

30 September 2002

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Dear Katy

FSA Discussion Paper 13: UK implementation of the new Basel and EU capital adequacy standards

The Investment Management Association is grateful for the opportunity to comment on the FSA's Discussion Paper 13. The IMA is the trade body representing the UK asset management industry. Its Members manage some £2 trillion of funds, and represent over 99% of the UK investment funds industry (unit trusts and oeics).

This letter raises some specific issues relevant to the investment management industry. To provide some context for our comments, however, we first wish to make two points.

1. IMA Members fall into three distinct groups for the purposes of this project.
 - Operators of retail collective investment schemes, who are outside the scope of the Investment Services Directive but are covered by the UCITS Directive. These firms are currently in PSB category 3 by virtue of their being given permission to deal in investments as principle (although discussions are continuing with the FSA on this point).
 - Asset managers who we believe are all subject to the ISD. These firms are in PSB category 4.
 - In-house asset managers of occupational pension schemes (OPS firms), who are outside the scope of the Integrated Prudential Sourcebook and therefore outside the scope of this project.
2. Some of the issues raised by this project are especially challenging for our Member firms, which in the past have not been subject to a great deal of proactive prudential supervision.

The issues raised in this Discussion Paper are closely related to several other initiatives. The IMA has responded separately to Discussion Paper 12, on regulatory reporting. We therefore make no further comments on issues relating to reporting or disclosure. The IMA's response to Consultation Paper 136, on Individual Capital Adequacy Standards was submitted to the FSA at the end of August.

As the paper says, the regime introduced by the revised Basel Accord and the Directive on Regulatory Capital will have far-reaching implications for capital adequacy regulation in the UK, and will involve major changes to existing standards and how they are applied at the level of individual firms. It has long been clear to everyone involved in the Basel process that implementation was going to be a large and complex exercise. It is also clear that work on implementation cannot wait until all the relevant laws and agreements are in place. We therefore welcome the fact that the FSA has made an early start, and look forward to continuing to work with you, in the context of the various industry consultation groups, in working on the details of implementation.

Scope

The paper correctly notes that changes to the Investment Services Directive will affect the scope of the implementation project. However, we would point out that operators of collective investment schemes will be affected by the implementation of the amended UCITS directive, which has to be implemented (at least for new entrants) by February 2004. We are discussing separately with the FSA how the prudential requirements of the amended UCITS Directive will be implemented in the UK. This is linked to the Basel/EU capital adequacy project, as the directive provisions on regulatory capital incorporate the provisions of Annex IV of the CAD. In addition, the European Commission is required to produce, by February 2005, a report for the Council and the Parliament on the capital requirements in the amended UCITS directive, accompanied by proposals for reform. It can be expected that the Basel Accord and the Directive on Regulatory Capital will have a significant influence on any amendments proposed by the Commission.

Given the existence of prudential requirements in this Directive, we would view with great concern any attempt by the FSA to apply requirements drawn from the Directive on Regulatory Capital on these firms (other than those already in the amended UCITS Directive). We would regard this as superequivalence, and we believe there to be no grounds for this. Of course, if the FSA wishes to pursue a super-equivalent requirement, it would have to justify such superequivalence in the way already set out in CP97 and repeated in DP13.

Optional approaches

On the implementation of the optional approaches to risk, our Members are most interested in the approach to implementing the operational risk charge. The DP mentions the use of individual waivers as a way of implementing the Advanced Measurement Approaches - the IMA supports this approach. We also support the idea of levying a specific charge to cover the cost of processing such a waiver application, provided that the fee is genuinely related to the amount of work involved: the alternative would mean that firms not applying for such a waiver would be subsidising those that did.

However, we would very much welcome further guidance on how the FSA plans to handle the other two approaches to operational risk: the Basic Indicator Approach and the Standardised Approach. We would urge the FSA to give serious thought to incorporating both these approaches as rules, between which firms could choose providing that any entry criteria were met. Self-certification could be used to certify compliance with any entry criteria.

The existence of a menu of approaches raises a further question: the FSA's attitude to and influence over a firm's choice of approach. Here the message in the DP is somewhat confused. In some places it says that the decision to apply to use an advanced approach 'must be the decision of senior managers, informed by their assessment of the costs and benefits' (paragraph 3.12). The IMA wholeheartedly supports this view, and would argue that it should apply to all the approaches, not just the most advanced.

But in the following paragraph to that quoted above, the DP says that the FSA 'shall of course want to ensure that where a firm chooses not to adopt an advanced approach mainly because it may lead to capital requirements higher than the standardised approaches...this is taken into account through increased capital requirements under Pillar 2.' This implies that the FSA will form a view on which firms ought to be employing the more advanced approaches and will use capital requirements under Pillar 2 to incentivise (to put it at its mildest) firms' senior management to implement a systems and controls regime (for instance the construction and maintenance of operational risk loss databases) when they do not feel that the benefits exceed the costs and where in their view any additional capital is not justified by the risks posed by the firm. In this context the use of adjectives such as 'challenging' is worrying – implying that the FSA has a prior view of which firms ought to be using the advanced approaches.

In terms of a progression from simple to advanced approaches, we are happy for the FSA to create an evolutionary path from the most basic to the most advanced approaches. But the FSA should not work on the assumption that all firms will want to follow such a path to its conclusion. Some will wish to do so, but equally some will wish start on the Basic Indicator or Standardised Approaches and stay there for a considerable time.

Superequivalence

We have already referred to one aspect of superequivalence above. We welcome the re-iteration in paragraph 3.8 of the existing commitment to restrict superequivalence to situations 'where there is a material risk of the standards otherwise being too low to help meet our regulatory requirements.'

Future work

It is certain that many more issues will arise during the implementation project. As always, we look forward to working constructively with the FSA in their resolution.

If you have any questions raised by this response, or you wish to explore some of the points raised further, please do not hesitate to contact us.

Yours sincerely

Altaf Cassam
(Drafted by Michael Stephenson)