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Federal Reserve Bank of Boston

To: Basel II ANPR Public File

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From: Patrick deFontnouvelle and Victoria Garrity

Subject: Meeting with Fitch Ratings

Attendees: Representatives from Fitch Ratings: Kim Olson, Managing Director & Regulatory Liaison; David Spring, Senior Director, North American Processing Banks; Eileen Fahey, Managing Director, North American Investment Banks; Sharon Haas, Managing Director, North American Commercial Banks; Gordon Scott, Managing Director; Krishnan Ramadurai, Senior Director; and Tim Beck, Associate Director. Federal Reserve Bank of Boston representatives: Linda Barriga, Victoria Garrity, and Ricki Sears.

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

Perspective: Fitch Ratings (Fitch) is one of the leading providers of independent credit ratings. Fitch Ratings is dual-headquartered in New York and London with operating offices and joint ventures in more than 50 locations. Fitch is a wholly owned subsidiary of Fimalac, S.A., a diversified holding company headquartered in Paris, France.

Items Discussed:

(1) *Current assessment methodology for capital*

The regulatory risk-based capital ratios do not play a major role in Fitch's capital assessment of processing banks given that these ratios focus on credit and market risk and not operational risk. Under the current regulatory scheme, there are no capital charges for assets under custody and assets under management. In order to correct for this, one alternative would be to use an informal add-on charge to existing capital ratios, say 10 basis points for assets under management and one basis point for assets under custody. Fitch, however, does not make this type of adjustment to tier 1 and total risk-based capital ratios since it is at best an indirect and imprecise method of capturing operational risk capital needs.

As part of its assessment of the capital of processing banks, one area that Fitch considers is leverage as measured via the common tangible equity or the tier-1leverage ratio. While also imperfect in terms of assessing inherent operational risk, the quality of the control environment or loss history, leverage ratios are somewhat useful, as the size of a processing bank's balance sheet can serve as a rough proxy for the size of the bank's custodian business due to the taking of custodial deposits. (However, one drawback is that asset management activities are not captured.) Of the two ratios, Fitch generally looks more closely at the tangible common equity ratio because: (1) it is a more conservative measure over the tier-1 leverage, as it excludes all preferred and trust preferred issues and intangibles; and (2) it allows for comparison between banks and non-banks (not subject to the Basel I regime) in terms of the overall level of capital relative to the balance sheet.

Fitch's capital assessment and ratings go beyond these capital measures. Fitch's assessment of operational risk focuses on the bank's mix of activities, complexity, history of operating losses, the potential magnitude of operational risk relative to credit and market risks, and whether risk management processes are appropriate for the level of complexity. Increasingly, Fitch is looking at how systematically the bank is thinking about operational risk and includes a discussion of the processes banks are using to identify, measure and manage operational risks and whether the bank is using an economic capital model. Fitch believes that quantifying operational risk in terms of economic capital is the best measure of capital needs at processing-intensive banks. While most U.S. processing banks have not completely developed the necessary capital models, Fitch thinks that Basel II will serve as a good catalyst to do so. Fitch will increasingly expect large and complex organizations to use more sophisticated measurement approaches for assessing operational risk and will give credit to improved risk measurement and management techniques and healthy capitalization levels relative to risk.

A high Basel II ratio (or strong capitalization levels relative to internal estimates of economic risk which may differ from Basel II) will not necessarily mean a strong credit rating, as Fitch considers many other factors aside from the company's capital position in the ratings process. These include earnings quality, liquidity, funding, franchise value, diversification, and management quality and strategy, and more.

(2) Capital Buffer

Fitch does not presently look at the size of the buffer (that is the difference between processing bank's relatively high Basel I risk-based capital ratios and the regulatory minimums). Representatives noted that it was debatable whether this buffer was originally intended to cover operational risk. Moreover, the usefulness of Basel I in addressing the risk profile of op-risk intensive institutions has been challenged by their increasing specialization. That is, as the processing banks have specialized (by divesting portions of their traditional credit business or growing their processing businesses relative to their credit activities), it gets easier to show high Basel I risk-weighted ratios due to fewer credit activities generating capital charges.

Fitch believes that the market will understand and accept that the Basel buffer of processing banks under Basel II will decline relative to traditional commercial banks as a result, all else equal, of a larger explicit charge for operational risk - a charge not included in the current regulatory capital regime. Fitch thinks that the market already implicitly factors in the need for capital to cover potential operational losses. Basel II operational risk rules will formalize the market's current informal assessment of the need for capital to cover operational risk, but should not lead to the expectation that additional capital be held, assuming that the inherent risk levels of the banks' activities remain the same. Similarly, Fitch will not penalize processing banks for a decrease in their buffer capital merely from the inclusion of an explicit charge for operational risk under Basel II.

(3) Non-bank Competition

Fitch segments the activities in which U.S. based processing banks specialize into the following categories: global custody, institutional asset management, wealth management, and mutual fund management. Non-bank competitors include investment companies, insurance companies, and investment banks and other companies such as software firms.

Most of the significant non-banks competitors also face capital and/or market-based constraints. For example, insurance companies must meet regulatory capital requirements pursuant to NAIC regulation. In addition, rating agencies usually expect insurance companies that are assigned investment-grade ratings to hold capital well above the regulatory minima. As for investment banks, the five largest U.S. firms will likely be subject to consolidated supervision and capital requirements under SEC rules, which envision applying Basel II-like requirements and will include an explicit charge for operational risk. Further, some investment banks are developing economic capital models and have devoted considerable time to advancing their measurement of operational risk. Investment companies do not have a defined regulatory capital regime; however, they are generally rated lower than processing banks, since they are not as well-diversified.

The custody market is dominated by banks; there are no significant non-bank competitors. However, there are some smaller non-banks that operate in other account processing market niches. The institutional asset management market could be divided into two groups: index investing and active investing. In indexed investing, all large participants are banks and new non-bank entrants would face scale disadvantages. In actively managed investing, banks compete with both bank and non-bank competitors. In the retail mutual fund market, banks compete with investment companies of all sizes, investment banks, and insurance companies. In the private wealth management market, banks compete with independent boutiques, investment banks, investment companies, and insurance firms. Smaller firms are able to compete with larger firms in this business as it is a "brand business."

Other less regulated firms have always been competitive in institutional asset management and wealth management. Initial and somewhat fragmentary survey data that banks provided to Fitch show that asset management activities require a relatively modest share of total operational risk capital while charges for custodial activities were comparatively larger. In light of the recent mutual fund scandals, Fitch notes that the market may want firms to hold more capital against asset management activities and to be able to articulate their strategy of managing risk- - this would apply for non-banks as well. Fitch believes that processing banks' scale and funding advantages tend to offset any negative effects that regulatory capital rules may have.

(4) Foreign Bank Competition

In addition to the Basel risk-based measures, U.S. banks are subject to Tier 1 leverage capital requirements under prompt corrective action standards, which can at times be more binding than the risk-based measures. Foreign banks (with the exception of Canada) are not subject to similar leverage ratio regulatory requirements. While some have argued that this places U.S. banks at a competitive disadvantage, it does not seem to have kept U.S. banks from achieving near-dominance in the global custody market over the last two decades.

(5) Concluding Thoughts on Competition

In concluding the discussion on competition dynamics, Fitch emphasized the following points.

- Other significant non-bank competitors (e.g., investment banks, insurance companies) also face regulatory capital requirements and capitalization expectations from the market.

- Fitch thinks the market will accept the fact that the computation of the Basel ratios has changed and understand that, all else equal, processing banks will have a larger explicit charge for operational risk and thereby a lower buffer vis-à-vis traditional commercial banks.

- Fitch will give credit in the ratings process to banks that pursue more advanced techniques in measuring and managing operational risk.

- As a general premise, the disadvantages that processing banks face compared to less and unregulated competitors are largely offset by banks' funding and scale advantages.

- If (and it is not clear that this will be the case) Basel II creates binding capital requirements on operational risk activities (i.e., banks having to hold more capital for conducting the same activities than before), this could theoretically result in some business (particularly some asset / wealth management activities) flowing to less regulated non-bank entities. However, some of this may be mitigated by the following:
    - The market imposing higher capital charges on some of these entities as a result of the mutual fund scandals.
    - Sarbanes Oxley is increasing the interest of non-banks in measuring and managing operational risk.
    - Greater transparency of hedge funds is currently being pursued by securities regulators, which may lead to more questions in the market about the amount leverage that these funds are taking on.

- Fitch thinks that Basel II's Advanced Measurement Approach will help to promote more of a "common language" around operational risk among various types of financial service providers, much like VAR models have become.