

MEMO# 16268

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EU COMMISSION THIRD CONSULTATION ON CAPITAL ADEQUACY INCLUDES NEW ASSET MANAGEMENT PROPOSALS

[16268] July 7, 2003 TO: INTERNATIONAL COMMITTEE No. 42-03 RE: EU COMMISSION THIRD CONSULTATION ON CAPITAL ADEQUACY INCLUDES NEW ASSET MANAGEMENT PROPOSALS

On July 1, 2003, the Commission of the European Union issued its third consultation paper on a new capital adequacy framework for credit institutions and investment firms, including asset managers, in the European Union.¹ The Commission's proposals are based on the third consultation paper issued by the Basel Committee in late April² and would be implemented in the EU under the Lamfalussy procedure.³ That is, the Commission envisions that a revised EU Capital Adequacy Directive would be drafted to focus on essential principles and policies and the annexes would contain the technical implementing rules, which could be changed at a later time without amending the Directive. The Commission continues to take the general view that the new capital adequacy framework should apply to all types of institutions to ensure a level playing field within Europe. With respect to operational risk, the Commission identifies three elements to the prudential framework. First, every institution would be required to comply with basic risk management standards (Annex I). Second, every institution would be subject to a minimum capital requirement for operational risk. Third, institutions would be required to disclose information on operational risk exposure and management. In the third consultation paper, the Commission proposes several significant changes to provisions that are of interest to the asset management industry. First, despite the Institute's comment letter and others, the Commission has reversed its position and has determined not to permit the use of insurance at this time for firms using the two simpler (Basic Indicator and Standardised) approaches to calculating minimum capital. As a result, only firms using the Advanced Measurement Approaches would be able to recognize insurance in calculating capital, and the Commission also limits the maximum capital alleviation to 20%, consistent with 1 The consultation paper is available at,

http://europa.eu.int/comm/internal_market/regcapital/cp3/2003-consultpaper3_en.htm. 2

The Basel Committee's consultation paper is available at,

<http://www.bis.org/bcb/bcbcp3.htm>. 3 The Final Report of the Committee of Wise Men (the Lamfalussy Committee) recommended a four-level approach for regulating securities markets. 2 the Basel proposals. In not permitting insurance to offset capital charges calculated under the two simpler methods, the Commission is of the view that the potential recognition of insurance under the simpler approaches should await further development in insurance products, progress in the mapping and measurement process of insured operational risk events, and the availability of a straightforward formula. The Commission expects to revisit these issues over time. Moreover, despite comments (including those of

the Institute), the Commission did not change the conditions under which Member States may exempt investment firm groups from the consolidated capital requirements. Therefore, one of the conditions for exemption continues to be that all institutions within the group must be authorized and supervised by the same Member State. One positive aspect of the Commission's proposals in the third consultation paper is the recognition and acceptance by the Commission of the argument made by the Institute and others that the Commission's previous proposals and the Basel proposals do not appropriately take into account the lower risk profile of the asset management sector. The Commission acknowledges that in the case of asset management firms, their limited activities and risk profile indicate the need for a modified approach. As a result, the Commission proposes that asset management firms that do not trade for their own account or underwrite securities would be permitted to continue to calculate their capital requirements under the current rules (firms must have a minimum capital of at least 13 weeks of expenditures). * * * The Commission is seeking comments (in both paper and electronic form) on the third consultation paper by October 22, 2003. If you have any comments or concerns on the Commission's consultation paper, please contact me at jchoi@ici.org or at (202) 326-5810. Jennifer S. Choi Associate Counsel

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