TwoRiver COMMUNITY BANK
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October 11, 2012

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 2-3
Washington, DC 20219

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

**Re: Basel III Capital Proposals**

Ladies and Gentlemen:

Thank you for the opportunity to provide comment on the Basel III proposals[1] that were recently issued for public comment by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.

**Applicability of Basel III to Community Banks**

Community banks should be allowed to continue using the current Basel I framework for computing their capital requirements. Basel III was designed to apply to the largest, internationally active banks and not community banks. Community banks did not engage in the highly leveraged activities that severely depleted capital levels of the largest banks and created panic in the financial markets. Community banks operate on a relationship-based business model that is specifically designed to serve customers in their respective communities on a long-term basis. This model contributes to the success of community banks all over the United States through practical, common sense approaches to managing risk. The largest banks operate purely on transaction volume and pay little attention to the customer relationship. This difference in banking models demonstrates the need to place tougher capital standards exclusively on the largest banks to better manage the ability to absorb losses.

**Incorporating AOCI as Part of Regulatory Capital**

Inclusion of accumulated other comprehensive income (AOCI) in capital for community banks will result in increased volatility in regulatory capital balances and could rapidly deplete capital levels under certain economic conditions. AOCI, for our bank and most community banks, represents unrealized gains and losses on investment securities held available-for-sale. Because these securities are held at fair value, any gains or losses due to changes in interest rates are captured in the valuation. Recently, both short-term and long-term interest rates have fallen to historic lows generating unprecedented unrealized gains for most investment securities. Additionally, demand for many implicitly and explicitly government guaranteed

[1] The proposals are titled: *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, and Transition Provisions*; *Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements; and Regulatory Capital Rules: Advanced Approaches Risk-based Capital Rules; Market Risk Capital Rule.*

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securities has risen due to a flight to safety and government intervention in the capital markets. This increased demand has caused credit spreads to tighten further increasing bond valuations.
Interest rates have fallen to levels that are unsustainable long-term once an economic recovery accelerates. As interest rates rise, fair values will fall causing the balance of AOCI to decline and become negative. Under the proposed rules, this decline will have a direct, immediate impact on common equity, tier 1, and total capital as the unrealized losses will reduce capital balances. At our bank, for instance, if interest rates increased by 300 basis points, my bank's bond portfolio would show a paper loss of $5.2 million. This would mean that our bank's tier 1 ratio would drop by 80 basis points.

Large financial institutions have the ability to mitigate the risks of capital volatility by entering into qualifying hedge accounting relationships for financial accounting purposes with the use of interest rate derivatives like interest rate swap, option, and futures contracts. Community banks, such as ours, do not have the knowledge or expertise to engage in these transactions and manage their associated risks, costs, and barriers to entry. Allowing unrealized gains and losses on available for sale securities to flow through to regulatory capital would bring interest rate risk into the regulatory capital standards, greatly increase the volatility of community banks' capital ratios, and undermine prudent risk management. As such, we feel strongly that community banks should continue to exclude AOCI from capital measures as they are currently required to do today.

**Capital Conservation Buffers**
Implementation of the capital conservation buffers for community banks will be difficult to achieve under the proposal and therefore should not be implemented. Many community banks will need to build additional capital balances to meet the minimum capital requirements with the buffers in place. Community banks do not have ready access to capital that the larger banks have through the capital markets. The only true way for community banks to increase capital is through the accumulation of retained earnings over time. Due to the longevity of this exceptional low interest rate environment, our profitability has come under pressure further hampering our ability to grow capital. If the regulators are unwilling to exempt community banks from the capital conservation buffers, additional time should be allotted (at least five years beyond 2019) in order for those banks that need the additional capital to retain and accumulate earnings accordingly.

**New Risk Weights for 1-4 Family Residential Mortgages:**
The proposed risk weight framework under Basel III is too complicated and will be an onerous regulatory burden that will penalize community banks and jeopardize the housing recovery. Increasing the risk weights for residential balloon loans, interest-only loans, and second liens will penalize community banks who offer these loan products to their customers and deprive customers of many financing options for residential property. Additionally, higher risk weights for balloon loans will further penalize community banks for mitigating interest rate risk in their asset-liability management. Community banks will be forced to originate only 15 or 30 year mortgages with durations that will make their balance sheets more sensitive to changes in long-term interest rates. Many community banks will either exit the residential loan market entirely or only originate those loans that can be sold to a GSE. Second liens will either become more expensive for borrowers or disappear altogether as banks will choose not to allocate additional capital to these balance sheet exposures. Community banks should be allowed to stay with the current Basel I risk weight framework for residential loans. Furthermore, community banks will be forced to make significant software upgrades and incur other operational costs to track mortgage loan-to-value ratios in order to determine the proper risk weight categories for mortgages.
**New Risk Weights for Past Due Assets:**
This rule is a disincentive to the conservative approach of placing a loan on nonaccrual if there is a slight chance of loss. We believe that placing loans on nonaccrual is good practice and fear that this rule may cause banks to extend loans and avoid placing loans on nonaccrual for the wrong reasons. Additionally, in our ASC 310 impairment analysis, any loan past due 90 days or more which has a shortfall in collateral or

collection value is already accounted for accordingly in our allowance for loan losses. Like many community banks, we are diligent in performing impairment analysis and updating our allowance calculation on a monthly basis.

In summary, I would recommend you consider exempting banks with assets under $50 billion from the rule. If it is implemented, retain the current treatment for unrealized gains and losses on available for sale debt and equity securities. Additionally, rules pertaining to the risk weights for 1-4 family residential mortgage and past due assets should be reconsidered.

Thank you for your consideration of these comments.

Sincerely,

Frank J. Patock, Jr.
Chairman of the Board of Directors