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Attn.: Docket No. OCC-2007-0004

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Attn.: Comments, Federal Deposit
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Ms. Jennifer J. Johnson, Secretary
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Attn.: Docket No. OP-1277

Regulation Comments
Chief Counsel's Office
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1700 G Street, NW
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Attn.: No. 2007-06

RE: Proposed Supervisory Guidance for Internal Ratings-Based Systems for Credit Risk, Advanced Measurement Approaches for Operational Risk, and the Supervisory Review Process (Pillar 2) Related to Basel II Implementation

Ladies and Gentlemen:

The PNC Financial Services Group, Inc. ("PNC"), and its principal subsidiary bank, PNC Bank, National Association ("PNC Bank"), both of Pittsburgh, Pennsylvania, are pleased to respond to the request for comments on the proposed supervisory guidance (No. OP-1277 (February 28, 2007)).[1] PNC is one of the largest diversified financial organizations in the United States, with approximately $122.6 billion in total assets as of March 31, 2007. Its major businesses include retail banking, corporate and institutional banking, asset management, and global fund processing services. PNC Bank has branches in the District of Columbia, Florida, Indiana, Kentucky, Maryland, New Jersey, Ohio, Pennsylvania, and Virginia. PNC also has twelve other bank subsidiary banks, with branches in Delaware, Maryland, Pennsylvania and Virginia.

PNC would like to thank the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision (together, the "Agencies") for the opportunity to comment on the

[1] 72 Fed. Reg. 9084 (Feb. 28, 2007).

Proposed Supervisory Guidance. This letter responds to the Agencies' request for comments on the proposed supervisory guidance related to Basel II implementation (referred to herein as "PSG").

Overall, we are supportive of efforts to provide additional detail for the advanced approaches and the supervisory review process in support of banks efforts to satisfy the qualification requirements in the Agencies Joint Notice of Proposed Rulemaking ("NPR"), "Risk Based Capital Standards: Advanced Capital Adequacy Framework"[2]. We believe that consistent and transparent regulation is important, as it will result in more efficient banking operations and in smoother and more effective supervision of banks. We are supportive of the Agencies' objectives and welcome the opportunity to provide our comments on the PSG to promote those objectives.

PNC would like to stress that the final U.S. rule and guidance needs to be closely aligned with the international framework in order to ensure the intended goals of Basel II. PNC would like to highlight some of the key high-level NPR items that are of concern to us:

® **Allow Alternative Credit and Operational Risk Approaches in the U.S.**
The international Basel framework allows banks to choose among three approaches for credit risk (Standardized, Foundation, and advanced IRB ("AIRB")) and operational risk (Basic Indicator, Standardized, and Advanced ("AMA")). PNC believes that the agencies should make every effort to align the U.S. rules with the international framework to ensure a level playing field with European banks. At a minimum, the Standardized approach for credit and operational risk should be available to U.S. banks. Ultimately, U.S. banks should be allowed to select the credit and operational risk methodologies that are most appropriate for them based on their risk-management and business needs.

In addition, U.S. banks should be able to adopt the Standardized approach in certain circumstances (subject to supervisory review to avoid cherry-picking), for example where a portfolio is running off, where a business is planned to be sold or a bank plans to leave a given market, where a portfolio is so immaterial that it does not warrant investment in the advanced approaches, or where data issues make it impractical to adopt the advanced approaches.

Finally, U.S. banks should have the flexibility to adopt the Standardized approach for operational risk while proceeding with the AIRB approach for credit risk. This flexibility would support banks that need to conserve resources and enable them to achieve better change management during the implementation period.

[2] 71 Fed. Reg.555380 (Sept. 25, 2006).

® **Align Transitional Floors**
U.S. banks will be subject to an additional year of transition floors, higher floor levels and the requirement that each bank formally "graduate" from one floor to the next by an administrative process. These are all divergences from the international framework that we do not believe to be necessary. The floors established in the international framework provide sufficient safeguards and achieve the same prudential objectives sought by the Agencies. We believe that the additional requirements further reduce the risk sensitivity of the new framework and move regulatory capital further away from banks' internal risk-management practices.

® **Phase-out the Leverage Ratio**
The leverage ratio should be retained during the capital-floor periods to manage the transition from Basel I to Basel II; however, this should be a temporary floor, subject to regulatory review within a reasonable period of time. The ratio lacks risk sensitivity and is inconsistent with the fundamental Basel II principle by which banks can improve their risk profiles either by holding additional capital or by holding less risk in their portfolios. Leaving the leverage ratio in place goes against the spirit that U.S. regulators embraced when they decided to replace Basel I with a more risk-sensitive framework and is inconsistent with the international framework. In addition, we believe that Pillar 2 (Supervisory Review) and Pillar 3 (Market Discipline) will ensure that banks have adequate capital to support all risks, including those not addressed in Pillar 1, and will promote market discipline in the form of increased public disclosures, respectively.

Response to Supervisory Guidance

The following comments are intended to produce a more risk sensitive framework without over-burdening participants. It is not our intent to comment upon all the supervisory guidance contained in the PSG. Rather, we have selected the specific guidance on which we would like to focus our attention based on their significance to PNC.

1. Internal Ratings-Based Systems for Credit Risk

S2-1 "Banks must identify obligor defaults in accordance with the IRB definition of default."

® PNC is concerned about the IRB default definition, which includes a credit-related loss of 5% or more of the exposure's initial carrying value in connection with the sale of the exposure or the transfer of the exposure to the held-for-sale, available-for-sale, trading account, or other reporting category. The 5% rule is prescriptive as opposed to being a principles-based approach, which would take into consideration a bank's

knowledge of the specific circumstances surrounding the loan and applicable market conditions. In addition, there appears to be no justification or analysis to support the 5% threshold for materiality of credit-related loss on sale. For example, the value of a 7-year term loan could decline by more than the 5% threshold if its rating agency rating declined one full grade, while a 1-year loan would have to be downgraded many grades before its value would breach the 5% threshold. In reality, one single borrower might have both types of facilities with PNC, which would create inconsistency in the application of such a rudimentary threshold. While we believe that the thresholds should be established by each individual bank, if the Agencies insist on a common threshold there should be some sort of sliding threshold based on relevant factors (such as the term of the transaction).

S2-3 "IRB risk rating systems must have two dimensions obligor default and loss severity corresponding to PD (obligor default), and ELGD and LGD (loss severity)."

® PNC believes that maintenance of both ELGD and LGD will create a parameter whose only use is for regulatory reporting. PNC currently calculates an LGD, which is equivalent to Basel II's ELGD. We currently do not have a parameter analogous to guidance LGD. We approximate the volatility of LGD through a currently established process, and believe that to maintain a separate parameter solely for Basel II purposes would be of little added value. Furthermore, empirical loss data is naturally more prevalent during adverse economic conditions when default levels are more elevated, which reduces the need for further stressing of the parameter.

S2-7 "A bank's rating policy must describe its ratings philosophy and how quickly obligors are expected to migrate from one rating grade to another in response to economic cycles."

® PNC agrees that banks should closely examine rating migrations of credits; however, we do not believe that 'how quickly obligors are expected to migrate from one rating to another' is something that should be incorporated into policy. Nor is there a metric that fully captures the multi-dimensional nature of ratings transitions.

S3-6 "The bank's retail exposure segmentation system must provide for the review and update (as appropriate) of assignments of retail exposures to segments whenever the bank receives new material information, but no less frequently than quarterly."

® PNC believes that an annual update would be sufficient. Given the granularity that is inherent in most retail portfolios, there is considerably less periodic fluctuation than in their corporate counterparts. Corporate parameters are only required to be updated annually, and we believe that an annual update would also be sufficient for retail portfolios.

S4-24 "Estimates of additional draw downs prior to default for individual wholesale exposures or retain segments must not be negative."

- ® PNC disagrees, as this would not reflect the negative drawdowns that we routinely experience on portfolios such as Asset Based Lending. This has been addressed in subsequent publications suggesting that these negative drawdowns be reflected within the estimate of Loss Given Default instead of Exposure at Default.

S7-5 "The systems and processes used by a bank for risk-based capital purposes must be consistent with the bank's internal risk management processes and management information reporting systems."

- ® Because risk parameters such as PD and LGD are typically utilized in the allowance setting process and limits, we believe that it would be difficult to align one set of parameters to satisfy both constituencies (accounting and regulatory). Arbitrary rules that affect parameter calculations (e.g., PD floors) also complicate the comparability and, ultimately, the utilization of a single set of parameters. Therefore, we would recommend that the Agencies definition of "consistent" allow for some degree of flexibility (especially for parameters where regulatory reporting requirements may not be consistent with financial reporting requirements).

S7-14 "Banks should establish ranges around the estimated values of risk parameter estimates and model results in which actual outcomes are expected to fall and have a validation policy that requires them to asses the reasons for difference and that outlines the timing and type of remedial actions taken when results fall outside of expected ranges."

- ® PNC is concerned that this guidance is too prescriptive for policy and would result in the policy constantly being updated to keep the 'established ranges around the estimated values of risk parameter estimates and model results' appropriate. Institutions will often have to utilize their risk rating systems for a significant number of years before such a range could be determined.

S11-8 "In order to use the RBA, the securitization exposure must be externally rated by an NRSRO, or be eligible for an inferred rating."

- ® The guidance further states that the applicable rating to be applied to a senior inferred rating is the current rating of the subordinate rated tranche. PNC does not believe that this should be the case. If we have a structure that has our risk position senior to another investor's risk that has a rating, we should at least have the next higher rating. For example, if the subordinate tranche is rated A+, and we have a senior tranche that is not explicitly rated, our inferred rating should be at least AA- (1 notch higher).

2. Operational Risk Advanced Measurement Approach

Overall, PNC believes that the standards serve as a sound basis for effective operational risk management practices. The following comments are intended to provide more

specific observations regarding several standards.

S4 "The bank must ensure that an effective framework is in place to identify, measure, monitor, and control operational risk, and to accurately compute the bank's operational risk component of the bank's risk-based capital requirement. The board of directors must at least annually, evaluate the effectiveness of, and approve, the bank's AMA System, including the strength of the bank's control infrastructure."

- ® PNC believes that the board's appropriately delegated agent should be responsible for this review, as we believe that very few board members would have the competence to do such an evaluation. In addition, we believe that it would be difficult to find qualified individuals to fulfill this function at the board level, given other necessary board responsibilities.

S28 "The bank may use internal estimates of dependence among operational losses within and across business lines and operational loss events if the bank can demonstrate to the satisfaction of its primary Federal supervisor that the bank's process for estimating dependence is sound, robust to a variety of scenarios, and implemented with integrity, and allows for uncertainty surrounding the estimates. If the bank has not made such a demonstration, it must sum operational risk exposure estimates across units of measures to calculate its total operational risk exposures."

- ® PNC believes that this guidance requires a degree of validation of dependence that is unattainable and that the requirement to sum up all operational risk exposures if the bank fails to demonstrate that its process fulfills all of the above requirements is unnecessarily conservative. We also believe that the level of prescriptiveness is unreasonable, since the data does not exist to prove dependence and, in practice, modelers must make assumptions. Instead, we recommend that the guidance should be more principles based to enable institutions to make reasonable assumptions about dependence. The guidance should, however, provide guidance on what supervisors should look for as to justification for the assumptions by clarifying what is expected in justifying the bank's assumptions.

S29 "The bank may adjust its operational risk exposure results by no more than 20 percent to reflect the impact of operational risk mitigants. In order to recognize the effects of risk mitigants, management must estimate its operational risk exposure with and without their effects."

- ® PNC believes that there should be guidance on operational risk mitigants with respect to the issues of extent and certainty of coverage and solvency. We disagree with the setting of an artificial 20 percent cap on risk mitigants. Although we recognize that the exposure cannot be eliminated completely (e.g., claims are not 100 percent paid, additional litigation costs) we believe that the cap

does not promote the use and development of risk mitigation, and could, in fact, lead to suboptimal risk-mitigation.

Generally the standards tend to be more principles based in regards to specific expectations to satisfy each standard. While PNC appreciates the flexibility afforded by the minimally prescriptive standards, this could create a challenge in ensuring alignment between PNC's approach to meeting the standards and specific supervisory agency expectations. As a result, we would like to emphasize the importance in ongoing dialogue and supervisory feedback as PNC continues to evolve its operational risk program.

3. Supervisory Review Process for the Advanced Process

PNC recognizes that Pillar 2 of the international Basel II framework is already largely in place in the U.S. due to the authority that federal regulators possess under the existing U.S. Prompt Corrective Actions requirements.[3] However, we would like to emphasize our support for the following principles embedded in the guidance:

- Responsibility of individual banks to define and develop their ICAAP
- Risk based framework that encourages risk management and governance
- Importance of capital planning

We support the Agencies' intention to leave the design and development of banks' ICAAP to the individual banks in order to reflect the complexity of each bank's operations and risk profile. We also support the notion that the ICAAP should be integrated with other management processes related to risk assessment, business planning and forecasting, pricing strategies and performance measurement so that it is incorporated into decision-making at both the consolidated and individual business-line levels. However, we would like some clarification of the proposal's declaration that "the ICAAP will likely go beyond the restrictive or simplifying assumptions in regulatory requirements" with respect to its rigorousness.

[3] Section 38 of the Federal Deposit Insurance Act (12 U.S.C. 1831o).

Conclusion

Thank you for providing this opportunity to comment. If you have questions about this comment letter, please feel free to contact me.

Sincerely,

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