Peoples
5 YEARS STATE BANK

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October 16, 2012

Mr. Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.,
Washington, DC 20429

RE: Regulatory Capital Rules: (1) Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Correction Act: RIN 3064-AD95; and (2) Standardized Approach for Risk-Weighted Assets, Market Discipline and Disclosure Requirements: RIN 3064-AD96

Dear Mr. Feldman:

Peoples State Bank ("Peoples") is a $700 million community bank headquartered in Wausau, Wisconsin which operates 8 locations in north central Wisconsin. As a community bank Director with Peoples, I am gravely concerned over the broad approach taken by the Federal Deposit Insurance Corporation (FDIC), together with the other banking regulatory bodies, (collectively, the Agencies) to impose a "one-size-fits-all" regulatory capital scheme despite the fact that the industry believed the Basel III proposals were intended for the very large, complex international institutions.

Respectfully, I believe this approach 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 marketplace.

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-repay, 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. These unwarranted cumulative regulatory burdens will increase expense, limit flexibility to service customers, raise loan interest rates, slow capital growth, and reduce local credit availability. 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 significant differences between community banks and large, complex international institutions—and must, therefore, not force a community bank into the same capital calculation 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 our most pressing 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, as there are changes in the value of an AFS security, 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, both actions hurting local credit availability. 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 or more expensive funding for the housing market and national and local governments, collectively.

If our net unrealized security gain was included in our June 30, 2012 regulatory capital calculations as proposed, our Tier 1 leverage ratio would have been approximately 9.75% versus the 9.45% reporting due to our current unrealized gain position. However, a quickly rising interest rate would cause our long-term fixed rate securities portfolio to increase in unrealized losses. At June 30, 2012, an instantaneous 300 basis point increase in market rates would have resulted in a total portfolio after tax unrealized loss of approximately $4.3 million. Assuming all other factors remained the same, our June 30, 2012 Tier 1 leverage ratio would drop in this scenario to 8.79% instead of the 9.45% reported even though nothing changed in our operation and no credit or principal losses would likely ever be realized. Such a change could create a need to raise expensive capital or curtail local loan growth from a factor that hasn't increased risk to our operation and occurs out of our control. For these reasons, I greatly oppose this proposed treatment. The Agencies must remove this treatment from the proposals.

Treatment of Trust Preferred Securities (TruPS)

The Agencies' treatment of trust preferred securities (TruPS) under the proposals must not be finalized as proposed. Presumably out of concern for such a debt instrument being treated as "capital", Congress, as part of the Dodd-Frank Act (DFA), prohibited any new issuances of TruPS; however, under the Collins amendment in DFA, TruPS are grandfathered for institutions between $500 million and $15 billion. Nonetheless, the Agencies' proposals ignore the Collins amendment by requiring a complete phase-out of TruPS beginning in 2013.

Many Wisconsin community banks hold TruPS as capital on their books. The proposed complete phase-out of TruPS creates a significant problem for community banks that are privately held, as they will have little access to capital. Investors in community banks are motivated by the growth opportunities such an investment affords rather than a desire to fill capital holes caused by changes in regulation.

Peoples, through its "one-bank" holding company, PSB Holdings, Inc., issued $7.5 million in TruPS as capital during 2005 and has used this capital to help support net organic local loan growth of $99 million since its issue. The TruPS represent a very low cost of capital, currently 1.03% over market funding costs on an after tax basis.

Replacement of this Tier 1 capital has two significant problems. First, we do not approach the capital markets for new equity funding, and local investors are reluctant to invest in capital instruments with uncertain cash flows (such as noncumulative preferred stock dividends). Therefore, there is no real market for us to acquire replacement Tier 1 capital at this time. Secondarily, credit spreads on new capital funding would be much higher than now paid on our TruPS, likely at least 7.00% on after tax basis for a noncumulative preferred stock issue. If the regulatory goal is to stabilize small bank capital, increasing their capital cost by nearly 7 times their existing cost by phasing out TruPS will not help.

I strenuously oppose the Agencies' treatment of TruPS beyond that which Congress intended under DFA. The Agencies must preserve the full intent of the Collins amendment to DFA by *permanently* grandfathering outstanding TruPS for institutions between $500 million and $15 billion.

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 first mortgages and home equity loans and lines of credit has experienced minimal losses with average net annual charge-offs of .33% during the three years ended December 31, 2011. 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 theses types of loans even though we have experienced minimal losses. Our primary residential mortgage loan production is fixed rate, long-term, secondary market qualifying mortgages that are sold to the FHLB or FNMA. However, as a community bank, we often make loans that are 3- or 5-year balloon mortgages with payments amortized over 30 years and retain these balloon loans on our balance sheet. Certain borrowers prefer these balloon loans due to lower closing costs than a secondary market long-term fixed rate loan due to small remaining principal, currently $88,000 per balloon mortgage outstanding at Peoples on average. In addition, certain properties in our rural markets cannot obtain "qualifying comparable appraisals" preventing the loan from being sold to the secondary market.

As the lender, we provide such loan products not only in order to offer loans to good borrowers but also to protect against the interest-rate risk in a 30 year fixed rate mortgage if held on our balance sheet. However, the new risk weights will discourage us from making such loans. For example, if we make a 5-year balloon loan with a LTV of 81-90%, the capital risk weight skyrockets from the current rule of 50% to 150% under the proposals. This type of treatment will detrimentally impact just how many loans I can offer my community and customers, will reduce or eliminate a traditional credit product that customers seek, and will also reduce our ability to protect against interest rate risk.

To minimize capital requirements and allow for competitive customer pricing, we would be forced to replace our traditional balloon mortgage product with an adjustable rate mortgage subject to rate movement caps and floors. While a Category 1 adjustable rate mortgage would allow an introductory fixed rate period (like a balloon term), subsequent years would continue a higher level of interest rate risk for our bank as significant market rate movements may not be fully reflected in the adjusted rate, increasing our risk to earnings and capital compared to holding our traditional balloon loan.

During the housing market crisis, our nation did see borrowers with balloon mortgages who were faced with foreclosure at the balloon date because the collateral value had declined significantly. As a community bank, Peoples, like every other community banker in Wisconsin that I know, would never start foreclosure action on a borrower in such a situation based solely on the balloon maturity date when payments were current. Our bank's practice for 50 years is to continue to roll the balloon loan to a new maturity date when borrowers are current on payments even if the collateral declined after loan origination. This is one large difference between how community banks and large international banks operate.

The Agencies must not finalize the proposed rules with such severe and unwarranted risk weighted treatment of residential mortgage exposures.

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. In the end, allowing a sound PMI provider to be used allows us to minimize the interest rate on loans to our first time buyers, and low to moderate income buyers, most of which cannot provide a 10% down payment.

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.

During the past three years, we have originated an average of $8 million of new residential mortgage loans sold to the secondary market each month. If a 100% credit conversion factor was applied to the 120 day early payment default representation period and we targeted a 12% total capital ratio, our capital needs would increase approximately $3.8 million, or over 5%, from our representation to the mortgage investor. Peoples has consistently been one of the top 2 residential mortgage originators in our market since 2000 and we have never been required to buyback a loan under the early default representation. This increased capital would be very costly when no real risk exists for our bank.

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.

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.

Our average net charge-off rate on HELOCs during the three years ended June 30, 2012 was just .37% of outstanding principal, similar to our average first mortgage residential mortgage loss rate of .21%. At Peoples, our HELOCs are conservatively underwritten and represent only incremental risk over our typical first mortgage loans held on our balance sheet. To also subject the related first mortgage to category 2 capital treatment if a HELOC exists further distorts the true capital need, increasing cost and interest rates for residential mortgage loan consumers.

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. The cost of compliance staffing is very high due to the specialized skill required. Based on our average new mortgage loan origination size, the wage and benefit cost for each new compliance staff would use up all the gross profit earned with approximately 70 new loan originations, or about 2 months of our "normalized" production outside of a refinance boom.

Secondarily, grandfather treatment will also cause mortgage rates to increase over what they could be as soon as the proposal is approved, even if the risk adjusted asset rules go into effect at a later date, because loans made today would be subject to those future rules.

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 significant differences between community banks and large, complex international institutions. Not only are our business models different (Main Street versus Wall Street), we do not have the size and scale to support the new fixed administrative costs that come with this proposed regulation and the growing regulatory burden industry wide. Regulation must not force a community bank into the same capital calculation and assumptions as a complex international institution. To do so will likely hurt credit availability for Main Street America and rural areas and could lead to elimination of community banking, further aggregating risk within large, complex banks considered too big to fail.

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

Sincerely,

Thomas A. Riiser
Director
Peoples State Bank