October 21, 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
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Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation,
550 17th Street, N.W.
Washington, D.C. 20429

Re: Notices of Proposed Regulations Pertaining to the Regulatory Capital Framework

Ladies and Gentlemen:

Thank you for the opportunity to provide comment on the Notices of Proposed Regulations ("NPRs") related to the implementation of Basel III (Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, and Transition Provisions; and Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements. These NPRs were approved and published on June 7, 2012, by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (collectively the "Banking Agencies").

BankNewport ("BN" of the "Bank") is a 194-year old, $1.1 billion community bank based in Newport, Rhode Island and is regulated by the Federal Deposit Insurance Corporation. The Bank is 100 percent owned by OceanPoint Financial Partners MHC, a non-public financial holding company regulated by the Federal Reserve. The Bank offers a broad product line serving the banking needs of both businesses and consumers. Like all community banks, we pride ourselves in the crucial role we play in meeting the banking services and financial needs of our customers and the contribution we make supporting the economic vitality and development of the communities we serve.

We understand that the financial crisis took a heavy toll on the industry and the FDIC Insurance Fund, and the reverberations are still being felt today across the globe. We are very supportive of a strong and healthy banking system and recognize that the cost of widespread bank failures is borne, in significant part, by those banks that had the financial strength to survive the crisis. For that reason, we think it is appropriate to explore ways to strengthen the industry and ensure its resilience to future economic downturns. While we recognize strengthening the banking industry is the intent of the proposed capital regulations, we believe there is a persuasive case that the implementation of the regulations as proposed will have materially adverse side-effects and public policy implications that require serious reflection.

It is our belief that the complexity, burdens and unintended consequences of the proposed capital regulations will have a lasting and adverse impact on community banks, the customers we serve and the crucial role we play in our nation's economy. The NPRs will significantly complicate and potentially compromise risk management and financial performance industry-wide. Some of them even run counter-intuitive to comments we recently received in an annual safety and soundness examination. We respectfully request that the proposals be rethought to ensure they accomplish the dual objectives of strengthening the industry, while avoiding and/or minimizing detrimental unintended consequences.

Listed below are some of the areas that I find most troubling:

## UNREALIZED GAINS/LOSSES ON AFS SECURITIES

The most significant aspect of the proposed regulations that I believe has profound implications for the financial management of our bank is the inclusion of Accumulated Other Comprehensive Income, including in particular, unrealized gains and losses from available for sale ("AFS") investment securities, in the numerator of the regulatory capital ratio. This feature of the NPRs will distort traditional measures of capital adequacy, is directionally inconsistent with prudent interest rate risk ("IRR") management, will put Banking Agencies' supervisory responsibilities at odds with financial reality, results in significant regulatory capital ratio volatility, greatly diminishes the utility of the bond portfolio in IRR management, discourages on-balance sheet liquidity, is poorly timed given the current rate environment and will adversely impact the industry's performance and ability to attract capital.

- **Inclusion of AOCI in the Numerator**
  Passing unrealized gains and losses in a bank's investment portfolio through to regulatory capital and the numerator of the regulatory capital ratio distorts, rather than makes more accurate, an institution's capital position and capital adequacy. Conceptually, capital is a financial representation of enterprise value. By passing a valuation adjustment from just one small quadrant of one half of the balance sheet through to capital, the proposed regulation ignores the off-setting valuation adjustments given a change in interest rates from the loan, deposit and borrowing portfolios of the bank. For our bank, the loan, deposit and borrowing portfolios are collectively seven times the size of the investment portfolio (loans, deposits and borrowings totaled $1.8 million, while the bank's investment portfolio totaled $261.5 million at September 30, 2012). By omitting these much more sizable and collectively off-setting components of the balance sheet, the proposed construction of regulatory capital distorts enterprise value. The practical consequence will be that regulatory capital will be either overstated in a falling rate environment, or understated in a rising rate environment. This treatment moves regulatory capital and the regulatory capital ratio farther away from, rather than closer to, a reliable representation of enterprise value and capital adequacy.

- **Directionally Inconsistent with Prudent IRR Management**
  The Bank is currently "asset" sensitive to changes in interest rates. As a consequence, we temper our natural balance sheet IRR positioning by having a bond portfolio structured "longer" than our loan portfolio, which reduces asset sensitivity and the volatility of our earnings. Mitigating IRR is an appropriate goal for both management and the regulatory agencies. Given our "natural" balance sheet positioning, inclusion of unrealized gains and losses from our AFS portfolio in the definition of regulatory capital creates outcomes that are directionally inconsistent with our IRR model and contrary to sound financial logic.

To give you an indication of such an impact, I will provide you some details from our latest IRR model. As noted, we are asset sensitive. When rates rise, the model value of our financial assets fall (**$74.5 million** given a 300 basis point rate shock), but the value of our financial liabilities fall even more (**$86.3 million**), resulting in an improvement in Economic Value of Equity (**$11.8 million**).

Of the $74.5 million drop in value of financial assets, **$18.7 million** is attributable to investments. By only including this amount in regulatory capital, it would appear that the Bank's capital is deteriorating even though economic value of equity had actually improved by **$11.8 million.**

- **Supervisory Responsibilities will be at Odds with Financial Reality**
  A rising rate environment is favorable to our Bank both from an Economic Value of Equity and earnings perspective. As is commonly understood, the current low rate environment is challenging for the banking industry since it results in compressed margins, diminished earning power and subpar financial performance. A rising rate environment would benefit the majority of institutions in the banking industry. The problem is that adoption of the proposed regulation, which would result in a significant reduction in the industry's regulatory capital position and regulatory capital ratios in the event of rising rates, would indicate just the opposite. This will put the regulatory agencies in the position of potentially pursuing supervisory and enforcement actions against institutions based upon deteriorating regulatory capital ratios, when their financial health and performance is actually improving, which makes no sense.

  The other factor complicating the Banking Agencies' supervisory responsibilities is that the decline in value of a bank's bond portfolio, which would be a driver of inadequate regulatory capital and therefore potential regulatory action, will be temporary. As the bonds the institution holds approach maturity, their valuation approaches par, first diminishing and then eliminating altogether the decline in value that was purely a creature of rising rates. With the passage of time, bond valuations would improve and regulatory capital ratios would recover. Therefore, it is quite possible that a regulator will be faced with taking supervisory or enforcement action against an institution for what amounts to a recognized temporary capital adequacy shortfall.

- **Introduces Significant Capital Ratio Volatility**
  By passing temporary changes to the valuation of the investment portfolio through to regulatory capital, the proposed regulation creates significant volatility in an institution's regulatory capital ratios. Using a hypothetical $100 million bank, even a relatively modestly positioned bond portfolio with a duration of three would subject the bank to 184 basis points of capital ratio volatility from a 300 basis points ("bps") change in rates

- **Undermines the Utility of Investments for IRR Management Purposes:**
  A community bank's investment portfolio is its most important IRR management tool. A bond portfolio is the right tool for IRR management because it is highly liquid, easily understood, can be repositioned relatively easily, contributes to earnings, supports liquidity, can be pledged as collateral for borrowings and is a risk based capital efficient asset class. By introducing an artificial construct that results in significant capital ratio volatility tied to the bond portfolio, bank management will be compelled to diminish the role of investments for IRR management

purposes, with wide ranging and adverse consequences in other key risk management areas of the bank.

IRR management is currently a point of emphasis by the regulators (and rightly so), which makes it illogical and counter-productive to take out of the hand of bank management the singularly most important tool available to mitigate the "natural" risk profile of the core components of the balance sheet (loans and deposits). I strongly recommend that the proposed regulation be revised to strike this harmful mechanism.

- **Discourages On-Balance Sheet Liquidity**
  The proposed capital regulation will likely have the impact of discouraging on-balance sheet liquidity across the industry. The regulation effectively imposes a "penalty" (through increased capital ratio volatility and a de facto Bond Portfolio Numerator Volatility Buffer) for holding more on-balance sheet liquidity. If the industry's strategy to reduce regulatory capital ratio volatility is to reduce the size of the investment portfolio or move holdings into held to maturity, then the effective impact of the proposed capital regulation is lower levels of on-balance sheet liquidity, which is undesirable from both the industry's and the regulatory agencies' perspectives.

- **The Regulation is Poorly Timed**
  Choosing this point in history, given record low interest rates and unprecedented (and unsustainable) monetary accommodation, to begin adjusting regulatory capital by changes in the valuation of investment securities is inadvisable. Given the unprecedented size of the Fed's balance sheet (> $3 trillion), the size of the national debt (> $16 trillion), the size of the federal budget deficit (> $1 trillion annually) and the unchartered territory of the Fed's monetary policy, there are a wide range of unpredictable future rate environments that could confront the industry. As an industry, we must and will manage that uncertainty and risk, but to institute an ill-advised, single asset class, mark to market into regulatory capital at this moment could have disastrous implications for the industry and FDIC Insurance Fund should the rate environment get out of control. We would assert that losing control of interest rates, given current extraordinary market conditions, is at least a "fat tail" event worth considering. Compounding the adverse (though in the case of higher quality instruments, temporary) impact of a significant rise in rates on portfolio valuations is the fact that investment portfolios are currently "oversized" by historical standards, which will only multiply the negative consequences for regulatory capital and regulatory capital ratios of a rise in interest rates.

## RISK WEIGHTING OF ASSETS

The first issue is the complexity and cost of regulatory compliance. There is a fair amount of supplemental data required to do these calculations in the regulatory model that is not currently gathered on call reports or in core systems. These cost increases will be disproportionately punitive to smaller banks.

The effective date of these changes, which are fully implemented on 1/1/2015, places a huge hurdle in front of institutions struggling to comply. January 1, 2015 is also the date when the new Common Equity to Risk Based Assets Requirement and the changes to the Tier 1 Capital to Risk Based Asset Requirement are fully phased in. Should the risk weight changes in the Standardized Approach NPR be imposed on community banks, they should be phased in gradually over time rather than all at once on 1/1/2015.

An example of a change in risk weights that needs more consideration is the fact that mortgage positions other than the first are automatically Category 2 if the institution does not control all the superior positions. The majority of first mortgages originated in this country are sold in the secondary market, meaning the institution taking any second mortgage position is likely to find that position classified as Category 2. Category 2 risk weights range from 100% to 200%.

Capital requirements under Total Risk Based Capital Minimums for well capital status on Category 2 positions would range from 10% to 20%. These capital requirements are commonly used as the denominator by institutions using loan pricing models to calculate ROEs (Risk Adjusted Return on Capital) on various kinds of loans in order to optimize the institution's use of its capital. Double the capital requirement and you cut the ROE (RAROC) in half. Doing so will cause the bank to take one of two actions. Many will stop offering the loan entirely. Others will raise interest rates and/or fees significantly to hit the ROE goal. Of course to the extent the bank is up against non-bank competitors not subject to the same capital standards, significant increases in rates to meet ROE goals will cause the bank to be non-competitive and to lose the loan.

It is a common practice in small business lending to take a second mortgage position on the entrepreneurs home as additional collateral. That position is typically unlimited and can run up to the full value of the home. It would be rare for the institution to hold all superior positions when taking the 2nd mortgage position to further collateralize a small business loan. As I interpret the proposed regulation, that would cause the unlimited Category 2 second mortgage position to have a 100% LTV and a 200% risk weight. And the regulation states that if any position of a loan is Category 2, the entire loan is category 2. It would appear that the Bank is being penalized for taking additional collateral on a small business loan by doubling the risk weight of the loan from 100% to 200%. Our Bank has not experienced higher losses as a result of taking additional collateral either. This provision in the Standardized Approach NPR may have a chilling effect on small business lending.

Of course, this second mortgage position issue leading to Category 2 designation also will have a negative effect on home equity lending. Institutions will be very reluctant to go beyond an 80% LTV in making home equity loans. I'm sure that is the intent of the proposal. However, the consequence will be to limit the consumer's ability to access home equity to deal with a child's college education expense, a medical emergency, the loss of a job, the desire to start a business, and all the other legitimate uses of home equity. Yes, there were some abuses with high LTV home equity lending but it does not seem logical that the alternative - an unsecured loan - to a consumer carries a 100% risk weight, while one backed by home equity would have a risk weight of 150% or 200%.

BankNewport has also provided 40-year amortization residential mortgage loans to new home buyers as means of creating home ownership. Changing this to a Category 2 loan would effectively end this program.

## ADVERSE AND UNINTENDED CONSEQUENCES:

There are aspects of the proposed regulation that we believe have the potential for adverse and unintended consequences, many of which were highlighted above.

- In order to minimize regulatory capital ratio volatility, the proposed regulation provides an incentive for community bank management:
  - To hold less, rather than more liquidity on its balance sheet increasing the bank's liquidity risk profile;
  - To move a greater proportion of its investment portfolio into held to maturity reducing liquidity and financial flexibility;
  - To hold shorter and lower duration investments hampering earnings and capital formation;
  - To hold shorter and lower duration investments accentuating asset sensitivity and increasing the bank's interest rate risk profile;
  - To hold shorter and lower duration investments, essentially favoring regulatory risk over IRR, liquidity, earnings and capital formation;
  - To explore the use of derivatives as an alternative tool to manage interest rate risk, which most community banks are not likely equipped to do well or prudently on a large scale.

- In order to minimize the adverse impact of the proposed changes to asset risk weightings on risk based capital ratios, community bank management will likely be incented:
  - To reduce or eliminate HELOC lending, which will be adverse for the housing recovery;
  - To reduce or eliminate higher LTV lending, having an adverse impact on low down payment/high LTV borrowers just at the time when the Fed is trying to help households refinance into lower costing loans;
  - To reduce the availability and pricing of residential finance, which will be adverse for the housing recovery and bank profitability, and diminish the quantity of collateral for FHLB borrowings elevating liquidity risk across the industry;
  - Discourage taking residential collateral as an "abundance of caution" for otherwise credit-worthy borrowers, potentially increasing credit risk to the bank and loan pricing to its customers;

**CONCLUSION:**

On its face, the proposed regulation isn't a dramatic or inadvisable change to regulatory capital ratio minimums. Ostensibly, it appears to not raise capital ratio requirements at all. But in reality, given the changes to the construction and composition of the numerator and risk weighted denominator, the practical impact of the proposed regulation is a de facto substantial increase in risk based capital requirements. Based upon my preliminary estimates for BankNewport, the practical effect of the proposed capital regulation is approximately 300 bps (100 bps due to changes to asset risk weightings, 150 bps due to the volatility resulting from the inclusion in the numerator of unrealized gains and losses from available for sale investments and 50 bps from the proposed Capital Conservation Buffer, which extends above well capitalized minimums). This would require BankNewport to consider raising capital from outside investors (not our intent) or radically restructure the balance sheet and the traditional community bank business model that has been working for us for almost 200 years. Was that really the intent of this proposal?

Respectfully submitted,
Gregory Derderian, CPA
Executive Vice-President, Chief Financial Officer