THE FEDERAL SAVINGS BANK

October 22, 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, D.C. 20219

Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

By electronic submission

Re: **Comment Letter on Basel III Capital Proposals[1] – Safe Harbor for Credit-Enhancing Representations & Warranties**

Ladies and Gentlemen:

Thank you for this opportunity to provide comment on the Basel III proposals recently approved for public comment by the Board of Governors of the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (collectively, the "banking agencies"). While all aspects of the Basel III proposals will have significant and long-lasting effects on this institution, this response focuses only on one particular aspect – the proposed removal of the current "safe harbor" for credit-enhancing representations and warranties.

A Veteran-owned bank, The Federal Savings Bank is an approximate $200 million community bank actively involved in the origination of home loans to first-time home buyers, veterans and working class Americans. The core of the Bank's operations is located in the heartland of America with significant footprints in the Chicago and Kansas City metropolitan areas as well as other parts of the country.

The vast majority of the Bank's lending business focuses on the origination of first mortgage loans for sale in the secondary market, with a significant focus on the VA market. As is standard in the industry, our agreements with investor correspondent banks typically carry a 120 day early payment default credit enhancement. Our experience, like most banks actively engaged in this sector, has been very good. In fact, since its shift in focus to mortgage lending 18 months ago, this Bank has originated and sold more than 2,800 loans totaling almost $830 million in volume.

In that time, this Bank has not been required to "take back" a single loan under a credit enhancement warranty.

Under the Basel III Standardized proposals, if a banking organization provides a credit enhancing representation or warranty on assets sold or otherwise transferred to third parties, including in cases of early default clauses or premium-refund clauses, the banking organization would treat such an arrangement as an off-balance sheet guarantee and apply a 100 percent credit conversion factor to the transferred loans while credit-enhancing representations and warranties are in place. 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 the sale of the mortgages).

If this part of the Basel III Standardized proposal is adopted, this Bank would see its risk-weighted assets more than triple! In addition, its total risk-weighted assets would exceed the total assets otherwise reported on the face of its balance sheet! The likely effect would be to require this Bank to raise additional capital to support its principal business activity or significantly reduce its commitment to the American mortgage market. The likely decision that will be made by many community banks will be to exit this market.

Community banks are the educators, the neighbors and the safe and sound lenders that know their customers and can most closely evaluate individual risk. They provide the wherewithal for those seeking a better opportunity and better life to meet their goals. Those community banks that have survived the economic devastation of the last three years are the strong survivors that need and have earned the support of the communities they serve.

Basel III is designed to level the playing field among major banking institutions that operate internationally. Force-feeding these same rules to community banks in the United States is unnecessary and in fact counter-productive, particularly in the current economic environment. Putting aside the operational costs of compliance, the new rules for calculating risk-weighted assets will have a particularly dramatic impact on the capital needed to support a mortgage-banking platform.

Not only will popular mortgage products originated by most banks attract <u>significantly higher capital charges</u>, the risk-based capital penalties for providing early payment default protection may force these banks away from the correspondent lending market. This will translate to less mortgage credit for Americans, who depend on community banks for their financial services. The timing could not be worse.

The positive experience across this sector of the market has been well recognized in the past through the current "120 day safe harbor" allowed in the determination of a bank's risk-weighted capital. To suddenly remove that safe harbor and require community banks to effectively bring four months' of business back onto their balance sheets is confusing at the very least when their individual and collective experience would indicate that no such treatment should otherwise be warranted.

As there is little evidence that the temporary representations and warranties associated with "pipeline mortgages" have resulted in significant losses for regulated banking organizations, even during the financial crisis, we urge the banking agencies to retain the 120 day safe harbor in the current rule.

If elements of Basel III must be forced upon community banks, then apply some of the Basel III changes to the amount and type of capital that qualifies. Specifically, change the numerator of the risk-based capital requirements, but don't change the way that community banks calculate risk-weighted assets—through the denominator, especially for residential mortgage loans, the lifeblood of our local communities.

Best regards,

William Morton

William Morton
Chief Financial Officer

PC: Mr. Hugh Carney, Senior Counsel
American Bankers Association

1 The three proposals are (i) Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action (**"Basel III Numerator NPR"**), 77 Fed. Reg. 52,792 (Aug. 30, 2012); (ii) Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements ("**Standardized Approach NPR"**); 7 Fed. Reg. 52,888 (Aug. 30, 2012); and (iii) Advanced Approaches Risk-Based Capital Rule; Market Risk Capital Rule (**"Advanced Approaches NPR**), 77 Fed. Reg. 52,978 (Aug. 30, 2012). Collectively, these are referred to as the "**proposals."**