April 16, 2000

PNC

Secretariat
Basel Committee on Banking Supervision
CH-4002
Basel, Switzerland
baselcommittee@bis.org

Re: Consultative Document: *Strengthening the resilience of the banking sector*

Dear Sir or Madam:

The PNC Financial Services Group ("PNC"), Pittsburgh, Pennsylvania, appreciates the Committee's invitation to comment on *Basel Committee on Banking Supervision, Consultative Document: Strengthening the resilience of the banking sector* ("BIS Capital"). PNC is one of the largest diversified financial services companies in the United States. It has businesses engaged in retail banking, corporate and institutional banking, asset management, residential mortgage banking and global investment servicing, providing many of its products and services nationally and others in its primary geographic markets located in Pennsylvania, Ohio, New Jersey, Michigan, Maryland, Illinois, Indiana, Kentucky, Florida, Missouri, Virginia, Delaware, Washington, D.C., and Wisconsin. PNC also provide certain investment servicing internationally. At December 31, 2009, PNC's consolidated total assets, deposits and shareholders' equity were \$269.9 billion, \$186.9 billion and \$29.9 billion, respectively.

PNC's capital management objectives reflect the needs and goals of our primary constituencies. We seek to provide our shareholders with consistent, high quality financial returns. Attaining this goal is imperative in meeting the goals of existing shareholders as well as providing access to new equity investors if and when needed. To meet the needs of our customers, PNC is committed to maintaining a capital position that will enable us to attain both our current and strategic business goals, which are very focused on our customers. PNC operates in a regulated industry; accordingly, a key financial goal is to maintain a regulatory capital position that exceeds existing requirements as well as to keep an adequate capital cushion to operate effectively during a period of financial stress.

PNC's capital objectives appear consistent with those set forth in BIS Capital – "*taken together, these measures will promote a better balance between financial innovation, economic efficiency, and sustainable growth over the long run.*" However, PNC strongly believes the "*proposed changes*" in BIS Capital designed to result in a "*banking sector that is less leveraged, less procyclical and more resilient to system wide stress*" will not produce the balanced objectives of sustainable growth and resiliency.

PNC strongly believes the standards recommended in both the BIS Capital and BIS Liquidity proposals are primarily focused on establishing and maintaining standards designed solely to preclude financial failure, and not on achieving the set of balanced objectives articulated in BIS Capital. PNC believes that if regulatory capital standards move too much in the direction of meeting only this one goal, the services and returns provided to other constituencies will be significantly diminished.

PNC believes implementation of BIS Capital would result in a substantial reduction in PNC's ability to perform its core financial intermediation functions and provide capital to its customers through its lending activities. Additionally, the proposals will increase the cost of credit to PNC's customers. These impacts will be felt by all banks, and PNC expects the unintended macroeconomic impact to be substantial. Specifically, the reduction in PNC's ability to function as a financial intermediary, coupled with increased credit costs, will translate into lower levels of domestic and global economic growth.

PNC supports the Committee's overall objective of strengthening the resiliency of the banking industry through stronger and more transparent capital requirements. That said, the proposed changes in BIS Capital would likely have significant unintended consequences, which should be thoroughly reviewed and evaluated before changes are made to existing capital standards. PNC believes the results of the ongoing Quantitative Impact Study, in combination with comments such as those provided herein, should be an integral part of this re-evaluation process.

Attached are more detailed comments on various aspects of BIS Capital. If you have any questions about the contents of this letter, please do not hesitate to contact me (412-762-2594 or randall.king@pnc.com). Thank you very much for the opportunity to comment on this proposal.

Sincerely,

Randall C. King
Executive Vice President
Head of Liability and Capital Management
PNC Bank, National Association

Attachment

cc: Michael D. Coldwell
Federal Reserve Bank of Cleveland

Morris Morgan
Office of the Comptroller of the Currency

William S. Demchak, Senior Vice Chairman
Richard J. Johnson, Executive Vice President and Chief Financial Officer
The PNC Financial Services Group, Inc.

Attachment

PNC Comments on Consultative Document: *Strengthening the resilience of the bank sector*

PNC Comment 1

BIS Capital paragraph 101 proposes that the carrying value of non-consolidated investments in "*certain banking, financial and insurance entities*" should be deducted from capital. PNC strongly believes this proposal should be modified to reflect the risk-taking activities and financial condition of the entity in which ownership is maintained, as well as any potential "cushion" created by the market value of such investments exceeding carrying cost.

The BIS Capital Executive Summary points to specific risk-taking activities that led to the financial crisis recently experienced -- most notably excessive leverage, off-balance sheet risk taking, concentrations of credit risks, and counterparty credit exposure. PNC acknowledges the rationale for the deduction proposed in paragraph 101 *("the purpose of the proposed deduction is to remove the double counting of capital in the banking sector and limit the degree of double counting in the wider financial system")* as prudent for the industry.

However, PNC believes that if this adjustment is made it should be done by increasing risk-weighted assets, not reducing capital. Furthermore, the risk-weighting factor should be scaled for both the degree and type of risk. For example, an investment in a financial firm with minimal leverage and off-balance sheet exposure, coupled with primarily fee-based revenue sources, could receive a 200% risk weighting, versus a highly leveraged, credit-extending financial company receiving a 1250% risk weighting (see PNC Comment 6 below).

PNC Comment 2

BIS Capital would change the current treatment of unrealized losses on available for sale ("AFS") securities in the United States based upon the implementation of paragraph 95 (*"No adjustment should be applied to remove from the Common Equity component of Tier 1 unrealised gains or losses recognised on the balance sheet"*).

Banks use their investment portfolios as an important tool in managing overall interest rate risk. Portfolio valuations will generally move in a direction opposite to that of bank deposit liabilities. That said, a reduction in portfolio valuation might be an indication of a prudently managed balance sheet, not a risk-taking activity. Accounting symmetry is not achieved currently given that changes in deposit valuations – and other asset and liability accounts – do not impact capital. The adoption of paragraph 95 would reinforce this inconsistent accounting standard within the regulatory capital framework. As detailed in the next paragraph, PNC believes existing accounting standards effectively deal with that portion of portfolio depreciation not related to interest rate risk management.

U.S. accounting standards effectively deal with that portion of unrealized losses in Available-for-Sale ("AFS") and Held-to-Maturity ("HTM") securities that are expected to ultimately be realized (through earnings) via other-than-temporary impairment ("OTTI") standards. In instances where a security's fair value is less than amortized cost, the bank does not intend to sell the security and it is more likely than not that the bank will not be required to sell the security prior to its fair value recovery, OTTI standards require that we recognize a current period loss (and hence reduction in capital) equal to the expected credit loss inherent in the security.

The great majority of unrealized losses in PNC's securities portfolio through the stress period were related to liquidity premiums, not credit-related OTTI. A potential unintended consequence of implementing Paragraph 95 is that firms would move underwater AFS securities to HTM for the sole purpose of avoiding the capital implications. This would reduce liquidity in the system, due to the significant constraints imposed on banks' ability to sell HTM securities via SFAS 115.

Finally, both BIS Liquidity and PNC's internal process have mechanisms to reduce the liquidity value assigned to non-liquid securities, in which unrealized losses were concentrated in the United States during the stress period. If the firm has the long-term ability to fund the illiquid assets and thereby limit losses to credit-specific losses, then current unrealized losses should not be deducted from regulatory capital.

PNC Comment 3

BIS Capital proposes that "*goodwill and other intangibles should be deducted from the Common Equity component of Tier I" (paragraph 96).*" The rationale is the *"high degree of uncertainty that intangible assets would have a positive realisable value in periods of stress or insolvency."*

This proposal would require that mortgage servicing rights ("MSRs") be fully deducted from equity. PNC believes that BIS international standards regarding the deduction of intangible assets should distinguish between revenue producing and non-revenue producing intangibles. Furthermore, consideration in the intangible deduction process should be given to the potential transferability, as well as the depth and breadth of the secondary market, for the subject intangibles. Consideration of these issues would lead to a differentiation of treatment between MSRs and non-revenue producing, less liquid intangibles.

PNC Comment 4

BIS Capital (paragraphs 98 and 99) requires that the full amount of Deferred Tax Assets ("DTAs") be deducted from capital. PNC acknowledges that an over reliance on DTAs as a source of forward revenue is not prudent, and believes one set of forward-looking earnings projections should be consistently applied for all capital adequacy analyses. A forward-looking approach is an integral part of risk management and the Basel framework. The federal bank regulatory agencies implemented the Supervisory Capital Assessment Program ("SCAP") utilizing a uniform forward-looking framework to project future net income and loss reserves over a two-year period. In the SCAP guidance, the Federal Reserve stated the two-year forward look provides a reasonable ability to project losses/income with some degree of confidence.

The DTA limitation should apply the same two-year earnings projections that are used for other aspects of capital adequacy. The BIS objective provides, "undue reliance on these assets is not appropriate for prudential purposes, as they may provide no protection to depositors or governmental deposit insurance funds in insolvency and can be suddenly written off in a period of stress." PNC believes it would be unreasonably arbitrary for a well-capitalized bank projecting book earnings over the next two years to value a DTA as if it were insolvent and in bankruptcy proceedings.

The current DTA rule also provides an overall look forward limitation of 10% of Tier I capital. PNC believes a total limitation is appropriate so that there is not an over reliance on DTAs as part of Tier I capital.

PNC Comment 5

Regarding BIS Capital paragraphs 106 and 107, PNC interprets the proposal to be consistent with current U.S. regulatory capital treatment for defined benefit pension fund assets and liabilities. More specifically, currently a net pension asset (pension assets greater than pension liabilities) or net pension liability (pension liabilities greater than pension assets) is recorded within other comprehensive income ("OCI"). This specific amount within OCI is deducted from (net pension asset) or added back to (net pension liability) capital. PNC acknowledges that the proposal of adjusting for neither a net liability, nor a net asset, where assets are not capable of being withdrawn and used for the protection of depositors and other creditors of a bank, may help ensure the Common Equity component of Tier I retains the confidence of regulators and market participants. Alternatively, if the intention of the proposal is to apply it separately to the gross pension assets and gross pension liabilities, then PNC strongly disagrees with this treatment. A gross application would conflict with the principal described in Paragraph 107, namely that the value of pension assets stems from a reduction in future payments into the fund.

PNC Comment 6

BIS Capital paragraph 108 requires that "*certain securitisation exposures ... receive a 1250% risk weight*." Adoption of this proposal would require dollar-for-dollar capitalization for securitizations rated below BB- regardless of the risk of loss inherent the security.

PNC believes dollar-for-dollar capitalization may be appropriate for high-risk "leveraged" or first-loss tranches of securitizations, but not for investment securities that represent the most senior classes of a securitization. The major credit rating agencies do not implicitly or explicitly state that the senior class of a securitization rated below BB- has a reasonable likelihood of a high loss rate. Standard and Poor's defines a B rated obligation as "an obligation ... more vulnerable to nonpayment than obligations rated 'BB,' but the obligor currently has the capacity to meet its financial commitment on the obligation. Adverse business, financial, or economic conditions will likely impair the obligor's capacity or willingness to meet its financial commitment on the obligation." Therefore, the proposed treatment described in paragraph 108 appears arbitrary in using the BB- rating as a cut-off point and assigning a dollar-for-dollar capital treatment below this cut-off rating.

PNC believes the OTTI accounting standards (described in PNC's BIS Capital Comment 2) appropriately addresses the issue of expected loss for sub-investment grade investment securities. The OTTI accounting standard requires a current period charge be taken for the expected loss to be realized over the full life of the security. The paragraph 108 proposal ignores projected expected losses, and assumes 100% loss for all securitizations below a certain ratings threshold. Using the existing OTTI standard to record a current period charge for expected losses provides a much better linkage between risk and the appropriate reduction to capital.

PNC Comment 7

BIS Capital proposes the establishment of a leverage ratio, in which off-balance sheet exposures are added to the asset denominator at a 100% conversion factor. PNC acknowledges that off-balance sheet exposures can create risks similar to on-balance sheet; however the proposed universal treatment of off-balance sheet instruments (paragraph 233, *"OBS items are a source of potentially significant leverage. The failure to include OBS items in the measure of exposure creates an incentive to shift items off the balance sheet to avoid the leverage ratio constraint. The Committee therefore proposes to include the above OBS items using a 100% credit conversion factor. This approach is simple and consistent with the view that OBS items are a significant source of leverage."*) does not differentiate risk appropriately.

If off-balance sheet exposures are included in the proposed leverage ratio, the conversion factor should be based upon the historical behaviour of the exposure during a stress period as well as the bank's contractual position. For example, a 100% conversion factor is not appropriate for commitments that the bank has the unilateral right to cancel.

The proposed treatment of off-balance sheet exposures in paragraph 233 is also inconsistent with the actual experience of troubled U.S. banks during the recent stress periods. As detailed in PNC Liquidity Comment 4, troubled U.S. banks experienced a significant decline in aggregate funded loans and unfunded commitments during the recent stress period. Support is provided in the PNC Liquidity Comment Appendix at page 3. This historical experience during a very stressful period for four separate large U.S. banks reinforces PNC's position that off-balance sheet exposures not receive a universal 100% factor in the calculation of a holistic leverage ratio.

Additionally, if the proposal is implemented, an unconditionally cancelable home equity line of credit will receive the same treatment as a committed, non-cancelable liquidity facility to a large corporate client. This type of universal treatment of off-balance sheet credit commitments could have the unintended consequence of significantly reducing the amount, or increasing the price, of this type of credit to PNC's customers.

PNC Comment 8

PNC supports the forward looking provisioning proposal put forth in Paragraph 244 of BIS Capital ("*loan loss provisions should be robust and based on sound methodologies that reflect expected credit losses in banks' existing loan portfolios over the life of the portfolio. The accounting model for provisioning should allow for early identification and recognition of losses by incorporating a broader range of available credit information than is permitted under the incurred loss model.*").

However, moving towards such forward looking provisioning will require alignment and coordination between this proposed approach and existing U.S. accounting standards that base provisioning on an incurred loss model. Under this methodology, before a loss is recorded, it must be probable and able to be estimated based upon facts and circumstances that exist today. In other words, in contrast to an expected loss methodology, future expectations about changes in facts and circumstances that exist today are not permitted. Currently, the Financial Accounting Standards Board ("FASB") is considering removing the probability threshold, which would move closer to an expected loss methodology. However, it appears that the FASB may still not permit future expectations about changes in facts and circumstances to be considered. Therefore, while credit losses may be recorded sooner, the concepts underlying the methodologies will not be consistent.

If the expected loss ("EL") approach were taken to provisioning through the financial statements, financial institutions would be able to build credit reserves during periods of low credit losses when profitability is generally higher. The ability to build reserves to cover future credit losses is strongly preferred to the alternative, which is to have insufficient reserves to cover EL as credit deteriorates and build the prudent credit cushion via increasing capital.

PNC believes there would be a strong positive signaling effect if a bank covered stress period losses by drawing down previously provided loan loss reserves compared to a bank incurring current period losses and reducing capital as credit deteriorates. In these hypothetical alternatives, the first bank signals being well prepared for a credit downturn and pro-actively managing through the cycle; the latter bank appears to be acting reactively as if such losses were not anticipated. Although the economics of these two alternatives – increase reserves or increase capital – produce similar cash flows outcomes, PNC advocates the reserve building strategy as a more transparent form of effective risk management.

Alternatively, one might consider permitting provisioning for stress test purposes to be calculated under an expected loss model versus an incurred loss model. In this manner, a financial institution would consider expected losses in determining its necessary capital buffer. Similar to the expected loss approach through provisioning, a capital buffer would be established in better economic times in expectation of an eventual downturn.