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October 22, 2012

The Honorable Thomas J. Curry, Comptroller
Office of the Comptroller of the Currency
Regs.comments@occ.treas.gov
Docket ID OCC-2012-0008, -0009 & -0010

The Honorable Martin J. Gruenberg, Acting Chairman
Federal Deposit Insurance Corporation
comments@FDIC.gov
RIN 3064-AD95, -AD96 & - AD97

Heads of the Agencies,

Thank you for the opportunity to provide comment on the Basel III proposals that were issued for public comment by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (collectively, the "Agencies").

Sterling Bank and Trust, F.S.B. ("SBT") is a 28 year old, $820 million thrift headquartered in Southfield, Michigan, that provides community banking services primarily in the San Francisco, California market area. We operate 15 community-based branches in the two states.

Our primary lending focus for the past several years has been to finance 1-4 single family mortgages in San Francisco. We employ rigorous underwriting standards evidenced by our historically low delinquency rates and very minimal charge offs on this portfolio, including through the recent recession. The availability of mortgage finance is essential to a strong housing market rebound -- the backbone of a strong economy. SBT has been serving its local communities' residential borrowing needs for years. We are proud of providing mortgage products that are well underwritten and are based on knowing our customers and the conditions in the markets we serve. Our comments regarding the Basel III proposal are from a community bank perspective and are organized as follows:

1. General Comments
2. Broad Concerns
3. Specific Concerns

1. <u>General Comments</u> - Basel III proposals were intended for systemically important global financial institutions without considering the unique business model of American community banks and the customers they serve. Basel III which is currently presented as a "one size fits all" solution does not take into account how different the American banking system is relative to other countries' systems. Specifically, Basel III was drafted to address banking systems that are comprised of a small number of large banks, whereas the American banking system has thousands of community banks with business models that are entirely different than "too big to fail" institutions.

   Choosing only one of the criteria used in a safe and sound underwriting process to set risk-based capital allocations, i.e., loan-to-value ratios, is myopic and ignores the multiple underwriting factors used to determine the credit worthiness of a borrower. The consequence of the proposed Basel III rules will be to reduce the availability of residential financing to very credit-worthy borrowers. This impact is contrary to public policy objectives to restore the availability of residential credit to support the recovery of the U.S. housing market.

   As a banker of 22 years and a chief financial officer of a community bank for more than a decade, I understand and appreciate the need for a strong capital position as the underpinning of a safe and sound bank as well as the entire banking system. My concern is not maintaining adequate capital levels, but rather the unintended affect that these proposals will have on the communities we serve by materially reducing our ability and willingness to make loans. Basel III also ignores the burden of complying with complex rules, data gathering and calculations that were intended for banks with thousands of employees, whereas SBT has one hundred and twenty-five. It is also believed that these new proposals will materially reduce the number of community banks, which have served and facilitated the creation of jobs and economic growth and are a resource to support a much needed economic recovery.

2. <u>Broad Concerns</u> - **Accumulated Other Comprehensive Income (AOCI).** Including unrealized gains and losses in the Available for Sale (AFS) portion of the securities portfolio in Tier 1 common equity capital will create volatility in the capital measurements that are merely a reflection of interest rate movements rather that an accurate assessment of an institution's true financial strength. When interest rates inevitably increase, banks with investment security holdings would likely experience significant **unrealized** losses even though they would continue to be profitable with these securities portfolios continuing to contribute to interest earnings as originally expected when the securities were purchased. Temporary pricing volatility resulting from interest rate fluctuations should not be equated to changes in credit risk requiring additional capital. National and international accounting standards already set forth requirements for the treatment of other than temporary impairments which should continue to be the important focus in evaluating the capital needed to support securities holdings by banks. This proposal could create scenarios in which formerly well-capitalized banks could become under capitalized in a relatively short time frame and face severe sanctions due strictly to interest rate movements. This proposal alone carries great risk of causing instability in the banking system.

3. Specific Concerns – SBT is concerned with criterion # 4 in defining a Category 1 mortgage. The definition is ambiguous and unnecessarily broad which may need modification, and at the very least clarification. The # 4 criterion states: **The terms of the residential mortgage exposure allow the annual rate of interest to increase no more than two percentage points in any twelve month period and no more than six percentage points over the life of the exposure.**

   For adjustable-rate-mortgages, the first rate reset is usually wider than the following annual rate resets because the time period to the first reset has a longer duration (3 to 7 years) than the subsequent reset periods, where the duration is usually one year. For example, a five-year ARM loan made in today's low rate environment at 3.5%, may see a material index rate (e.g. 1 year LIBOR change from 0.4% to 3.5%) increase in 2017 when the rate is required to be reset for the first time. Hence, as a common practice, the initial rate reset usually allows a reset range of more than 2% to reflect the movement in interest rates in the previous 3-7 years, though the cap on total change over the life is 6%. In this case, a new annual adjustable rate above 5.50% will not endanger the mortgage loan because the underwriting process took into consideration the borrower's ability to repay the loan using: (a) the maximum interest rate that may apply during the first five years after the date of the closing of the loan; and (b) the amount of the residential mortgage exposure is the maximum possible contractual exposure over the life of the mortgage as of the date of the closing of the transaction. There should be no need to restrict the initial reset range. For this reason, we suggest the agencies **change the rate reset range from 2% to 3% for the initial rate reset**, or exempt the initial rate reset period by changing Criterion # 4 to: The terms of the residential mortgage exposure allow the annual rate of interest to increase no more than two percentage points in any twelve month period **following the initial rate reset** and no more than six percentage points over the life of the exposure.

   As of September 2012, SBT has a delinquency rate of 10 basis points in its residential mortgage portfolio. For the past three years, the charge-off ratios have been 0.0% for 2008, 0.02% for 2009, 0.0% for 2010, 0.12% for 2011, and 0.01% year to date as of September 2012. Most of our loans with contractual rate-resets with an initial reset range larger than 2% have actually reset to a lower level in the past years. These loans have performed extremely well after their initial rate reset, as they have benefited from the low-rate environment. These loans should not be classified as Category 2 residential mortgages. Criterion # 4 is unclear as to how loans should be classified after the "greater than 2%" period has expired. The proposed capital rule should focus on the potential risk in the future, not be based on the terms at origination date which are not relevant after the initial rate reset has passed. SBT suggests the agencies clarify Criterion # 4 by changing it to: "The terms of the residential mortgage exposure allow the annual rate of interest to increase no more than two percentage points in any twelve month period following the initial rate reset **over the remaining life of the exposure** and no more than six percentage points over the **remaining** life of the exposure." After this change, the rule will still differentiate high-risk floating rate mortgage loans, but avoid unnecessarily including those loans that have passed their initial rate reset and will comply with rule for the remainder of their lives.

If the rules stand as is, it will be very punitive to the community banks that offer ARM mortgage loans. For some thrifts, over 70% of their loans will be affected by this definition, causing a significant decrease in the risk-based capital ratio while not reflecting the true risk remaining in the underlying mortgage loans. Thus, mortgage lending capacity will be substantially curtailed. If the agencies do not change the proposed rule on the rate and term definition, SBT strongly suggests that the agencies exempt the existing loans prior to implementation of Basel III and apply the criterion only to new production closed after the effective date of this regulation.

In summary, community banks should be excluded from Basel III as its proposals were designed for the largest banks without regard to the unique risk profile and community-based business model of community banks. Consequently the unintended consequences have the potential to severely impact the community banking system negatively and create results that contradict current public policy.

In particular we are concerned with the interpretation of criterion # 4 to define a Category 1 mortgage. In its current form it has the potential to substantially impact community banks that offer adjustable rate mortgage loans with a higher than 2% contractual initial rate reset.

We appreciate the opportunity to comment on this proposal. If you have any questions or would like additional information please contact the undersigned at 248-948-8776.

Sincerely,

Tom Lopp

Tom Lopp
Chief Financial Officer,
Sterling Bank and Trust, F.S.B.