From: Charlie Cullen <ccullen@theprovidentbank.com>
Sent: Friday, October 19, 2012 3:48 PM
To: Comments
Subject: Basel III FDIC RIN 3064-AD95, RIN 3064-AD96, and RIN 3064-D97

THE PROVIDENT BANK

October 19, 2012

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 2-3
Washington, DC 20219

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

Ladies and Gentlemen:

Thank you for the opportunity to provide comment on the Basel III proposals[1] that were recently issued for public comment by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.

The Provident Bank is a $550 million, state-chartered mutual bank established in 1828. Our mission is "dedicated to the delivery of qualify financial products to our customers with the highest level of convenience, personal service and value while *operating in a manner consistent with fundamentals of sound banking*. As of June 30, 2012, The Provident Bank had Tier 1 leverage capital of 11.89%, Tier 1 risk-based capital of 17.40%, and Total risk-based capital of 18.96%. The Provident Bank applied for and received $17 million of capital form the Small Business Lending Fund; as of June 30, 2012, we have lent out an additional $21 million of qualifying small business loans.

Applicability of Basel III to Community Banks

Community banks should be allowed to continue using the current Basel I framework for computing their capital requirements. Basel III was designed to apply to the largest, internationally active, banks and not community banks. Community banks did not engage in the highly leveraged activities that severely depleted capital levels of the largest banks and created panic in the financial markets.
Community banks operate on a relationship-based business model that is specifically designed to serve customers in their respective communities on a long-term basis. This model contributes to the success of community banks all over the United States through practical, common sense approaches to managing risk. The largest banks operate purely on transaction volume and pay little attention to the customer relationship. This difference in banking models demonstrates the need to place tougher capital standards exclusively on the largest banks to better manage the ability to absorb losses.

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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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Incorporating AOCI as Part of Regulatory Capital

Inclusion of accumulated other comprehensive income (AOCI) in capital for community banks will result in increased volatility in regulatory capital balances and could rapidly deplete capital levels under certain economic conditions. AOCI for most community banks represents unrealized gains and losses on investment securities held available-for-sale. Because these securities are held at fair value, any gains or losses due to changes in interest rates are captured in the valuation. Recently, both short-term and long-term interest rates have fallen to historic lows generating unprecedented unrealized gains for most investment securities. Additionally, demand for many implicitly and explicitly government guaranteed securities has risen due to a flight to safety and government intervention in the capital markets. This increased demand has caused credit spreads to tighten further increasing bond valuations.

Interest rates have fallen to levels that are unsustainable long-term once an economic recovery accelerates. As interest rates rise, fair values will fall causing the balance of AOCI to decline and become negative. This decline will have a direct, immediate impact on common equity, tier 1, and total capital as the unrealized losses will reduce capital balances. At my bank, for instance, if interest rates increased by 300 basis points, my bank's bond portfolio would show a paper loss of approximately $19.6 million. This would mean that my bank's tier one ratio would drop from 11.89% to 8.23%, a decrease of 3.66%.

Large financial institutions have the ability to mitigate the risks of capital volatility by entering into qualifying hedge accounting relationships for financial accounting purposes with the use of interest rate derivatives like interest rate swap, option, and futures contracts. Community banks do not have the knowledge or expertise to engage in these transactions and manage their associated risks, costs, and barriers to entry. Community banks should continue to exclude AOCI from capital measures as they are currently required to do today.

If the Agencies are determined to require all unrealized gains and losses to flow through capital, we strongly suggest that unrealized gains and losses that predominantly result from changes in interest rate risk should be carved out. In other words, the Agencies should consider filtering unrealized gains and losses for securities that do not have credit risk. This approach would exclude from regulatory capital unrealized gains and losses resulting from such low-risk securities as U.S. government and agency debt obligations and U.S. GSE debt obligations.

Capital Conservation Buffers

Implementation of the capital conservation buffers for community banks will be difficult to achieve under the proposal and therefore should not be implemented. Many community banks will need to build additional capital balances to meet the minimum capital requirements with the buffers in place. Additionally, this action will result incent banks to stop lending as they will not have the capital to support additional loans. This is not what the economy needs during the

Community banks do not have ready access to capital that the larger banks have through the capital markets. This is especially true for non-stock mutual banks. The only way for mutual community banks to increase capital is through the accumulation of retained earnings over time. Due to the current ultra low interest rate environment, community bank profitability has diminished further hampering their ability to grow capital. If the regulators are unwilling to exempt community banks from the capital conservation buffers, additional time should be allotted (at least five years beyond 2019) in order for those banks that need the additional capital to retain and accumulate earnings accordingly.

New Risk Weights

The proposed risk weight framework under Basel III is too complicated and will be an onerous regulatory burden that will penalize community banks and jeopardize the housing recovery. Increasing the risk weights for residential balloon loans, interest-only loans, and second liens will penalize community banks who offer these loan products to their customers and deprive customers of many financing options for residential property.

Additionally, higher risk weights for balloon loans will further penalize community banks for mitigating interest rate risk in their asset-liability management. Community banks will be forced to originate only 15 or 30 year mortgages with durations that will make their balance sheets more sensitive to changes in long-term interest rates. Many community banks will either exit the residential loan market entirely or only originate those loans that can be sold to a GSE. Second liens will either become more expensive for borrowers or disappear altogether as banks will choose not to allocate additional capital to these balance sheet exposures. Community banks should be allowed to stay with the current Basel I risk weight framework for residential loans. Furthermore, community banks will be forced to make significant software upgrades and incur other operational costs to track mortgage loan-to-value ratios in order to determine the proper risk weight categories for mortgages.

These actions will also result in unintended consequences which will adversely affect the availability of credit in many markets and drive up the cost of that credit for consumers and businesses. This leads us to question why the Federal Reserve, which has in recent years gone to great lengths to keep interest rates and the cost of credit low, would throw water on the flame of economic recovery that we see today. This is particularly true for credit extended to home buyers and the desired recovery in housing.

Any final rule should grandfather all existing mortgage exposures by assigning them risk weights as required under the current general risk-based capital requirements (*i.e.* 50% risk weight). Grandfathering such mortgages is appropriate for at least three reasons:

- First, many banks will not have the data necessary to assign mortgage categories under the proposal.
- Second, even if a bank has the data necessary to calculate the risk weights applicable to each mortgage, it would be extremely burdensome for many banks—the extent of which would be scaled to the number of exposures—to examine old records in order to determine mortgage categories and calculate LTV ratios under the proposed framework.
- Third, given the substantial increase in capital that would be required for such existing category 2 mortgages, which may constitute a substantial amount of assets on an institution's balance sheet, the retroactive impact of the proposed treatment would be especially harsh. Given that the Basel III NPR is already substantially increasing required minimum capital, the need for retroactive application of the new standards is significantly attenuated.

We also feel that increasing the risk weighting on delinquent loans is redundant. Delinquent loans must be considered in the Allowance for Loan Loss analysis. Community banks are already highly regulated in this area and are criticized severely if we do not adequately recognize the need for reserves to mitigate possible future losses on these loans. Moreover, the additional capital burden will have the unintended consequence of reducing the willingness of community banks to work with delinquent borrowers; this will result in increased foreclosure activity instead of working with the borrower so that they may keep their home.

In Closing

We feel that it would be appropriate to delay (something that has already occurred in other countries struggling with similar, albeit less issues with the proposal) the implementation of the capital NPR's given all the questions that are still circulating without clear answers readily available for them.
Extending the timeline would afford the Federal Reserve and the other regulatory agencies a better opportunity to consider the potential unintended consequences of the NPR's, adjustments to reduce unexpected adverse results, and/or a less complicated approach to meeting the capital improvement mandate.

Despite this being just a proposal at this point, when combined with new rules and regulations enacted by the CFPB, we are considering exiting business lines (i.e. residential lending due to the lack of a safe harbor treatment on qualified mortgages). One can only assume that if passed in current form, other profitable business lines will take a similar path, ultimately making banks less profitable with two certain outcomes: 1) Banks will be forced to take on additional risk to offset the loss of income and 2) credit for consumers and small businesses will be significantly less available and more expensive.

We all share a common goal of an improved economy with a safe, healthy banking system. You cannot have an improved economy without a healthy community bank system! Small business lending and the consumer still drive the economy in this country. Both of these groups will be adversely affected by the proposed rules, further complicating and prolonging an exit to this financial crisis. The very things the NPR is trying to prevent could actually be made worse due to unintended (yet very real) consequences. We are obviously biased to the views of the community banks we serve. However, we also feel the collateral damage the consumer would potentially suffer in regards to a decrease of affordable housing credit (during a cycle where the Fed has pulled all stops to ensure its availability) would be unavoidable.

We respectfully ask for your consideration on the points raised in this letter, and appreciate your time in reading it.

Very truly yours,

Charles R. Cullen
President & CEO

CC: Senator John Kerry
Senator Scott Brown
Representative John Tierney

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