



Yesterday, Today, Tomorrow... Since 1899

October 8, 2012

Jennifer J. Johnson, Secretary  
Board of Governors of the Fed 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

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

**RE: Basel III Capital Proposals**

Ladies and Gentleman:

I appreciate 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.

I am gravely concerned over the broad approach that has been taken to impose a "one-size-fits-all" regulatory capital scheme despite the fact that the industry believed Basel III proposals were intended for the very large, complex international institutions.

Our bank was founded in 1899 in Port Washington, Wisconsin. Port Washington State Bank is a family owned financial institution spanning five generations. We have 6 locations and have grown to \$425,000,000 in assets. We are a traditional community bank serving Ozaukee County, Wisconsin. We currently service over \$380,000,000 in mortgage loans. We are dedicated to the communities we serve and strive to be a leader in helping to improve each of our communities. One example of this is, is our involvement with Habitat for Humanity of Ozaukee County. We donated funds to help build a home as well allocated 2 days for employees and officers to help build the home.

We like most other community banks in our country want to make sure we are able to continue serving our communities in the way we have in the past. We believe the current proposed Basel III requirements excessively tightens regulatory capital requirements on community banks which is unwarranted, beyond Congressional intent in many respects and will likely cause a disruption in available credit in our market place.

I wish to remind the Agencies that, in addition to the proposed Basel III rules, there are currently at least ten major mortgage related rulemakings in various stages of development (HOEPA, MLO compensation, TILA/RESPA integration, two appraisal rules, ability-to-pay, risk retention, escrow requirements, and mortgage servicing rules under both TILA and RESPA). This, in turn, builds upon at least seven major final rulemakings in the previous 36 months (RESPA reform, HPML requirements, two MDIA implementation rules, appraisal reforms, appraisal guidelines, and MLO compensation).

I am very much concerned about the cumulative burden these rules will have on my institution. It is vitally important that the proposed regulatory capital rules be analyzed together in the context of other rulemakings and regulatory reforms—and be prospective in approach. The Agencies must not create capital requirements that are based upon occurrences in the past, under a different regulatory environment, and without consideration of other rulemakings and reforms.

For these reasons and for the concerns outlined below, the Agencies must withdraw the proposed regulatory capital rules, conduct additional study and analysis, and only propose capital rules which take into consideration the impact other regulatory proposals and reforms will have on risk. The Agencies must recognize that there are many differences between community banks and large, complex international institutions—and must, therefore, not force a community bank into the same capital calculation “peg-hole” as a sophisticated international institution.

If the Agencies do not withdraw the proposals to further study the drastic impact they will have on community banks and on the U.S. financial industry as a whole, I urge the Agencies to take into consideration the specific concerns and recommended changes noted below.

## Accumulated Other Comprehensive Income (AOCI)

As proposed, all unrealized gains and losses on available for sale securities (AFS) must “flow through” to common equity tier 1 capital. Therefore, if there is a change in the value of an AFS security (which can occur daily in some circumstances), that change must immediately be accounted for in regulatory capital. I wish to remind the Agencies that unrealized gains and losses occur in AFS portfolios primarily as a result of movements in interest rates—and *not* as a result of credit risk.

If the rules are finalized as proposed, with the inclusion of unrealized losses of AFS securities in common equity tier 1 capital, rising interest rates would put downward pressure on banking organizations’ capital levels. This will potentially cause my bank to reduce our growth or shrink our securities portfolios considerably in order to maintain capital ratios at the desired or required levels.

Additionally, as a community bank, we have been an investor in our local government entities. However, as proposed, the rules would discourage my bank from holding municipal securities, including holding U.S. Treasuries, because of the interest rate impact on such long-duration assets. This, in turn, could lead to a lower return on assets for my bank and less funding for the housing market and national and local governments, collectively.

Currently our bank has a \$133 million bond portfolio made up of primarily government backed agencies and municipal securities.. These investments have little, if any, risk of loss, but are subject to interest rate risk, which we manage very closely. At the present time we have an unrealized gain of approximately \$1.5 million. Shock testing our portfolio indicates that a 300 point increase in interest rates would create over a \$16 million change in the market value adjustment and dramatically decrease our capital under Basel III. A pro forma calculation under Basel III (as best as we can estimate and understand the proposal) we would have a Tier1 Risked Based Capital Ratio of 11.17%. After applying the rate shock and including the unrealized losses our Tier1 Risked Base Capital Ratio would decrease almost 5%. This adjustment to capital is made even though nothing changed other than the interest rate environment.

For these reasons, I greatly oppose this proposed treatment. The Agencies must remove this treatment from the proposals.

## Capital Risk-Weights for Residential Mortgages and Related Matters, High Volatility Commercial Real Estate (HVCRE), and Home-Equity Lines of Credit (HELOCs)

The Agencies' proposals place new significantly higher capital risk weights in several categories of real property-secured loans despite having neither empirical evidence to substantiate the need for such heightened capital levels, nor a mandate under law. The proposals raise several significant concerns, including the following.

### *Residential Mortgage Exposures Risk Weights*

The proposals assign risk weights to residential mortgage exposures based on whether the loan is a "traditional" mortgage (Category 1) or a "riskier" mortgage (Category 2) *and* the loan-to-value (LTV) ratio of the mortgage. The current risk weight for a real estate mortgage is generally 50%; however, depending upon the Category and LTV ratio of a particular residential mortgage, the capital risk could rise to 200%. These higher risk weights appear to be arbitrarily set as there is no empirical data presented by the Agencies to support this extraordinary increase in risk weights for certain types of mortgages.

Respectfully, I challenge the Agencies' assumption that a residential mortgage has a higher degree of risk based exclusively upon the loan having a balloon payment, an adjustable rate, or an interest-only payment, to warrant the substantial increases in capital risk weights that are proposed. In fact, our portfolio of balloon loans, adjustable rate loans, or interest-only loans has experienced minimum losses. In 2010 and 2011 we had a default rate of .17% of our 1-4 family residential loans. The Agencies' proposed capital treatment far outweighs the reality of risk that we have experienced for these types of loans.

In addition, the substantial increase in risk weights will discourage my bank from making these types of loans even though we have experienced minimal losses. As a community bank, we make loans that are 3- or 5-year adjustable rate mortgages and balloon mortgages with payments amortized

Some loans that have been modified by Port Washington State Bank would not have qualified under the federal Home Affordable loan program. However we were still able to modify the loan with our borrowers that benefited both the borrower and the bank. This should not be considered Category 2 mortgage.

The Agencies must allow for the same capital treatment of restructuring or modification for any mortgage as they would permit a loan restructure or modification under HAMP.

### *Removal of PMI Recognition When Determining Loan LTV*

The bank's residential mortgage portfolio would also be negatively impacted by the proposed change in treatment of private mortgage insurance (PMI). The proposed rules do not recognize PMI when determining an LTV for a particular loan. Therefore, mortgages would be subject to high risk weights even if PMI reduced the risk of loss for such loans. It is difficult in today's challenging economy for borrowers to come up with 10% down payment, much less an amount higher than that, thus, PMI continues to be a product purchased to protect against repayment default risks. I recognize the concerns expressed by the Agencies within the proposed rules regarding less financially-sound PMI providers; however, where a bank can demonstrate that a particular PMI provider is financially sound, the bank should be permitted to recognize PMI when determining the particular loan's LTV ratio for capital risk weight purposes.

The Agencies' proposals must recognize that PMI reduces the risk of loss for such loans, and must, therefore, provide for the recognition of PMI when determining a loan's LTV ratio.

### *Capital Requirements for Loans with Credit-Enhancing Representations and Warranties*

Under the proposed rules, if a bank provides a credit-enhancing representation or warranty on assets it sold or otherwise transferred to third parties, the bank would be required to treat such an arrangement as an off-balance sheet guaranty and apply a 100% credit conversion factor to the transferred loans while the credit-enhancing representations and warranties are in place. This new requirement would affect any mortgage sold with a representation or warranty that contains (1) an early default clause, and/or (2) certain premium refund classes that cover assets guaranteed, in whole or in part, by the U.S. government or a government-sponsored entity. Currently, the risk-based capital charges do not apply to mortgages once they are sold to third parties, even where the seller provides representations and warranties to take back mortgages that experience a very early payment default—such as within 120-days of the sale of the mortgage.

The proposal would result in substantial additional capital charges for the mortgages we sell and will limit the amount of credit I can make available to potential borrowers. I believe there is little evidence that the temporary representations and warranties associated with these mortgages have resulted in significant losses for a regulated financial institution—even during the financial crisis.

As a result, the Agencies must retain the 120-day safe harbor under the current risk weight rules and not impose this additional capital charge.

### *High Volatility Commercial Real Estate (HVCRE)*

As proposed, high volatility commercial real estate (HVCRE) is defined as acquisition, development and construction (ADC) commercial real estate loans except: (1) One- to four-family residential ADC loans; or (2) commercial real estate ADC loans in which: (a) applicable regulatory LTV requirements are met; (b) the borrower has contributed cash to the project of at least 15% of the real estate's "appraised as completed" value prior to the advancement of funds by the bank; and (c) the borrower-contributed capital is contractually required to remain in the project until the credit facility is

converted to permanent financing, sold or paid in full. Under the proposed standardized approach, each HVCRE loan in a bank's portfolio will be assigned a 150 percent risk weight.

While I recognize the fact that certain types of commercial real estate (CRE) lending may pose a higher risk given today's economic environment, the Agencies' proposals impose a higher risk weight without considering any of the following mitigating factors in connection with a particular transaction: LTV ratio; dollar amount of the loan; other commercial real estate assets of the borrower; any guaranty; or other general risk-mitigating factors of a particular CRE loan request. Just as these risk-mitigating factors are analyzed when we decide whether to approve or deny a particular CRE loan request, the Agencies must also take these mitigating factors into consideration when assigning a capital risk weight to a particular CRE.

If mitigating factors are not taken into consideration, the proposals would hinder our commercial real estate lending and negatively impact our community growth and well being. It would also put community banks at a competitive disadvantage with larger regional banks.

Therefore, the Agencies must revise their proposed HVCRE risk weight to take into consideration risk-mitigating factors.

### *Home-equity Lines of Credit (HELOCs)*

The proposal classifies all junior liens, such as home-equity lines of credit (HELOCs), as Category 2 exposures with risk weights ranging from 100 to 200%. In addition, a bank that holds two or more mortgages on the same property would be required to treat *all* the mortgages on the property—even the first lien mortgage—as Category 2 exposures. Thus, if a bank that made the first lien also makes the junior lien, the junior lien may “taint” the first lien thereby causing the first lien to be placed in Category 2, and resulting in a higher risk weight for the first lien. By contrast, if one bank makes the first lien and a different bank makes the junior lien, then the junior lien does not change the risk

weight of the first lien. There is one exception to this general treatment; however, that exception is very narrow and thus, most junior lien mortgages will likely be deemed Category 2 mortgages.

Again, this is another area within the proposals for which the Agencies have provided no data to support their assertion that all HELOCs are risky and warrant such severe treatment. In reality, HELOCs are carefully underwritten—based not only on the value of the home, but upon the borrower's creditworthiness and with some of the strongest LTV ratios.

Currently our bank has a \$15 million HELOC portfolio. The delinquency rate of this portfolio is .15% and our 3 year average historical loss rate is .11%. It will also be difficult and time consuming to track the different categories for proper risk weightings.

The Agencies must remove the treatment that all HELOCs are an automatic Category 2 classification.

### **No Grandfather Treatment for Existing Mortgage Loans**

Finally, the proposed rules do not include any type of grandfather provision. Thus, *all* mortgage loans currently on the bank's books will be subject to the new capital requirements. This will require bank staff to examine old mortgage underwriting files to determine the appropriate category and LTV ratio for each mortgage. This is a daunting task and comes at a time when the industry is also implementing numerous other *substantial* regulatory revisions and reforms previously mentioned. We simply do not have resources necessary to gather all of the information required to properly determine the revised risk weights for existing mortgage loans.

We currently have over 4,000 loans that we would need to examine to determine the appropriate category and LTV ratio for each mortgage.



The Agencies must grandfather all existing mortgage exposures by assigning them the current general capital risk-based weights.

## Conclusion

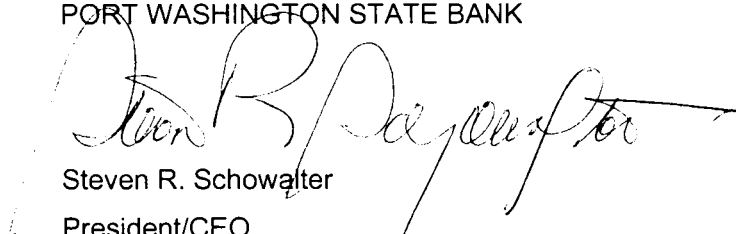
For the concerns outlined above, the Agencies must withdraw the proposed regulatory capital rules, conduct additional study and analysis, and only propose capital rules which take into consideration the impact other regulatory proposals and reforms have on risk.

The Agencies must recognize that there are many differences between community banks and large, complex international institutions—and must, therefore, not force a community bank into the same capital calculation “peg-hole” as a complex international institution.

I appreciate the opportunity to comment on the Agencies’ proposals.

Sincerely,

PORT WASHINGTON STATE BANK



Steven R. Schowalter  
President/CEO