Federal Reserve Bank of Boston

To: Basel II ANPR Public File

Date: June 8, 2004

From: Patrick deFontnouvelle and Victoria Garrity

Subject: Meeting with Standard & Poor's

Attendees: Representative from Standard & Poor's: Jonathan Ukeiley, Director, Financial Services Ratings and Charles Rauch, Managing Director, Financial Services Ratings. 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: Standard & Poor's is one of the leading providers of independent credit ratings. The company has 5,000 employees in 20 countries throughout the world.

Key Points Discussed:

(1) *Current assessment methodology for capital.*

Standard & Poor's proprietary capital model is the primary driver for assessing capital, but regulatory capital is also taken into consideration. Standard & Poor's already incorporates an operational risk capital charge into its capital assessment of trust and custody banks by deducting a certain basis point amount from capital for the amount of assets under custody (AUC) and assets under management (AUM).

With regard to assets under management, Standard & Poor's methodology requires banks to hold more capital for money market funds than for equities and fixed income pooled funds, as it is the investor who takes the market risk for the latter two asset classes. The bank, on the other hand, provides an implicit guarantee with money market funds. This is because a bank will step in and support its sponsored money market funds if they are in danger of "breaking the buck".

For AUC, Standard & Poor's uses a tiering methodology or step function. In the custody business, a firm must have a minimum amount of capital to be considered a serious player given the amount of up-front fixed costs to get into this business line. But as the volume of business grows, incremental needs for technology investments do not follow a straight line function, but rather a step function that benefits from certain economies of scale. The minimum capital charge for AUC is $100 million.

Others may use revenue or expenses instead of AUC or AUM. However, Standard & Poor's does not believe that these are good metrics because they are affected by competition and pricing. For example, if trust banks are competing on price, revenues and earnings come under pressure. A capital charge based on revenues would reduce a bank's capital requirements at the very time it may need additional capital. To go one step further, a bank may cut expenses, perhaps in risk management or technology, in order to preserve bottom line earnings. An expense based capital charge would then reduce the bank's capital requirement at the very moment it may be more exposed to operational risks.

As for non-banks, standalone asset managers don't typically have tangible capital unless affiliated with a regulated entity. Some standalone asset managers have negative tangible equity given the number of acquisitions they have completed that resulted in a large amount of goodwill. For these entities, Standard & Poor's evaluates capital via a cash flow analysis that focuses on EBITDA and interest coverage. Standard & Poor's also looks at business position and franchise value in determining their credit rating.

Standard & Poor's employs a second methodology for comparing capital adequacy among the trust and custody banks. There are two steps in this methodology, which allocates Tier 1 regulatory capital ratios among the traditional banking businesses and the off-balance sheet businesses. First, Standard & Poor's allocates a certain dollar amount of Tier 1 capital to the traditional banking businesses; specifically the amount the bank needs to be considered "well-capitalized" under current regulatory definitions. Second, Standard & Poor's compares the remaining dollar amount of Tier 1 capital to the levels of AUC and AUM for the derived operational risk capital charge.

(2) Capital Buffer

Standard & Poor's expects all investment grade banks to hold a buffer, an amount of capital above the regulatory minimums, for business reasons, and because clients expect their banks to be financially sound. More specifically, the institutional clients require trust and custody banks to have a high credit rating and solid capital base. Institutional investors would rather not worry about their bank being under financial distress and siphoning resources from its custody operations in order to boost profitability.

Standard & Poor's representatives expect that the banks would use some of the existing buffer to offset Basel II's operational risk charge and don't see banks going out into the market to raise capital. They see potential regulatory changes relating to trust preferred securities as having more of an effect on bank capital than the operational risk charge.

Were the Basel II operational risk capital charge implemented, Standard & Poor's would revisit its capital methodology and make any necessary changes. If the regulatory charge is less than its current charge, Standard & Poor's may still choose to apply an add-on. The agency noted that the trust and custody banks have some of the highest ratings within its universe of rated banks. Alternatively, Standard & Poor's could take an adverse rating action if capital declines.

(3) Capital of Foreign Banks

To assess the capital of foreign banks, the same methodology used for domestic banks can be applied.

(4) Capital of Nonbank Processors

Standard & Poor's advised that it does not look at equity/asset ratios for standalone asset managers as these entities do not have much in the way of assets on their balance sheet.

Consequently, a high equity/asset ratio may be more reflective of a small balance sheet than a high capital level.

Non-bank processors such as DST and Fiserv are covered in Standard & Poor's Industrial Ratings Group. These entities have an industrial type of capital structure and are analyzed from a cash flow perspective.