AUBURNBANK

October 22, 2012

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Office of the Comptroller of the Currency
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Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

VIA MAIL & E-MAIL

Re: Basel III and Standardized Approach Notices of Proposed Rulemaking ("NPRs")

Ladies and Gentlemen:

AuburnBank appreciates the opportunity to comment on the Basel III and Standardized Approach NPRs that were recently issued for public comment by the Federal Reserve Board, the office of the Comptroller of the Currency, and the Federal Insurance Corporation (collectively, the "agencies").

With over $750 million in assets, AuburnBank (the "Bank") is headquartered in Auburn, Alabama and was founded in 1907. We are community oriented and focus primarily on offering commercial and consumer loan and deposit services to individuals and small and middle market businesses in East Alabama, including Lee County and surrounding areas.

We support the objective of improving the quality and quantity of regulatory capital and to build additional capacity into the banking system to absorb losses in times of future market and economic stress. However, we believe certain proposed changes within the Basel III NPR are contrary to the stated objectives of safety and soundness and would only increase instability in regulatory capital for the banking industry.

In addition, while no one disputes that risks were miscalculated during the recent financial crisis, we do not support the Standardized Approach NPR, which aims to enhance the risk sensitivity of the agencies' capital requirements by revising the calculation of risk-weighted assets. We believe the proposed changes to the calculation of risk weighted assets are unnecessarily complex, overly prescriptive, and in some cases lack any justification. We are also concerned about the costs of implementing the proposals included in the Standardized Approach NPR and the possible unintended consequences such as reducing the availability of credit in smaller communities and incenting further consolidation in the banking industry because of the increasing cost of regulatory compliance.

While both the Basel III and the Standardized Approach NPRs have proposed changes that may be reasonable in isolation, we are concerned that the combined impact of both NPRs if implemented unchanged will have a disproportionately negative impact on community banks and more importantly, the communities they serve. Ultimately, in our judgment, the NPRs considered together fail the "forest for the trees" test.

While this letter will not address every issue within the Basel III and Standardized Approach NPRs, we will focus on areas that we believe will have a significant negative impact on community banks.

We would appreciate your consideration of the following specific comments.

Components of Capital and Eligibility Criteria for Regulatory Capital Instruments (Basel III NPR)

Treatment of Unrealized Gains and Losses of Certain Debt Securities in Common Equity Tier 1 Capital (CET1)

In the Basel III NPR, the agencies acknowledge that allowing unrealized gains and losses on AFS debt securities to be included in CET1 could introduce substantial volatility in a banking organization's regulatory capital ratios. We agree with this assessment. Furthermore, we believe this proposal is contrary to the agencies' stated objectives of improving the quality and quantity of regulatory capital and to build additional capacity in the banking system to absorb losses in times of future market and economic stress.

In effect, by allowing unrealized gains and losses on AFS debt securities to be included in CET1, there is a hidden increase in the risk weighting of these assets because banks would be compelled to maintain an "AFS capital buffer" that contemplates significant changes in benchmark interest rates in order to ensure the institution maintained the required minimum capital ratios and/or the 2.5% conservation buffer. In certain interest rate shock scenarios, this could cause an AFS debt security with little or no credit risk to carry a higher capital charge than a loan with inherently more credit risk.

While we can appreciate the agencies concern over credit risk in the investment portfolio, we believe this concern is mitigated by the other-than-temporary impairment rules included in GAAP currently. In fact, GAAP recognizes that changes in the fair value of a security may have no bearing on the probability of collecting contractual cash flows due (even for those securities whose unrealized gains and losses are more likely to result from changes in credit spreads and not primarily due to fluctuations in the benchmark interest rate). To some observers, this proposal seems to indicate the agencies are more concerned with the fair value of a bank's assets in a liquidation scenario, such as a bank failure. If fair value is so important to the determination of capital, why don't the agencies require a fair value assessment of a bank's largest portfolio of assets - the loan portfolio? Because the agencies recognize that fair valuing the loan portfolio would distort regulatory capital and would ignore the traditional banking business model of evaluating the risk of collection of future cash flows. This same argument should apply for AFS debt securities and should not be rejected solely because AFS debt securities may be sold for liquidity needs. Accordingly, we believe the agencies should retain the current treatment for unrealized gains and losses on AFS debt securities in any final rule.

If the agencies ultimately decide to pursue an alternative treatment to exclude from CET1 unrealized gains and losses on AFS debt securities whose changes in fair value are primarily due to fluctuations in a benchmark interest rate, we believe the agencies need to clearly delineate what types of securities will be excluded. Under the alternative treatment, at minimum, we believe changes in unrealized gains and losses for the following security types should be excluded from CET1:

1. U.S. government and agency debt obligations;
2. U.S. GSE debt obligations, including GSE guaranty obligations such as mortgage pass-throughs and CMOs and SBA guaranteed pools; and,
3. U.S. States and political subdivisions debt obligations.

<u>Phase-out schedule for non-qualifying capital instruments of depository institution holding companies under $15 billion for and depository institutions</u>

Despite the exemption provided under the Collins Amendment within the Dodd Frank Act, the Basel III NPR requires all institutions under $15 billion to deduct trust preferred capital instruments from Tier 1 Capital over 10 years. Once again, this proposal disproportionately impacts community banks because of their limited access to capital markets. While we fully agree with the agencies' objective of increasing the quality and quantity of regulatory capital, the Dodd Frank Act has already ensured that banks will no longer be able to use trust preferred instruments to grow Tier 1 Capital and reduce the level of loss absorbent capital. As a result, we recommend the agencies remain consistent with the intent of the Collins Amendment and allow the grandfathering of existing trust preferred securities to continue to be included in Tier 1 capital for institutions under $15 billion in assets.

Capital Conservation Buffer (Basel III NPR)

While this proposal was clearly crafted with the right intentions, we do not believe the capital conservation buffer meets the agencies' state objective of improving the quality and quantity of regulatory capital and to build additional capacity into the banking system to absorb losses in times of future market and economic stress. The NPR suggests that the conservation buffer would "provide incentives for banking organizations to hold sufficient capital to reduce the risk that their capital levels would fall below their minimum requirements during stressful conditions." Are the current rules regarding Prompt Corrective Action not enough incentive to hold sufficient capital? If not, why is their very little difference (0.5%) between the regulatory capital ratios required for a well-capitalized institution and what is required for the conservation buffer? If the agencies have discretionary authority to impose capital distribution restrictions currently, why is there a need to substitute the judgment of experienced bank examiners with specific knowledge of the institutions they supervise for arbitrary and automatic triggers? In our opinion, this proposal could have a chilling impact on the ability of financial institution to raise capital in times of economic distress, further accelerating an institutions deteriorating capital position. Consequently, we recommend the agencies remove the capital conservation buffer from any final rule.

Introduction and Overview (Standardized Approach NPR)

We are very concerned with the Standardized Approach NPR and its impact on community banks. As previously stated, we believe the proposed changes to the calculation of risk weighted assets are unnecessarily complex, overly prescriptive, and in some cases lack any justification. Additionally, we are concerned about the costs of implementing the proposals included in the Standardized Approach NPR and the possible unintended consequences such as reducing the availability of credit in smaller communities and incenting further consolidation in the banking industry because of the increasing cost of regulatory compliance.

We believe the agencies must ask whether they are missing the "forest for the trees" with this NPR. Hasn't the Basel III NPR met the agencies' stated objectives by raising the quality (increased requirement for common equity) and quantity (increased minimum ratios) of regulatory capital? Why introduce additional cost and complexity when regulatory capital ratios can be increased simply by focusing on the numerator? What about the costly systems that will be required to accurately account for the varying loan characteristics under each proposal? No matter how valid the reasoning for increasing risk weightings for certain types of loans, we believe arguing over the finer details of the proposal misses the point. The combination of the Basel III NPR and the Standardized Approach NPR will have significant unintended consequences for community banks. Consequently, we believe that community banks should not be required to adopt the Standardized Approach, but continue to follow the general risk-based capital rules. At this time, we do not have a threshold recommendation for applying the general risk-based capital rules. In our opinion, $1 billion in assets would be too low, but we are also aware of some institutions that are as big as $10 billion in assets that still operate a community bank business model.

Finally, despite our recommendation for a community bank exemption from the Standardized Approach, we believe specific sections within the proposal could be improved and will provide additional comments below.

Residential mortgage exposures and Off-Balance Sheet Items (Standardized Approach NPR)

The NPR states, "the agencies propose to apply . . . . higher risk weights for nontraditional loans that present greater risk." Although we do not believe community banks had any significant role in offering nontraditional mortgage products leading up to the financial crisis, we understand the agencies interest in reviewing risk weightings for these loan products.

The NPR proposes two categories of residential mortgages: Category I and Category II. In order for a residential mortgage loan to avoid the higher risk classification, Category II (which carries risk weightings of 100% to 200% depending on LTV), the NPR specifies that:

> *The terms of the mortgage provide for regular periodic payments that do not: (i) result in an increase of the principal balance; (ii) allow the borrower to defer repayment of principal of the residential mortgage; or (iii) result in a balloon payment.*

We agree that higher risk mortgage products, such as option ARMs and reverse mortgages, should generally carry higher risk weightings. However, we do not agree that a balloon payment in and of itself makes a loan higher risk. In fact, many community banks have viewed offering short-term loans (5 year balloon) with reasonable amortization periods as a better underwriting practice because the borrowers must renew their loans at more frequent intervals which allows the lender to better monitor the credits. Therefore, we recommend that the agencies clarify this requirement to ensure that loans that are underwritten with standard loan terms do not automatically carry a higher risk weighting because the loan results in a balloon payment.

Finally, our bank has an active mortgage division that originates and sells residential mortgage loans in the secondary market. All of our loans are sold without recourse; however, our loan sale agreements typically provide customary representations and warranties, including early default clauses that are typically 120 days or less. Based upon our reading of the NPR, it appears that we would be required to apply a credit conversion factor of 100% to loans sold without recourse simply because the 120 day warranty for early default had not expired. We believe this could have significant unintended consequences on our ability and others to meet the credit needs of the communities we serve and would deal another blow to an already weakened housing market. Additionally, in our experience, the warranty provided for early default has rarely resulted in any actual loss. As a result, we believe the agencies should remove this proposal and continue to apply the general risk-based capital requirements for assets sold with customary representations and warranties.

Conclusion

Although we have detailed specific comments and concerns regarding certain proposed revisions in the Basel III and Standardized Approach NPRs, we want to reiterate our support for the objective of improving the quality and quantity of regulatory capital and to build additional capacity into the banking system to absorb losses in times of future market and economic stress.

We are proud to have served our local communities for over a century and we are proud to call ourselves community bankers. We urge the agencies to carefully consider these comments and others to ensure the ongoing success of communities across this nation.

Should you require further information or have any questions, we would be pleased to discuss our views on this matter with you and your colleagues.

Sincerely,

Robert W. Dumas

Robert W. Dumas
President/CEO

David A. Hedges

David A. Hedges
Vice President, Controller & CFO

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