OC12-245

October 5, 2012

The Honorable Ben S. Bernanke
Chairman
Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20429

The Honorable Thomas J. Curry
Comptroller of the Currency
Office of the Comptroller of the Currency
250 E Street, SW
Washington, DC 20219

The Honorable Martin J. Gruenberg
Acting Chairman
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Re: Implementation of Basel III – Regulatory Capital Proposals

Dear Chairman Bernanke, Acting Chairman Gruenberg and Comptroller Curry:

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").

Borrego Springs Bank (the "Bank") is a small community bank headquartered in La Mesa, California, a suburb of San Diego County. The Bank was formed in 1982 with its roots originally in the desert town of Borrego Springs. For the nearly 20 years, the Bank has narrowed its focus and has gained expertise in the area of small business lending, primarily utilizing government guarantee programs offered by the U.S. Small Business Administration ("SBA") and the U.S. Department of Agriculture ("USDA") to provide credit to small business owners. The Bank has ranked among the top SBA and USDA lenders nationwide for many years.

With approximately $125 million in assets, the Bank's SBA and USDA lending operations have provided in excess of $100 million per year in credit to small businesses, providing either working capital or financing for small business owners to purchase real estate for use by their businesses. The Bank's small business customers span the nation, with businesses located in 48 of the 50 states.

We are supportive of the review of current capital standards and the effort to ensure safety and soundness of all financial institutions, especially in light of recent economic events. However, it appears that Basel III, in its current form, would have unintended consequences for small business lenders such as the Bank.

Of specific concern under the proposed rule is that, in general, the Bank would be required to deduct from its Tier 1 Capital 100% of all nonmortgage servicing assets and all mortgage servicing assets that exceed 10% of such capital. In addition, the mortgage servicing asset

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balance below the 10% threshold would receive a 100% risk weight, which would eventually increase to 250% over time.

Under the SBA's 7(a) program and the USDA's B&I program, which generally provide a 75%-85% guarantee from the respective government agency, after funding the loan for the small business client, the Bank typically sells the guaranteed portion of the loan on the secondary market. All such sales are consummated on a "servicing retained basis", requiring the Bank to hold the rights and obligations of servicing the loan over its life. The Bank continues to hold the unguaranteed portion of the loan on its books and maintains the ongoing relationship with the small business owner.

SBA guidelines require lenders to retain a minimum of 100 basis points of the future loan interest (and the Bank's USDA loan sales are typically structured to retain 50 basis points) as a "servicing fee" as compensation for servicing the guaranteed portion of the loan. Under the accounting guidelines of Accounting Standards Codification 860, "Transfers and Servicing" ("ASC 860"), the Bank is required to record a servicing asset related to the future cash flows associated with retaining such servicing.

ASC 860 also requires, in general, that the Bank record a discount against the retained, unguaranteed portion of the loan, in order that it also be recorded at fair value.

The servicing asset and the discount generally offset one another, and as each is amortized/accreted through the Bank's income statement using similar average life assumptions, the net effect to capital is fairly neutral over the life of the loan. Similarly, an early payoff or default on the loan would not result in a significant impact on capital, because the servicing asset and discount remaining on the books at that time would offset each other when written off.

This is in sharp contrast to mortgage servicing assets created by large consumer mortgage originators/servicers because they do not typically retain any portion of the loans they sell, which means they do not record an offsetting discount. As a result, prepayment or default can have a significant negative impact to the consumer mortgage servicers' capital.

The treatment of mortgage servicing assets in the calculation of capital under the proposed Basel III framework, if implemented, would result in the reduction of the Bank's Tier 1 capital by 16.9%, as shown below:

(estimate as of June 30, 2012)	**Pre-BASEL III**	**Post-BASEL III**
Common, Surplus and Retained Earnings	14,106,000	14,106,000
Unrealized Gain (Loss) on AFS Securities	-	-
	14,106,000	14,106,000
Excess Servicing Asset Adjustment	-	(2,388,000)
Common Equity Tier 1 Capital	14,106,000	11,718,000
Capital lost as a result of Basel III		16.9%

The Bank's Tier 1 Capital to Risk-weighted Assets and Total Capital to Risk-weighted Assets Ratios would also be reduced significantly as a result of the implementation of BASEL III in its current form.

Such decreases in capital could result in the Bank being deemed less than well-capitalized, which would have significant negative ramifications on the Bank's ability to continue to do business. A 16.9% reduction in capital would likely equate, at a minimum, to a decrease of $16.9 million per year in related small business loan fundings.

According to SBA data, every $1 million lent out under the SBA's programs creates or saves 33 jobs. A $16.9 million reduction in lending could, therefore, result in approximately 558 fewer jobs being created or saved by small businesses, which are critical to the nation's economic recovery.

While the intent of Basel III appears to be to strengthen the financial industry, it appears that an unintended consequence of the language is punitive to small business owners and the banks that lend to them. The ASC 860 accounting guidance builds in "protection" to a bank's capital in the form of a discount on retained, unguaranteed portions of loans that offsets the risk of a servicing asset write-off resulting from prepayment or default; as such, it would seem that the new, proposed limitations to capital related to SBA servicing assets is unnecessary and unwarranted.

We strongly urge you to consider the adverse impact of these proposed Basel III requirements and ask that small business lenders and/or community banks under a certain size be exempt from these requirements.

We appreciate your consideration of this matter.

Sincerely,

William P. Ruhlman, II
President/Chief Executive Officer

cc: Senators Johnson and Shelby, Senate Committee on Banking
Senators Landrieu and Snow, Senate Committee on Small Business
Representatives Bachus and Frank, House Committee on Financial Services
Representatives Graves and Velasquez, House Committee on Small Business
Hugh Carney, American Bankers' Association