



September 14, 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<sup>1</sup> that were recently approved by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (collectively the "banking agencies").

Ridgestone Bank, with locations in Brookfield, Wisconsin and Schaumburg, Illinois, is a \$400 million community bank with a strong focus on SBA lending and has been 11<sup>th</sup> in the nation in dollar volume with the SBA. We are writing today to comment on the Basel III Capital Proposals as they relate to servicing assets.

### **Servicing Asset**

The SBA 7(a) program provides for guarantees of 75% to 85% of each qualifying loan, subject to a maximum guaranteed amount. The community bank lender generally sells the guaranteed portion of the loan in an active secondary market and retains the unguaranteed

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<sup>1</sup> 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.*

portion in its portfolio. The sale of SBA guaranteed loans is controlled by the SBA Secondary Participation Guaranty Agreement ("1086 agreement"). All sales of SBA guaranteed loans are executed on a servicing retained basis, and the community bank lender retains the rights and obligations to service the loans. The standard sale structure under the 1086 agreement provides for the community bank lender to retain a portion of the cash flow from the interest payment received on the loan. This cash flow is commonly known as a "servicing spread." SBA regulations require the community bank lender to keep a minimum 100 basis points in servicing spread for any guaranteed loan sold for a premium. The minimum servicing spread is further defined in the 1086 agreement as a "minimum service fee" of 40 basis points and a minimum "premium protection" fee of 60 basis points. The servicing spread is recognized as a "servicing asset" to the extent the spread exceeds "adequate compensation" for the servicing function. Industry practice recognizes adequate compensation for servicing SBA loans as the minimum service fee of 40 basis points. The fair value of the servicing asset is measured at the discounted present value of the premium protection fee over the expected life of the related loan using appropriate discount rates and prepayment assumptions based on industry statistics.

When a loan sale involves the transfer of an interest less than the entire loan, the controlling accounting method under Accounting Standards Codification ("ASC") 860, "Transfers and Servicing," requires the seller to reallocate the recorded investment in the loan between the assets transferred and the assets retained in proportion to the relative fair value of the respective assets as of the date of sale. The maximum gain on sale that can be recognized is the difference between the fair value of the assets sold and the reallocated investment in the assets sold. The community bank lender measures the fair value of the guaranteed portion sold by the cash premium bid by the broker/dealer.

The fair values of the servicing asset and the unguaranteed portion retained are based on discounted cash flow calculations as explained above. The limitation on the maximum gain recognition results in a book discount recorded on the unguaranteed portion of the loan. The gain on sale recognized in income is the sum of the cash premium on the guaranteed loan, the fair value of the servicing assets recognized, less the discount recorded on the unguaranteed portion retained.

Servicing assets are initially recognized at fair value and amortized over the expected life of the related loans as a reduction of the servicing income recognized from the servicing spread. The amortized basis in the servicing asset is tested for impairment at regular intervals, usually quarterly. The fair value of the servicing asset is recalculated as of the date of the test and compared against the amortized basis. If the amortized basis exceeds the fair value, the asset is considered impaired and is written down to fair value through a valuation allowance on the asset and a charge against earnings.

The purpose of the required servicing spread and premium protection fee is not only to provide an incentive for performance on the part of the community bank lender/servicer, but to provide an incentive for a third party servicer to accept the account if there was a need to transfer the servicing. While discounted present value introduces an intangible nature to the servicing asset, never the less there is a future cash flow. This is a different

category of intangible than goodwill, which is more of a fickle capital markets measure supporting some market multiple to book value which may or may not be proven through efficient markets in the long term. Existing regulations recognize the nature of the servicing asset and afford exception capital treatment relative to goodwill. This exception treatment has been well served. The Basel III proposal effectively eliminates that exception.

An additional compensating measure supporting more lenient capital treatment of servicing assets in the case of SBA guaranteed loans lies in the discount recorded on the unguaranteed portion of the loan. If the servicing asset is considered the capitalization of future servicing income, the discount can be considered the deferral of current period gain on sale. The servicing asset and discount are generally recognized in like amounts and amortize and accrete in like amounts over the same useful life. The effect of loan prepayments tends to accelerate the respective amortization and accretion equally. All of this tends to cancel out to a capital neutral position and therefore an additional haircut to capital for regulatory ratios is not required. Finally and maybe most significant of all is the periodic impairment testing on the servicing asset. This provides for self-regulating capital maintenance making the additional restrictions in the Basel III proposal redundant and excessively penal.

Servicing assets for secondary market activity related to SBA loans are different than a servicing asset for home mortgages. The impact on community banks that have secondary market activity consisting of SBA lending is that we retain a significant part of the loan. We retain an economic interest in the loans that we sell. In addition, the accounting treatment for the retained portion requires that we record a discount, as discussed above. This discount should be considered with the servicing asset in any deduction from capital related to calculation of the capital ratios since the discount is not based on any credit risk or expected future losses related to the loans but accounting treatment required because the retained portion is deemed to be less valuable. No such discount is required on conventional loans that are made where there is no government guarantee.

Servicing loans is a specialty of many banks, including many community banks, and the servicing asset will oftentimes exceed 10% of capital. Currently, Ridgestone Bank's servicing asset is approximately 25% of capital. The proposed deduction of servicing assets that exceed 10% of capital combined with the high risk weight will severely impact Ridgestone Bank's capital ratios. The deduction of the servicing asset will impact the capital by greater than \$4 million. This would lower the current Tier 1 leverage ratio by more than 100 basis points. Current rules already impose a 10% haircut on the fair market value of servicing assets that are included in regulatory capital. Imposing the new requirement will even further impact U.S. banks beyond the 10% haircut.

Because of this, we respectfully request that the proposed rule be changed to allow 100% of fair market value of servicing assets rather than requiring a deduction from capital. An alternative to allowing the full servicing asset would be to allow the asset to be offset by the corresponding discount on the retained portion of the loans.

Thank you again for the opportunity to comment on the proposed rulings. Please feel free to contact us at 262.789.1011 with any questions.

Sincerely,

A handwritten signature in black ink, appearing to read 'B. W. Lammers', with a long horizontal flourish extending to the right.

Bruce W. Lammers  
CEO

A handwritten signature in black ink, appearing to read 'Jessica Fritz', with a large, rounded loop at the end.

Jessica Fritz  
CFO