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October 22, 2012

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

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

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

Heads of the Agencies:

The management of Flushing Financial Corporation understands the challenging role that financial service industry regulators have been given by both the U.S. Congress and the Basel Committees to enact both the specific requirements of the Wall Street Reform and Consumer Protection Act and the guidance issued from the Basel III accord. We also appreciate the need for strong capital requirements for all banks and thrifts. In an effort to support these regulatory initiatives and provide constructive feedback on the proposed changes to capital calculations, we respectfully submit our comments on the first two notices of proposed rulemaking (NPR), titled *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, and Transition Provisions* and *Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements.*

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Financial Corporation

Mortgage Lending

Our main concern is the requirement for 1-to-4 family Adjustable Rate Mortgage ("ARM") loans to have at least a 2% adjustment cap and contain at least a 6% lifetime cap to avoid the less favorable category "Two" treatment for risk based capital ("RBC"). Although well intentioned, this stipulation would have immediate negative consequences for a significant number of community banks. In many cases, banks offered a substantially below market initial interest rate to the borrower in exchange for the borrower accepting the future risk of rising interest rates. This was a common banking practice for over 30 years. The proposal would now encourage the origination of loans that shift most of the risk of rising interest rates away from the borrower and on to the lender. The requirement also does not differentiate between different types of ARMs. For example, a 2% adjustment cap is reasonable for a 1 year ARM but it significantly increases the lenders exposure for ARMs that have longer adjustment periods. In addition to increasing future interest rate risk from adding caps, many banks would suffer an immediate reduction of their RBC ratio based on their existing loan portfolio. This reduction in the RBC ratio will cause these banks to decrease their lending which will reduce economic activity. Changing the risk-weighting for loans that have already been priced and originated will result in devaluing these loans and subsequently devaluing the equity of the note holders just as lenders are starting to recover from the effects of a severe economic downturn.

Background on Value of ARM loans

ARM loans have traditionally been used by three very different types of borrowers. First are the borrowers beginning their working career. These borrowers will earn higher incomes in the future that will enable them to afford a higher loan payment if rates rise. The lower starting interest rates enable these borrowers to buy a home, build equity and take advantage of the related tax deductions. Other borrowers who use ARMs are people who don't intend to live in a property for more than a few years. Some borrowers are planning to downsize, others are planning to buy a larger house, while others may be considering a move to a different geographic location. All of these borrowers can take advantage of the lower initial rates offered on ARMs since they do not intend to occupy their property for the full amortization term of the loan. Finally there are short to medium term investors looking to buy and sell a rental property. All of these ARM borrowers are able to get a lower interest rate for a limited period of time, which suits their needs, while their lenders are able to offset a portion of the associated interest rate risk.

Major Points Submitted for Your Consideration

The reason suggested for requiring more capital for these ARM loans is that a prolonged rise in interest rates may cause some ARM borrowers to have difficulty making their payments (i.e. increase credit risk). However, if this happens the lender can chose to either restructure the loan or look to the underlying collateral for recovery, or the borrower could sell the property. Alternatively interest rate caps on every ARM loan can dramatically decrease earnings in a rising interest rate environment. Adjustment caps will force banks to rely more on derivatives for protection. Derivatives require sophisticated valuation and monitoring and expose the banks to "basis" risk. This added expense will ultimately have to be passed on to the borrower in the form of either higher rates or fees, or less ARM types to choose from. Borrowers who would normally be able to obtain loans with 5 year adjustment periods will most likely

have to settle for 1 year adjustment periods. This will cause many borrowers to either forgo purchases/refinances or pay a much higher rate for a fixed rate mortgage. Both choices will hurt lenders who will then either lose business or have to sell or hedge the fixed rate mortgage. Either choice will curtail the type of 1-to-4 family ARM lending that many lenders are currently doing at a time when the real estate market is just beginning to improve.

As previously mentioned, another significant problem is the effect the proposal would have on the existing ARM loans that do not have the required interest rate caps. Many lenders are currently holding these loans which would now decrease in market value due to their negative impact on the note holders RBC ratio. This destruction of value could be very substantial. Therefore, at the very least, existing ARM loans should be exempt from the requirements. This is fair and appropriate since lenders structured and priced these loans under the existing rules. However, based on the current proposed rule changes, the lenders will experience a significant reduction in their RBC ratio as well as the ARM's market value even though the loans were prudently underwritten and designed to lower a lenders interest rate risk.

The NPR also presents other problems for lenders that have existing loans with balloon payments, loans underwritten as "limited documentation" loans or variable rate Home Equity Lines of Credit that are tied to an index such as the Prime Rate. An exemption should also be provided for these existing loans which were priced under the current rules. Not providing exemptions for existing loans may have the unintended consequence of immediately reducing the loans' market value. Here again the future effect of the NPR would be either to increase the difficulty for lenders in managing interest rate risk (no balloon payments or variable rate loans), or decrease loan options for borrowers (only full documentation programs would be offered). The ultimate impact would be decreased availability of real estate financing during a weak economic environment.

We respectfully urge you to consider these factors and ideally revise the proposal by removing these requirements for loans to be eligible for category 1 treatment. At the very least, existing loans that are ARMs without interest rate caps, have a balloon payment, are limited documentation loans, or variable rate Home Equity Lines of Credit, should be Grandfathered for Category 1 treatment.

Trust Preferred

The value of Trust Preferred securities to small and medium sized banks (banks under $15 billion in assets) and their holding companies was recognized under section 171 of the Dodd-Frank Act. This section contains favorable Grandfather provisions for allowing Tier 1 capital treatment for certain existing Trust Preferred securities. Small and medium sized banks/holding companies do not have the same ability to raise equity in the capital markets as easy as larger banks/holding companies. The hybrid attributes of Trust Preferred securities are a valuable source of capital that enables small and medium sized community banks to more cost-effectively compete with larger banks. If small and medium size banking institutions have to replace this form of capital with common equity, they will suffer an increase in expenses and a dilution to existing shareholders. Furthermore the change in capital treatment will do little to increase overall safety and soundness. However, the added expenses will indirectly restrain small and medium size community banks from fulfilling their fundamental mission of providing competitive interest rates on loans and deposits to their communities.

Including Unrealized Gains and Losses on Available for Sale Securities in RBC

The NPR requires inclusion of unrealized gains and losses for securities categorized as Available for Sale ("AFS") in regulatory capital as a method for adjusting for the change in market values. This element of the NPR will also have a major negative impact on banks. First there will be increased volatility of capital ratios as fluctuations in AFS securities prices will now be included in the capital calculations. Second, there will be a loss of liquidity to banks that classify securities as Held to Maturity to avoid the increased capital volatility. Third, capital will be lowered by price changes due to interest rate movements in securities that have little to no credit risk such as U.S. government sponsored securities. This last item suggests that it is the intent of this element of the NPR to mitigate interest rate risk. A more effective way to manage interest rate risk is by measuring changes in a banks economic value of equity and income through shock tests and simulations. Shock tests and simulations include all assets and liabilities not just a bank's investment portfolio. If bank management or regulators determine based on the simulations that interest rate risk is too high, the bank can use a variety of methods to mitigate it rather than just deleverage to improve capital ratios. However, the NPR would re-price a portion of the asset side of the balance sheet and ignore the liability side of the balance sheet. Unrealized changes in the market value of investments by itself does not reflect the financial health of a bank since those assets correspond to liabilities. To recap, there will be unintended consequences of capital volatility, decreased liquidity and inefficient capital adjustments for interest rate risk if unrealized gains and losses on AFS securities are included in capital.

Unfunded Pension Liabilities for Defined Benefit Plans

The NPR would require banks/holding companies to deduct unfunded pension plan liabilities from their regulatory capital. Unfunded liabilities will change as interest rates and the associated cash flow assumptions fluctuate over time. Therefore deducting unfunded pension liabilities may add volatility to the capital ratios. Also, subtracting the liabilities from capital does not mitigate the FDIC's exposure in the event of a bank failure since these liabilities are subordinate to the FDIC's claims on assets. In addition the unfunded liability is already recognized in the financial statements, providing full transparency to investors. Therefore the current treatment of non-inclusion of under or over funding of pension liabilities continues to be the most reasonable approach for capital calculation purposes.

Summary

To summarize, every prudent banker recognizes the need for strong capital levels and the importance of linking capital levels to the risks taken. However, if these NPRs are implemented in their current form they will:

- Significantly decrease the value of existing bank assets and inappropriately reduce existing capital;
- Limit loan options for borrowers and increase their borrowing costs with little ancillary benefit to them;
- Increase interest rate risk for banks;
- Penalize banks for reasonable capital deployment decisions made under the existing rules;
- Limit product innovation;
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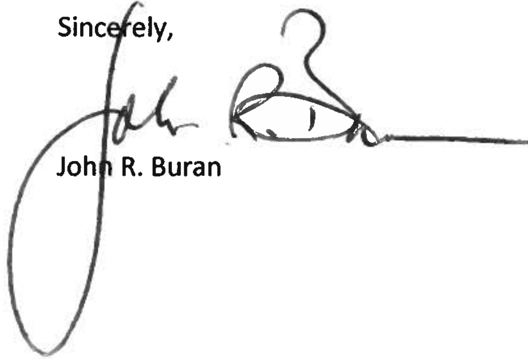
- Lead to an overall reduction in Bank lending which would negatively impact an already weak U.S. economy.

Thank you very much for your time and consideration of our concerns.

Sincerely,



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