The PNC Financial Services Group, Inc.
249 Fifth Avenue
One PNC Plaza, 21st Floor
Pittsburgh, PA 15222-2707

412 768-4251 Tel
412 762-5920 Fax
james.keller@pnc.com

James S. Keller
Chief Regulatory Counsel

May 31, 2001

By e-mail: BCBS.Capital@bis.org

Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland

Re: Request for Comments on The New Basel Capital Accord

Ladies and Gentlemen:

The PNC Financial Services Group, Inc. ("PNC"), Pittsburgh, Pennsylvania, is pleased to respond to the request for comments by the Basel Committee on Banking Supervision ("Committee") on The New Basel Capital Accord ("NBCA"). PNC has been an active participant in several banking trade association groups that have prepared comments on the NBCA, but we also appreciate the opportunity to present the views of our organization on this significant initiative.

PNC is one of the largest diversified financial organizations in the United States, with $71.0 billion in assets as of March 31, 2001. Its major businesses include community banking, corporate banking, real estate finance, asset-based lending, wealth management, and global fund services. PNC also engages in business outside the United States through BlackRock, PNC's investment advisory subsidiary, and PFPC, PNC's global funds servicing subsidiary. PNC's lead bank, PNC Bank, National Association, Pittsburgh, Pennsylvania (with assets of $64.5 billion as of March 31, 2001), has branches in Florida, Indiana, Kentucky, Ohio, New Jersey and Pennsylvania.

PNC would like to commend the Committee for its work toward a more fair and consistent conceptual risk capital framework. The January 16, 2001 consultative document represents considerable progress relative to both the 1988 Basel Accord and previous versions of the NBCA. It is a turning point in the regulation of bank capital because the credit risk provisions further align regulatory capital with the concept of economic capital that is utilized by many best practices financial institutions. Further, the NBCA will reduce the need for costly regulatory capital arbitrage, as it should improve the relative allocation of capital to more closely reflect actual differences in risk.

Credit Risk-Based Capital Standards

While PNC believes that the NBCA makes significant progress toward greater risk transparency and reduces the need for regulatory capital arbitrage, there are certain areas that we believe require changes to represent industry best practices. We believe that these areas, which

generally arise out of the incongruencies between the NBCA and best practices economic capital attribution processes, are surmountable. Our major issues are:

1. the absolute and relative level of risk capital produced by the various NBCA approaches, in particular the Foundation internal ratings-based ("IRB") approach;

2. the extensive disclosure requirements for the IRB approaches;

3. the greater possibility of inconsistent application of supervisory standards across nations;

4. the greater cost to implement for Advanced approach practitioners; and

5. calculations/risk parameters:

   - validation—In general, most financial institutions do not yet have enough internal data for appropriate, "though-the-cycle" validation of probability of default ("PD"), loss given default ("LGD") and exposure at default ("EAD");

   - LGD and EAD are far too conservative in the Foundation Approach, resulting in a punitively high capital level;

   - the granularity adjustment represents some progress but does not give benefit for diversification across industry and other relevant dimensions; and

   - best practice financial institutions do not feel the need for the arbitrary distinction in methodologies between Corporate, Sovereign, Bank and Project Finance.

Finally, PNC would request the opportunity to comment on a more finalized version of the retail and securitization sections of the NBCA.

Operating Risk Capital Standards

PNC is deeply concerned with the proposed operational risk-based requirement. We believe that this component of the NBCA could significantly increase the net amount of overall capital required without any evidence that the operational risk is a significant cause of bank failure or that a supervisory approach to addressing operational risk has proven unsatisfactory. Finally, unlike the proposed credit risk proposals, the operational risk provisions would not result in aligning regulatory capital with the concept of economic capital utilized by most best practices financial institutions.

Credit Risk Capital Discussion

The following sections provide further clarification of the credit risk issues:

1.a. Absolute Levels of Capital

The Committee has indicated that the ultimate capital ratios produced by the NBCA should be consistent with those produced by the 1988 Accord for the overall banking system. It is unlikely that such an objective will be achieved under the NBCA consultative document. For PNC, we have estimated that total capital would increase under both the Standardized and Foundation approaches, while the Advanced approach would essentially be capital neutral (see below).

Percent Change in Total Capital Relative to Current Accord

		% Chg.[1]
Standardized		+30%
Foundation		+49%
Advanced		-8%

Further, during the phase-in period (2004-2006) the capital requirement for Advanced IRB practitioners would be limited to 90 percent of the capital requirement that would result under the Foundation approach.[2] If PNC were to attain Advanced IRB status, then the institution would see a net 44 percent (49 percent x 90 percent) increase in required capital during the phase-in period. This would suggest that financial institutions would seek the Standardized approach rather than attempt to qualify for either of the IRB approaches. Further, we believe that PNC's results are commensurate with results at other U.S. financial institutions.[3] One solution to this inclination would be to re-benchmark the absolute levels of capital produced by the three approaches. We feel that globally, financial institutions would be willing to work with Basel in this benchmarking process to assure equity and consistency across all financial institutions.

1.b. Relative Levels of Capital

To provide banks with an incentive to implement more complex capital approaches, one would expect capital rates to decrease as the complexity of approach increases. Under the current version of the NBCA this would not be the case. Required capital would increase significantly

[1] These percentages include for comparison purposes 20 percent operating capital.

[2] This dual calculation method would also impose an undue burden to implement and maintain two parallel capital calculation approaches. We would prefer that this provision be eliminated and that minimum capital during some phase-in period be expressed relative to current regulatory capital requirements or governed under Pillar II.

[3] Through our involvement in the Risk Management Association peer group surveys we have learned that the results shown above are not a PNC phenomenon but are rather more systemic.

under both the Standardized and Foundation Approaches, while the Advanced Approach would reduce capital slightly. Our conversations with U.S. regulators have confirmed that this outcome was not their intent with the current proposal. Thus, the Committee should ensure that these disparities are resolved prior to finalization of the NBCA. Again, this disparity could be rectified by a formal re-benchmarking process.

2. IRB Disclosure Requirements

Pillar 3 of the NBCA recommends the establishment of formal disclosure requirements to encourage greater market transparency. As proposed, the extensive disclosure requirements would require significant incremental resources for IRB institutions. We are also concerned that even with these extensive requirements, institutions will interpret and present their disclosures inconsistently with one another. For example, as part of the core disclosures each institution must present a maturity distribution of its credit exposures. Without any further clarification, an institution might disclose either original maturity, remaining maturity or weighted average life. The institutions also might or might not include prepayments in their maturity calculation. While we would concur that thorough disclosure is a desirable course of action, considerable care must be taken to ensure disclosure consistency on a global basis. We would recommend that the Committee work with an industry group (such as the Risk Management Association) to develop a set of appropriate and consistent disclosure standards. Such standards should specify that institutions disclose assumptions, definitions, processes and risk horizon.

3. Consistency of Application

One of the principal accomplishments of the NBCA is the establishment of a supervisory review process that includes supervisor discretion. The NBCA also contains many more processes that are open to interpretation relative to its predecessor. Even under the current Basel Capital Accord, which is relatively rigid compared to the proposed frameworks, there are vast differences among the international bank regulatory agencies interpretation of various aspects of the Accord. While we believe that this flexibility will generally have a positive impact on the supervisory review process, we would like the Committee to ensure consistency of application by international supervisory authorities.

4. Cost

As mentioned earlier, the NBCA proposal would significantly increase PNC's capital requirement during the phase-in period and provide minimal benefit beyond the phase-in, yet it would require significant additional resources. While most financial institutions have significant risk management infrastructures in place, the burden of NBCA calculations would be incremental in terms of added resources.[4] First, staff costs are likely to increase owing to the incremental nature of the commitment to the IRB approaches. Next, the validation and disclosure requirements

[4] Most institutions would need to continue to provide estimates of internal economic capital allocations in addition to the NBCA calculations.

in the NBCA will also most likely require the establishment of central data warehouses to support IRB approaches. During the early stages of implementation, training and education of financial institution personnel will also add cost to the process. Notwithstanding these costs, we feel that most institutions capable of attaining Advanced IRB status will commit the resources to do so if they are presented with a substantive incentive in the form of a more robust, risk sensitive capital allocation framework.

5. NBCA Retail and Securitization Methodology

The current version of the consultative document contains very tentative methodologies for both retail credits and securitization. Proper integration of both of these methodologies is necessary for the success of NBCA. If retail calculation results are not consistent with corporate calculation results, the opportunity for intra-institution regulatory capital arbitrage will arise. For a number of different types of loans, such as small business loans, the institution would have the discretion of classifying the loans as <u>either</u> retail or corporate. If either classification provides an incentive in the form of lower capital requirements, practitioners will choose the classification that produces lower regulatory capital requirements. This intra-institution regulatory capital arbitrage could be reduced by proper benchmarking of both retail and corporate capital requirements for a given loan type.

The NBCA is also largely silent as to the regulatory capital assessment methodology for securitizations. Again, in order to reduce the likelihood of intra-institution regulatory capital arbitrage, the Committee must ensure that capital requirements for securitized assets are consistent with the on balance sheet treatment of the same loans (minus potential risk mitigation provided by the securitization structure, of course). This is consistent with the procedures of most best practices financial institutions. While comments from regulators have confirmed that both of these methodologies are relatively nascent at this point, we would encourage the Committee to allow for an adequate comment period on more finalized versions of both the retail and securitization components of the NBCA.

6. Calculations and Risk Parameters

Validation

We commend the Committee in constructing its framework for a more risk-sensitive regulatory capital calculation approach. The primary risk parameters under the NBCA, probability of default ("PD"), loss given default ("LGD") and exposure at default ("EAD"), represent a solid foundation for the assessment of IRB credit risk capital. Moreover, inclusion of these risk parameters is generally consistent with economic capital calculations of best practices financial institutions. Our primary concern is not with the risk parameters themselves but rather with the validation requirements set forth in the NBCA. In general, very few institutions have both breadth (a large number of defaults across a broad cross-section of industries) and depth (losses over an entire business cycle) in their internal historical risk data. Many institutions have begun to address

the breadth problem by supplementing internal data with external loan loss databases.[5] With respect to the depth of data, few if any institutions will have adequate "through the cycle" loan loss experience to satisfy a literal interpretation of the NBCA depth requirements. Accordingly, the degree to which the Committee allows external loan loss databases to enter into the validation process will in large part determine the number of institutions that will be able to achieve Advanced IRB status. As part of this validation effort, the Committee is also requesting annual revalidation of PDs, LGDs and EADs. Independent stress testing must also be performed at least every six months. Again, these validation procedures will require significant incremental resources for IRB institutions.

Foundation Approach Risk Parameters

The LGD and EAD estimates incorporated into the Foundation IRB approach are onerous. The Foundation approach utilizes LGDs of 50 percent and 75 percent for senior and subordinated claims, respectively. Actual experience from publicly available loan loss databases would indicate that LGDs for both senior and subordinated loans are significantly lower than Committee assumptions.[6] We would recommend that the Committee, at a minimum, reduce these LGDs to a level commensurate with the industry loss experience for loans, rather than using bond data.

The Foundation approach also incorporates a uniform EAD of 75 percent for all exposures. Industry research has shown that the EADs vary widely across risk categories.[7] These studies would seem to indicate that the EAD rate of 75 percent may be too high for some institutions and that different EADs should be assigned for different levels of risk.

Granularity Adjustment

The granularity adjustment attempts to describe the extent of single borrower concentrations within a portfolio. We laud Basel for it efforts to determine the effects of obligor risk concentrations. However, the Committee addresses only one dimension of concentrations. A portfolio can also be concentrated with respect to industry, country or other factor. A portfolio of 100 loans, all to computer software companies, will have greater portfolio loss variability, all other things being equal, than that of a broadly diversified portfolio of similar size, PD, LGD and EAD. In short, an institution cannot obtain the full regulatory capital benefit of broadly diversifying its portfolio across industry or other relevant loss variability mitigants.

In addition, the NBCA specifies that exposures should be grouped into homogenous pools exhibiting similar residuals of undiversified idiosyncratic risk. There are a number of different

---

[5] For example Loan Pricing Corporation's Loan Loss Database, Moody's Default Risk Service database and Risk Management Association's LIED database.

[6] PNC had an average LGD of roughly 30 percent during 1996-2000.

[7] Asarnow & Marker [95] & Araten & Jacobs [01].

ways that one could affect such groupings (e.g., by PD, by PD and LGD). Depending upon how one groups these loans into homogenous pools, it is conceivable that one could obtain significantly different granularity adjustment factors.

Frequency of Validation & Stress Testing

The NBCA requests annual validation of most significant risk parameters. Given the importance of these risk parameters to the capital estimation process, it is essential that the appropriateness of these parameters be evaluated periodically. However, for institutions with a "through the cycle" view of risk parameters, it is unlikely that an event in any single year would affect the long-term stability of such risk parameters. Frequent revisions of quantitative risk parameters may also serve to undermine the ability of businesses to incorporate capital into the decision-making process. Accordingly, for institutions with a long-term (through the cycle) risk perspective, we would recommend that these main risk parameters be reevaluated on a less frequent basis, perhaps every two to three years.

The NBCA also recommends semi-annual stress testing. Stress tests represent the sensitivity of one's portfolio to extreme, but nonetheless plausible, events. It is improbable that the sensitivity to or magnitude of such extremity would change significantly over a six-month period. Accordingly, we recommend that enterprise-wide stress tests be performed on an annual basis.

Operational Risk-Based Capital Standards Discussion

The NBCA's fundamental intention is to provide for a more risk-sensitive regulatory capital profile. Although we do not criticize the goal of developing increasing sensitivity to operational risk, we do believe the new proposal will introduce a whole host of new issues and challenges for PNC and the banking industry as the proposal has conceptual and practical application shortcomings.

Our overarching issue with the operational risk treatment in NBCA is the gross ambiguity of the proposed methodologies, flawed by suppositions that operational risk measurements can be likened to market or credit risks, without consideration for qualitative factors, such as behaviors and control structures, that drive operational risk. The NBCA introduces operational risk capital charges that are not meaningfully related to the actual operational risk profile of the company.

One of our principal concerns in implementing NBCA is the requirement for standardized classification and collection of data across our businesses. The demands of data collection and analysis will require a new operational risk infrastructure and discipline. Major costs will likely be incurred in the establishment of new processes and launch of a loss database to begin collecting the required data.

PNC's more specific comments on the operational risk component follow.

Definition

The broadness of the proposed definition of operational risk is a fundamental issue with the proposed methodology. In the absence of a clear definition of the concept, ambiguities are certain to abound in applying the concept and understanding the basis of the associated capital charge. A clarification of overlaps between operational risk and credit or market risks is needed to avoid the duplication of capital charges.

Any definition of operational risk intended as the basis for a regulatory capital charge should preclude "indirect" loss events, such as impact upon future earnings. The fact that the impact is not related to current capital would argue against such a charge. Including indirect losses in the definition of operational risk also adds complexity to loss definitions and, subsequently, data interpretation and collection. Indirect losses are difficult to quantify, leading to confusion and double counting in data collection and capital assignment.

PNC <u>recommends</u> a more concise definition of operational risk that is focused on direct losses and that expressly excludes business, strategic and reputation risks, such as:

> "Operational Risk is the risk of direct loss of earnings owing to internal events involving staff inadequacy, gross errors or illegal conduct; from inadequate or failed internal processes and systems; or from external events -- where such risk is not already covered by credit, market, and interest rate risks."

Categorization

The business line approach is predicated upon the application of a single, standardized set of theoretical business units to real-life businesses that may vary widely in their activities, operating environments and risks. No matter how comprehensive a proposed structure, it would seem unlikely that one set of standard business units would adequately reflect those of all actual organizations. For example, many PNC businesses cross multiple NBCA-defined business lines. Some PNC businesses do not map into the proposed structure at all. Several businesses have been organized as processing units and, although related to business lines, do not have the same risk profiles.

Businesses are dynamic – growing, contracting, and changing in focus, offerings and services. It is problematic to expect to establish a standard set of business line definitions that are suitable for all organizations in the industry. Business line categorizations that do not easily reflect the institutions' management and operating structures will hinder data collection, causing confusion in interpretation and reporting of operational risk information.

The proposed loss types are ambiguous, and need to be further defined for inclusion in a robust operational risk methodology. With regulatory guidance in the form of the proposed loss types, operational risk groups in the industry can address further definition or standardization. For example, the Working Group on Operational Risk of the Institute of International Finance, Inc.

recently drafted a schematic that focuses, more appropriately, on the loss event, and not the cause of the event. The two-tier loss event categorization, for example, would provide clarification to tracking operational risk related financial impacts. PNC recommends further clarification and rationalization of loss identification and tracking.

Calibration

To be consistent with market and credit risk measurement, the capital charge for operational risk would need to be calibrated against unexpected loss. The lack of robust historical loss data precludes evaluation of any perceived loss distribution. It's uncertain whether the concept is even transferable to operational risk. Historical operational loss data would not necessarily be a good basis for indicating future losses, or lend itself to meaningful stress testing.

The Committee accepts conceptually that capital is for unexpected operational risk losses – provisions, loss deductions, risk transfer and pricing should cover expected losses. The operational risk capital charge structure proposed by the NBCA, however, does not reflect this fundamental concept, calculating capital for both expected and unexpected losses. At a minimum, we would oppose capital charges for expected losses.

Measurement

The proposed exposure indicators are based on the assumption that there is a direct relationship between the level of risk and the high level financial indicators of size or income. These top-down indicators are inappropriate proxies for risk exposure at the business activity level, which can result in inappropriate capital charges. For example, a capital charge based on income could result in a bank with growing income having to hold more capital than a bank with decreasing income because of operational write-offs. A capital charge based on size may also inappropriately disregard other factors such as complexity or marketability. Regardless of their actual risk profile, all banks will be held to an arbitrary capital standard. To be effective in measuring risk exposure for holding capital, the methodology needs to be effective in capturing, at an activity level, those factors that drive operational risk.

Incentives

Traditionally, banks manage operational risks through risk management culture and standards of internal control. Under the NBCA, risk management activities and internal controls that serve to mitigate operational risk losses are not given appropriate consideration in capital calculations. Also, it is unclear if the regulators will recognize risk transfer products as substitutes for regulatory capital. Capital charges can only be affected by changes in exposure indicators discussed above. As a result, businesses of similar size or exposure characteristics would be treated equally, regardless of the strength of their risk management processes. Without the opportunity to manage the capital charge through positive change, banks would manage the charge and not the risk. The value of a comprehensive risk management process and strong internal

controls should be recognized with regulatory capital relief in the capital measurement methodology.

Consistency

A significant issue is the treatment of banks relative to that of unregulated financial and non-financial competitors. The potential exists that the NBCA would require banks to hold regulatory capital against activities in which they directly compete with non-regulated entities. It is of major concern that these bank-affiliated businesses would suffer a competitive disadvantage by being required to hold capital for operational risk, whereas their non-bank competitors, with identical businesses, would not be under the same regulatory capital constraint. Rather than reduce risk, the effect might be to drive business away from the regulated entities.

Conclusion

Once again, we express PNC's appreciation for this opportunity to provide the Committee with the above comments, which we hope will be helpful to the Committee in further refining the risk-sensitive standardized and internal measurement approaches to capital adequacy. Please feel free to contact us if we can be of any assistance with respect to the matters discussed in this letter.

Very truly yours,

James S. Keller

James S. Keller

cc: Board of Governors of the Federal Reserve System
Office of the Comptroller of the Currency