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Office of the Comptroller of the Currency
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Washington, DC 20219
regs.comments@occ.treas.gov
Attn.: Docket No. 05-16

Mr. Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
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Comments@FDIC.gov
Attn.: Comments/Legal ESS

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the
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Washington, DC 20551
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Attn.: Docket No. R-1238

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
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Washington, DC 20552
regs.comments@ots.treas.gov
Attn.: No. 2005-40

RE: Joint Advance Notice of Proposed Rulemaking on Risk-Based Capital Guidelines

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 advance notice of proposed rulemaking regarding potential revisions to the existing risk-based capital framework (70 Fed. Reg. 61068 (October 20, 2005)) ("ANPR"). PNC is one of the largest diversified financial organizations in the United States, with approximately $93.3 billion in total assets as of September 30, 2005. 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 one other bank subsidiary, PNC Bank, Delaware, Wilmington, Delaware, which has branches in Delaware.

PNC would like to thank 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 ANPR. This letter responds to the Agencies' request for comments on possible modifications to the Basel I risk-based capital standards (referred to herein as "Basel IA").

Overall, we are supportive of efforts to improve the Basel I risk-based capital standards. The lack of risk sensitivity has been a known deficiency of the existing accord, and we welcome the opportunity to improve on this framework. The stated objective of the ANPR is "to update [the] risk-based capital standards to enhance the risk sensitivity of the capital charges, to reflect changes in accounting standards and financial markets, and to address competitive equity questions that, ultimately, may be raised by U.S. implementation of the Basel II framework." In addition to the objectives established in the ANPR, we believe that the following should be high-level objectives for the modifications:

1. Capital Levels—Levels should be directionally consistent with those produced by Basel II. However, we would continue to expect Basel II to elicit lower capital weights to provide incentives for institutions to implement best practice risk management processes. In addition, we believe that excessive credit concentrations lead to greater risk and should attract higher capital rates.

2. Cost—Complexity of regulatory requirements and implementation should not be overly burdensome for the targeted constituency.

3. Consistency—There should be minimal room for interpretation. An asset should attract the same amount of capital regardless of which institution holds the asset.

In summary, the modifications should equitably increase risk sensitivity without over-burdening institutions. Within this context, we note that the five percent well-capitalized standard for a leverage ratio effectively forces U.S. banks to hold higher levels of capital regardless of other capital ratios. Many large U.S. banks find that the leverage ratio is becoming more binding, reducing their ability to grow their portfolios of low-risk assets. We would note that, with some exceptions, neither the U.S. securitization rules nor the five percent minimum leverage requirement are in effect in other G-10 countries.

Response to ANPR Questions

The following comments are intended to produce a more risk sensitive framework without over-burdening participants. In addition, we have provided an overview of issues that we believe need to be addressed by U.S. regulators in their development of Basel IA for banks that do not use the advanced internal ratings based ("AIRB") approach.

1. Tiered Approach for Non-AIRB banks

Basel IA, in its current form, may result in a compromise that does not meet the needs of any of the constituent banks. The current proposal runs the risk of creating a compromise

between a simple model and a complex model that promotes more granular risk assessments, but requires the development of redundant systems and data. In addition, for some more complex institutions, the proposed framework may be too simplistic, while for less complex institutions, it may represent an unnecessary and significant regulatory burden. It is our belief that three levels of capital regulation are needed to ensure that one or more classes of banks in the United States are not put at a competitive disadvantage. In addition, such a structure would enable banks to select an approach that is appropriate for their level of complexity, business objectives, risk appetite and operating environment. These levels should be structured similarly to the international Basel II tiers so that the complexity and risk management requirements are increased at each level. Overall, as a bank improves its risk measurement and management capabilities, its rate of capital attraction would decline, all other things held constant. The risk of an inappropriate decline or level of minimal capital at a bank would be mitigated/eliminated through a supervisory process, much like Pillar 2 of Basel II.

Community banks should be allowed to continue to operate under Basel I with possible adjustments (e.g., for residential mortgages) for the following reasons:

- Basel I is not binding for a majority of these banks as they tend to hold much more capital than the regulatory minimum;

- It may be prohibitively expensive for these institutions to move to a new Accord;

- A number of small, community bank organizations are privately held and would have no interest in developing the necessary infrastructure to comply with the more complex data management and manipulation that would be the hallmark of Basel IA; and

- The bucketing procedures required under Basel IA require data that cannot be found in the general ledgers of many banks and, as such, may require costly system changes.

Overall, we would anticipate that the expense of moving away from Basel I might be greater than any benefits that the community banks or regulators could expect.

Many larger institutions ("super-community," "regional" and "super-regional") have not made the necessary investment required to transition to Basel II at this time. However, they should be incented to progress from Basel I to a more risk sensitive regulatory capital structure. The use of a tier in between Basel I and Basel II would allow larger institutions to receive credit for the more risk-sensitive capital structures that they have developed to date and encourage them to continue developing more sophisticated risk measurement processes.

In promoting a multi-tiered approach, we do not believe that banks should be able to pick and choose different methodologies for different parts of their portfolio; instead they would "graduate" to more sophisticated practices as their risk management processes and systems evolve. In other words, any Basel I bank could opt in to Basel IA once they have met the requirements and any Basel IA bank could opt in to Basel II once they have met these requirements. To encourage a bank to progress through this structure, risk weights should be aligned with Basel II, but be a bit more conservative at each preceding level to encourage banks to attain the Basel II thresholds. Asset categories (corporate, sovereign, etc.) should be better aligned with Basel II asset categories.

	LEVEL 1 Community Banks	LEVEL 2 Larger Banks	LEVEL 3 Mandatory Banks
Minimum Methodology (during phase in only)	Basel I	Basel I	Basel I
Target Methodology	Basel IA	Basel IA	Basel II
Opt In (most advanced Methodology	Basel IA	Basel II	Basel II

2. Increase the Number of Risk-weight Categories

PNC would generally support increasing the number of risk-weighting categories to allow for greater granularity of credit risk measurement. We believe that between seven and ten categories is manageable and would provide beneficial granularity. Additionally, it is our opinion that a 10 percent risk weight would add value to the process, as would the addition of a 350 percent risk weight for a limited group of assets (e.g., equities and sub-prime loans).

Capital assessments for Basel I, Basel IA and Basel II should be directionally consistent so as to provide incentive for banks to improve their risk management processes. As banks move from simpler models (which have a higher potential for inaccuracy) to more sophisticated models (which have a lower potential for inaccuracy) for risk assessment it is expected that the capital necessary to support a bank's portfolio would be lower, all other things held constant, as there is no longer a need to add incremental capital for potential inaccuracies.

3. Expanded Use of External Ratings

We would generally be supportive of using external credit ratings to provide greater credit risk granularity. However, only a small portion of typical middle-tier and community banks' corporate customers are rated by a nationally recognized statistical rating organizations ("NRSRO"). The vast majority of such customers are often private companies, and thus middle-tier and community banks would not receive any benefit from this part of the proposal. Moreover, these banks may choose to lend to unrated customers over non-investment grade customers in order to avoid the incremental capital charge described in the ANPR.

Finally, we recommend that regulators strive for clarity and consistency with respect to whether external ratings are to be based on long-term or short-term ratings.

4. Broaden Credit Risk Assessment Methodologies for Residential Mortgages

We would encourage an approach to add granularity to the residential mortgage portfolio. Using a matrix approach combining loan-to value ("LTV") and either original FICO or an updated FICO would add additional value to that approach. In addition, we believe that updates to FICO and LTV be no more frequent than quarterly; however, LTV updates should not require new appraisals, but be based on statistical property value forecasting methodologies.

We also do not support the use of a debt-to-income ("D/I") ratio as a means of determining capital requirements. D/I is not always a predictive variable for all segments of mortgage lending (e.g., high net worth). Couple that with the fact that a customer's D/I is constantly changing over the life of a loan indicates that a D/I point of reference could be very inaccurate.

To the extent that non-traditional mortgages raise safety and soundness concerns, we believe that this concern should be addressed through the supervisory process, and not by capital charges. For instance, many interest-only products are used in the "jumbo mortgage market" and are appropriate for that consumer segment. In addition, we recommend that non-traditional mortgage loans be subject to the same matrix as other mortgage loans.

There is merit in allowing for varying levels of capital requirements on first mortgage position (as opposed to purchase money) loans. From a monitoring and reporting standpoint, that is most easily accomplished based on the original LTV. However, with respect to using updated LTVs as a means to further reduce the required capital, we would argue that the cost to perform periodic full re-appraisals would make that approach unreasonable. Instead, we would propose that banks be allowed to use statistical property value forecasting methodologies in lieu of full appraisals.

5. Modify Capital Assigned to Commitments With Less than One Year Original Maturity

One of the main criticisms of Basel I was the lack of capital attracted by commitments of less than one year. Arbitrage of this shortcoming has led to an entire market of 364-day revolvers. Addressing this shortcoming should be a central component of any modification of Basel I. Clearly, shorter maturity obligations should receive lower risk weights than comparable instruments with longer maturities. While these short-term facilities have less risk than their longer-term counterparts, they do nonetheless have some risk (as opposed to the current treatment where they attract no regulatory capital). Therefore, we support the ANPR's proposal to apply a 10 percent credit conversion factor on short-term commitments, and to retain the existing 50 percent credit conversion factor for longer-term commitments.

6. Lack of an Explicit Operational Risk Charge

Basel I focuses on a credit risk capital charge with no capital assigned to operational risk. Therefore, we would encourage the addition of a specific charge for operational risk or "other risk" in addition to credit risk capital charges. This would make Basel IA more conceptually consistent with Basel II; would be in line with best practices as it has been found that economic charges for operational and other risks are quite significant; and, by introducing such a charge, would result in a credit risk charge being reduced to more appropriate levels. This charge would be even more imperative if Basel 1A is going to be applied to large regional banks with disparate business line composition. We would recommend that Basel IA implement something like the Basel II Basic Indicator or Standardized Approach. These approaches are relatively simple and would be the first step toward rectifying the current inequity.

7. Leverage Ratio

The five percent well-capitalized standard for a leverage ratio effectively forces U.S. banks to hold higher risk assets – those for which the best practice EC estimate is over five percent. Continuing the requirement that banks maintain a minimum leverage ratio will reduce the benefit of opting in to Basel IA or II, as the leverage ratio is reducing the ability of large banks to grow their low-risk asset portfolios. This will limit U.S. banks' ability to compete in the global markets, as foreign banks are not subject to the same type of restriction. U.S. banks would also be at a disadvantage when competing for market share against non-regulated financial institutions. Therefore, we recommend that this ratio be eliminated.

Conclusion

PNC is supportive of efforts to improve the Basel risk-based capital standards. In this regard, the lack of risk sensitivity has been a known deficiency of the existing accord, and we welcome the initiative to improve this framework for institutions that do not migrate to Basel II. However, we believe that improvements should be in line with the set of overall objectives, as discussed in this letter.

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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