INVESTMENT COMPANY INSTITUTE

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

Dear Members of the Basel Committee:

The Investment Company Institute appreciates the opportunity to comment on the second consultation of the Basel Committee on Banking Supervision (Committee) on a revised capital adequacy framework. The Institute is the national association of the US investment company industry. Our membership includes 8,391 open-end investment companies ("mutual funds"), 489 closed-end investment companies, and 8 sponsors of unit investment trusts. Our mutual fund members have assets in excess of $7.0 trillion, accounting for approximately 95% of total industry assets, and over 83.5 million individual shareholders.

The new Basel Accord, once agreed to by the members of the Committee, including the United States, would come into effect in each of the member jurisdictions when the member adopts domestic requirements in line with the new Accord. The principal changes to the 1988 Accord that would be made by the new Accord will be the approaches to credit risk and the explicit inclusion of capital requirements for operational risk. The Committee's Consultation Document describes three approaches to capital requirements for operational risk – basic indicator, standardized, and internal measurement. Under both the standardized and internal measurement approaches to calculating capital for operational risk, operational risks would be calculated for each business line, including asset management. Under the new Accord, the minimum capital requirements would apply not only to banks and banking groups but also would apply on a consolidated basis to holding companies that are parents of banking groups.[1]

We are writing to share two specific concerns regarding the Committee's Consultation Document. First, we are concerned about the implications for the asset management industry of the Committee's determination to assess the operational risks of asset management activities. Second, we question whether the approaches suggested

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[1] The Consultation Document defines a banking group as a group that engages predominately in banking activities. We understand that domestic regulations, and not the Basel Accord, would define for purposes of the capital requirement what constitutes "engaging predominately in banking activities."

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by the Committee appropriately consider the operational risks of asset management firms.

Imposing Capital Based on Activities of Asset Management Affiliates

As a general matter, we would respectfully caution that any proposal that would impose a capital charge based on the operational risks of non-banking activities be carefully considered, especially in light of consolidation of the financial services industry. As more firms consolidate under a single corporate umbrella and depending on the universe of holding companies to which the Basel Accord would apply, we believe that the assessment of operational risks of financial service activities within the Basel Accord could have implications beyond the banking industry.

Accordingly, we would encourage the Committee and its member banking regulators to work closely with the primary regulators of non-bank financial services firms, such as the US Securities and Exchange Commission, and with IOSCO before imposing capital requirement on banking groups and their holding companies based on operational risks of other industries. We believe that the Committee would benefit from the expertise of the regulators that are primarily responsible for non-banking financial services industries, and close coordination between the Committee and the primary regulators could prevent the imposition of inappropriate or disparate requirements.

Asset managers that are registered with the US SEC as investment advisers are not subject to any capital requirements in the United States. Moreover, the US Congress in 1999 explicitly considered and rejected the imposition of capital requirements on bank holding companies based on activities of registered investment adviser affiliates. Under section 5(c)(A)(3) of the Bank Holding Company Act of 1956, the Federal Reserve Board cannot impose capital requirements on an affiliate registered as an investment adviser with the SEC or any state or take into account the activities, operations, or investments of an affiliated mutual fund in establishing or assessing bank holding company capital or capital adequacy rules. Although we appreciate the Committee's concern to ensure the safety and soundness of banks, we question whether the Committee should require holding companies of banking groups or banks that have asset management subsidiaries to incur a capital charge for their asset management affiliates.

Assessing Operational Risks Involved in Asset Management

We also believe it is unwise to impose capital requirements with respect to asset management without clearly identifying the specific operational risks involved in asset management. We believe a careful study of these risks must be undertaken before the Committee develops approaches that would calibrate capital to the operational risks of asset management. Because the Committee has not identified specific operational risks involved in asset management, it is subject to doubt whether the proposed indicators in the Committee's Consultation Document are the appropriate proxies for the amount of operational risk for asset management activities.

Finally, the Consultation Document also states that the Committee plans to work with the industry on the possible recognition of operational risk mitigation techniques, including the use of insurance. We would encourage the Committee to consult with industry and the primary regulators, especially in the area of asset management, about factors that mitigate operational risk. For example, certain aspects of a mutual fund regulatory system – including provisions that address operations of mutual funds (such as strict regulation of transactions that raise potential conflicts of interest and valuation of fund portfolios), provide for annual audit by independent accountants, and require fidelity bonding to protect against fraud by employees of mutual funds -- may mitigate against operational risk. In addition, the availability and widespread practice of using insurance to cover operational risk also should be recognized as appropriate alternatives to regulatory capital requirements.

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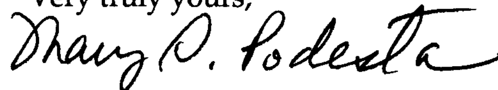
If we can provide any other information or if you would like to discuss further any issues, please call me at (202) 326-5826 or Jennifer Choi at (202) 326-5810.

Very truly yours,



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