October 15, 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.

Although there are numerous items included in the proposal, the one item that causes the most concern to our Bank, and I would assume most other community banks, is the inclusion of accumulated other comprehensive income ("AOCI") in capital. This inclusion 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 classified as available-for-sale. Unrealized gains and losses within the available-for-sale investment portfolio are primarily a result of movements in interest rates as opposed to resulting from credit risk. Because these securities are held at fair value, any gains or losses due to changes in interest rates are captured in the valuation. As you are aware, both short-term and long-term interest rates have fallen to historic lows generating unprecedented unrealized gains for most of the investment classes that are held by community banks. Additionally, demand for many implicitly and explicitly government

[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.*

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 in the 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 our Bank, for instance, if interest rates increased by 300 basis points, our bond portfolio would show a paper loss of $4,570,000 (net of tax effect). This would mean that our Tier 1 ratio would drop by 12%. For financial accounting purposes, large financial institutions have the ability to mitigate the risks of capital volatility by entering into qualifying hedge accounting relationships by becoming active in interest rate derivatives like interest rate swap, option, and futures contracts. Community banks do not have the inherent knowledge or expertise to engage in these transactions as well as manage the associated risks, costs, and barriers to entry.

In addition, the current economic cycle has resulted in weak loan demand and historically high levels of assets invested in securities. This places an even larger percentage of bank assets subject to the aforementioned changes in market rates and the impact of the AOCI requirements.

It is my opinion that community banks should continue to exclude AOCI from capital measures as they are currently required to do today.

I am also of the opinion that 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.

Again, thank you for the opportunity to provide you with my comments.

Sincerely,

Mitchell A. Derenzo
Executive Vice President
Chief Financial Officer