the internal rating approaches but also in the standardized approach. This is necessary to allow for a level playing field between banks using different approaches in the first pillar. Finally, we would like the Committee to consider to allow for a bank to apply the standard look-through approach to one (category) of funds while at the same time applying internal rating approaches to another (category) of investment funds ("partial use"). There is a practical necessity for the possibility to use both approaches at the same time for different funds as a bank may not be in the position or does not consider it economically feasible to collect the wealth of information necessary to apply the internal rating approaches to all investment funds in the banking or trading book, e.g. for a small holding in a fund which invests in emerging market debt which is usually not analysed in the internal rating system of this bank.

Investment fund units serving as collateral for loans

FEFSI also urges the Committee to reconsider its proposal (paragraph 122) to allow - similar to the logic of paragraph 330 - either the view that holdings in funds containing both equity investments and other non-equity types of investments can be treated as a single investment based on the haircut applicable to the majority of the fund's holdings or to apply a look-through approach to assets in the investment funds serving as loan collateral. The haircut that could be applied by the institution should in any case not be the highest haircut applicable to any security in which the fund can invest. This approach would overstate the risk inherent in investment funds. Instead, it would be more appropriate to allow under the look-through approach for a haircut that could be based on the asset weighted average of the haircuts that are applicable to the securities in which the fund can invest.

If you would like any further information on any of the above, we would be pleased to provide further explanation.

Yours sincerely,

Steffen Matthias
Secretary General

Annex 1

Operational Risk and Capital Requirements in the European Investment Fund Industry

A report by Bruno Biais, Catherine Casamatta and Jean-Charles Rochet

Summary of Findings and Policy Implications

The main empirical evidence and theoretical arguments presented in the Toulouse study included the following.

Limited Risks in Investment Fund Management

The Study confirms the view that neither systemic risk nor the incentive problem can be used as a justification for capital regulation of the investment fund industry. Indeed, investment fund management companies pose no significant systemic threat, i.e. default by one company could not endanger the stability of the European or global financial system. And there is no government safety net that could create incentives for investment fund managers to take excessive risks – a problem often referred to as the moral-hazard problem. It follows that only investor protection is relevant to the regulation of operational risk in investment fund management companies.

This was also one of the main conclusions of the 2001 OXERA report[i] as well as of the study recently published in the USA by the Investment Company Institute.[ii]

Limited Operational Losses in Investment Fund Management

The main empirical findings of the Study can be summarized as follows:

- On average, total operational losses per firm over one year amounted to €0.93 million. Relative to the assets under management, the median operational loss amounted to 0.3 basis point (bp) while the mean amounted to 0.96 bp.

- For the majority of firms, the ratio of actual capital to assets under management was 25 bp, and the mean of this ratio amounted to 75 bp. For most countries actual capital far exceeds the required capital.

- For more than 75% of the investment fund management companies surveyed, operational losses were below 10% of capital.

- The largest operating single loss event reported by the sample of firms was €0.95 million. This loss amounted to 14.2% of the capital held by that company and to 0.14 bp of its assets under management. The largest total yearly loss amounted to 17.31 bp of the assets managed by the company concerned.[iii]

These results are similar to those presented in the 2001 OXERA Report and in other recent studies[iv].

Limited Justification for Capital Requirements

One of the key contributions of the Study is to highlight that the prudential regulation of operational risk in fund management should rely primarily on market discipline, disclosure rules and insurance, because those tools tend to create incentives for investment fund management companies to implement sound monitoring systems for operational risk.

The importance of market discipline as a risk mitigation factor is demonstrated in the theoretical analysis of the Study, which shows that if investors can understand that capital provide incentives to exert effort to reduce operational risk, "*market forces lead the fund management company to choose the level which optimally trades off the benefits of greater incentives to monitor and the cost of capital, i.e. the level of capital that would be chosen by a benevolent regulator".*[v] Thus, "*while this theoretical analysis shows that capital is useful, it suggests that capital requirements are not."*[vi]

The Study also argues that if investors are unable to observe the level of capital of the investment fund management companies, or to analyse how it influences incentives and operational losses, regulatory intervention can be beneficial. However, "*While regulation could involve some capital requirements, it could and should also rely on other tools*"[vii]. The study emphasizes in particular the importance of the following tools:

- **Depositaries**, which are already playing in the European investment fund industry *"an important role as asset safe keepers and by monitoring certain obligations faced by the fund managers."*[viii] This function, which is provided for in the UCITS Directive, "*complements the monitoring role of the fund management company, and thus contributes to reducing operational risk."*[ix]

- **Disclosure and transparency requirements**, which help investors to understand more clearly the services and activities of investment fund management companies. The Study also notes that if the regulator can directly observe the efficiency and reliability of the control systems implemented by the fund management company, the need for capital requirements is reduced.

- **Insurance**, which can play a role as a risk mitigant because "*The insurance company would have every incentive to design the optimal combination of monitoring and contracting clauses, such that the fund management company would implement effective control of operational risk*"[x].

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[i] "Risks and Regulation in European Asset Management: Is there a Role for Capital Requirements?", A Report by Professor Julian Franks and Professor Colin Mayer and Oxford Economic Research Associates, 2001, published by the European Asset Management Association in January 2001, and available on the EAMA website, www.eama.org

[ii] "The Regulation of Operational Risk in Investment Management Companies" by Professor Charles W. Calomiris and Professor Richard J. Herring, in Perspective, September 2002, available at www.ici.org/pdf/per08-02.pdf.

[iii] The study also reports the specific case of a firm that incurred a total yearly loss corresponding to 74% of its capital. As this firm

is located in a country where capital requirements play no role in the regulatory framework, this ratio has little significance. The ratio of the total loss incurred by this firm in relation to its fixed overhead, which amounted to 3%, provides a more appropriate measure of the financial impact of this loss.

[iv] See in particular: “What do you know about the latest capital requirements for fund operational risks? What to they know about operational risks in the fund business?”, Paper presented by Patrick Zurstrassen at the ICBI Fund Forum in Rome on July 4, 2002.

[v] See Introduction (page 13).
[vi] See Executive Summary.
[vii] See Conclusion and Policy Implications (page 37).
[viii] See Executive Summary.
[ix] See Conclusion and Policy Implications (page 37).
[x] See Conclusion and Policy Implications (page 38).