



July 31, 2003

Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland
email@bis.org

Re: Comments on the Third Consultative Document for the New Basel Capital Accord

Ladies and Gentlemen:

The PNC Financial Services Group, Inc. (“PNC”), Pittsburgh, Pennsylvania, appreciates the opportunity to provide feedback on the Third Consultative Paper (“CP3”) of The New Basel Capital Accord. As a leader in risk management practices, PNC is keenly aware of the impact the NBCA will have on our organization and the overall industry. Enabling industry practitioners to shape the NBCA’s guidelines promotes the desired convergence of industry best practices and regulatory requirements.

PNC is one of the largest diversified financial organizations in the United States, with \$67.0 billion in total assets as of June 30, 2003. 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, Inc., PNC’s investment advisory subsidiary, and PFPC, PNC’s global funds servicing subsidiary. PNC’s lead bank, PNC Bank, National Association, Pittsburgh, Pennsylvania, has branches in Florida, Indiana, Kentucky, Ohio, New Jersey and Pennsylvania.

The progress of the Basel Committee (“Committee”) in enhancing capital adequacy standards and validation methodologies is commendable. PNC is encouraged by the extended application of the internal ratings approach and the movement towards a more consistent capital definition.

Furthermore, refinement of risk measurement techniques from prior Committee publications dovetails with PNC's current risk assessment initiatives. Despite these favorable developments, closer industry alignment could be achieved.

This comment letter identifies PNC's issues regarding CP3's guidelines and explains the general implications of each on the industry. They are presented below in order of significance to PNC.

- **Expected Loss (EL) Parameters:** CP3 should employ exposure at default ("EAD") and loss given default ("LGD") measures that are consistent with observed industry data.
- **Pillar 3 Disclosures:** Certain disclosures could allow reverse engineering of competitor portfolios. CP3 disclosure guidelines hamper intended benefits.
- **Operational Risk:** CP3 prescribes overly conservative restrictions for calculating operational capital.
- **Confidence Intervals:** Applying a 99.9% confidence interval to credit and operational risk calculations will likely result in regulatory capital exceeding most banks' economic capital.
- **Real Estate:** The higher volatility classification of acquisition, development, and construction ("ADC") exposures is not supported by an analysis of bank ADC loans or PNC's own experience. Using both the foundation and advanced internal ratings-based ("IRB") approaches, regulatory capital for low and high volatility portfolios was determined to be substantially higher than calculated economic capital.
- **Asset Securitization:** There are several concerns pertaining to liquidity facility capital calculations.

- **Capital Definition:** The Committee's definition of capital is still not consistent with that of industry risk practitioners. The approach for measuring economic capital also requires alignment with industry practice.

The remainder of this letter is devoted to reviewing these issues in detail.

EL Parameters

The proposal to use LGD and EAD parameters that are more conservative than through-the-cycle measures fosters a disconnect between assumed risk and required capital. While margin in a specific instance may be prudent, additional conservatism across all classes cannot be rationalized. Furthermore, clarification is required on how to quantify the parameter margins.

The parameter conservatism requirement is accentuated when the Committee's proposals for confidence interval use and stress testing are accounted for. This layering of conservative assumptions is particularly troubling. We believe that the Committee should focus on accuracy of inputs and introduce a conservative margin only if there is a high degree of uncertainty around a particular input. Specific concerns regarding the EL parameter and stress-testing proposals are discussed below; the confidence interval guideline is addressed separately in this letter.

PNC's measures for probability of default ("PD"), EAD, and LGD are already deemed to be conservative given the historical data from which they are derived. The majority of PNC's historical data observations occur during a recessionary period; hence, default events are more frequent than during an expansionary period. Furthermore, observed correlations among PD, EAD, and LGD result in higher losses and exposure for each default. Employing default-weighted averages for parameter calculations thereby results in a more conservative assessment of expected loss.

Though the Committee's stress test usage guidelines require further definition, the general direction runs contrary to industry practice. Stress tests and scenario analyses are used primarily to gauge the magnitude of loss during worst-case events—market disruptions of a low frequency, high severity

nature. Adding a capital margin based on any type of stress/scenario test would render the final capital charge highly punitive. Stress and scenario events should be used solely to gauge the sensitivity of an institution's capital to changes in relevant risk parameters.

Pillar 3 Disclosures

Pillar 3 guidelines still require the publication of data that is too sensitive. Required disclosure of detailed exposure information could enable the reverse engineering of an institution's portfolios. Notwithstanding this issue, the lack of a data audit requirement may undermine the credibility of published information. Additionally, there is the overriding challenge of enforcing consistent disclosure standards across disparate institutions and differing regulatory regimes.

Operational Risk

Based upon the underlying requirements of the advanced measurement approaches ("AMA"), CP3 maintains a punitive approach for calculating operational risk capital. First, use of a 99.9% confidence interval overstates the area of the loss distribution upon which regulatory capital should be based. This interval is closer to the benchmark used for calculating operational economic capital, thereby belying the essence of minimal capital requirements. (This issue will be discussed in more detail below.)

Second, most institutions will require many years to collect data of sufficient quality to derive inter-business event correlations. Assuming perfect correlation, in the interim, will result in a punitive capital charge. This will be exacerbated should other conservative measures be employed.

Finally, the 20% cap on insurance recognition is too stringent, provided the other insurance requirements are met. Excluding outliers, long-term historical data has proven insurance to be an effective loss mitigant for operational events. Its efficacy as a risk transfer agent is comparable to that of credit and market risk hedges. Barring data to the contrary, this cap should be raised to a more realistic level.

Confidence Intervals

The Committee currently proposes using a 99.9% confidence interval for credit and AMA operational risk capital calculations (CP3, paragraph 627). Such a high interval will result in regulatory capital equaling or exceeding most banks' economic capital measure. PNC's economic capital is already calculated at a comparable interval for several asset classes. As such, we believe this requirement contradicts Basel's aim for minimum capital adequacy.

Such a conservative interval ignores the inherent diversification benefits of maintaining exposures across disparate asset groups. Even if a corporate-wide 99.9% confidence interval is required, individual asset classes need not be subject to such a stringent level. In actuality, subjecting individual portfolios to a 99.5% interval would endow them with adequate capital buffers while simultaneously providing a reasonably conservative buffer at the enterprise level.

Real Estate

PNC questions the Committee's choice of a more strict capital function for ADC lending, or high volatility commercial real estate ("HVCRE") exposures. First, there is no bank industry data available that indicates this class of real estate to be of higher volatility than investment (standing) real estate loans. PNC's internally available loss data do not support this interpretation either.

Second, no data suggest that ADC loans have higher volatility than corporate & industrial ("C&I") exposures. The mortgage data analyzed to support this position were not bank-originated loans. As such, they did not exhibit key factors present in bank-originated loans that would make the performance less volatile. Among others, we can ascribe two key reasons for assigning the low asset correlation function to ADC loans.

First, many acquisition and construction loans require guarantees (in certain cases more than one). Guarantees have proven to be an effective risk transfer mechanism. Provided that the joint probability of default (and not a pure PD substitution) is applied to EL calculations, default correlations will decline—possibly even below those of standing real estate.

Second, many construction loans have a duration of less than three years. This mitigates the likelihood of financial deterioration for the obligor or guarantor. Moreover, this timeframe is sufficiently short to avoid precipitous changes in market conditions. The short duration advantage is best exemplified by the fact that approximately half of the period is used for lease up activity.

As a final note, PNC's internal analyses have demonstrated that the proposed regulatory capital for income-producing real estate ("IPRE") and HVCRE portfolios is substantially higher than PNC's internal calculations of economic capital. The analyses were undertaken using both the foundation and advanced approaches. Using the advanced approach, the proposed regulatory capital assignment would be approximately 2% and 3% higher than PNC's internally calculated economic capital for IPRE and HVCRE portfolios, respectively. Under the Foundation IRB approach, proposed regulatory capital would be 4% and 5% higher, respectively, than PNC's economic capital.

Asset Securitization

Guidelines for liquidity facility capital require modification to better align with the inherent risk of multi-seller conduits. First, a credit conversion factor of 20% should be allowed for under 1-year maturities using the ratings-based approach ("RBA") and supervisory formula ("SF") approach. This should increase to 50% for maturities greater than 1 year.

Second, the option to use banks' internal ratings should be made available--provided that it applies solely to investment grade positions. This would significantly reduce the cost and resources required to assess capital under the RBA and SF approach. An internal ratings approach would enable a more rigorous assessment of risk and permit allowances for excess spread and trade receivables. Conservatism embedded in the RBA and SF approach would also be reduced to a more realistic threshold.

Third, to avoid the resource-consuming application of the SF approach, banks should be permitted to utilize the external rating of the underlying transaction. It is acknowledged that this may result in a capital assignment greater than that of the liquidity position.

Finally, the proposed top-down approach may not provide a clear assessment of transaction risk. Information regarding default probabilities cannot always be reliably obtained because of the originator's confidentiality requirements. When substitute "proxy" PDs, which are inherently conservative, are applied to conservative capital formulas, the resulting capital charge is generally too biased to reflect inherent risk. The issue is compounded by the lack of a credit enhancement provision. In short, a less complex capital assessment methodology should be made available.

Capital Definition

The Basel definition of balance sheet capital is inconsistent with that used by industry risk practitioners. While the Basel definition includes subordinated debt and the allowance for loan and lease losses ("ALLL"), industry equates only tangible equity and general reserves as part of actual capital. We feel that because subordinated debt does not mitigate the probability of insolvency, it should not be included in the definition of capital.

Basel's measurement of economic capital also requires modification to align with industry practice. To portray economic capital as loss at the confidence interval ("LCI")--without subtracting expected loss--ignores the accounting role of future margin income. Though Basel may justify this by the inclusion of the ALLL in balance sheet capital, this ALLL accounting methodology will still be questioned. Though CP3 appears to allow for deduction of the ALLL from Pillar 1 capital--up to the full EL portion (CP3, paragraphs 347-348)--the definitions require consistency. A uniform definition is paramount not only to promote alignment between regulatory and economic capital but also to ensure competitive equity across markets.

PNC is grateful for the opportunity to provide its insight with respect to the CP3 guidelines. The enhanced risk sensitivity and assessment framework reflect an appreciable step in reaching

concordance with industry best practices. As such, we look forward to assisting the Committee in shaping the outstanding issues so that convergence can be realized in a timely fashion. We invite you to contact us with any questions related to the points raised in this letter.

Very truly yours,



William S. Demchak
Vice Chairman and Chief Financial Officer

cc:

Office of the Comptroller of the Currency
250 E Street SW
Independence Square
Washington, DC 20219

Federal Reserve Board
Basel 2003 Capital Proposal
Mail Stop 179, 20th and C Streets, NW
Washington, DC 20551