european · asset · management · association

23 February 2001

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 European Asset Management Association (EAMA) represents the European asset management industry. A list of members is attached.

Reasons for commissioning independent report into capital requirements for asset management industry

As you will be aware from previous correspondence – see attached letters from EAMA to Commissioner Bolkestein of 21 December 1999 and of 26 April 2000, 30 August 2000 and 16 October 2000 to Mr Mogg - and previous meetings with your services on 7 April 2000 and 20 October 2000, EAMA is deeply concerned about the impact of capital requirements on the European asset management industry.

As indicated in our letter of 26 April 2000, and with the encouragement of your services, EAMA commissioned an independent report into the operational risk profile of the European asset management industry and the appropriate regulatory response. The report, "Risks and Regulation in European Asset Management: Is there a role for Capital Requirements?", was written by Professor Julian Franks of the London Business School, Professor Colin Mayer of the Saïd Business School and Oxford Economic Research Associates Ltd.

The preliminary report was made available to your services prior to publication of the Commission's first consultative document and the draft final report (virtually the same as the final report) was made available to your services prior to the publication of the Commission's Second Consultative document.

The final report has now been published. All references in this letter to this report are in italics. The report is available on the following websites of trade association members of EAMA: http://www.afg-asffi.com, http://www.assogestioni.it, http://www.iaim.ie and http://www.ifma.org.uk. Bound hard copies of the report are available on request from EAMA.

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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 many European asset management companies are owned by banks most are not *(Table 5.1)* 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 European asset management industry is very different from the European banking industry because:

1 Systemic risk

European asset management firms pose no significant threat to the European or global financial system as:

a) They do not generally trade on their own account so are not counterparties to trades *(page 18)*.

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 (see below) and the impact of any operational failure is generally mitigated by:

a) Client assets are legally separate from the asset management company's own assets and are generally held by external or non-group custodians so that client assets are not at risk *(page 59, page 91)*.

c) Asset management companies do not generally provide any guarantee as to the performance of funds under management and, in the few cases where such guarantees are provided, the guarantee is generally hedged *(page 76)*.

Size of operational losses in asset management industry normally low

The Report indicates that

i) the typical size of operational loss sustained within the European asset management industry *(see Table 7.13)* 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" *(page 101)*.

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

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

1 Damage to competition within European asset management industry

The 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. The imposition of a high capital requirement would constitute an entry barrier *(page 16)*.

2 Damage to competitive position of European asset management industry

The 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 *(page 157)*. 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 *(page 16)*.

3 Damage to small business

Small business would be adversely affected in two ways by the imposition of high capital requirements on asset management companies.

a) Firstly asset managers wishing to set up a small niche asset management business to exploit their specialist skills would be inhibited from doing so. Some asset management firms which would be established in the absence of high capital requirements would not be established.

b) Many small asset management firms specialise in investing in smaller quoted companies the market capitalisation of which may be too low to merit coverage by a larger asset management firm. To the extent that such small asset management companies are discouraged from operating, there will be less expertise available for investing funds in smaller quoted companies. One of the main exit routes for venture capitalists to realise their investments will become blocked and venture capital companies will, therefore, be less inclined to invest in SMEs than they would otherwise be. There will thus be less funds available for investment in SMEs.

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 European asset management industry.

Validity of expenditure based capital requirement

It is not at all clear to our members 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 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 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 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.

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 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.

The Report indicates *(page 16)* 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. EAMA would be pleased to help the European Commission in considering the merits of these approaches to regulation, if appropriate by commissioning further independent research.

Response to Questionnaire for Regulatory Capital Review

We would also ask you to note our attached response to the Questionnaire for Regulatory Capital Review. This answers the specific questions asked by the European Commission although, as indicated above, we believe that, as far as the asset management industry is concerned, the questions asked are predicated on an inappropriate approach to regulatory capital.

If you would like any further information on any of the above, or other issues affecting the European asset management industry, we would be pleased to assist.

Yours sincerely

Donald Brydon
President