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Electronically Submitted

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Re: Comments in Response to Consultative Document—*Interest Rate Risk in the Banking Book*

Ladies and Gentlemen:

The PNC Financial Services Group, Inc. ("PNC") appreciates the opportunity to provide comments on the Basel Committee on Banking Supervision's (the "Basel Committee") consultative document regarding the risk management, capital treatment and supervision of interest rate risk in the banking book (the "IRRBB Proposal" or "Proposal").[1] The IRRBB Proposal seeks to enhance the regulatory capital treatment and supervision of interest rate risk in the banking book ("IRRBB"). To that end, the IRRBB Proposal requests comment on two alternatives—(i) a Pillar 1 approach with a standardized measure for calculating an additional IRRBB minimum capital requirement; or (ii) an enhanced version of the current Pillar 2 approach with quantitative and qualitative disclosure requirements that, among other things, would include disclosure of the standardized IRRBB measure included in the proposed Pillar 1 approach.

I. Overview of PNC and its Regional Bank Business Model

PNC is a regional banking organization headquartered in Pittsburgh, Pennsylvania, and provides a range of traditional retail banking, corporate and institutional banking, asset management and residential mortgage banking products and services predominantly in the United States. As of June 30, 2015, PNC had total consolidated assets of $354.2 billion. PNC has very limited

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[1] Basel Committee, Consultative Document: *Interest Rate Risk in the Banking Book* (June 2015), *available at* http://www.bis.org/bcbs/publ/d319.htm.

foreign operations and our international activities primarily consist of serving the needs of our U.S. customers overseas.[2]

As a result of PNC's focus on traditional deposit-taking and lending activities, and limited nonbanking and foreign activities, the composition of PNC's balance sheet differs, in a number of important respects, from that of larger, more complex and internationally active banking organizations, such as those U.S. and foreign banking organizations that have been identified as global systemically important banking organizations ("G-SIBs").[3] For example:

- Customer transaction, savings and time deposits comprise the majority of PNC's total liabilities (as of June 30, 2015, PNC had approximately $240 billion in deposits relative to total liabilities of $308.3 billion);
- Loans and leases comprise the majority of PNC's total assets (PNC had total loans and leases of $202.1 billion as of June 30, 2015);[4] and
- PNC's loan-to-deposit ratio is approximately 87%.

Therefore, at PNC, interest rate risk results primarily from our traditional banking activities of gathering deposits and extending loans.

PNC recognizes the importance of sound risk management practices to measure, monitor and control interest rate risk and we support appropriate and robust supervisory oversight of interest rate risk management at banking organizations of all sizes and business models.[5] PNC also is subject to the U.S. Comprehensive Capital Analysis and Review ("CCAR") requirements and the stress test requirements under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). These requirements evaluate the adequacy of large U.S. banking organizations' capital in light of a broad set of risks, including changes in interest rates and variability in earnings, across a range of scenarios developed by supervisors as well as by the banking organizations.[6] Together with the current, robust Pillar 2 approach to IRRBB in the United States, the CCAR and Dodd-Frank Act stress test requirements ensure large U.S. banking organizations, including PNC, maintain capital levels that appropriately address interest rate risk.

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[2] PNC has limited operations in Canada, the United Kingdom and the Bahamas.

[3] Financial Stability Board, *2014 Update of List of Global Systemically Important Banks (G-SIBs)* (Nov. 6, 2014), *available at* http://www.financialstabilityboard.org/wp-content/uploads/r_141106b.pdf.

[4] *Source*: The PNC Financial Services Group, Inc., Consolidated Financial Statements for Holding Companies of Form FR Y-9C (June 30, 2015).

[5] *See, e.g.*, Interagency Advisory on Interest Rate Risk Management (Jan. 6, 2010), *available at* http://www.occ.treas.gov/news-issuances/bulletins/2010/bulletin-2010-1.html.

[6] Supervisory scenarios include assumptions regarding the shock impacting the yield curve. For example, the supervisory adverse scenario released for the 2014 CCAR and Dodd-Frank Act stress test exercises assumed a global aversion to long-term debt instruments resulting in a rapid rise in long-term rates and a steeper yield curve. *See* Board of Governors of the Federal Reserve System, *2014 Supervisory Scenarios for Annual Stress Tests Required under the Dodd-Frank Act Stress Testing Rules and the Capital Plan Rule* (Nov. 1, 2013), *available at* http://www.federalreserve.gov/bankinforeg/bcreg20131101a1.pdf.

Moreover, at PNC, the Risk Committee of the Board of Directors assigns an overall risk appetite for interest rate risk including measures of changes of duration of the economic value of equity ("EVE") and cumulative net interest income ("NII"). Management has a corresponding and clearly-defined interest rate risk policy and governance structure under the Executive Asset & Liability Committee, and appoints the Asset & Liability Management unit to centrally manage interest rate risk with independent oversight by Market Risk Management. To assess its interest rate risk, PNC has developed internal models for various asset and liability elements of its balance sheet according to their characteristics and available empirical evidence in order to measure the sensitivities of both EVE and NII to a set of projected as well as stressed interest rate environments. When forecasting its balance sheet, PNC uses a dynamic approach by considering the prepayment and redemption of balance sheet assets and liabilities, as well as the projected volume and characteristics of new business added to the balance sheet.

II. Concerns with the IRRBB Proposal and Recommendations

We support the Basel Committee's fundamental objectives underlying the Proposal. However, we have serious concerns with the Proposal, including that:

- A Pillar 1 approach to addressing IRRBB would result in an inaccurate measure of interest rate risk for banking organizations in the U.S. and other jurisdictions, in part because of the lack of a well-defined standard to determine the level of real loss to a banking organization's capital as a result of a reduction in either EVE or NII. Accordingly, a banking organization could be forced to manage to, and hold capital based on, a flawed Pillar 1 measure of IRRBB in a manner that is inconsistent with its actual interest rate risk and supervisory-reviewed risk management framework; and

- A standardized, one-size-fits-all approach to measuring IRRBB—whether as part of a Pillar 1 or Pillar 2 framework—would not provide an accurate assessment of IRRBB due to the diversity of balance sheets, business models and products across jurisdictions and markets, or even within individual jurisdictions, which can result in vastly different interest rate risk profiles.

PNC participated in the development of the comment letter submitted collectively by PNC and other U.S. regional banking organizations[7] (the "Regional Bank Comment Letter") as well as the comment letters submitted by The Clearing House Association, the Securities Industry and Financial Markets Association and the Financial Services Roundtable; the American Bankers Association; and the Institute of International Finance, the International Banking Federation, the Global Financial Markets Association, and the International Swaps and Derivatives Association (collectively the "Trade Association Comment Letters"). We support the comments and concerns reflected in the Regional Bank Comment Letter and the Trade Association Comment Letters, and the comments and recommendations in this letter are intended to underscore the

[7] Letter to the Basel Committee from BBVA Compass Bancshares, Inc., Capital One Financial Corp., Fifth Third Bancorp, KeyCorp, PNC and U.S. Bancorp (Sept. 11, 2015).

comments contained in those letters. Our principal concerns with the IRRBB Proposal and our key recommendations are as follows.

A. Fundamental Flaws Underlying a Pillar 1 Approach to IRRBB

The proposed Pillar 1 approach suffers from a fundamental flaw in that it would require banking organizations to hold capital based on fluctuations in potential earnings, rather than the risk of loss of capital. In other words, the Proposal would require banking organizations to hold additional capital based on a projected loss of the *opportunity* for higher earnings, even if the underlying earnings stream is projected to remain positive. As a general matter, regulatory capital requirements are intended to protect against and absorb future losses that would deplete capital, not lost earnings opportunity.

Commercial banking organizations, such as PNC, engage in extending credit to customers by relying primarily on a base of customer deposits for funding. Profits in a commercial bank business model derive primarily from the NII margin between the risk-adjusted rates earned on loans extended to customers and the rates paid on deposit liabilities. In the banking book, a change in interest rates may lead to lower NII earnings, but not necessarily to a loss that would impact capital. The proposed Pillar 1 approach would overstate a banking organization's IRRBB and inappropriately impose a capital charge where there is no potential for a real loss to capital.

Over time, a banking organization's positive NII accumulates and builds a cushion against temporary declines in NII. The Proposal's measure for IRRBB, EVE, essentially represents an aggregation of the NII stream and the cushion built up through NII accumulation would be reflected in the EVE premium over the book value of the banking organization's assets and liabilities. Fluctuations in NII, and thus EVE, occur over time due to changes in market interest rates. These changes in NII or EVE, however, only present "opportunity" gains and losses in terms of the banking organization's existing interest rate margin profile relative to the base case interest rate environment. The Proposal, however, fails to recognize that a short-term reduction in NII or EVE does not necessarily translate into a loss to capital.

The flaws underlying the Proposal's Pillar 1 EVE approach are discussed in detail in the Trade Association Letters. A key flaw of the proposed EVE framework is that it is built on the assumption of a static balance sheet with standardized run-off scenarios, rather than a going-concern 'dynamic' balance sheet that takes into account projected balance sheet changes. This assumed static balance sheet in the Proposal conflicts with sound risk management practices. As a result, the proposed Pillar 1 framework could create incentives for banking organizations to manage the overall duration of their balance sheets to the misaligned Proposal in order to reduce the impact of any capital charge, ultimately contributing to greater risk. The Proposal's Pillar 1 framework, therefore, would only lead to mismanagement of IRRBB.

The Basel Committee previously determined that an internationally-harmonized Pillar 1 framework is not suitable for managing and measuring interest rate risk.[8] Moreover, the Basel

[8] *See* Basel Committee, *Principles for the Management and Supervision of Interest Rate Risk* (July 2004), *available at* http://www.bis.org/publ/bcbs108.pdf.

Committee also has recognized that the complexity of implementing a standardized model for IRRBB across heterogeneous markets and banking organizations, and across a diverse range of products favors a Pillar 2 framework.[9] We believe these conclusions remain as true today as they were in 2004. In light of the flaws attending a Pillar 1 approach and the concerns of misaligned incentives and unintended consequences, we urge the Basel Committee not to adopt the proposed Pillar 1 approach.

B. A Standardized Measurement Approach—Whether Used in a Pillar 1 or Pillar 2 Framework—is Not Suitable for IRRBB

The composition of banking organizations' balance sheets and products and the behavior of their customers can vary significantly across jurisdictions as well as within a particular jurisdiction. Given these specificities, a standardized approach for measuring IRRBB, including as part of a Pillar 2 approach, is not appropriate. Accordingly, we believe that IRRBB is more appropriately addressed through a flexible supervisory approach, rather than through a one-size-fits-all standardized approach.

A standardized IRRBB measure cannot provide the necessary accuracy to capture the diversity and varying degrees of complexity of diverse balance sheets among banking organizations. The flaws of a standardized measurement approach are particularly acute with respect to the assumptions included in the Proposal for non-maturity deposits ("NMDs"), which have diverse characteristics and interest rate risk profiles. To measure and manage the interest rate risk of NMDs, PNC utilizes empirical models to estimate balances and rate behavior. These models are calibrated using internal historical data and reflect characteristics specific to PNC's customers and the products offered by PNC, including, among other things, behavioral characteristics, pricing strategy, competitive factors in our markets, the interest rate environment, and lending opportunities. In addition to incorporating the forward-looking judgment of PNC's balance sheet management team, PNC's analysis also considers the input of product management experts and the impact of new products and activities, including the impact on the existing suite of products. To the contrary, the Proposal's assumptions with respect to NMDs places arbitrary constraints on parameters including, for example, pass-through rates, stability, and weighted-average life. These constraints are far too restrictive and do not enable a realistic representation of the interest rate sensitivity of NMDs.

Moreover, including a standardized IRRBB measure as part of a revised Pillar 2 approach would introduce a likely inaccurate representation of a banking organization's IRRBB to the detriment of both the banking organization and its supervisors. Requiring disclosure of a standardized measure that does not accurately capture a banking organization's IRRBB, as contemplated under the Proposal, would be misleading and would not provide supervisors, investors or counterparties an accurate view of any banking organization's IRRBB. Accordingly, we recommend that the Basel Committee abandon the proposed one-size-fits-all standardized IRRBB measure—whether as part of a Pillar 1 or a Pillar 2 approach—and instead focus on

[9] *See* Basel Committee, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (June 2004), *available at* http://www.bis.org/publ/bcbs107.pdf. *See also* Proposal, at 9.

adopting appropriate enhancements to the current Pillar 2 approach. Our recommendations for potential enhancements to the current Pillar 2 approach are discussed in the following subsection.

C. Recommended Alternatives to the IRRBB Proposal—Potential Enhancements to the Pillar 2 Framework

Given the heterogeneity of, among other things, balance sheets, products, and customer behavior across banking organizations and jurisdictions, a flexible and tailored Pillar 2 approach provides the appropriate means of incorporating IRRBB into the regulatory framework. We believe the current U.S. Pillar 2 approach is a robust example of how a Pillar 2 approach can successfully and appropriately ensure the sound management of IRRBB. In the United States, this Pillar 2 approach is further supported by the U.S. supervisors' CCAR and Dodd-Frank Act Stress Test requirements. IRRBB is evaluated as part of the CCAR exercise, which takes into account a broad set of risks.[10] Accordingly, large U.S. banking organizations, including PNC, appropriately capture interest rate risk in their capital planning and internal capital adequacy assessment processes (ICAAP).

Nonetheless, we would support appropriate enhancements to the current Pillar 2 approach. For example, we would support the use of interest rate shock scenarios in a supervisory Pillar 2 framework. The Basel Committee should focus on establishing principles for national supervisors to follow in developing jurisdiction-specific requirements for such scenarios. As opposed to the proposed shock scenarios, which would be applied uniformly to arrive at a set of standardized global shock parameters, the shock scenarios should be defined by national supervisors. Such an approach would allow supervisors to tailor scenarios to the nature of the balance sheet and business models of specific institutions or groups of institutions within their jurisdictions. This would provide supervisors and banking organizations the necessary flexibility to evaluate sensitivity to IRRBB using an EVE or NII framework (or both) based on characteristics that would best suit the banking organizations' portfolios.

Measurement of IRRBB is extremely complex. Due to the likelihood of market confusion regarding the results of the shock scenarios, we recommend that the results should be reported to supervisors rather than be required to be disclosed to the public. Supervisors have the requisite expertise and familiarity with the banking organizations that they oversee and, as a result, are best equipped to understand nuances that could cause differences in banking organizations' results under the shock scenarios that do not reflect banking organizations' relative IRRBB profiles. We recognize that there may be opportunities to enhance public disclosures of interest rate risk, however it is important that any such disclosure requirements not force banking organizations to disclose sensitive, confidential or proprietary business information.

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[10] For example, CCAR specifically evaluates the adequacy of a banking organization's capital in light of, among other things, the variability in earnings over a particular time horizon in a range of scenarios, including a severely adverse scenario. Supervisors have the ability to adjust scenarios to capture interest rate risk in both a rising rate and decreasing rate environment. *See, e.g.*, *supra* note 6.

D. Comments on Credit Spread Risk in the Banking Book and Allocation of Internal Capital Specifically for IRRBB

PNC does not support the proposed integration of credit spread risk in the banking book ("CSRBB") into the Pillar 2 framework. We believe credit risk is adequately captured through the current regulatory capital framework as well as, in the case of large U.S. banking organizations, the U.S. supervisors' CCAR exercise. Further, the Proposal does not adequately develop the definition or scope of CSRBB, thus making it difficult to provide meaningful commentary. In light of the important questions concerning CSRBB that remain unaddressed, we believe it is premature to include CSRBB in any IRRBB framework.

We note that Principle 9 of the Proposal would require that banking organizations specifically allocate internal capital to IRRBB. PNC believes it is premature to introduce such a requirement into the Pillar 2 framework at this stage. As discussed above, there is a serious measurement issue with IRRBB given the lack of a well-defined standard to determine the level of real loss to a banking organization's capital as a result of a reduction in either EVE or NII. Furthermore, there are many risk factors that can contribute to a potential loss to capital. Accordingly, under the existing Pillar 2 framework, banking organizations follow a comprehensive and holistic approach to managing capital adequacy, i.e., IRRBB is considered alongside other risks as part of the capital planning process. Requiring banking organizations to allocate capital on a standalone basis to individual risk factors would deprive banks of the benefit of having diversified business activities and portfolios.

III. Conclusion

Thank you for the opportunity to comment on the Proposal. We would be pleased to discuss our comments and recommendations further with representatives of the Basel Committee. In addition, if you have any questions regarding this letter or our recommendations, please do not hesitate to contact me at +1-212-527-3003 or bill.parsley@pnc.com.

Sincerely,

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