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Attn: No. 2003-27

Re: Comments on the Advanced Notice of Proposed Rulemaking

Ladies and Gentlemen:

The PNC Financial Services Group, Inc. ("PNC"), Pittsburgh, Pennsylvania, is grateful for the opportunity to comment on the Risk-Based Capital Guidelines Advanced Notice of Proposed Rulemaking ("ANPR") for The New Basel Capital Accord ("NBCA"). As with the NBCA's third consultative paper ("CP3"), the ANPR establishes enhancements in the methodologies for measuring, validating, and reporting risk. These changes dovetail with PNC's commitment to being a leading risk management institution and will instill within other institutions a desire to reach beyond minimum requirements. With industry feedback incorporated into the ANPR framework, a timely convergence of supervisory requirements and best practices will be achieved.

PNC is one of the largest diversified financial organizations in the United States, with $72.3 billion in total assets as of September 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 Indiana, Kentucky, New Jersey, Ohio, and Pennsylvania.

PNC is pleased to see many of the beneficial principles outlined by CP3 retained in the ANPR. In particular, the risk sensitive capital formulae and operational risk provisions encourage risk management advances without mandating industry-wide change. Furthermore, the criteria used to select mandatory Advanced Internal Ratings-Based ("A-IRB") approach institutions are clear and rational. Despite these favorable aspects, there remain a number of guidelines outside the range of industry best practice. Modifying these per the commentary of PNC and other institutions will bolster the ANPR's effectiveness at ensuring capital adequacy and competitive equity.

This letter addresses the questions posed by the ANPR that are of relevance to PNC. Each set of ANPR questions--reprinted in order of publication--is followed by PNC's response. Other concerns with ANPR guidelines that are not addressed by these responses are discussed separately in this letter.

Responses to ANPR questions

- ANPR p. 14 questions:

What are commenters' views on the relative pros and cons of a bifurcated regulatory capital framework versus a single regulatory capital framework? Would a bifurcated approach lead to an increase in industry consolidation? Why or why not? What are the competitive implications for community and mid-size regional banks? Would institutions outside of the core group be compelled for competitive reasons to opt-in to the advanced approaches? Under what circumstances might this occur and what are the implications? What are the competitive implications of continuing to operate under a regulatory capital framework that is not risk sensitive?

PNC agrees with the industry view that a bifurcated approach is required to accommodate smaller banks that do not utilize economic capital in the same manner as larger institutions. Smaller banks typically lack sophisticated risk quantification analytics (e.g., a framework to analyze operational risks) required for Basel A-IRB compliance.

Small- to medium-size banks that choose to adopt Basel A-IRB (opt-in) would benefit from the enhanced risk discipline and insight provided by the IRB framework. However, this benefit would be at least partially offset by the investment in technology and staffing required for implementation. Even operating under A-IRB, smaller banks would still not pose competitive threats to larger banks since pricing mechanisms would remain unchanged.

If regulatory minimum capital requirements declined under the advanced approaches, would the dollar amount of capital held by advanced approach banking organizations also be expected to decline? To the extent that advanced approach institutions have lower capital charges on certain assets, how probable and significant are concerns that those institutions would realize competitive benefits in terms of pricing credit, enhanced returns on equity, and potentially higher risk-based capital ratios? To what extent do similar effects already exist under the current general risk-based capital rules (for example, through securitization or other techniques that lower relative capital charges on particular assets for only some institutions)? If they do exist now, what is the evidence of competitive harm?

Capital held by A-IRB institutions would not likely decline, as U.S. banks hold capital commensurate with the risks they assume—not the minimum requirements. The level of capital held will depend largely on the risk of bank portfolios as measured by economic capital. This practice ensures that a buffer exists between the regulatory minimums and what the economic capital models prescribe. The buffer serves to absorb

temporary changes in a bank's risk profile or regulatory requirements, thereby ensuring adequate capitalization.

Because U.S. bank pricing is more aligned with economic capital assessments, competitive inequities will not arise among domestic competitors. However, reductions in capital charges may lead foreign competitors, who typically price from regulatory capital, to reduce prices.

Apart from the approaches described in this ANPR, are there other regulatory capital approaches that are capable of ameliorating competitive concerns while at the same time achieving the goal of better matching regulatory capital to economic risks? Are there specific modifications to the proposed approaches or to the general risk-based capital rules that the Agencies should consider?

Certain modifications to the existing approaches will adequately address competitive concerns and help align regulatory capital to economic risk. These modifications are described throughout the remainder of this letter in response to specific ANPR questions.

- ANPR p. 20 questions

Given the general principle that the advanced approaches are expected to be implemented at the same time across all material portfolios, business lines, and geographic regions, to what degree should the Agencies be concerned that, for example, data may not be available for key portfolios, business lines, or regions?

Satisfying data history requirements is one of the preeminent challenges faced by PNC and its peers. Not only do data gaps exist, but also certain exposure classes lack the required length of history. The adequacy of operational risk data is also problematic, as many institutions have only recently commenced data collection initiatives. With slight modification and clarification to the ANPR guidelines, most of these issues can be reconciled.

If the NBCA is to take effect January 1, 2007 then consideration should be given to shortening credit parameter history requirements, at least for the transitional period. For example, Basel CP3 paragraph 234 states that banks can have a minimum of two years of data at the implementation date. ANPR guidelines do not specify whether banks can avail themselves of any such history relief. This provision would enable institutions to ensure that they have sufficient, valid credit parameter data across all relevant business lines. It would also encourage more non-mandatory banks to pursue Basel compliance.

In addition to a transitional arrangement, the standard loss given default ("LGD") data requirement should be truncated from 7 to 5 years. Requiring use of older loss data may skew LGD estimates because of changes in lending practices or portfolio management techniques over the course of such timeframes. Older LGD values are also more difficult to calculate because of incomplete charge-off and recovery data. A 5-year LGD history would also be consistent with the probability of default ("PD") and exposure at default ("EAD") history requirements, which are deemed to be reasonable. We recommend that institutions that minimally meet the timeframe requirement or with data quality issues be addressed through Pillar II, as referenced in the existing ANPR guidance.

Though a 5-year history requirement seems prudent for parameter estimation, clarification on what constitutes the 5-year "profile" is needed. Specifically, what constitutes a period of stress within a time series? Details on the nature of the stressed period, including quantity of defaults and affected business lines, would help institutions better focus their data collection efforts. If stressed periods are to be utilized, it's assumed that the capital function will need recalibration. Otherwise, the goal of having a framework that is capital-neutral, and which provides incentives for A-IRB adoption, will not be met.

In reference to operational risk data, it is unclear why the advanced management approaches ("AMA") need to be implemented concurrently with credit risk. The two risk domains are functionally independent and share little in the way of assessment framework. It is recommended that institutions be allowed to implement the AMA within a reasonable period of time relative to their attainment of A-IRB status. Though the transitional three-year history requirement is beneficial, there is no provision for incorporating external data into parameter estimation. Post-transition, some institutions may still lack sufficient internal data to fulfill the standard five-year data history requirement. The ability to supplement internal records with relevant external data would greatly aid the accuracy of capital calculations. As a substitute for the 5-year requirement, a 3-year internal, 5-year external data history combination should be considered.

In the event that these accommodations are made, PNC would have no objection to a simultaneous implementation of A-IRB across material business lines (a materiality threshold of, perhaps, 10% of Tier 1 capital would be a useful component to ensure that institutions do not spend inordinate resources to capture smaller exposure groups). However, in the absence of any changes it is suggested that institutions be allowed to stagger implementation in order of those businesses with the most complete data histories. Understandably, an institution's strategy would have to be clearly articulated in its Basel implementation plan to U.S. supervisors.

Is there a need for further transitional arrangements? Please be specific, including suggested durations for such transitions. Do the projected dates provide an adequate timeframe for core banks to be ready to implement the advanced approaches? What other options should the Agencies consider?

As mentioned we would like to see further definition of transitional data history requirements, specifically as they relate to credit risk parameters. In addition, clarification should be made as to the effective date for historical data. It is not clear from ANPR guidelines whether data history requirements take effect on the 1/1/07 implementation date or the first transition period. Given the challenges faced in collecting valid data, it is recommended that 1/1/07 be used as the data effective date.

The Agencies seek comment on appropriate thresholds for determining whether a portfolio, business line, or geographic exposure would be material. Considerations should include relative asset size, percentages of capital, and associated levels of risk for a given portfolio, business line, or geographic region.

Materiality thresholds for business lines and portfolios should be established using a capital-at-risk measure, not a benchmark based upon assets or exposure. We recommend that the threshold for materiality be set at 10% of Tier 1 capital.

- ANPR p. 25 questions

The Agencies seek comment on the conceptual basis of the A-IRB approach, including all of the aspects just described. What are the advantages and disadvantages of the A-IRB approach relative to alternatives, including those that would allow greater flexibility to use internal models and those that would be more cautious in incorporating statistical techniques (such as greater use of credit ratings by external rating agencies)? The Agencies also encourage comment on the extent to which the necessary conditions of the conceptual justification for the A-IRB approach are reasonably met, and if not, what adjustments or alternative approach would be warranted. Should the A-IRB capital regime be based on a framework that allocates capital to EL plus UL, or to UL only? Which approach would more closely align the regulatory framework to the internal capital allocation techniques currently used by large institutions? If the framework were recalibrated solely to UL, modifications to the rest of the A-IRB framework would be required. The Agencies seek commenters' views on issues that would arise as a result of such recalibration.

A-IRB represents a substantial improvement over the existing capital framework and promotes closer alignment of regulatory minimums and industry best practice. However, additional refinement is required to ensure that guidelines represent minimum standards and use industry-consistent definitions. These concerns

are elucidated in PNC's responses to other ANPR questions. In general, they relate to excessive conservativeness in parameter estimation techniques and inconsistencies between regulatory and industry definitions for capital and default.

- ANPR p. 29 questions

The Agencies seek comment on the proposed definition of wholesale exposures and on the proposed inputs to the wholesale A-IRB capital formulas. What are views on the proposed definitions of default, PD, LGD, EAD, and M? Are there specific issues with the standards for the quantification of PD, LGD, EAD, or M on which the Agencies should focus?

The default definition proposed by the ANPR requires simplification and slight modification in order to ensure greater consistency with the industry's definition. Simplification would address those definitional categories not typically employed by U.S. banks. These include the categories for sold loans, distressed restructurings, 90-days past due, and bankruptcy. Modification of the definition is recommended in the areas of silent defaults, asset-based/debtor-in-possession lending, and facilities with collateral coverage.

Simplification of the existing definition would avoid the need for banks to employ two different risk rating frameworks—one for internal use and another for regulatory reporting. In the case of sold loans, institutions have found it difficult to isolate credit-specific losses from those affected by market supply/demand, interest rates, and liquidity. Hence, sold loans are typically not considered when estimating a business' PD parameter. Because distressed restructurings are often prompted by the desire to maintain a business relationship, a default flag is rarely assigned--even if conditions warrant one. Finally, categories for 90-days past due and bankruptcy are sometimes omitted from the default definition because of redundancy with the non-accrual category. Loans that are 90-days past due are often, by definition, in non-accrual. Similarly, a bankruptcy declaration would typically trigger a non-accrual designation.

In addition to simplification, we recommend that the definition be modified to better reflect actual lending practices. First, many institutions do not consider silent defaults since the resulting increase in PD is usually offset by a lower average LGD. Records of historical defaults that would have been ascribed to this category are elusive in some institutions.

Second, text should be appended to exempt asset-based and debtor-in-possession lending from the current default definition. These businesses have a unique operating structure characterized by borrowers who are

in, or close to, default (using the standard corporate definition). Losses, though, are minimized through the use of fastidious collateral monitoring. Including these customers in the definition would add little value to parameter estimates since the high default rate (by common standards) would be more than offset by the negligible losses.

Even if the proposed definitions were adopted, many institutions would be unable to modify their watchlist and credit recovery policies within a reasonable timeframe. The cost alone would be difficult to justify given the degree to which other Basel initiatives are consuming human and financial resources. Streamlining the default definition will ease the burden of identifying past defaults and allow institutions to focus on more essential Basel work items. If loan sales are to remain a component of default then materiality rules need to be developed for loan size and sales discount. Otherwise, there will be inconsistent default definitions across institutions.

As explained in PNC's CP3 response letter, several changes are required to align parameter estimation with industry best practice. Generally, all parameters need not be held to a 99.9% soundness standard in conjunction with to-be-defined conservative margins and stress test results. These conservative measures, once combined, may result in regulatory capital exceeding economic capital and risk influencing pricing. While a conservative margin over derived parameter estimates may be reasonable in some instances (such as when historical data is sparse), it cannot be so great as to compress the buffer between institutions' regulatory and economic capital. Currently, any one of the prescribed "conservative margins" may engender this result.

To address these concerns, guidelines should specify a more modest confidence interval, perhaps 99.5%, for portfolio-level parameters (which would effectively result in a ~99.9% soundness standard for the entire bank). Furthermore, stress tests should be relegated to evaluating the sensitivity of capital holdings to worst-case events; they should not be used to set parameter estimates. The LGD and EAD parameter estimation horizon should mimic that for PDs. Using recession-only data to calculate LGD and EAD estimates and the conservative 99.9% confidence interval is too punitive for the purpose of deriving minimal capital thresholds. In short, parameter estimates should be based purely on expectations of future performance without the addition of conservative margin.

- ANPR p. 33 questions

If the Agencies include a SME adjustment, are the $50 million threshold and the proposed approach to measurement of borrower size appropriate? What standards should be applied to the borrower size measurement (for example, frequency of measurement, use of size buckets rather than precise measurements)? Does the proposed borrower size adjustment add a meaningful element of risk sensitivity sufficient to balance the costs associated with its computation? The Agencies are interested in comments on whether it is necessary to include an SME adjustment in the A-IRB approach. Data supporting views is encouraged.

We believe that the rationale for the small- to medium-sized enterprise ("SME") adjustment is sound given the inherently lower asset value correlation ("AVC") of smaller firms (by way of their greater sensitivity to idiosyncratic risk). However, we feel that AVC, and not sales size, should be used to differentiate among exposure classes. The AVC of SMEs is the only measure that transcends geographic and political boundaries; measures such as sales or exposure are not consistent.

Exposures within the SME domain could be further differentiated by their portfolio management technique, since this is largely indicative of the AVC. Loans managed as part of a pool could be given capital relief that's commensurate with the pool's PD or EL grade, as large pools are often subdivided by such measures. Loans that are individually rated could benefit from a different tier of capital relief. Overall, this methodology will enhance competitive equity and reduce complication stemming from exposures with high sales variability.

- ANPR p. 34 questions

The Agencies invite comment on ways to deal with cyclicality in LGDs. How can risk sensitivity be achieved without creating undue burden?

As previously discussed, LGDs predicated on recessionary time spans will go beyond minimum capital requirements and risk having regulatory capital exceed economic capital. LGDs should instead be calculated from a through-the-cycle ("TTC") period using weighted average defaults. This alone provides adequate sensitivity since the majority of default events occur during recessionary times. Furthermore, correlations among PD, EAD, and LGD result in higher losses for each default.

Alternately, point-in-time ("PIT") LGDs could be employed, rendering capital to be more of a PIT measure of risk. This would result in an institutions' capital buffer shrinking during recessionary times and increasing

during expansions. Procyclicality could become an issue under this proposal, depending upon the number of other markets adopting the PIT approach.

- ANPR p. 36 questions

The Agencies invite the submission of empirical evidence regarding the (relative or absolute) asset correlations characterizing portfolios of ADC loans, as well as comments regarding the circumstances under which such loans would appropriately be categorized as HVCRE. The Agencies also invite comment on the appropriateness of exempting from the high-asset-correlation category ADC loans with substantial equity or that are pre-sold or sufficiently pre-leased. The Agencies invite comment on what standard should be used in determining whether a property is sufficiently pre-leased when prevailing occupancy rates are unusually low. The Agencies invite comment on whether high-asset-correlation treatment for one- to four-family residential construction loans is appropriate, or whether they should be included in the low-asset-correlation category. In cases where loans finance the construction of a subdivision or other group of houses, some of which are pre-sold while others are not, the Agencies invite comment regarding how the "pre-sold" exception should be interpreted. The Agencies invite comment on the competitive impact of treating defined classes of CRE differently. What are commenters' views on an alternative approach where there is only one risk weight function for all CRE? If a single risk weight function for all CRE is considered, what would be the appropriate asset correlation to employ?

In footnote 19 (bottom of page 33) the ANPR states "CRE exposures are typically non-recourse exposures". We agree that this is consistent with data researched for prior "white papers," but it is not accurate in reference to bank construction loans.

We also feel that the lack of available commercial bank data makes the statements on asset correlations more conjecture than fact-based. From our discussions with other major real estate lenders, the lack of default and loss data is more from lack of observations than difficulty in gathering data. We continue to believe that the changes in commercial real estate ("CRE") lending, following the 1987-1991 real estate crisis, are a significant driver for the low observed defaults and losses.

To address cyclical LGDs, we suggest using the emerging data on commercial property performance or value changes to determine acceptable LGD bands by property type. Banks may alter significant deal structures based on current market conditions; the outlook for the property type in a particular market is a common driving factor. Thus, these would be mutually supporting methodologies.

The supervisory slotting criteria ("SSC") approach does not appear to offer a better implementation solution. Bank risk rating criteria, at least for core and opt-in banks, is much more granular than the current slotting

criteria. In addition, new credit decisions are rarely approved in the fourth category (weak). Rather, the core issue pertains to the change in risk rating over the life of the project. Bank strategies in dealing with deteriorating credit situations will also impact PD and LGD outcomes, making the regulatory task more difficult in defining additional rating criteria.

Duration clearly adds risk to any transaction. The table on page 35 of the ANPR indicates that the capital assignment on a three-year, high volatility commercial real estate ("HVCRE") transaction (at a .05 PD) is *twice* that of a one-year loan. Available bank loan market pricing will *not* support such a difference. This is critical as construction loans generally have 36-month durations. We continue to believe that in the absence of actual bank default and loss data (including the correctness of creating an HVCRE classification), new requirements could result in a substantial and unwarranted shift of capital away from acquisition, developmental, and construction ("ADC") loans.

The issue of borrower equity as a key risk factor for loan performance is revisited on page 35. Since 1993, two substantial reforms--FIRREA and FDICIA--have been created that deal with property value, loan-to-value, and borrower equity. Without an examination of how banks determine project values and deal structures today, their portfolio performance would indicate that this is not as substantial an issue as it was pre-1993.

Overall, PNC believes that all real estate should be treated with a single risk weight function and that it be based on low asset correlation. This includes 1-4 family properties. To do otherwise is to potentially penalize the banking industry for risks not in evidence. As commercial banks are the primary supplier of ADC loans in the U.S., this could have profound market implications. Barring substantial loan pricing changes in the markets, risk-adjusted returns on real estate would fall relative to other available bank assets, reducing the amount of bank capital assigned to the real estate industry.

- ANPR p. 37 questions

The Agencies are seeking comment on the wholesale A-IRB capital formulas and the resulting capital requirements. Would this approach provide a meaningful and appropriate increase in risk sensitivity in the sense that the results are consistent with alternative assessments of the credit risks associated with such exposures or the capital needed to support them? If not, where are there material inconsistencies? Does the proposed A-IRB maturity adjustment appropriately address the risk differences between loans with differing maturities?

The A-IRB capital formulas currently provide a meaningful portrayal of risk when tested with successive PD and LGD input grades. The maturity adjustment is similarly effective, except in the context of under 1-year facilities. For these instances an allowance should be offered to reflect the greater economic certainty inherent in shorter horizons. The allowance should assume the form of a reduced PD, holding the maturity constant at 1 year. The maturity should not be adjusted below 1 year because mark-to-market ("MTM") losses are typically not incurred from pre-maturity facility closeouts.

- ANPR p. 38 questions

The Agencies are interested in comment on whether the proposed $1 million threshold provides the appropriate dividing line between those SME exposures that banking organizations should be allowed to treat on a pooled basis under the retail A-IRB framework and those SME exposures that should be rated individually and treated under the wholesale A-IRB framework.

Consistent with our recommendation for corporate SMEs, retail SME thresholds should also be tied to AVCs and not measures that are inconsistent across countries. The AVCs of each institution's exposure groups are (presumably) sufficiently different as to make a single threshold inappropriate. If a meaningful threshold is to be employed, each institution should establish it from internally calculated and validated AVCs. Institutions would review their threshold annually by reevaluating the AVCs of the relevant exposures.

ANPR p. 42 questions

For the QRE sub-category of retail exposures only, the Agencies are seeking comment on whether or not to allow banking organizations to offset a portion of the AIRB capital requirement relating to EL by demonstrating that their anticipated FMI for this sub-category is likely to more than sufficiently cover EL over the next year.

Although recent Basel developments appear encouraging, capital should not be required to cover expected losses ("EL"). This recommendation applies to Qualifying Revolving Exposures ("QRE") as well as all other wholesale and retail categories. Proper pricing methodology dictates that expected future margin income ("FMI") is sufficient to cover expected losses and a return to capital. Banks employ a shareholder value added ("SVA") formula to ensure that margins are sufficient to generate a positive SVA. By requiring

capital to cover both expected and unexpected losses, banks would effectively be double counting expected loss provisions.

The Agencies are seeking comment on the proposed definitions of the retail AIRB exposure category and sub-categories. Do the proposed categories provide a reasonable balance between the need for differential treatment to achieve risk-sensitivity and the desire to avoid excessive complexity in the retail A-IRB framework? What are views on the proposed approach to inclusion of SMEs in the other retail category? The Agencies are also seeking views on the proposed approach to defining the risk inputs for the retail A-IRB framework. Is the proposed degree of flexibility in their calculation, including the application of specific floors, appropriate?

Definitions for the retail A-IRB category and input parameters are consistent with industry best practice. The inclusion of SMEs in the "Other Retail" category seems prudent considering the similarity of their AVCs to retail exposures. As stated previously, any measure used as a segmentation threshold should be consistent across countries. The proposed $1M exposure threshold would not be as practical as a rule allowing institutions to define "Other Retail" exposures by AVC, as proxied by management characteristics such as whether the credit is managed individually or as a pool.

Additionally, a waiver of the 10% LGD floor should be allowed if an institution can prove that lower LGDs have been historically observed. Otherwise, this floor compounds the conservative bias engendered by other IRB guidelines.

The Agencies are seeking comment on the minimum time requirements for data history and experience with portfolio segmentation and risk management systems: Are these time requirements appropriate during the transition period? Describe any reasons for not being able to meet the time requirements.

This topic is addressed on pp 4-6 of this letter.

- ANPR p. 46 questions

The Agencies are interested in views on whether partial recognition of FMI should be permitted in cases where the amount of eligible FMI fails to meet the required minimum. The Agencies also are interested in views on the level of portfolio segmentation at which it would be appropriate to perform the FMI calculation. Would a requirement that FMI eligibility calculations be performed separately for each portfolio segment effectively allow FMI to offset EL capital requirements for QREs?

Comparing expected FMI to EL does not provide an accurate comparison of excess margin to required reserves, as FMI projections are based on historical loss volatility. Instead, we recommend that an SVA test be performed to ascertain whether FMI is adequate for a particular product segment. If SVA is positive, FMI will undoubtedly cover expected losses. Only if SVA is non-positive should any capital be assigned to cover EL; however, this would indicate an inherent pricing problem. The SVA test should be applied to products across all segments, not just QREs.

- ANPR p. 48 questions

The Agencies are seeking comment on the retail A-IRB capital formulas and the resulting capital requirements, including the specific issues mentioned. Are there particular retail product lines or retail activities for which the resulting A-IRB capital requirements would not be appropriate, either because of a misalignment with underlying risks or because of other potential consequences?

Retail product capital formulas generally seem to be adequate. However, a maturity adjustment should be offered as it is for other exposure classes. This would enhance retail risk sensitivity and improve competitive equity among institutions.

- ANPR p. 49 questions

The Agencies recognize the existence of various issues in regard to the proposed treatment of ALLL amounts in excess of the 1.25 percent limit and are interested in views on these subjects, as well as related issues concerning the incorporation of expected losses in the A-IRB framework and the treatment of the ALLL generally. Specifically, the Agencies invite comment on the domestic competitive impact of the potential difference in the treatment of reserves described above. The Agencies seek views on this issue, including whether the proposed U.S. treatment has significant competitive implications. Feedback also is sought on whether there is an inconsistency in the treatment of general specific provisions (all of which may be used as an offset against the EL portion of the A-IRB capital requirement) in comparison to the treatment of the ALLL (for which only those amounts of general reserves exceeding the 1.25 percent limit may be used to offset the EL capital charge).

Definitions for Tier 1 capital and economic capital require reconciliation with industry best practice. First, the inclusion of subordinated debt in Tier 1 capital belies the purpose of holding capital, since subordinated debt does not mitigate the probability of insolvency. In contrast, industry equates only tangible equity and general reserves--insolvency mitigants--to Tier 1 capital.

To ensure competitive equity across markets and provide alignment with the industry definition, Tier 1 should be redefined to represent the entire ALLL plus tangible equity. Furthermore, the ½ to 1 relationship between Tier 1 capital and total capital should be replaced by an insolvency probability (confidence interval) comparable to a low investment grade rating. Such a measure would enable a uniform comparison across all institutions; the existing ½ to 1 ratio does not ensure that Tier 1 capital is adequate to provide an appropriate soundness standard.

Total capital should be defined as loss at the confidence interval ("LCI") less EL. Moreover, it should not include any form of subordinated debt. The EL exclusion relates to the earlier point about having FMI cover the EL provision.

- ANPR pp 58-59 questions

Industry comment is sought on whether a more uniform method of adjusting PD or LGD estimates should be adopted for various types of guarantees to minimize inconsistencies in treatment across institutions and, if so, views on what methods would best reflect industry practices. In this regard, the Agencies would be particularly interested in information on how banking organizations are currently treating various forms of guarantees within their economic capital allocation systems and the methods used to adjust PD, LGD, EAD, and any combination thereof.

PNC agrees with the industry position that double default and double recovery effects should be allowed for parameter estimation. Even using a conservative AVC (e.g., 75%) between guarantor and obligor, the joint guarantor-obligor PD yields a more realistic capital value than use of the guarantor PD alone. As long as institutions can cite valid data to support use of the joint guarantor-obligor PD, the adjustment should be permitted.

While we believe it is prudent to accommodate guarantees at some level, the decision of whether to apply them at the PD or LGD level should be left to the institution. This latitude will better accommodate A-IRB banks' extant risk rating systems and lending practices.

- ANPR p. 64 questions

The Agencies encourage comment on whether the definition of an equity exposure is sufficiently clear to allow banking organizations to make an appropriate determination as to the characterization of their assets.

PNC believes the current equity exposure definition to be adequate.

Comment is sought on whether the materiality thresholds set forth above are appropriate.

PNC believes that existing equity materiality thresholds are appropriate.

- ANPR pp. 92 and 97 questions

Does the broad structure that the Agencies have outlined incorporate all the key elements that should be factored into the operational risk framework for regulatory capital? If not, what other issues should be addressed? Are any elements included not directly relevant for operational risk measurement or management? The Agencies have not included indirect losses (for example, opportunity costs) in the definition of operational risk against which institutions would have to hold capital; because such losses can be substantial, should they be included in the definition of operational risk?

The Agencies seek comment on the reasonableness of the criteria for recognition of risk mitigants in reducing an institution's operational risk exposure. In particular, do the criteria allow for recognition of common insurance policies? If not, what criteria are most binding against current insurance products? Other than insurance, are there additional risk mitigation products that should be considered for operational risk?

We believe that the inclusion of an operational risk capital assignment is prudent, given the industry's historical losses in this domain. Furthermore, we appreciate the latitude provided for banks' recognition of risk correlation. Overall, however, we feel that capital calculation guidelines require less conservatism. Clarification is also requested on several guideline elements.

Use of a 99.9% confidence interval will render the regulatory capital charge comparable to that of an economic capital assessment. This could foster the same undesirable pricing effect that conservative credit guidelines may trigger. Moreover, limiting insurance-based risk exposure reductions to 20% is too punitive. Insurance (or other mitigants) used to offset operational exposures should be set at a level commensurate with historical loss recoveries, which are higher than implied by a 20% cap.

Clarification on data source/history requirements is required to enable banks to calculate an accurate capital charge and identify relevant data sources. First, minimum requirements for using external data, from the

standpoint of both stand-alone usage and application with internal data, would be useful. This is because most banks will be partially relying on external data until internal histories are sufficient. Therefore, it would be desirable to know how many years of external data are required for a given reduction in the 5-year internal data history.

Finally, banks should not have to hold capital for indirect losses, such as opportunity costs or foregone transactions. Because foregone transactions never enter financial records, they do not warrant reserve or capital assignment. However, tracking such indirect losses is practical--from a business perspective--since it enhances operational risk analysis and loss mitigation techniques.

- ANPR p. 95 questions

The Agencies are introducing the concept of an operational risk management function, while emphasizing the importance of the roles played by the board, management, lines of business, and audit. Are the responsibilities delineated for each of these functions sufficiently clear and would they result in a satisfactory process for managing the operational risk framework?

The proposed responsibilities are satisfactory.

- ANPR p. 102 questions

The Agencies seek comment on the feasibility of such an approach to the disclosure of pertinent information and also whether commenters have any other suggestions regarding how best to present the required disclosures.

PNC values the importance of market discipline and agrees that transparency of information is a crucial vehicle for goal attainment. However, current guidelines require the disclosure of several data types that could render institutions vulnerable to portfolio reverse-engineering. These pertain mainly to quantitative disclosures.

Disclosures for credit risk and prior credit losses pose the greatest threat to data security. Specifically, information pertaining to exposures and undrawn commitments by PD grade, industry concentration, geographic distribution, and prior loss factors could reveal individual

customer identities. In contrast, quantitative disclosures for capital requirement by risk type, capital structure, and capital adequacy offer more benign—and perhaps more meaningful—portfolio insights.

Notwithstanding confidentiality issues, the value of prescribed quantitative disclosures is undermined by the lack of consistent risk grading methodologies among institutions. The lack of an external audit requirement exacerbates this by raising concerns over data credibility. There is also the risk of having disclosed information be misconstrued by individuals who are not familiar with risk trends or evaluation methodologies. An example is the publication of actual and predicted losses. The discrepancies observed in short-term timeframes may be misinterpreted as flawed risk measurement or incorrect inherent risk.

Comments are requested on whether the Agencies' description of the required formal disclosure policy is adequate, or whether additional guidance would be useful.

The current description is adequate.

Comments are requested regarding whether any of the information sought by the Agencies to be disclosed raises any particular concerns regarding the disclosure of proprietary or confidential information. If a commenter believes certain of the required information would be proprietary or confidential, the Agencies seek comment on why that is so and alternatives that would meet the objectives of the required disclosure.

See response to the first set of disclosure questions.

The Agencies also seek comment regarding the most efficient means for institutions to meet the disclosure requirements. Specifically, the Agencies are interested in comments about the feasibility of requiring institutions to provide all requested information in one location and also whether commenters have other suggestions on how to ensure that the requested information is readily available to market participants.

Disclosures not already contained in regular financial reports should be provided in a comprehensive report accessible through a dedicated public website. Such a website could be created exclusively for Basel disclosure reporting and be maintained by the Bank of International Settlements. It is reasonable for institutions to reference the location of disclosures not contained in this comprehensive report, provided that said disclosures are listed in published financial reports.

Commentary on other ANPR guidelines

- Capital Management Policy

ANPR guidelines require a bank's capital management policy to be consistent with its risk rating methodology in terms of input data. The necessity of this rule is unclear; banks employ different methodologies for specific reasons. A bank that bases economic capital on current economic conditions may value the need for accurate performance measures. Simultaneously, the bank may rely upon TTC parameter estimates for capital planning purposes. For these reasons we recommend that a bifurcated approach be allowed.

- Commercial Mortgage-Backed Securities ("CMBS") Treatment

For highly rated CMBS, the A-IRB approach requires capital charges to be no less than 56 b.p. of the investment value. This is very conservative given that some CMBS have historical losses averaging only 1 b.p. With the current rules based on historical collateralized debt obligation ("CDO") performance, the actual volatility of CMBS is not reflected. It is recommended that highly-rated CMBS historical data be reviewed so that the capital charge can be better aligned with their underlying risk.

The capital charge for sub-investment grade CMBS is higher than that of sub-investment grade corporate obligations. The higher implied risk is not substantiated by the way these CMBS are serviced, however. CMBS mortgage pools are maintained in a manner that allows a special servicer to work-out or liquidate the underlying loans. This renders their risk comparable to a bank-owned corporate loan. Data that substantiates this risk profile is available.

PNC appreciates the opportunity to help refine the proposals set forth in the ANPR guidelines. While these guidelines largely achieve the goal of improved risk sensitivity and assessment, incorporating the recommendations of PNC and other industry members will ensure consistency with best practices and fair competition. Please contact us with any questions related to the points raised in this letter.

Very truly yours,

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Risk Analytics