# MESABA BANCSHARES, INC.

American Bank
MEMBER FDIC

THE LAKE BANK
MEMBER FDIC

October 19, 2012

Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
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Washington, D.C. 20429
**Delivered via email to:** comments@FDIC.gov

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551
**Delivered via email to:** regs.comments@federalreserve.gov

Re: Basel III Capital Proposals

Ladies and Gentlemen:

Thank you for the extended opportunity to comment on the Basel III Notices of Proposed Rulemaking that were issued by the agencies for public comment in June 2012.

Mesaba Bancshares, Inc. is made up of two separate community bank charters located in northeastern Minnesota: American Bank of the North and The Lake Bank. American Bank has $600 million in assets and serves small communities located along Minnesota's Iron Range. Its market area extends 110 miles along the rural Highway 169 corridor from Grand Rapids (population 10,869) through Calumet (population 367), Nashwauk (population 983), Hibbing ( population 16,361), Chisholm (population 4,976), Mountain Iron (population 2,869), Cook (population 574), Orr (population 249), and Biwabik (population 969). The Lake Bank has $100 million in assets and serves the Two Harbors (population 3,745) and Silver Bay (population 1,887) communities located on the north shore of Lake Superior north of Duluth, MN. Both banks have a focus on small business and residential mortgage lending. American Bank has 192 employees and The Lake Bank has 31 employees. We are two community banks run by community bankers who have a solid understanding of and a strong stake in the small communities we serve.

After considering how the proposed rules will affect our two community banks, I respectfully submit the following comments:

**Capital Conservation Buffer**

Under the proposed rules, banks that do not maintain the full capital conservation buffer will be subject to restrictions on capital distributions and on the payment of executive compensation. Existing regulations are in place that require banks to obtain approval to pay dividends over a certain percentage of recent earnings, and formal and informal agreements between troubled banks and their regulators also further control the dividend activities of these institutions. The proposed capital conservation buffer is not necessary to further regulate dividends. Further, troubled banks have restrictions on executive compensation under the golden parachute payment restrictions of Part 359. Additional one-size-fits-all restrictions will likely make it more difficult to attract and retain quality executives, especially in down times when a bank would especially benefit from strong management.

Of additional concern is that the proposed rules do not exclude Subchapter-S tax distributions to shareholders from the capital conservation buffer restrictions. A bank that is an S-Corporation does not pay its taxes directly; it generally makes tax distributions to its shareholders to fund their respective tax liabilities relating to the bank's business. This proposed rule potentially restricts a bank from making tax distributions to its S-Corp shareholders, which can have an impact on the bank's ability to maintain this advantageous tax status, and/or may make it difficult for Subchapter-S banks to attract shareholders. This is detrimental to community banks like ours who have limited sources of capital.

The agencies should reconsider the inclusion of the capital conservation buffer, particularly as it relates to community banks and S-corporations. It seems as though proper avenues for restricting dividends and executive compensation are already in place, and that these decisions are best left to the regulators on a case-by-case basis.

**Inclusion of AOCI in Regulatory Capital**

The proposed inclusion of accumulated other comprehensive income (AOCI) on available –for-sale (AFS) debt securities in the calculation of Common Equity Tier 1 Capital (CET1) is of great concern. Both of our banks have very simple balance sheets, and in this period of low loan demand each bank now has 15 to 20 percent of total assets invested in liquid US Treasury and Agencies bonds. As the economy improves and loan demand resumes we will be able to sell these liquid bonds and reinvest the funds in loans to small businesses in our local communities.

As a community bank with limited sources of capital we cannot afford to have AOCI on AFS debt securities affect our regulatory capital ratios. Should this proposal pass we will have two options: 1) reclassify all debt securities to held to maturity (HTM) or 2) sell the portfolio. Reclassifying the portfolio to HTM is not an option as it would take the liquidity out of the portfolio and not allow us to reinvest those funds in local loans as loan demand improves. Selling our current portfolio would leave us with excess cash from local core deposits that would still require capital but earn almost nothing when netting FDIC insurance premiums from the 25 basis points currently earned on excess cash left at the Federal Reserve or from similar fed fund sold options.

Another problem that this section of the proposal creates relates to public deposits. As stated above, we simply cannot afford the risk of having swings in AOCI run through regulatory capital. However, we do use debt securities to collateralize a good portion of the $75 million in local public deposits that we service. We currently have two options to collateralize these deposits: pledging of government bonds and Federal Home Loan Bank Letters of Credit. We would still be able to utilize FHLB LOCs to collateralize public deposits, however this comes at a cost of 12.5 basis points, and the letters of credit utilize our primary source of secondary liquidity. While we could use the public deposits themselves to secure the LOCs, the majority of the deposits are non-maturing, therefore timing and liquidity issues will no doubt arise making this an unrealistic solution. Therefore, the inclusion of AOCI in regulatory capital would limit our ability to accept and service the deposits of our local cities, counties, townships and school districts.

**Phase-Out of Deferred Tax Assets from Tier 1 Capital Eligibility**

Both American Bank and The Lake Bank have deferred tax assets (DTAs) arising from net operating loss carryforwards (NOL CFs). Under the proposed rulemaking, these portions of each bank's DTA will be excluded from CET1. The Lake Bank's NOL CF arose in 2002 and 2003 when the bank was under a cease and desist order. The bank was sold in 2004 and due to IRS Section 382 only $117,000 of the NOL CF can be utilized each year, meaning that this carryforward asset will be on the books through 2022, not necessarily due to an inability to utilize the asset, but due to IRS limitations on its use. The proposed rules would eliminate this valuable asset from capital, even though its use is only slowed by an IRS rule applied at the time of the purchase of the bank.

Also, under current regulatory accounting rules and US Generally Accepted Accounting Principals (GAAP) we are required to review our DTAs and assess whether a valuation allowance should be established against them. Further, under current regulatory capital rules, each quarter we must assess the amount of the DTA that can be utilized in the next twelve months and disallow the rest of the asset for regulatory capital purposes. This treatment is more restrictive than that allowed by GAAP. While this requires judgment on our part, both our external auditors and our regulatory examiners affirm our judgment annually.

The IRS allows net operating loss carryforwards to be utilized for 20 years, making DTAs arising from NOL CFs quite valuable. Under the current regulatory capital rules they are already disallowed to the extent that they cannot be utilized within the next 12 months. This combined with the review of both external auditors and regulatory examiners makes the inclusion of these assets in regulatory capital appropriate, therefore the limitation proposed in the new rules is not appropriate.

**Limitation on Inclusion of Allowance for Loan and Lease Losses in Regulatory Capital**

I was quite surprised to see that the arbitrary 1.25 percent limitation on the inclusion of the bank's Allowance for Loan and Lease Losses (ALLL) was not removed as part of this proposal. We are prudently maintaining ALLLs of 4.15 percent of total risk weighted assets (TRWAs) (3.87 percent of total loans) at American Bank and 3.87 percent of TRWA (2.25 percent of total loans) at The Lake Bank. This high level of ALLL is not due to an attempt to manage earnings in times of low credit losses by over-reserving, as was a factor in originally implementing the limitation. Our high reserves are due to a regimented, realistic analysis of the quality of our loan portfolio, which is affirmed over and over again by our external auditors and regulatory examiners. This limitation is no longer appropriate, even if the Basel III proposals are not implemented. If the proposals are implemented, this limitation is even more inappropriate as it results in a double counting of several risk elements on our balance sheets, including high LTVs, underwriting criteria, and past due status, as these elements will inherently cause us to increase our ALLL, plus will cause us to hold additional capital as their risk weightings will increase under the standardized approach.

I sincerely hope that the agencies will consider removing the 1.25 percent limitation on the inclusion of the bank's ALLL if the Basel III proposals are adopted. Even if the Basel III proposals are not adopted, I still sincerely hope that the agencies will consider removing this limitation from the existing capital rules.

**Phase Out of Trust Preferred Securities as a Tier 1 Capital Element**

The proposed rule phases out Trust Preferred Securities (TruPS) from inclusion in Tier 1 capital. This phase out is proposed even though the Collins Amendment in the Dodd-Frank Act grandfathers TruPS for banks between $500 million and $15 billion in assets. Current regulatory capital standards limit the inclusion of TruPS in Tier 1 capital to one third of core capital elements. Their inclusion in Tier 2 capital is further limited to 50 percent of Tier 1 capital, and total Tier 2 capital is also limited to total Tier 1 capital. I hope that the agencies consider these limitations that are already in place, coupled with the fact that Dodd-Frank grandfathered their inclusion for banks between $500 million and $15 billion, before implementing rules that phase them out from inclusion in regulatory capital.

**Revised Risk-Weighting on Residential Mortgage Exposures**

The proposed Standardized Approach for Risk Weighted Assets (Standardized Approach) divides mortgages into two categories, with Category 1 being seen as having less risk and therefore being assigned less risk-weight (35 to 100 percent) and Category 2 being seen as having higher risk and therefore being assigned a higher risk-weight (100 to 200 percent). Of great concern is that balloon features disqualify a mortgage loan from inclusion in Category 1. Small community banks like ours have used balloon features on residential mortgages as an interest rate risk management strategy. Using this strategy we are able to offer our customers long-term amortization on their home loans without utilizing non-core funding sources or entering into complex interest rate swaps or engaging in other derivative transactions to hedge the interest rate risk. In addition, the balloon feature gives us a chance to periodically review the credit and secure additional collateral if necessary. Additionally, if at renewal the credit is found to be stressed, the risk rating can then be adjusted and additional provisions can be made as appropriate, which would then reflect the additional risk of the loan in the bank's CET1.

American Bank currently has $87 million in residential balloon mortgages (approximately 1,000 loans) and The Lake Bank has $2.3 million in residential balloon mortgages (21 loans). It is of great importance that we be able to continue to offer these mortgage loans to our customers as often these customers will not qualify for a long-term fixed mortgage loan in the secondary market due to a lack of comparable home sales in our rural areas. Other factors that preclude our customers from securing secondary market financing is being self employed or purchasing a mobile or manufactured home, as is common in our rural market.

Balloon mortgages allow us to offer mortgage loans to our customers without compromising our interest rate sensitivity position, but if they will automatically require 100 percent capital for an otherwise low-risk instrument, and 150 or 200 percent for a loan with a LTV of over 80 percent, we will need to consider if we can continue to offer these loans to our customers. I hope the agencies consider the importance of balloon mortgages for rural community banks and their customers and either exempt community banks from this rule or eliminate the balloon loan exclusion from the category 1 definition.

**Loan to Value Measures in Establishing Risk Weighting**

The proposed Standardized Approach relies heavily on loan to value (LTV) for determining the risk weight of a residential mortgage. LTV is a measure of risk, and it is already included to some degree in the current regulatory capital rules where mortgages with high LTVs are not eligible for 50 percent risk weight. However, we make loans based on a variety of underwriting standards, and a high LTV does not necessarily justify a risk weighting of 150 or 200 percent. Under the proposed rule situations will no doubt arise where a loan to an otherwise strong borrower is assigned a higher risk weighting due to a high LTV on the loan, even if the borrower's debt to income, net worth, liquidity, and/or and credit history are exceptionally strong.

Of additional note is that under the proposal, Category 2 residential mortgages with a LTV of 80 to 90 percent receive a 150 percent risk weight, and those with LTVs over 90 percent receive a 200 percent risk weight. Our HELOC portfolios will fall into Category 2 and loans with a LTV of over 80 percent will be assigned a 150-200 percent risk weight. On the other hand, unsecured consumer loans receive a risk weight of 100 percent. It is hard to understand why a collateralized loan, even if the loan to value is high, would have double to risk weight of an unsecured loan. It seems as though an appropriate maximum risk weight for a loan secured by a residential mortgage is 100 percent, and I hope the agencies either exempt community banks from these rules or make this change.

**Record-Keeping Burden**

As a small banking organization with limited human resources, I appreciate that the agencies supplied a Basel III calculator to assist in analyzing the effect the proposed rulemaking would have on our two banks. However, it quickly became clear that we do not have the data available to analyze the true impact that the proposed Standardized Approach for Risk-Weighted Assets will have on our banks. As the proposal includes no grandfather provisions, should it become effective for community banks most of our real estate loan files (5,700 for American Bank and 480 for The Lake Bank) will need to be analyzed for appropriate market value. In addition to the LTV analysis, further analysis will need to be done on the residential mortgage underwriting to determine if the loan fits into Category 1 for residential mortgage exposure, and in-depth analysis will need to be done on ADC loans to determine the amount and type of capital the borrower contributed at closing to determine if a loan can be exempted from the 150 percent risk weight for HVCRE exposures. Also, our current core systems will need to be modified to track this data, and ongoing analysis will be necessary.

While the agencies believe that the LTV information should be readily available from the mortgage loan documents and thus should not present an issue for banking organizations in calculating the risk-based capital under the proposed requirements, by not including a grandfather clause for existing loans the gathering of this data on existing loans will in fact present an issue for community banks with limited human resources. Additionally, the analysis of underwriting and initial capital contribution will take a fair amount of time for each file. Assuming each loan file takes an average of ½ hour to analyze (which I believe is likely light), it would take a full time person working on nothing but this project over a year to complete the analysis necessary to determine an accurate risk-rating of our real estate loans under the proposed standardized approach for risk-weighted assets. Our limited staff is already stressed under the burden of significant regulatory changes brought about by Dodd-Frank and other recent regulations. Should the proposal be adopted I hope that the Agencies will either exempt community banks or include a grandfather clause for existing loans for both the mortgage and HVCRE loan provisions.

**Risk Weighting of Unfunded Loan Commitments**

The proposed Standardized Approach requires banks to apply a 20 percent risk weight to unfunded loan commitments with durations of one year or less. Currently these commitments receive a 0 percent risk weighting. We continually monitor our unfunded loan commitments to ensure we have capital and liquidity to fund these commitments. American Bank and The Lake Bank currently have $31 million and $2.3 million, respectively, in commitments with a duration of one year or less, and this proposal would require us to hold capital for 20 percent of them. Many of these commitments are to small businesses that rely on these lines for liquidity or support during seasonal or other cyclical times. We will need to consider our ability to make these lines available to small businesses if we need to hold capital on them, particularly on lines that are not often drawn on. One solution may be to apply a 0 percent risk weighting to any line that has a duration of less than one year and is under 5 percent of the bank's capital, though this approach would likely introduce further record keeping burden on banks. A better solution would be to continue to assign all unfunded commitments with a duration of one year or less a 0 percent risk weighting or exempt community banks from these rules.

**Risk Weighting of Credit-Enhancing Representations and Warranties for Mortgages Sold**

Perhaps the most alarming element of the proposed Standardized Approach is the 100 percent credit conversion factor (CCF) of assets subject to a "credit-enhancing representation or warranty". Under the proposed rule, "if a banking organization provides a credit-enhancing representation or warranty on assets it sold or otherwise transferred to third parties, including in cases of early default clauses or premium-refund clauses, the banking organization would treat such an arrangement as an off-balance sheet guarantee and apply a 100 percent CCF to the exposure amount". The NPR further states that "the proposed risk-based capital treatment for off-balance sheet items is consistent with section 165(k) of the Dodd-Frank Act which provides that, in the case of a bank holding company with $50 billion or more in total consolidated assets the computation of capital for purposes of meeting capital requirements shall take into account any off-balance-sheet activities of the company. The proposal complies with the requirements of section 165(k) of the Dodd-Frank Act by requiring a bank holding company to hold risk-based capital for its off-balance sheet exposures, as described in sections 31, 33, 34 and 35 of the proposal."

As part of the standardized correspondent agreements we have with our secondary market lenders we represent and warrant a multitude of items, all of which we believe to be in compliance with at the time we sell a loan. However, these standard representations and warrants also state that we will repurchase any mortgage loan sold where our representations and warrants become false, even upon the occurrence of subsequent events. Further, we may be required to repurchase a loan <u>at any time</u> based on the mortgagor or any third party's fraud or misrepresentation, regardless of our knowledge of that fraud or misrepresentation. In short, for the life of the loan we are at risk of needing to repurchase that loan. However, in the past 10 years American Bank and The Lake Bank have had to repurchase 5 and 1 loans, respectively. Considering that we have sold an estimated 2,000 and 700 loans, respectively, over that same time period, it is clear that these repurchases are rare. Further, of these 6 loans that we needed to repurchase in the past 10 years, we were able to correct and resell two of them, and three of them were due to disagreements on the eligibility of the collateral, whereby we simply booked those performing loans on our books as we, as discussed previously, do with other loans in our area that don't qualify for the secondary market due to non-conforming collateral. The final loan was due to the secondary market lender's not accepting our calculation of the self-employed borrower's income, and that loan, repurchased in 2003, is still a performing loan on our books that has never once been past due.

The proposed rule also states that a CCF shall be applied to exposures relating to premium-refund clauses. These clauses also exist in our standard correspondent agreements, and have a definitive 120 day time period associated with them. The proposed rule states that a 100 percent CCF should be applied to the exposure, which I would argue is the premium itself and not the loan amount, however this could be more clearly defined in the rule. It becomes a moot point, however, due to the issue discussed in the paragraph above, as the representation and warranties clauses also would require a return of service released premium paid. This means that under the proposed rule we would need to hold capital for our earned premiums for the life of each loan.

Both American Bank and The Lake Bank sell a considerable number and dollar amount of residential mortgage loans to the secondary market. By doing so we are able to provide our customers access to low, long-term fixed rate mortgages without taking the interest rate risk on our balance sheet. Alternatively we earn fee income by originating and selling these loans to the secondary market. American Bank and The Lake Bank sell an average of $26 million and $10 million in mortgage loans per year, respectively, to the secondary market. Aside from keeping the interest rate risk off our balance sheets, we simply don't have access to the capital needed to hold these loans on our balance sheets. Assuming an average mortgage loan life of 7 years, American Bank and The Lake Bank at any time respectively have an estimated $182 million and $70 million in existing mortgage loans out on the secondary market. A CCF of 100 percent on these off balance sheet liabilities would represent a 42 percent increase in current risk weighted assets for American Bank and an astounding 117 percent increase in current risk weighted assets for The Lake Bank. We simply do not have access to capital to cover what this rule is proposing.

Looking back on our 10-year history it is clear that we have minimal risk due to the representations and warranties that we make to our secondary market lenders. The proposed rule will effectively require us to hold capital for all loans sold to the secondary market, which as illustrated above is simply not possible. Another issue with this proposed rule is reporting - after we sell the loan we do not have knowledge of its outstanding balance. Secondary market loans are often re-sold, and current information systems would not allow us to measure our exposure. If the proposed rule is adopted we will need to exit the mortgage origination market and send our customers to the big-bank across the street who does have access to capital markets to raise capital to cover the exposure or to non-bank brokers who do not have these capital constraints. Not only would this result in a loss of substantial fee income for our banks, it will also likely result in a loss of core customers who switch their relationship to a big bank who is able to serve their mortgage needs. Further, as stated above we are unable to measure the amount of current exposure we have on loans sold to the secondary market in the past, and even if an estimate was made of that exposure we would not be able to raise capital to cover the substantial additional risk weighted assets this rule creates.

I hope that the agencies give serious consideration to the effect that this proposal will have on community banks. One solution would be to base the exposure on each bank's individual loss history, though this becomes a record keeping burden and the issue of information on existing balances loans sold not being available would still be an obstacle.. A better solution would be to follow suit with section 165(k) of the Dodd-Frank Act and exempt banks and holding companies with less than $50 billion or more in total consolidated assets from this requirement. I truly believe that without this exemption community banks will be forced to exit the residential mortgage origination business as they simply will not have the capital to participate. I further believe that the introduction of this rule as it relates to mortgages sold in the past will create a capital deficit for community banks that they will not be able to recover from.

**Conclusion**

As detailed above, the proposed rules will present a magnitude of problems for our two community banks, and for community banks like ours all around the country. If implemented, the proposed rule would likely:

- Add a challenge to attracting and retaining quality executive management,
- Make an IRS Subchapter-S election difficult,
- Force us to sell a majority of our bond portfolios,
- Make it difficult to accept/collateralize our local pubic deposits,
- Reduce current and future capital attributed to a valuable NOL carryforward assets,
- Double count several risk elements in our loan portfolio due the continuing 1.25 percent ALLL limitation,
- Force us to turn away customers who are seeking mortgages on non-conforming homes which are common in rural areas like ours,
- Put an unreasonable risk weight on mortgages that are secured by a second liens,
- Present an additional tremendous record keeping burden to our small staff which is already buried under the magnitude of regulatory changes that have materialized over the past few years,
- Force us to cut back on short term operating lines that our local small businesses depend on for seasonal or other cyclical liquidity needs,
- Force us to exit the mortgage origination market and send our customers to mega banks or non-banks for their residential mortgage needs.
- Create a capital deficit relating to loans previously sold to the secondary market that we simply could not recover from.

These proposed rules have the potential to put an end to community banking. The rules are one-size-fits-all, and will create capital rules that small community banks like ours don't have the resources to comply with, as well as capital deficits that community banks with limited access to capital won't be able to recover from. The best solution would be to exempt community banks from Basel III and the Standardized Approach to Risk-Weighting, and leave the regulation of community banks' capital in the hands of our individual regulators. If this solution is not chosen, further research and analysis on the risk to community banks must be performed by the agencies before final rules are implemented.

I appreciate the opportunity to comment. Thank you for your time and consideration.

Sincerely,

Christina Cavallin, CPA (inactive)
Investment Officer, American Bank of the North
Chief Financial Officer, The Lake Bank