William A. Loving, Jr., CLBB
President & CEO

Pendleton Community Bank
"We want to be yourbank"
www.YourBank.com

October 12, 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, DC 20219

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

We, as an industry, have gone through a very tenuous time placing extreme pressure on many institutions' capital; and, in some cases, created losses that eroded capital to an unacceptable level leading to the demise of the organization. We as an industry, and I as author of this letter, also understand the need for a capital structure that will provide for growth in times of prosperity as well as a cushion in times of economic downturns like the one we are trying to exit, as I write this letter.

I have a concern with the proposal for many reasons, but simply put, the proposal implies that a "one size fits all" approach to this issue is warranted. However, I disagree. Basel III was originally conceived as an international standard that would apply only to the largest internationally active banks, but as proposed, would subject

[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.*

community banks to the same complex and detailed standards that more complex financial firms would be subject to. Basel III imposes rigid, arbitrary and impossibly high capital regulations to smaller, relationship lenders like community bankers. Community banks have a simple capital structure and should not be subject to the increased operational cost and capital volatility of a more complex and dynamic formula. Unchanged, these Basel III capital rules, together with the extended near-zero interest rate environment and extremely restrictive proposed mortgage and other new credit rules, will significantly impact every community bank in this nation. It will permanently damage Main Street, rural America, and millions of credit-seeking consumers and small businesses because it doesn't recognize the unique characteristics of the loans community banks make every day.

If I may, I will articulate the areas of specific and recognizable concern. They are:

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 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 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. 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 my bank, for instance, if interest rates increased by 300 basis points (which is not a stretch given the amount they have fallen since 2007), my bank's bond portfolio would show a net paper loss of $2,000,000. This would mean that my bank's tier one capital would drop 11.03% and the ratio would be decreased from 14.01% to 12.62% or a 9.92% decrease. While the ratio would remain above any regulatory standards, both now and proposed, the significance of the impact would mean a potential change in philosophy towards growth and specific lending categories, due to our mindset on capital preservation and desired levels. Given that most community bankers are facing similar economic pressures (some for varying reasons), I would imagine their investment portfolios are like ours, at historically high levels, and would be impacted similarly by a decline in interest rates. Many, however, unlike my institution, may not be able to absorb the "paper" change in capital and still maintain adequate capital levels.

Large financial institutions, on the other hand, 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 swaps, options, and futures contracts. Community banks do not have the knowledge or expertise to engage in these transactions and manage their associated risks, costs, and barriers to entry.

Responsible banks and bankers use Available For Sale "AFS" for liquidity purposes and as an interest rate risk vehicle. Inclusion of this component in the capital calculation could potentially provide misleading information that could have unintended reputational consequences suggesting (or possibly demanding) a course of action that is contrary to management's strategic plans. Community banks should continue to exclude AOCI from capital measures as they are currently required to do today.

New Risk Weights

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 utilizing this product to mitigate interest rate risk in their asset-liability management. Consequently, 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, therefore, 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. Furthermore, the pending definition of a "Qualified Mortgage" could potentially, based upon these risk weights, force lenders out of the mortgage market entirely. For my institution, we traditionally have provided mortgage financing to the five (5) communities we serve offering term notes, balloon mortgages, and adjustable rate mortgages. These loans are well under written; and, when compared against other categories of loans, these second mortgages and in some cases, 1st mortgages, will carry a higher risk weight and will increase the cost of this product to borrowers who are faced with rising costs from all fronts. Community Banks should not be penalized for structuring the duration of the mortgage to meet Asset/Liability restrictions by imposing higher risk weights. The risk weight should reflect the risk. A balloon mortgage doesn't always reflect higher risks. Community banks should be allowed to stay with the current Basel I risk weight framework for residential loans. Furthermore, in addition to the cost of retaining more capital per transaction, 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.

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 the ready access to capital that the larger banks have through the capital markets. The only way for community banks to increase capital is through the accumulation of retained earnings over time. Due to the current ultra-low interest rate environment, community bank profitability has diminished further hampering their 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.

Allowance for Loan Loss Inclusion Limitation

The proposal, as outlined, places a restriction on the level of the Allowance for Loan Loss that can be used in computation of regulatory capital. The proposal, as is the case today, will only allow consideration of the first 1.25% regardless of the amount in the total reserve. This fact, in itself, is a concern as capital is being restricted; however, by limiting the amount of the Allowance that can be included in the computation of capital, along with the increased risk weights for loans 90 days or more past due and nonperforming, capital is taking a double hit. Community bankers have long been known for their ability (because we know our customers and the inherent risk) to acknowledge risks in their portfolios and adequately set aside reserves to protect against any anticipated loss. What this proposal does is add another reserve, or a reserve to the reserve, with the increased risk weights. In my institution, the impact of this section of the proposal is essentially a reduction in capital in the approximate amount of approximately $5,000,000. As it stands today, the $2,000,000 we have allocated to our reserve to cover anticipated losses above the 1.25 level will be more than doubled when considering the impact of the increased risk weight on nonperforming loans- loans that we have accounted for in our reserve calculation. If the proposal moves forward, I would ask that consideration be given to the inclusion of the entire reserve in the computation of capital versus limiting the level to 1.25.

Other Factors and Concerns

In addition to the known areas, I have grave concern over the unintended consequences. I mentioned earlier that community banks will need to upgrade systems and/or purchase additional software to account for and track the required data.

Additionally, as noted earlier, this proposal is saddled with complicated calculations and measurements that were designed for the most complicated and internationally active institutions. Community banks, and my bank, are not complicated. One of the unintended consequences, along with the potential decline in mortgage and other lending, is the likelihood bankers will find themselves at odds, or even worse, facing regulatory criticism or action, due to incorrectly interpreting the rule and misappropriating the classification of loan type. This will lead to further banker/regulator tensions and higher costs to comply with this complicated proposal. I can attest that at my institution, we have changed our compliance structure to formulate a "Compliance Committee" to augment our full time Compliance Officer in light of this proposal and the others that are being considered and adopted. The end result is higher costs that will impact the customer, the bank, and the economy- all at a time when we need all elements moving forward and not being impeded.

I appreciate your time and the opportunity to present this comment letter on behalf of Pendleton Community Bank, a $260 million institution serving four rural markets in West Virginia and one Virginia community. A community bank's business model, like ours, is unique. It is different, and this approach to capital standards doesn't mirror our model. A "one size fits all" approach is not the answer. I look forward to relief from the proposal; and, should I be able to address any of my comments further, please feel free to contact me at 304-358-2311 or bloving@yourbank.com.

Respectfully Submitted,

William A. Loving, Jr., CLBB
President & CEO