COMMENT LETTER

May 30, 2001

Comment Letter on EU Proposed Capital Adequacy Standards, May 2001

May 29, 2001

Commissioner Frederik Bolkestein
European Commission
Av. de Cortenberg, 107
B 1049
Brussels, Belgium

Dear Commissioner Bolkestein:

The Investment Company Institute appreciates the opportunity to comment on the second consultation of the European Commission on a new capital adequacy framework for credit institutions and investment firms. The Institute is the national association of the US investment company industry. [1] Many of our members manage European mutual funds and pension funds through their European-based affiliates.

The Commission's consultative paper on capital adequacy is intended to complement the work of the Basel Committee on Banking Supervision while focusing on issues of particular concern to the European Union (EU). The Commission suggests in the consultation paper that a new capital charge based on operational risks could be introduced into the current capital regulatory framework. This approach would be consistent with the new proposed Basel Accord, which (among other things) would include explicit capital requirements for operational risk. Unlike the Basel Accord, which would impose the minimum capital requirements on banks, banking groups, and holding companies that are parents of banking groups, the Capital Adequacy Directive (CAD) and revisions thereto would apply the requirements of the directive to investment firms as well as to credit institutions. In addition, the revised CAD may affect management companies of UCITS funds for the first time if the UCITS amendments that reference the requirements for capital charges based on expenditures in the CAD are adopted. In light of the potentially broad application of the revised CAD to EU-based institutions, we are writing to share our comments regarding the Commission's consultation paper.

Capital Requirements Should Reflect Risks of Asset Management

As an initial matter, we believe it would be unwise to introduce into the CAD the Basel

Committee’s proposal to impose capital requirements based on operational risks for asset management firms without first clearly identifying the specific operational risks involved in asset management. We believe that the businesses of banking and asset management are fundamentally different and that any capital requirement imposed on institutions that engage in these diverse activities must take into consideration the separate risks involved in these businesses.2

In contrast to the business of banking, the business of managing assets does not require large amounts of capital to protect investors. First, the business of asset management itself is not capital intensive. Second, because client assets typically are not in the custody of the asset manager, they are not at risk if the asset manager experiences financial reverses.

Regulatory capital requirements should be set at levels commensurate with the activities in which asset management firms are engaged to avoid the imposition of inappropriate requirements. For this reason, a careful study of the operational risks involved in asset management should be undertaken before the Commission develops approaches that would calibrate capital to the operational risks of asset management.

Calculation of Capital Should Take into Account Risk Mitigation Techniques

In the consultation paper, the Commission also states that harmonized principles should be developed to recognize risk mitigation techniques under the internal measurement approach for assessing operational risks.3 We would encourage the Commission to permit asset management firms to reduce capital charges for factors that mitigate operational risk generally regardless of the methodology used to calculate operational risks.

For example, certain aspects of mutual fund regulation—including provisions that address operations of mutual funds (such as strict regulation of valuation of fund portfolios), provide for annual audit by independent accountants, require bonding, or establish investor compensation schemes to protect against fraud by employees of mutual funds—help mitigate against operational risk and therefore should reduce the amount of capital that must be held by managers of these funds. 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.

* * *

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,

Mary S. Podesta
Senior Counsel

Attachment

ENDNOTES

1 The Institute’s membership includes 8,500 open-end investment companies ("mutual funds"), 492 closed-end investment companies, and 8 sponsors of unit investment trusts.

Our mutual fund members have assets in excess of $6.6 trillion, accounting for approximately 95% of total US industry assets, and over 83.5 million individual shareholders.

2 We have expressed our concerns on these matters in a letter to the Basel Committee, a copy of which is attached.

3 The Commission would permit risk mitigation techniques under the standardized approach only for mandatory professional liability insurance.