MEMBER F.D.I.C.
NODAWAY VALLEY BANK
SINCE 1868

October 9, 2012

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th 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
Attn: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

RE: Proposed Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Capital Ratios/Capital Adequacy (R-1442, Docket ID OCC-2012-0008, et seq.)

Ladies and Gentlemen:

Introduction and Background

On behalf of Nodaway Valley Bank ("NVB"), we appreciate the opportunity to comment on the above-referenced joint notice of proposed rulemaking released on June 7, 2012 by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (collectively, "the Agencies"). We respectfully request that the Agencies reconsider the proposed rules due to the detrimental impact they will undoubtedly have on NVB and countless community banks around the country, the communities and markets they serve, and community bank customers of all types.

NVB is a $780 million community bank in northwest Missouri that has dependably served its communities and surrounding areas since 1868 with branch locations in St. Joseph, Maryville, Savannah, and Mound City, Missouri. NVB's customers primarily consist of working families and farmers, small business owners, and localized/regional commercial businesses and industry. Throughout its near 150 year existence, NVB has remained locally owned and operated and serves as a major employer within its region with nearly 200 employees. NVB maintains a strong record of charitable giving and civic investment that benefits its communities as a whole. Ownership and staff live with and among NVB customers, therefore, a mutual desire for stability and growth within the region persists. As a community bank with an unusually long

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history, NVB has a positive record of delivering traditional banking services that include innovative products and services afforded through continuous investment in "the business", coupled with the advancement of local and regional economies NVB cultivates through its investment/bond portfolio purchases.

Throughout its history, NVB has maintained abundant capital to support its customers and community related endeavors in a prudent manner (and intends to continue). However, due to the Agencies' proposed capital rules, NVB's ability to operate effectively, fully support its customer base, and invest in its communities as described herein are placed at significant risk. Like virtually all community banks, NVB did not (and will not) engage in the highly leveraged and extraordinarily risky activities of the mega banks that formed the impetus for the "great recession" from which our country continues to recover. Consequently, the Agencies' proposed capital rules are misguided as a "one size fits all" approach for community banks. Applied to NVB, the proposed rules are particularly harmful to its: (1) investment/bond portfolio as a capital and liquidity source, (2) reliance on trust preferred securities for capital supply, (3) ability to offer a full array of loan products to creditworthy borrowers in a cost-effective manner to NVB *and* its customers, and (4) capacity to responsibly distribute dividends to its shareholders as a Sub-Chapter S corp bank.

1)Investment/Bond Portfolio - Including AOCI in Regulatory Capital

NVB is not unique among community banks in that the impact of Basel III would leave it no choice but to radically alter its investment portfolio purchases. The effect of removing the Accumulated Other Comprehensive Income (AOCI) filter from capital ratios, effectively requiring banks to mark to market their available for sale (AFS) securities is unnecessary, imprudent, and unusually penal for community banks.

The current makeup of assets in NVB's investment portfolio is emblematic of its historically conservative philosophy. Our investment portfolio presently contains roughly $111 million in assets of which approximately 70% are government backed agencies. These assets have little to no risk of loss but they are not immune to interest rate risk. At the present time under Basel I capital standards, NVB's Tier One capital is 12.2%, well above the well-capitalized threshold of 6.0%. If, however, Basel III capital standards were imposed and interest rates were to increase 300 basis points, our Tier One capital would drop to 8.3%, due at least in part to a $15 million plus market value adjustment to our investment portfolio.

Depending on the circumstances and interest rate movements, Basel III may force NVB to shrink its investment portfolio at any given time to boost its Tier One capital and subject NVB to heightened liquidity risk in the process. Since NVB's track record of conservative investment philosophy has served it and its customer base well, to partially eliminate a reliable source of funding seems illogical if not unfair. The Basel III consequences would be especially harmful to NVB because it typically holds its securities to maturity.

A fundamental benefit to the current Basel I standards is that they do <u>not</u> overstate the impact of short term market movements on the bank's capital as it relates to a significant portion of the investment portfolio. Basel III, on the other hand, does just that and would force banks to evaluate portfolio acquisitions based on interest rate risk far more than credit risk, all in an effort to minimize the impact of unrealized gains and losses from short term interest rate fluctuations. This scenario prevents banks from holding securities of good asset quality closer to maturity when an unrealized loss may convert to an unrealized gain over time (such as securities that took a hit when the recession hit in 2007 but recovered by 2010). Additionally, Basel III will limit the number, class, and quality of securities that NVB can purchase, creating the secondary effect of hurting communities within our markets that rely on banks to purchase municipal and other local government securities. Conversely, the flexibility of holding AFS securities under Basel I irrespective of any Tier One capital impact enables community banks to consistently buy long term municipal bonds, which buttresses the infrastructure and capital improvement needs of local governments while preventing increased rates in the municipal debt market.

For these and other reasons related to the community bank realm as a whole, we urge the Agencies to stick with the current Basel I capital standards that govern the investment portfolio.

2)<u>Proposed Phase-Out of Trust Preferred Securities – Tier One Capital Ratio</u>

We respectfully request that the proposed ten (10) year phase out of trust preferred capital from Tier One to Tier Two status be withdrawn. To do otherwise would turn the Collins Amendment of Dodd Frank - i.e. federal legislation signed into law by President Obama that includes trust preferreds in Tier One capital for banking companies under $15 billion in assets ("Dodd Frank") – on its head. Passed only two years ago in July 2010, Dodd-Frank intended to protect and preserve community banks' utilization of trust preferred securities for capital purposes over the long term. We believe it would be fundamentally unjust and detrimental to quickly reverse course when we committed to growth and expansion using trust preferred securities like many other community banks when the current capital rules were enacted and later upheld by Dodd Frank/Collins Amendment for banks our size.

NVB relied on the capital standards governing trust preferreds when it acquired The Heritage Bank of St. Joseph in 2003. The Heritage acquisition, which increased NVB's asset size from $350 million to $525 million, could not have occurred without the inclusion of trust preferred securities in Tier One capital. As a result of an increased customer base, expanded trade territory, enhanced efficiencies, and increased earnings realized from the Heritage acquisition, NVB has grown even further since 2003 to its current size of approximately $780 million in assets. Customers have recognized the strength and quality that NVB provides, as evidenced by the increased market share NVB has consistently achieved in St. Joseph since the Heritage acquisition.

The negative impact to customers cannot be overstated if trust preferreds are no longer included in Tier One capital. Along with community banks impacted by more restricted capital standards, NVB may be forced to restrict lending activity. If NVB's balance sheet must be reduced to remain well capitalized, reduced lending would also constrain NVB's legal lending limit, threatening our ability to feed large lines of strong asset quality and potentially forcing us to pass on large loans that exceed our lending limit. Ultimately, only the mega banks may benefit as smaller banking organizations either cannot compete due to capital constraints or, even worse, fall by the wayside. Collectively, these developments obviously would be unfavorable not only to NVB customers, but customers of all community banks holding trust preferreds. This strong possibility is not aided by the present climate, a time when credit is already too difficult to obtain in various parts of the country according to many consumer protection organizations. Bottom line, the scenario would be a tough pill to swallow for all community bank stakeholders – e.g. customers, community banks, regulators, etc. – at a time when the economic recovery struggles to achieve sustained traction.

We believe Congress and President Obama got it right when they agreed upon the Collins Amendment to Dodd Frank that permits banks under $15 billion assets to include trust preferreds in their Tier One capital ratios. We urge the Agencies to retain that standard.

3)Loan Portfolio – Risk Weights/Residential Mortgage Lending/Delinquent Loans

1-4 Family Residential Mortgages and Home Equity Loans

The proposed risk weights to the loan portfolio will impair residential lending in general, hamstring the housing recovery, and saddle the overall economy. Whether the result of increased borrowing rates to account for higher capital requirements or restricted credit access for creditworthy borrowers (or a combination of the two), home loan borrowers will likely be the biggest losers. The number of residential loans that will qualify for preferred treatment – and be excluded from the proposed risk weights – are small enough that community banks' ability to offer comprehensive residential lending services may be too costly to sustain.

The risk weightings for residential loans will further deplete capital if community banks hope to maintain their current portfolio levels. Loans of 80% loan-to-value (LTV) ratios or higher are so disproportionately risk-weighted that many community banks could not justify allocating the necessary capital to stay in the home loan business. While all residential loan customers may suffer from higher rates (to account for the hit to capital), one or more classes of borrowers may be penalized more than others. For example, young families and other young consumers in the market for their first or second homes – a class of borrowers more commonly in the 80% LTV range based on their limited earnings history – will likely suffer more from higher rates and restricted access to credit. And that says nothing about the large portfolios of residential loans at lower LTVs that require additional capital allocation, all of which increases the cost to underwrite loans to the detriment of all consumers.

Community banks will also have difficulty underwriting loans for those customers who may not qualify under the more stringent underwriting requirements flowing from Dodd Frank and other regulatory requirements recently adopted. Currently, it is not uncommon for customers to qualify for a short term ARM or balloon product that enables them to establish a positive record of performance and build additional equity to later qualify for a long term fixed rate loan on the secondary market. Under the proposed risk weights, however, community banks will be far less likely to offer such products to qualifying customers due to the associated strain on capital. Customers with income levels sufficient to buy a home who are in the process of establishing credit or rehabilitating their credit due to a past downgrade will likely have nowhere to turn.

The adverse consequences and challenges to basic residential lending practices posed by the proposed risk weights will present the same problems for home equity loans. While NVB's home equity portfolio is not significant, the negative impact to community banks in general is significant.

Delinquent Loans

We believe that the proposed assignment of risk-weights to past due loans is yet another unnecessary measure with needlessly harmful consequences. We feel that this risk can continue to be effectively managed through astute and conservative administration of the allowance for loan loss reserve ("LLR") under current rules. Otherwise, it creates the scenario of punishing community banks with plentiful LLR levels with a decrease in capital. The compounding effect of such an outcome is unreasonable and excessive.

Applied to NVB, a bank with an outstanding record in terms of loan loss, we find the proposed risk weights to be puzzling if not troubling based on our recent examination history. Over the past ten years, regulators have pushed us to reduce our contributions to LLR. However, NVB utilized a more conservative approach by consistently funding its LLR at higher levels to account for the risk the struggling economy posed to our loan portfolio. Reconciling the negative impact to capital posed by the proposed risk weights for delinquent loans with the regulatory push for a lower LLR is, at best, a mixed message, and, at worst, an inequitable outcome for NVB.

4)Subchapter S Banks

The distribution prohibitions and capital conservation buffers appear to prevent Subchapter S banks from making necessary distributions to shareholders in amounts equal to their respective income tax liabilities. The shareholders of Nodaway Valley Bancshares, Inc. ("Bancshares") – the holding company of NVB, its sole asset – rely on dividends from Bancshares to pay their individual tax liabilities on earned income.

To ensure that Subchapter S banks like ours do not run afoul of the Internal Revenue Code, these provisions within the proposed capital rules should be reexamined.

Conclusion

Please remember that the original intent of Basel III is to safeguard against the mismanagement of the international mega banks of abnormally large asset size, not community banks. In that vein, it should come as no surprise that Basel III makes for numerous problems that would pointlessly challenge community banks' ability to operate while impacting customers in a negative fashion on many levels. The impact to community banks toward the smaller end of the "asset spectrum" may be so destructive that banks of that size will be forced to close. Nobody wins if that occurs.

Recent federal regulator comments outline the dangers of Basel III perhaps better than anyone. Former President of The Federal Reserve Bank of Kansas City ("KC Fed") and current

FDIC Vice Chair Tom Hoenig had this to say at The American Banker Regulatory Symposium in Washington, D.C. on September 14, 2012:

> "I believe the Committee should agree to delay implementation and revisit the proposal. Absent that, the United States should not implement Basel III, but reject the Basel approach to capital and go back to the basics."

Mr. Hoenig's successor at the KC Fed, Esther George, expressed similar concerns in her September 28, 2012 speech at the Financial Stability Institute – China Banking Regulatory Commission Regional Policy Forum on Financial Stability and Macroprudential Supervision in Beijing, China:

> "A second reason for altering our supervisory approach is that we risk adding complexity to financial regulation without increasing the effectiveness of our supervision. The Basel capital requirements are emblematic of this with the estimation and calibration of thousands of parameters – all of which are likely to be based on a limited range of past samples and cycles."

Thank you for considering our request that community banks remain exempt from the many travails and pitfalls of Basel III.

Respectfully submitted,

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President & CEO

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Respectfully submitted,

R. Cort Hegarty
Senior Executive Vice President/COO