

GAETA & EVESON, P.A.

Attorneys at Law

700 Spring Forest Road, Suite 335

Raleigh, North Carolina 27609

(919) 845-2558 Telephone

(919) 518-2146 Facsimile

www.banklawnc.com

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VIA EMAIL

Honorable Thomas J. Curry, Comptroller
Office of the Comptroller of the Currency
regs.comments@occ.treas.gov
Docket ID OCC-2012-0008, -0009 & -0010

The Honorable Ben S. Bernanke, Chairman
Board of Governors of the Federal Reserve System
regs.comments@federalreserve.gov
Docket No. 1442

The Honorable Martin J. Gruenberg, Acting Chairman
Federal Deposit Insurance Corporation
comments@FDIC.gov
RIN 3064-AD95, -AD96 & -AD97

Re: *Regulatory Capital Rules:*

Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action

Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements

Dear Sirs:

Thank you for the opportunity to comment on the joint notices of proposed rulemaking (“NPRs”) referenced above, which are intended to implement agreements reached by the Basel Committee on Banking Supervision in *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems*, December 2010 (“Basel III Accord”), consistent with provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act” or “DFA”). We are not commenting on the proposed Advanced Approaches Risk-Based Capital Rule; Market Risk Capital Rule.

Our law firm has a practice focused almost exclusively on the representation of community banks in connection with corporate, securities and regulatory matters. We currently serve as counsel to over thirty community banks in the State of North Carolina. As a result, regulations of the type proposed in the NPRs involve issues with which we have great familiarity.

If the NPRs are implemented as proposed, we believe they will have a profound negative effect on all community banks.

Costs of Compliance

As you are well aware, Basel III is an international framework intended for systemically important institutions that compete on a global scale. Its forced application to the community bank sector will result in disproportionate costs of compliance for smaller institutions. The issue is not simply one of increased compliance cost, but whether the typical community bank has the management resources and time to comply with the 700 pages of new regulations in the NPRs at all. Most community banks lack the management resources and systems to comply. We also question whether the risk profile of a typical community bank warrants regulation of this nature.

Institutions with less than \$5 billion in total assets should be exempted from the proposed regulations.

Available for Sale Securities Portfolio

The Basel III NPR proposes to reflect unrealized gains and losses on available for sale (“AFS”) securities in regulatory capital. This approach would be logical if unrealized losses on AFS were always due purely to the credit rating of the issuer, but the value of AFS are also impacted to a large degree by interest rates. This proposed capital recognition would, therefore, be impacted to a large degree by temporary impairments resulting from fluctuations in market interest rates.

Given the historically current low interest rate environment, it is fair to assume that rates will rise significantly at some point in the future. When this occurs, virtually every bank in the country will experience a reduction in regulatory capital that is not truly linked to its respective risk profile. Most community banks in this position would be forced to shrink their balance sheets just at the time that economic recovery is hitting its full stride or increase their capital levels to cover unrealized losses that would never be recognized if those securities were held to maturity.

One obvious solution to the artificial capital volatility problem that would be created by the NPRs would be to reclassify the securities portfolio as held to maturity. This would address the problem of capital volatility; however, it would also severely curtail the utility of the

securities portfolio as a tool to manage interest rate risk. Ultimately, this would have an adverse effect on safety and soundness.

We suggest a carve out from the proposed rule that exempts unrealized gains and losses that predominately result from changes in interest rate risk. The Agencies should also consider filtering unrealized gains and losses for securities that do not have a credit risk, namely securities that come within the definition of “Type I Securities” under 12 CFR Part 1.2(j).

Risk Weightings

The NPRs would require the collection and reporting of information on numerous asset categories and the assignment of updated, ongoing risk weightings in real time. The increased capital levels that the proposed risk weightings require, not to mention the added cost and burden of compliance with these provisions, will only make it harder for community banks to compete.

If financial institutions are adequately addressing the risk for delinquent loans through the allowance for loan and lease losses, then adding a risk weight of 150% should not be necessary. We suggest that this provision be revised to require financial institutions to adequately address this risk through allowances for loan and lease losses, and not by increasing the risk weight of delinquent loans. This provision, as proposed in the NPR, amounts to a credit sensitive, after the fact penalty. The better, and more transparent, approach would be to adequately address troubled credits through reserve loss settings.

Home Equity Lending

The NPRs would require that all junior liens secured by 1-to-4 family residential real estate be classified as Category 2 exposures with risk weights ranging from 100% to 200%. In addition, a bank that holds two or more mortgages on the same property would be required to treat all the mortgages on the property as Category 2 exposures, even a first lien mortgage.

While there is a proposed exception if (i) a bank holds both the first and junior lien on the same property; (ii) no party holds an intervening lien; and (iii) the combined exposure meets all requirements of a Category 1 mortgage, we suggest a broader exception that would apply where a bank holds two or more mortgages on the same property and the first lien is a Category 1 exposure.

Mortgage Servicing

Under the NPRs, mortgage servicing assets in excess of 10% of common equity tier 1 will no longer be counted at tier 1 capital. Further, financial institutions would be required to hold capital against assets with credit enhancing representations and warranties, including mortgages in process of being securitized. This will clearly have an adverse effect not only on

community banks, but also on the availability of residential mortgage loans to consumers. The likely effect will be to push the origination of mortgage products out into under-regulated origination channels, to the ultimate detriment of the consumer.

Existing mortgage servicing assets should be grandfathered and the Agencies should allow banks to include 100% of the fair market value of readily marketable mortgage servicing assets to reduce the impact of the proposed rule. In addition, there should be no deduction from capital for mortgage servicing rights.

Trust Preferred Securities

The Dodd-Frank Act explicitly preserves the capital treatment for outstanding trust preferred securities issued by smaller bank holding companies. The phase out proposed in the NPRs appears very clearly to be contradictory to Congressional intent in the Dodd-Frank Act, which states that bank holding companies with assets of less than \$15 billion as of December 31, 2009 will be permitted to continue to include trust preferred securities that were issued before May 19, 2010 as Tier 1 capital.

The proposed phase-out would have a disproportionately adverse, if not punitive, effect on community banks, because smaller institutions simply do not have the access to the capital markets that regional, super-regional and global institutions enjoy. Most community banks will struggle to replace this capital due to their small market capitalization levels.

Furthermore, since grandfathered trust preferred securities are already outstanding, it is unclear what supervisory motive could possibly be served by the disqualification of qualifying capital that is currently on the balance sheet and available to absorb losses.

This element of the NPR should be removed.

Capital Conservation Buffer

The NPRs would require a bank to maintain a “capital conservation buffer” of additional common equity Tier 1 capital equal to 2.5% of risk weighted assets in order to avoid restrictions, or outright prohibitions, on capital distributions and discretionary bonus payments to executive officers.

This provision will cripple the ability of community banks to compete with larger competitors by making it more difficult to recruit and retain personnel. It will also adversely affect the return on equity (ROE) of banks, which will in turn make it even more difficult for community banks to attract investors and access the capital markets.

There are already regulatory provisions in place that restrict the payment of dividends, the repurchase of securities, and the payment of bonuses under prompt corrective action and the Agencies already have a full complement of regulatory tools at their disposal to regulate distributions and bonuses when needed, ranging from board resolutions, memoranda of understanding, written agreements, consent orders and orders to cease and desist. If a financial institution is "well capitalized" under applicable regulatory standards, then it should not be required to hold additional capital in order to pay dividends or bonuses. Excessive risk taking within multinational investment banks may have been a major contributing factor leading to the financial crisis, but excessive risk taking and excessive compensation within community banks was not. While all can agree that the financial services industry is, and should be, highly regulated, it is also still a for-profit business. Banks should not have to apologize if they play by the rules and realize a profit and they should not be required to hold additional capital in order to distribute a portion of that profit to investors and employees.

The proposed "capital conservation buffer" should be not be implemented.

Conclusion

The application of the proposed rules described in this letter would severely undermine the ability of community banks to compete with larger competitors. Basel III was intended to provide a framework for institutions that compete internationally. Many of our clients only compete within a single county or town. They should not be subject to identical standards.

Our firm has commented, from time to time, on various proposed regulations. We cannot recall, however, a body of proposed regulation that would so clearly threaten the continued viability of community banks in the United States. If the intent of this regulation is to foment consolidation and eradicate small banks from the competitive landscape, it will have its intended effect. If, however, the Agencies value the continued ability of community banks to provide financial products and services to consumers and small businesses, many of whom are underbanked by regional, super-regional, and global institutions, then we urge the Agencies to revise the NPRs, if not abandon them altogether.

Thank you for the opportunity to comment on the proposed rules.

Yours very truly,

GAETA & EVESON, P.A.



Todd H. Eveson