October 1, 2012

Senator Max Baucus
Senator Jon Tester
Representative Dennis Rehberg
Consumer Finance Protection Bureau
Federal Deposit Insurance Corporation
United States Treasury
Federal Reserve Corporation

Dear Sirs/Madams:

I recently visited your office as a member of the Montana Bankers Association delegation. We talked about the impact upon community banks from the Basel III accord as well as the Dodd-Frank Act.

It is very difficult to divorce the impacts of Basel III and Dodd-Frank from one another because nobody really understands the combined impact of these complicated regulations yet. We believe it is very unwise to adopt regulations without knowing their impact, something most regulators we talked to during our visit admitted.

As of August 31, 2012, Manhattan Bank was a well capitalized bank with Tier 1 capital of 9.63%, Tier 2 capital of 10.43% and Tier 3 capital of 16.41%. Concurrently, we have excess liquidity since our investment portfolio has become oversized as loan demand remains weak. We also have a satisfactory CRA rating, something that these regulations could place at risk.

Given the historical low returns being generated by the investment portfolio at present, the value of the portfolio is exposed to large losses once interest rates begin climbing. We shocked the portfolio by 400 basis points to determine if we would still be well capitalized. This increase in interest rates would drop Tier 1 capital to 6.29%, Tier 2 capital to 7.07% and Tier 3 capital to 11.36%, still a well capitalized bank but with a much narrower margin.

Such a simple mathematical exercise is inadequate in light of the complexity of the impending impacts of Dodd-Frank and Basel III. For example, regulators are proposing that banks retain 5% of mortgages sold into the secondary market. The requirement to retain ownership in these assets, combined with normal loan growth once the economy begins to recover more, will result in asset growth in a probable area of around 10%. Combined with the investment portfolio

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devaluation, our Tier 3 capital would then drop to 10.80%, barely adequate to remain well capitalized. Should loan growth be higher, say 10% or more, Tier 3 capital could fall below 10% and we would fail to remain a well capitalized bank. I can foresee a couple of problematic issues as this scenario unfolds.

The first issue involves potentially running afoul of other regulations as we strive to maintain capital adequacy. The easiest issue to deal with from the standpoint of a community bank will be to change the designation of part or even all of the investment portfolio from 'available for sale' to 'held to maturity.' This act would help relieve capital pressure, but at the expense of liquidity. A thornier problem would potentially be running afoul of the Community Reinvestment Act. Although most of our loans would still be made to borrowers within our community, a smaller percentage of them will be to low and moderate income borrowers as expanded upon in the next paragraph. I have a sneaky suspicion that an overzealous examiner won't be too concerned that bank regulations themselves are a direct cause of this potential problem.

The second and most problematic issue arising from stressed capital levels is the availability of credit to low income consumers. Banks will have to begin rationing credit to only the most credit worthy and profitable borrowers in an effort to retain capital adequacy and profitability. Many, if not most, low income consumers won't make the cut. Fully 25% of the census tracts our bank serves are low and moderate income areas. We have a proud history of meeting the credit needs of these consumers at approval rates very similar to middle and upper income consumers. However, we have not historically had regulations making it illegal to meet the home improvement borrowing needs of these low and moderate income consumers because we could not document 100% of their income. We also haven't had regulations requiring us to allocate higher levels of capital to support their loans when the variability of their finances causes temporary setbacks which, in turn, result in higher risk weighting for those loans. Basel III and Dodd-Frank will not serve these people well.

There will hopefully be retained earnings going forward to bolster capital levels, but I hope you see the trend. Offsetting these hoped-for retained earnings will be other drags on earnings and demands for capital yet to be addressed. For example, Senator Durbin is making statements that bank interchange income needs to be cut further. The Consumer Finance Protection Bureau (CFPB) is striving to further reduce overdraft fee income while simultaneously adding incredible amounts of compliance expenses, particularly in the area of 1-4 family mortgages.

The banking industry has been requesting the definition of a 'qualified mortgage' which would define the terms/standards banks must meet to avoid retaining 5% ownership in mortgages, thereby retaining adequate capital. But the CFPB is not backing away from its preferred alternative of 'rebuttable presumption' which not only does not allow banks to sell 100% of a mortgage but which also gives regulators, consumers and class action attorneys the ability to sue banks years after a mortgage is made for alleged shortcomings in underwriting said mortgages.

During our visit with regulators last week, they asked for detailed, objective letters to support our requests of them. How in the world do you estimate the legal costs of defending mortgages you made 10 or 20 years earlier? Political moods in Washington D.C. and around America can be fickle so I think it would be naïve of lenders to assume their decisions will not be second-guessed by future politicians and regulators in the absence of a 'qualified mortgage.' The low

profit margins and increased capital demands of making mortgage loans will require banks to limit their potential liability from making these loans in any way possible. Since we almost have to continue making mortgages to meet the needs of our customers, I assume the bank response to these ill-conceived regulations will be to make only the highest quality mortgages, thereby limiting legal risk. Again, this will have the effect of making credit difficult and more expensive for low income consumers, the people the CFPB is purported to protect.

Most of the content of this letter has centered around capital adequacy. Profitability is quickly moving to the forefront of this matter as well. Ill-conceived regulation is already hurting this industry unnecessarily and has the potential to do much more harm. An example of this type of regulation is the Durbin Amendment to the Dodd-Frank Act. This was an arbitrary slap at banks by a populist politician and his greedy benefactors. The potential legal exposure to banks if the CFPB continues down the road of 'rebuttable presumption' will be huge. The trial lawyers of America must be gleefully hoping the CFPB sticks to that course.

Our direct compliance costs have increased by over 50% since the passage of the Dodd-Frank Act. When one considers that something over 4,000 pages of regulations have been written to date just to implement 30% of the act, only God knows how much more our compliance costs will grow. It seems that is has become politically unacceptable to be profitable. Just so regulators understand that along with decreased profits comes decreased capital growth and decreased lending capacity. We community banks simply don't have access to capital markets like the Washington D.C. establishment seems to think we do, so capital growth is almost always going to come from retained earnings. Of course, there is always the alternative of selling a bank but I have yet to witness a small community that is served as well by a large bank as it was by the community bank it acquired. Small businesses and lower income consumers have more difficulty meeting the more rigid policies of large banks than they do those of smaller community banks.

Some regulators such as Mr. Bernanke continue to suggest that community banks won't be subjected to all the provisions of Basel III. Others are quite succinct in stating their intentions to make the accord apply to all banks. I cannot believe American regulators are pawning this off on American banks in its present form. It puts the large American banks at a terrific competitive disadvantage to their European counterparts unless European regulators adopt the risk policies of American regulators. Sheila Bair pointed out in her article from the November 21, 2011, issue of *Fortune Magazine* that Basel II allows European banks to treat sovereign debt as having zero risk, thereby bolstering their nearly non-existent capital levels. I find it incredible that somebody would say Greek bonds have no risk. The KPMG booklet I read regarding Basel III claims the risk weighting aspects of Basel II remain unchanged in Basel III. Does it not bother our regulators to enter into an accord whereby our European competitors play by a different set of rules than we do?

Everybody recognizes that the Wall Street enterprises that are lumped into the same 'bank' category as us community banks needed to be reined in. The lack of ethics and the preponderance of greed there was and still is appalling. However, Congress used a shot gun to address the problem when it should have been addressed with a rifle. A rifle hits a small defined target without collateral damage to the target's surroundings. A shot gun hits a wide target, inflicting damage not only to the intended target but to the target's surroundings as well. We

community banks feel like Washington D.C. used a very powerful shot gun when aiming at Wall Street, inflicting more damage on community banks than upon Wall Street.

Small banks similar to ours used to be acquired at 2 times book value and even higher. In the wake of Basel III and Dodd-Frank , the value of small bank stock is pretty close to book value. Most of this decrease in value is attributable to the damaged profitability of small banks by the preponderance of ill-conceived regulation the past few years. If the goal for American community banks is to make more loans, do not continue to demand ever-increasing capital levels while simultaneously striving to eliminate our income sources. If the goal of American small banks is to meet the needs of all our community, do not adopt regulations making it more difficult to serve our low and moderate income clientele. Please take more time to consider the consequences of these proposed regulations and the harm they can inflict on low to moderate income consumers as well as community banks.

Thank you for taking the time to view our concerns. Please use your influence to direct the regulators to consider the needs of your low and moderate income constituency as well as those of community banks. Basel III and Dodd-Frank are harming both.

Sincerely,

Robert J. DeWit
President

Cc: Montana Bankers Association