INTERMOUNTAIN COMMUNITY BANCORP

October 21, 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 and Standardized Risk-Weighted Asset Approach Proposals

Ladies and Gentlemen:

Thank you for the opportunity to provide comment on the Basel III and Standardized Risk-Weighted Assets proposals 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").

Intermountain Community Bancorp ("IMCB") is the holding company for Panhandle State Bank ("PSB") an Idaho-based, state-chartered community bank founded in 1981. With assets of $950 million we serve primarily rural communities in Idaho through 19 branch offices. As a true community bank, we serve the deposit, investment and credit needs of consumers, businesses, and farmers in the markets in which we operate.

We are in support of strengthening the capital requirements at financial institutions, both bank and non-bank, to ensure that the U.S. financial services industry can withstand difficult economic conditions likely to be experienced in the future. As with many other community banks, we have taken strong steps to bolster our capital position and reduce overall risk of loss over the last several years. This response by the community banking industry occurred as a result of industry and regulatory safeguards already in place, amidst the worst economic conditions since the Great Depression.

Our greatest concern with the proposed regulation is the multiple ways in which regulatory capital is impacted. The various proposals not only have a cumulative impact that undermines banks' ability to reasonably meet the standards in various economic environments, but also adds

INTERMOUNTAIN COMMUNITY BANCORP
P.O. Box 967 • Sandpoint, Idaho 83864 • (208) 263-0505 • E-mail: imcb@intermountainbank.com

complexity and cost to the calculation of capital. Furthermore, the cumulative impact of these proposed regulations comes at a time when community banks are already struggling with a tremendous number of other new regulations. To meet the added burden of these regulations, we have already added several new staff (at a combined annual cost exceeding $120,000) and outsourced our mortgage servicing at an additional annual cost of approximately $100,000. Our initial analysis of the BASEL III proposals indicates that it would cost an additional $40,000 to $70,000 annually in staff, consulting and/or system changes to comply with the new calculation requirements.

The combined impact of higher, more complex capital requirements and the higher cost of complying with the various new regulations being implemented will have a chilling impact on the new entry and retention of existing private capital into the banking industry. Forecasted industry returns are already low given challenging economic conditions and compressed margins, and these regulations only add to the challenges. As such, rather than bolstering overall industry capital, the combined impact will likely result in stagnant or reduced capital for the industry. Constrained industry capital levels will, in turn, negatively impact the future availability of loans to the businesses, consumers and farmers that community banks best serve, and who are the engine of enhanced economic growth.

As an example of the impact of the combined capital proposals on a micro scale, using the analysis tool provided by the banking agencies, we remain very well-capitalized but lose approximately 3.5% in the Tier 1 risk-based capital ratio. With IMCB's current Tier 1 capital balance of $114.4 million, this translates into a reduced lending capacity of approximately $212 million, or 1/3 of IMCB's current loans outstanding. While this in itself may not cause our bank to shrink, it will certainly limit its ability to grow by lending more money into the communities it serves. If this impact is multiplied across the 7,000 banks in the country, most of which are not as well capitalized as IMCB, it will likely have a substantial impact on future economic growth.

In addition to these general concerns, we have a number of concerns about specific recommendations in the proposals. These include the following:

1. **The Inclusion of Unrealized Investment Security Gains and Losses in Capital Calculations**

   IMCB, like most banks right now, has unrealized gains on its books, so inclusion would actually increase current capital levels. However, we are in a period of record low interest rates, and any movement up in interest rates will likely turn current gains into unrealized losses. This negative impact is exaggerated by the fact that for IMCB and most other banks, the investment portfolio now comprises a much larger percentage of assets than it did prior to the recession. For example, a relatively modest 2 percent increase in interest rates on a $300 million portfolio with duration of 2 years would result in lost capital of 4% of the investment portfolio or $12 million. For many institutions, this impact alone would push them below the well-capitalized status. Given a standard leverage ratio of 10:1, a capital reduction of $12 million would also reduce the potential ability to lend by about $120 million.

Like most other community banks, IMCB does not classify most of its investment portfolio as trading assets, and thereby asserts that it can (and often does) hold securities to maturity. Given this situation, the inclusion of unrealized gains and losses in the capital calculations adds unnecessary volatility to the capital ratios of community banks and would likely result in one of the following outcomes: (1) a bank classifying many of its securities as held-to-maturity, which significantly reduces flexibility if the bank needs to adjust its investment portfolio for liquidity or earnings purposes; (2) a substantial shortening in the duration of the bank's investment portfolio, which will hamper earnings and may not be congruent with the rest of the bank's balance sheet; or least likely, (3) the acceptance of significant volatility, which will require the bank to make significant changes in its lending and funding strategies on a frequent basis as market rates change.

One additional and likely impact of this proposal is the negative effect it may have on municipal bonds and mortgage-backed securities. Banks are generally significant buyers of both of these types of longer-term assets. If they are forced to reduce these holdings to lower duration and volatility, both markets will likely suffer long-term negative impacts from having fewer potential buyers.

2. **The Exclusion of Fair Market Gains on Derivatives that Are Used to Hedge Assets and Liabilities that Are Not Fair Valued:**

In light of the proposal regarding the securities portfolio above, this recommendation seems inconsistent. Banks should always actively manage risks associated with interest rates going up or down. In doing so, banks could potentially offset some of the volatility resulting from the securities recommendation above by hedging their balance sheet against rising interest rates. Then, if rates actually rose, they would recognize fair market gains on the hedge that would offset the fair market losses from the investment portfolio. However, the current recommendations specifically prevent this treatment thus potentially increasing the bank's risk to rate volatility. As such, we would prefer the recommendations discussed in Item 1 above not be implemented, but if they are, then banks should at least have the opportunity to offset the capital volatility by using and recognizing the changing fair value of hedges.

3. **Phase-out of Trust Preferred Obligations from Tier 1 capital**

We recognize and agree with the goal of bringing more common equity into the community banking industry. In fact, we were one of the relatively few fortunate institutions to successfully raise common equity capital over the past couple years. However, given the other proposals made, there appears to be no overriding reason to phase-out existing trust preferred obligations. The proposals already require a new common equity ratio, which by its very nature, places additional emphasis on common equity. In addition, the final guidance could simply eliminate Tier 1 capital treatment for new trust preferred obligations, while allowing the grandfathering of existing obligations. In doing so, the guidance would preserve what clearly is a cheap cost of current capital for many institutions and reduce pressure for community banks to seek even more capital at a time when other sources of capital are and will likely be scarce. If banks are not able

to replace the capital except through earnings, this will again likely have a constraining impact on our ability to lend, and as such, hamper the communities in which we serve. As an example, the exclusion of $16 million in Trust Preferreds that we currently maintain would reduce potential lending capability by approximately $160 million.

4. Treatment of the Deferred Tax Asset ("DTA") in the Capital Calculations

The proposed treatment of the DTA is arguably easier than the current treatment, which allows a bank to exclude from the disallowed portion the potential reduction in the DTA resulting from projected taxable income over the next year, but requires the inclusion of both tax loss carryforwards and temporary differences in the disallowed portion. That said, the treatment is still a significant departure from GAAP treatment, which already requires companies to assess whether the DTA will likely be realized and record a valuation allowance against the DTA if it is unlikely that it will. The proposals contain no strong rationale for why the regulations require a more restrictive stance than GAAP, and have a decidedly negative impact on an industry that is recovering from the worst downturn since the Depression.

5. Treatment of Mortgage Assets for Risk-Weighted Capital Purposes

We have several concerns with the proposed guidance regarding mortgage assets, as follows:

- The intensified focus on mortgages appears to be a reaction to the last crisis and ignores potential volatility in other asset classes. No one can argue that mortgage and mortgage-related assets created many losses for banks of all sizes during the last crisis, although certainly community banks suffered far fewer losses than many other institutions. However, prior to this period, mortgages had been one of the safest asset classes for many years. In the next significant disruption, it may be agricultural loans, commercial loans, student loans or some other lending class that experiences the greatest shock. Following the methodology employed under this proposal, the calculation of risk-weighted capital would then need to incorporate underwriting elements for all these classes, a stance that would require calculations so complex as to likely make them unmanageable. It seems easier and more generally effective to simply require higher capital levels overall than to try to delve into the underwriting parameters of particular asset classes for particular treatment.
- The intensified risk weightings also ignore the ability of the Allowance for Loan Loss and Lease ("ALLL") calculations to monitor and manage changing asset risk levels more effectively than the capital calculation models. ALLL systems are already embedded in bank credit operations and as such can be modified more easily to control for different risks in different asset classes. Existing regulatory scrutiny and potential changes in the ALLL methodology seem to provide more comprehensive and prudent opportunities to offset particular risk in banks' portfolios.

- Any modification of a loan, except under HAMP, would require a reassessment of the loan and potentially its movement from a Category 1 to Category 2 loan, resulting in a higher risk-weighting for the same loan. This will either adversely impact the bank's capital ratios for a loan carrying the same or even lower risk as before, or limit the bank's desire to modify the loan.
- The guidance as proposed would require building and maintaining new tracking systems to report on the items required. Many institutions, including IMCB, do not track LTVs and other underwriting characteristics on consumer and mortgage loans on systems that link directly with the call report software. As such, IMCB would either have to maintain this information on the linked system, resulting in duplication of effort, or try to integrate the other systems with the call report application. In either case, it would require additional manpower and system resources to accomplish this.
- The inclusion of all 2nd lien positions and balloon loans in Category 2 ignores many of the underlying underwriting characteristics generally relied upon in other parts of this particular guidance, and as such, could assign excessively high risk weights to loans that may represent a very prudent underwriting risk. Community banks often make "blind deed of trust loans" or balloon mortgage loans to high income, stable individuals with strong net worth positions in order to facilitate tax advantages or because the particular property does not meet standard secondary market underwriting guidelines. Again, it seems the more appropriate method for approaching risk mitigation with these types of loans would be through the ALLL methodology.
- In addition, should the bank make a 2nd lien loan on a property for which it holds the first lien and the 2nd lien loan is a category 2 loan, it changes the first lien loan to a category 2 loan, regardless of the underwriting characteristics of the first lien loan. This actively discourages both relationship banking and the active control of a credit relationship by the bank, and there is no significant rationale for treating the first lien loan in this manner.
- Finally, the proposals contain no analysis that indicates that the proposed guidance would actually and meaningfully lower the risk of failure in community banking institutions. Many community banks already maintain strong underwriting standards for mortgage loans, and as such, the implementation of the above proposals may only create additional restrictions and cost, without meaningfully lowering the risk in the community banking industry.

6. High Volatility Commercial Real Estate

The desire to reduce potential exposure from these types of loans is understandable, given the significant impact that construction, acquisition and development loans had on community banks over the past four years, IMCB included. That said, the proposed approach again singles out one particular loan type, ignores underwriting standards employed by various institutions, and oddly enough, exempts construction and development loans made on 1-4 family residential property (which created many of the losses). As with the mortgage proposals above, the desired outcome seems more

appropriately reached through the requirement to maintain overall higher levels of capital and improve ALLL modeling.

In addition, the higher proposed capital requirements, coupled with tougher underwriting standards and tighter regulatory scrutiny, is already having a constraining effect on the construction and housing markets and will make it even more expensive to construct or buy a home in the future.

7. **Removal of the 120-day Safe Harbor Provision on Mortgage Representations**

   Under the current general risk-based capital framework, risk based capital charges do not apply to mortgages once they are sold to third parties, even where the seller provides representations and warranties to take back mortgages that experience very early payment defaults (i.e., within 120 days of sale of the mortgages). Very few loans default in the first 120 days of origination, and as such, the inclusion of these loans in the risk-based capital calculation creates complexity, negatively impacts bank capital, and likely increases the cost of mortgage loans, with very little reduction in industry risk.

8. **Assigning a 20% Risk-weighting to All Unfunded Commitments Less than 1 Year**

   There is little evidence and none contained in the proposed guidance that suggests that short-term unfunded commitments created significant additional losses for the industry, either in the most recent downturn or in historically longer periods. In addition, an allowance for potential loss is already assigned to these commitments as a liability on the balance sheet. There seems to be no significant benefit derived from assigning a risk-weighting to these commitments, and the impact again is negative on the potential lending capabilities of banks. In our particular case, the inclusion of these commitments added $22.4 million in risk-weighted assets, thereby effectively eliminating the potential for $22.4 million in additional outstanding loans to our communities.

9. **Treatment of 90-day Delinquent and Non-Accrual Loans**

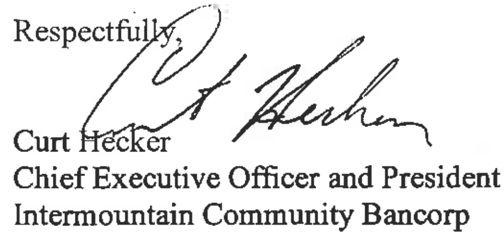
   Under the guidance, these loans would automatically receive a 150% risk-weighting. Such loans already negatively impact bank capital levels through their assessment as part of the ALLL process. Adding the 150% risk-weighting would create a "double penalty" on these assets, and in the event of another significant downturn, create additional pressure on bank capital levels and further reduce potential lending. As such, the "double penalty" becomes pro-cyclical, masking volatility when times are good and increasing volatility in challenging economic times.

In summary, we agree that the community banking industry should both (1) maintain higher capital levels; and (2) prudently underwrite, monitor and manage its asset portfolios to mitigate risk. However, the guidance as proposed goes far beyond these goals. If enacted as is, the guidance will significantly constrain new lending activity, make accessing private capital markets more difficult, and add to both the cost and complexity of operating a community bank.

We encourage careful consideration of both the separate and cumulative impacts of these proposals and other regulations currently being implemented on the community banking industry. We assert that the same basic goals could be achieved through a much simpler approach focused on requiring the higher capital levels proposed, including a common equity ratio as one of the key ratios, and continuing regulatory focus on credit and ALLL management.

Thank you for your consideration.

Respectfully,



Curt Hecker
Chief Executive Officer and President
Intermountain Community Bancorp

cc: Intermountain Community Bancorp Board of Directors
The Honorable Senator Mike Crapo
The Honorable Senator James Risch
The Honorable Representative Raul Labrador