VALLEY REPUBLIC BANK

September 27, 2012

Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street N.W.
Washington, D.C. 20429

Re: Basel III Capital Proposals (Basel III FDIC RIN 3064-AD95, RIN 3064-AD96, and RIN 3064-D97)

Ladies and Gentlemen:

Thank you for the opportunity to provide comment on the Basel III proposals[1] that were recently approved by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (collectively the "banking agencies"). I must tell you at the outset that I am opposed to the implementation of the Capital Proposals, as they are currently written.

Valley Republic Bank ("VRB") is headquartered in Bakersfield, California, the county seat for Kern County. Kern County's economy is based upon the diverse assets of agriculture, energy, healthcare, logistics and the aerospace/defense industries. Key industries in the County, such as value-added agriculture, are regional and national leaders, and new ones, such as transportation and logistics, are emerging and growing. The County also has distinctive assets related to renewable energy and aerospace, two areas with significant potential to expand and develop. While the County's economy is generally diverse and resilient, every sector of our local economy has been negatively impacted by the recession; recovery remains very slow to develop.

VRB is one of only two locally-headquartered community banks serving the Greater Bakersfield area. As such, we have assumed a significant role in providing quality banking services to the local small businesses and professional individuals of this area. We believe that VRB is in a unique position to assist the businesses in our community to not only recover from the economic downturn, but to begin to expand their operations.

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[1] The proposals are titled: *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, and Transition Provisions; Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements; and Regulatory Capital Rules: Advanced Approaches Risk-based Capital Rules; Market Risk Capital Rule.*

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I believe the proposed Basel III capital rules will have a negative impact on the ability of our local community banks to serve the local banking needs of our city's businesses and professionals going forward.

One of my greatest concerns is the proposed requirement that Unrealized Gains and Losses flow through the bank's Regulatory Capital account, directly impacting regulatory common equity Tier I (CET1). Under the current risk-based capital rules, unrealized gains and losses on AFS debt securities are reported in accumulated other comprehensive income; however, these unrealized gains and losses are not included in Regulatory Capital. Rather, the unrealized gains and losses, as a component of AOCI, provide clear disclosure of those amounts in the financial statements of the bank, without impacting Regulatory Capital.

If the Basel III proposed rules go into effect, an enormous potential for uncertainty and extreme volatility will be introduced into the banking industry's Regulatory Capital accounts; the possibility is created for a bank with exceptional Tier I and total risk-based capital ratios under today's regulatory capital rules to suddenly be subjected to the penalties and oftentimes devastating effects of being considered under-capitalized merely because external interest rates have changed. The reality is, of course, that the underlying strength of the bank's capital position has not changed whatsoever – these are unrealized gains and losses.

Unrealized losses in AFS securities are temporary in nature and, absent any actual impairment, the bank holding these securities will recover all contractual principal plus interest. While the bank holding these securities may earn less interest income than if the funds were invested at new rates, prudent asset/liability management can mitigate the risk of losses in a rising rate environment by matching the assets with liabilities that have similar re-pricing characteristics.

The proposed rule requiring recognition of unrealized gains and losses through Regulatory Capital would, at the very least, negatively impact our bank's ability to contribute to our city's economic recovery in a rising rate environment. The inclusion of unrealized losses on AFS securities in a rising rate environment would put downward pressure on the bank's capital levels, potentially causing the bank to reduce the growth of, or even shrink, our securities portfolio considerably to maintain capital ratios at desired or required levels. This scenario would, most likely, also cause the bank to be forced to sell AFS securities thereby converting those unrealized losses into realized losses, which directly impacts profitability. The decline in capital levels and profitability would immediately begin to impact the bank's ability to continue to make new loans, which is a key component of any economic recovery scenario.

Finally, this proposed capital rule would have the effect of discouraging banks from engaging in routine activities used as an important asset/liability management tool. In addition, as a way to avoid some of the volatility this new rule would bring about, banks will be forced to reduce investments in AFS securities and carry larger balances in cash and cash equivalents. This, in turn, will reduce funding available for the purchase of FNMA, FHLMC and GNMA securities, which would negatively impact the housing sector and reduce the bank's earnings even further. Adding to this negative scenario is the possibility that banks that are not able to find investments with minimal potential for unrealized losses may work to further reduce their cost of funds in order to shrink their balance sheets and improve capital ratios. This would hurt consumers, especially retirees who tend to hold higher cash balances as a percentage of retirement assets.

The proposed rule should be revised so that unrealized gains and losses on AFS securities that reside in accumulated other comprehensive income do not flow through Regulatory Capital. This would allow unrealized losses due to credit impairment to be reflected in capital by way of OTTI analysis, but would exclude the interest rate impact. With the overwhelmingly negative effects that the current economic environment has had on banks in general, the last thing we need is the adoption of new capital rules that introduce unnecessary volatility into the regulatory capital ratios and create an environment in which banks may be forced into an undercapitalized position due to nothing more than the movement in interest rates. While we do recognize that many of the Basel III capital proposals will improve monitoring and maintenance of appropriate capital levels, the requirement that unrealized gains and losses on AFS securities flow through Regulatory Capital has potential negative consequences that far outweigh any possible benefits that might be derived from this requirement.

Looking briefly at other elements of the proposed rules, increasing the risk weights on delinquent loans seems to be appropriate. Maintaining an additional capital buffer is conservative and prudent when the balance sheet contains assets with greater inherent risk. However, much of the capital buffer associated with these loans is already included in the ALLL. When a loan becomes adversely classified, Tier I capital decreases as the provision for loan losses increases, while Tier II capital typically increases through the addition to the ALLL. In times of severe economic stress, however, the balance of the ALLL can often exceed the current limit of 1.25% of risk-weighted assets for inclusion in Tier II capital. Under the NPR, when a loan becomes delinquent, risk-weighted assets would increase while Tier I capital would necessarily decrease. At the same time, some banks may get no credit for the additional buffer in the ALLL if their allowance exceeds the cap. While the increased levels of Tier I capital is appropriate, the cap on the amount of the ALLL that is included in Tier II capital should be increased substantially or eliminated altogether, so that banks do not get impacted twice by the same event.

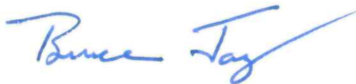
With regard to cash flow hedges, the proposed rules do not appear to be reasonable or appropriate. Cash flow hedges, including interest rate caps and interest rate swaps, can

be effective tools for managing interest rate risk. With interest rates at historic lows, many banks, including Valley Republic Bank, must consider ways to hedge our deposits and other liabilities against rising interest rates. Typically, as interest rates change a cash flow hedge will fluctuate in value, with any changes flowing through other comprehensive income. At the same time, the liability being hedged typically also changes in value – in the opposite direction – but the changes in value of these liabilities are not reflected in the financial statements. Under the NPR, banks would have to deduct from Regulatory Capital only negative changes in fair value of cash flow hedges, without any regard to the fact that there is no offsetting benefit associated with the hedged item. This rule will discourage banks, such as Valley Republic Bank, from utilizing an effective tool to mitigate exposure to interest rate risk. This, I believe, is exactly the opposite effect of what bank regulators would want to occur.

We agree with the decision to phase out the inclusion of trust preferred securities in capital. Debt is not equity. However, we would also suggest that the final rule reduce or eliminate the amount of subordinated debt that can be included in Tier II capital.

Thank you for your consideration and for the opportunity to comment on this proposal.

Sincerely,



Bruce Jay
President
Chief Executive Officer