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October 21, 2012

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

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

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 Deposit Insurance Corporation, the Federal Reserve Board, and the Office of the Comptroller of the Currency.

NVE Bank is a $700 million, state-chartered mutual bank established in 1887 headquartered in Englewood, New Jersey. Throughout our 125 year history, we have remained a mutual bank, which means that we exist for one reason and one reason only: to help our customers, local businesses and communities prosper, not to maximize returns to stockholders. We support our communities through twelve branch locations in northern New Jersey which provide relationship-based products and services to consumers and area businesses. Our 110 employees are committed to our customers and are strongly focused on social responsibility within our communities. NVE continues to be financially sound as we conservatively manage risk to protect our depositors. As of June 30, 2012, NVE Bank had Tier I Leverage Capital of 11.27%; Tier I Risk Based Capital of 20.04%; and Total Risk Based Capital of 20.63%.

[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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Historically, mutual community banks have been a vital part of the fabric of many communities and their future viability must be protected and enhanced. Unfortunately, the impact of the Basel III Proposals will generally be harmful, and possibly systemically threatening to mutual industry. While the focus of this letter is the effect of the Basel III Proposals on mutual banking institutions and NVE Bank specifically, it is our understanding that similar concerns are being raised in other countries by similar cooperative non-stock forms of banking institutions. NVE Bank is in complete agreement with the position that a strong capital base is vital to banking institutions and the maintenance of a safe and sound banking system. However, in an attempt to address macro market concerns, the Basel III Proposals paint with a broad brush and sweep community based mutual form institutions into the same regulatory framework as systemically large stock form institutions. Indeed, recent reports in trade publications have suggested the Basel III Proposals will have a much more severe impact on small and mid-sized banks than on the large systemically important money center banks. The "one-size fits all" approach not only is inappropriate with respect to mutual form institutions, but could very well result in unintended consequences that are exactly the opposite of those which the proposals are trying to accomplish.

Mutual form institutions have been the bedrock of many communities for generations. Mutual banks are community based and community focused. As previously mentioned, in 2012 NVE Bank is celebrating its 125th year anniversary as a mutual community bank. The depositors and borrowers of a mutual institution are the residual "owners" of the institution. We are concerned that the drafters of the Basel III Proposals do not truly understand the value, nature and unique role of mutual institutions. We believe that the impact of these proposals will have significant, perhaps unintended, consequences on mutual institutions which could dramatically impact the future viability and existence of community based mutual non-stock banks in the United States.

The definition of "Common Equity Tier 1 Capital" is set forth under Basel III proposal Section 4a. to Addendum 1. It is clear that the proposal tries to differentiate between community banking institutions and larger systemically important institutions. While this differentiation is certainly appropriate and speaks to the drafters' attempt to distinguish between community banking institutions and larger institutions, it does not take the next step which is to differentiate between and acknowledge that not all community banking organizations are the same. Banks come in all shapes and sizes. There are systemically important money center banks, nationally significant regional banks, mid-sized and small banks, publicly owned banks, privately held banks, subchapter S banks, and mutual non-stock institutions. Generally, the FRB has defined community banks as those with under $10 billion in assets. This is a rather broad and all-encompassing definition. Mutual banks are a subset of community banks. As of December 31, 2010, there were 577 banks organized in the mutual form accounting for $209 billion in assets. The nomenclature of Common Equity Tier 1 Capital in and of itself highlights the apparent lack of understanding or acknowledgement by the drafters of the Basel III Proposals concerning mutual institutions. The aforementioned definition itself is premised on and relates to a stock form organization; the words "Common Equity" can only mean common stock, something only a stock form institution can have and that is unavailable to a mutual institution.

The drafters of the Basel III Proposals appear to fail to take into account the uniqueness of and the benefits offered by mutual banks. The Proposals do not seem to give significant consideration to this specialized form of organization which historically has posed little risk,

providing longstanding and significant benefits to the communities they serve. The proposal states that "Most of the capital of mutual banking organizations is generally in the form of retained earnings (including retained earnings surplus accounts) and the agencies believe that mutual banking organizations generally should be able to meet the proposed regulatory capital requirements". The document does not reference any study or empirical analysis performed by any banking regulatory agency to support this statement. Although we hope the referenced statement will prove correct, without doubt the Basel III Proposals as drafted will have a detrimental effect on the current capital cushion or surplus that mutual banks realize today and the new standard will cause future regulatory capital level requirements to be greater and more volatile. Moreover, at the same time that Basel III would reduce the current excess capital cushion of mutual banks, the proposal simultaneously eliminates the use of pledged accounts by mutual institutions, a long-standing acceptable Tier 1 capital instrument. While mutual institutions currently are generally highly capitalized, the Basel III Proposals unnecessarily deny them alternatives to raising additional loss-absorbing capital and maintaining their status as mutual banks. This "one size fits all" approach disregards that the ability of mutual institutions to raise capital beyond retained earnings is severely limited as compared to stock institutions. If left unaddressed, the Basel III Proposals could be the beginning of a rapid decline of the mutual form of organization among banks. Not only is the capital structure of mutual institutions different from large banking institutions, it is different from stock form community banking institutions.

Stock based institutions may have access to capital markets via, among other things, the sale of common equity securities in the marketplace by a public offering or private placement. However, this avenue for capital formation is not available to mutual institutions. As a mutual bank, our capital increases only through the retention of earnings and, while we support strengthening the quality and loss absorption safeguards in financial institutions, we are concerned by the unintended consequences the adoption of several of the Basel III provisions may have on mutual community banks.

The American Bankers Association ("ABA") and the Independent Community Bankers of American ("ICBA") have highlighted the challenges many community banks will face in accessing the national capital markets compared to the relative ease of larger banks. A mutual bank faces an even greater challenge, given their inability to raise capital except through retained earnings growth. If, for example, a mutual bank fell short of the proposed Basel III capital conservation buffer, its only option would be to shrink. This would severely impact the bank's customers and its local community. An increase in a mutual community bank's capital requirement reduces the bank's ability to leverage capital, reduces earnings, minimizes returns and restricts community lending. As a result, qualified families will struggle to gain financing for their first homes, small businesses will have trouble getting much-needed credit to fund their operations and communities will lose the benefits that a mutual organization provides in supporting their growth.

While organized for historically different reasons, mutual form banks and credit unions share a common foundation: they are non-stock form. All credit unions are organized as co-operatives which is essentially the same as the mutual form of organization. However, the Basel III Proposals do not apply to credit unions. Credit unions are exempt because there is a belief that

they pose no systemic risk and it is accepted that they did not contribute to the recent banking crisis. The vast majority of mutual community banks do not pose systemic risk to the economy and did not contribute to the recent banking crisis. The largest mutual based bank is approximately one-sixth the size of the largest credit union. Yet, mutual banks are being lumped into a "one size fits all" set of rules developed for systemically important stock based banking institutions. We believe that mutual banks should be treated on a similar basis to credit unions for the purposes of the capital proposals of Basel III and/or be given the opportunity to raise non-stock form of capital instruments, such as "Mutual Investment Certificates" which would count as the highest form of Tier 1 capital (equivalent to common stock for stock form institutions) under the proposed Grimm Bill H.R. 4217 (Mutual Community Bank Competitive Equality Act). This bill has been strongly supported by the trade group America's Mutual Banks (AMB) whose membership consists solely of banking institutions organized under the mutual form of ownership.

The Basel III proposal also provides that unrealized gains and losses on all available-for-sale securities (AFS securities) held by an institution be reflected in Common Equity Tier 1 Capital. At a time of historically low interest rates and low loan demand, banks have been investing their excess cash balances into the securities market. As interest rates rise, fair values of fixed income securities will decline causing the balance of accumulated other comprehensive income to fall and directly reduce capital balances. As a mutual bank we decided not to engage in high risk derivative hedging strategies (which have been a source of regulatory concerns with other institutions) to potentially mitigate the effect of temporary market value adjustments of securities due to higher interest rates. To alleviate this potential volatility in capital, a mutual or community bank would be faced with making decisions which could include shortening the duration of the investment portfolio and thus lowering earnings, or classifying all investments as held-to-maturity which would reduce a bank's ability to respond to market movements and limit its liquidity options and its ability to effectively manage interest rate risk by restructuring its portfolio. NVE Bank's investment portfolio is approximately $170 million and is comprised almost entirely of government sponsored mortgage-backed securities. These investments have no or little credit risk but are subject to temporary market value changes due to interest rate fluctuations. Stress testing of our investment portfolio indicates that a 300 basis point immediate increase in interest rates would decrease the market value and would significantly reduce the Bank's Tier I capital ratio. Allowing unrealized gains and losses on available-for-sale securities to flow through to regulatory capital introduces a new artificial regulatory created interest rate risk volatility component to the regulatory capital standards. However, Basel III only recognizes the isolated effects on market values of a subset of the balance sheet (AFS securities). This computation ignores the significant inverse correlated benefit of the economic value of core deposits. Core deposits increase in economic value when interest rates increase and thus have an inverse correlation to the value of fixed income securities. Core deposits at many mutual community banks represent a significant portion of the true economic value of the organization. In the aforementioned stress testing scenario (up 300 basis points), the increased value of our core deposits would well exceed the loss in value of the investment portfolio. Selectively applying mark-to-market accounting to one small segment of a community bank's balance sheet (AFS securities) distorts any benefit or attempt to have regulatory capital mirror some type of fair market calculation, causes unnecessary volatility to regulatory capital (making the capital ratios of mutual community banks harder to maintain) and will be misleading and confusing to

any reader of a bank's financial statements. Additionally, the de-facto selective mark to market of these securities could lead to unintended consequences such as lower liquidity levels (as more securities are designated held to maturity to avoid the mark to market volatility to regulatory capital) and reduce the ability of management to restructure the balance sheet to manage interest rate risk.

Another concern we have with the Basel III proposals is the increased risk weighting on delinquent loans for regulatory capital purposes. Currently, delinquent loans must be considered in the allowance for loan and lease loss analysis (under GAAP) and sufficient reserves must be set aside for these potential losses, an area that is highly scrutinized by regulators and auditors. By also increasing the amount of capital a bank must hold related to these past due loans, in essence banks are being required to double reserve for these assets. This seems a reactionary response to the recent economic events, does not represent a thoughtful, long-term approach to the situation and is not in the best interest of banks and the communities they serve. We believe this issue is best addressed through the allowance for loan and lease loss calculation and should not be double counted through increased regulatory capital requirements.

The standardized approach for risk-weighted assets proposal presents key challenges for community banks' mortgage and consumer lending operations and could inhibit their ability to lend. The proposed rules do not include a "grandfather" provision for loans currently in a bank's loan portfolio which creates an additional administrative burden and cost. As a result, banks will be required to examine old mortgage underwriting files to determine the appropriate category (category 1 or category 2) under which a residential mortgage loan should be classified. Basel III also proposes an increase in risk weightings for residential mortgage loans that in many cases is higher than other loan types that are traditionally considered more risky. In addition, the proposed rules do not recognize the bank's utilization of private mortgage insurance ("PMI") to mitigate credit losses. Mortgages are therefore subject to high risk weights even if PMI reduces the economic risk of loss on such loans.

Home equity lending is one of the few remaining consumer lending products that has not been dominated by non-bank entities. The standardized risk-weighted assets proposal assigns junior liens on residential property a risk weight range of 100 to 200 percent. If a bank holds two or more mortgages on the same property, the bank would be required to treat all mortgages on the property the same, most likely tainting the first lien position and causing it to also be classified as a category 2 exposure. By contrast, if one bank makes the first lien and a separate bank makes the junior lien, the first lien is not "tainted" by the existence of the second lien and may qualify for category 1 classification. We presently hold first and second lien positions (many with combined loan-to-value ratios below 60%) on many of our customer's primary residences, and believe a 100% risk weighting on combined first and second lien mortgage loans does not accurately assess the risks inherent in these loans. By holding the first and second lien position, we believe the bank is in a superior position to assess and appropriately manage any risks associated with these loans.

In conclusion, we believe Basel III was designed to apply to the largest, internationally active banks and not mutual community banks. Basel III already distinguishes and acknowledges different forms of institutions by excluding credit unions which have very similar capital

structures and operations as mutual non-stock banks, while not affording the same avenues to the capital markets as stock based institutions. Mutual community banks did not engage in the highly leveraged activities that severely depleted the capital levels of the largest banks and created panic in the financial markets. Higher and more complex capital requirements would mean less funding available for lending as well as less profitable loans, which could force mutual community banks to curtail lending or convert to stock based form of ownership and potentially eliminate the viability of this historically important and vital type of non-stock banking institution.

For the above mentioned reasons, we believe mutual community banks should not be subject to Basel III but rather allowed to continue using the current Basel I framework for computing their capital requirements.

NVE Bank appreciates the opportunity to comment on the Basel III Proposals. Please feel free to contact me at 201-816-2800 with any questions you might have regarding this letter.

Very truly yours,

Robert Rey
President/Chief Executive Officer
NVE Bank