

October 22, 2012

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

Jennifer J. Johnson, Secretary  
Board of Governors of the Federal Reserve  
System  
20<sup>th</sup> 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, D.C. 20219

Re: Basel III Capital Proposals

Dear Sir or Madam:

Thank you for the opportunity to provide comment on the Basel III proposals that were recently approved by the Federal Reserve Board, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation (collectively the "banking agencies").

Fremont Bancorporation and its wholly owned subsidiary Fremont Bank (together the "Bank") is a full service financial institution, which has served the Greater San Francisco Bay Area for nearly 50 years. At September 30, 2012 the Bank had \$2.5 billion of assets, of which \$1.6 billion were evenly split between residential and commercial loans to individuals, real estate investors and small businesses. The Bank funds its assets with \$2.1 billion of deposits from the communities that it operates in. The Bank also has a significant residential origination and servicing operation, which will originate and sell \$7 billion of residential loans this year, mostly on a servicing retained basis, and services \$8.2 billion of mostly residential loans for others. The Bank currently employs 850 people.

The Bank's ownership is closely held and it converted to an S-Corporation income tax structure in 2005, which limits it to 100 shareholders. Accordingly, its access to capital is limited and any significant changes to the capital regulations can have a substantial effect on the Bank's business model and its ability to continue to serve its communities.

Following are our concerns with the proposed capital rules:

**Deduction of Mortgage Servicing Assets that Exceed 10% of Common Equity Tier 1 Capital and risk weighting the allowable asset 250%**

Originating and servicing residential mortgages for individuals in our community has been a key business for the Bank for nearly 50 years and which it has made substantial investment in to service our customer's mortgage loans accurately and efficiently. The servicing fees earned by the Bank are a significant and stable source of income. Furthermore, the loan servicing relationship the Bank establishes with its customers is key to developing other business relationships for deposit, investment and wealth management services and business loans.

The value of MSR's created at the time of loan origination is a critical component of the Bank's mortgage model. The Bank has stepped in to retain servicing rights when others have withdrawn helping to maintain demand. This demand creates better overall pricing which is passed down to consumers in terms of lower financing costs. The proposal to limit MSR's in the Bank's capital will create a higher cost model which the consumer will ultimately bear.

The Bank accounts for and values its mortgage servicing rights ("MSR") in a conservative manner. However, even in the current low interest rate cycle, when valuations are at the low point, our capitalized servicing asset is approaching the 10% of Common Equity Tier 1 ("CET1") threshold.

With the significant increase in capital requirements for MSR's under the proposal (17% to 28%) the Bank may be forced to limit, reduce or sell its long standing and very essential mortgage loan servicing business.

The Bank recommends that the proposed Basel III limits on MSR's and the revised risk weighting not be adopted. However, if the banking agencies deem it important to move forward with a proposal to limit MSR's in an institution's regulatory capital, the Bank recommends the impact be reduced through the following recommendations:

- Increase the cap to 25% of CET1
- create a more favorable limitation for government and agency servicing than for private label servicing
- eliminate the existing and proposed valuation haircut of 10%
- existing MSR's should be grandfathered from the proposed rules

**Phase out of Trust Preferred Securities as Capital Instruments**

The Bank has Trust Preferred Securities ("TPS") in its capital structure. Qualifying TPS that comply with the Federal Reserve's requirements, were an available, cost-effective, long-term source of capital for financial institutions and should have a place with reasonable limits in Tier 1 capital. The proposal to phase out TPS is inconsistent with the intent of the Collins amendment to the Dodd-Frank Act. As a closely held S-Corporation with limited access to capital, the proposed phase out of TPS will have a significant negative effect on the Bank's ability to continue to provide competitive home mortgages to individuals and loans to investors and small businesses in its communities. Under the Bank's tax structure, the capital cannot easily be replaced with outside capital. Under the proposal to phase out

TPS, the Bank will most likely need to reduce assets which will have a negative effect on its communities.

The Bank recommends that the proposed rule be revised to fully recognize the intent of the Collins amendment by permanently grandfathering outstanding TPS for institutions between \$500 million and \$15 billion.

#### **Requiring Unrealized Gains and Losses on Available for Sale Securities to flow through CET1**

The Bank's security portfolio is a significant source of liquidity. The Bank generally limits investments to government agency and government sponsored enterprises ("GSE") guaranteed mortgage backed securities and other high grade fixed income investments. It manages its securities portfolio for liquidity and income as opposed to gains and losses from trading and so it generally holds investments to maturity. However, the accounting classification is generally available for sale ("AFS") to preserve the liquidity benefit. The Bank believes that the proposal would introduce substantial volatility into regulatory capital due to changes in interest rates. In addition when interest rates rise, the current unrealized gain in the portfolio could reverse to a loss and result in a significant reduction in capital just at a time when there is a higher demand for credit in its communities. Under the existing proposal, the Bank will either reduce its securities portfolio, which would result in a reduction of earnings, or be forced to carry an extra capital cushion to avoid the volatility.

The Bank recommends that the proposed rule be revised so that unrealized gains and losses on AFS securities that reside in accumulated other comprehensive income do not flow through to regulatory capital. If the agencies are determined to require unrealized gains and losses to flow through capital, we suggest that unrealized gains and losses that predominantly result from changes in interest rates should be carved out. This approach would exclude from regulatory capital unrealized gains and losses resulting from such low credit risk securities as U.S. government and agency debt obligations and U.S. GSE debt obligations. Alternatively, community banks (assets \$10 billion and under), with their limited access to capital, should be exempted from the proposed changes or allowed 6 months to 1 year to adjust to any related reduction in capital.

#### **Increase in the Risk Weighted Asset Amount for Residential Mortgages**

New methodologies are proposed to classify residential mortgages and risk weight residential mortgages that are heavily dependent on data. The new methodologies apply to new and existing mortgages. The specific underwriting data that is required to classify existing mortgages will be very difficult and burdensome to obtain and costly. Also, given the increase in capital that could be required for existing category 2 mortgages, the retroactive impact of the proposed treatment would be especially harsh. Furthermore, the Bank already analyzes the risk of collectability on all of its loans and establishes appropriate reserves for the expected losses. Therefore the requirement for an additional capital allocation based on higher risk weightings is duplicative.

The Bank recommends that the proposed risk weightings for residential loans not be adopted. If the agencies are determined to increase risk weightings on residential mortgages, the Bank recommends

any final rule should grandfather all existing mortgages by assigning risk weights required under the current risk weighting standards.

The proposal provides that if the Bank holds two or more mortgage loans on the same residential property, and one of the loans is Category 2, then the Bank would be required to treat all of the loans on the property as Category 2. This treatment is inconsistent with the actual risk profile of these loans. A junior lien extended by the Bank does not necessarily increase the risk of the exposure. And why would the risk be any different if the same bank extends both loans as opposed to two independent institutions? The Bank often provides home equity loans to its borrowers that have a first mortgage. Since it has already underwritten and qualified the borrower for the first mortgage, the underwriting process for the home equity loan is very cost effective. However, under the proposal, the Bank would be reluctant to extend a home equity loan or line of credit to an existing first mortgage borrower because making such loans could cause our Category 1 first mortgages with low risk-weights to shift to Category 2 mortgages with substantially higher risk-weights.

The Bank recommends that the first lien and junior lien mortgages be evaluated independently, based on the different risks of each, and not aggregated into a single loan for risk-weight purposes when made by the same institution. The terms of a junior lien should not cause the senior lien on the same property to fall into Category 2.

#### **Credit Enhancing Representations and Warranties**

Under the proposal, credit enhancing representations and warranties on assets sold or otherwise transferred to third parties, including cases of early default clauses or premium-refund clauses, would require the Bank to treat such an arrangement as an off-balance sheet guarantee and apply a 100 percent credit conversion factor to the exposure amount. The proposal is overly harsh because it applies a broad, one-size-fits-all approach to an off-balance sheet exposure that is already covered by reserves on the balance sheet. The Bank will originate and sell \$7 billion of loans this year and it will have only a handful of loans returned under a premium refund clause. Additionally, the proposal appears to do away with a valuable exclusion that aids regulatory and capital efficiency. Provisions such as the early default protection generally expire within 120 days and are currently not subject to risk based capital requirements under the "safe harbor". However, this safe harbor does not appear in the proposal. Requiring the Bank to hold capital against this temporary exposure at a credit conversion factor of 100% of the loans sold during a significant volume period would absorb a substantial amount of the Bank's capital and place it below the current minimum capital standards.

The Bank recommends continuing the existing 120 days "safe harbor" for credit enhancing representations and warranties and removing the application of the credit conversion factor. Regulators can then perform periodic reviews of the adequacy of the reserves and reserve process as part of the Bank's annual examination. This approach will provide a more accurate and nuanced picture of the Bank's exposure in this area rather than using the blunt instrument contained in the proposed credit conversion factor.

## Summary

The cumulative effect of the above proposals and the general increase in the minimum capital requirements above the current well-capitalized prompt corrective action standards will have a significant impact on the Bank and the communities which it serves and most community banks in this Country. As we have tried to demonstrate in this letter, changes to capital requirements have real world consequences which can include higher prices for consumers, fewer choices for consumers, and a lower availability of credit. These changes can also force banks to actively manage their balance sheets by selling assets, shrinking in size, and reducing their ability to meet the financial needs of the communities they serve. And while we have tried to tailor our comments in this letter to the specific operating parameters of our institution, the Basel III proposal in total presents general, overarching areas of concern where the full extent and nature of potential negative consequences remains very real, but unknown.

I strongly urge you to consider these impacts and the recommendations made here and in other comment letters you receive from the industry.

Sincerely,



cc: The Honorable Dianne Feinstein  
The Honorable Mike Honda  
The Honorable Pete Stark  
Mr. Paul Fung, Assistant Deputy Commissioner, CADFI