Federal Reserve Bank of Boston

To: Basel II ANPR Public File

Date: June 7, 2004

From: Patrick deFontnouvelle and Victoria Garrity

Subject: Meeting with Moody's Investors Service

Attendees: Representatives from Moody's: David Fanger and Rosemarie Conforte. Federal Reserve Bank of Boston representatives: Patrick deFontnouvelle, Linda Barriga, and Victoria Garrity.

Purpose: To obtain information on how rating agencies currently assess capital for banking institutions primarily engaged in processing-related business lines and how the agency would view the impact of a potential operational risk capital charge under Basel II.

Perspective: Moody's is one of the leading providers of independent credit ratings. Moody's maintains offices in most of the world's major financial centers and employs more than 1,800 people worldwide.

Key Points Discussed:

(1) Competition in Processing Business Lines

Competitors in the custody business are banks. For the majority of banks in the custody business, this line comprises a significant portion of their business. In the asset management market, competitors are banks, brokers, and fund managers. The processing business is comprised of both bank and nonbank competitors. Processors include Metavente and Total Systems, both of which are owned by bank holding companies. Metavente is owned by Marshall & Ilsley while Total Systems is owned by Synovus.

(2) Capital at Banks

In assessing bank capital, Moody's considers whether a bank meets the definition of well-capitalized. But Moody's puts greater weight on tangible common equity to risk-weighted assets plus securitized assets. However, capital is not a leading indicator of bank credit quality and therefore is not a major driver of Moody's ratings. Instead, Moody's focuses on earnings generation and earnings stability as well as franchise value. However, lower capital could result in an adverse rating action. Generally, most banks receive no "extra credit" for holding a buffer. This is because by definition banks are highly leveraged – by itself, 50 extra basis points of capital are unlikely to make the difference as to whether or not a healthy bank will ultimately fail. However, large capital buffers can result in higher ratings.

A bank holding company's liquidity is subject to regulatory risk. A bank holding company's ability to withdraw funds from bank subsidiaries is limited by regulators, but organizations not affiliated with a bank do not have this restriction.

European banks tend to have lower leverage ratios than U.S. banks as they often have more low risk-weighted assets than U.S. banks.

(3) Capital at Nonbanks

When looking at nonbanks, Moody's considers such factors as revenue stream, hard assets, goodwill, debt/equity, and earnings. In some cases, Moody's looks at different businesses within the same company separately as "blended leverage" is not a meaningful concept. For example, Moody's separated Sears into two businesses: credit card and retail.

(4) Basel II

Custody banks have lower credit risk profiles and can apply the buffer capital they hold to operational risk. In this way, many banks are already holding capital for operational risk. One of the big factors will be how effective banks are at explaining Basel II to clients.