Wednesday, October 17th, 2012

The Honorable Ben Bernanke
Chairman
The Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20429

The Honorable Tom Curry
Comptroller
Office of the Comptroller of the Currency
250 E Street, S.W.
Washington, D.C. 20219

The Honorable Martin J. Gruenberg
Chairman
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

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COMPTROLLER
OF THE CURRENCY

Dear Chairman Bernanke, Comptroller Curry, and Chairman Gruenberg:

I am writing to express my concerns about the proposed Basel III standards that will impact all financial institutions in our country and could seriously restrict the ability of institutions such as mine to serve the communities in which we operate. Those of us who strive to better our communities and our country as a whole by providing much-needed credit see major obstacles in the standards due to the unnecessary and burdensome capital requirements of the proposed rule. We recognize the commendable intent of Basel III to safeguard the global financial system. However, we feel that imposing standards better suited to large national and even international institutions on small, community banks is misguided. We ask you to amend the standards to better ensure that they are appropriate to each covered institution's size, scale, and complexity.

My bank, like so many others in more rural parts of the country, was formed by local individuals to provide a wide variety of credit to areas that would be considered economically disadvantaged. For many decades, my bank has extended consumer, agricultural, business and mortgage loans that meet the specific needs of borrowers we know on a personal basis. We've been able to structure those loans with various maturities and repayment terms so that borrowers who rely on income that may be seasonal or from public assistance can obtain needed credit. Many of these loans are mortgage loans that we cannot sell to investors because they have features not conforming to FNMA standards. I stress those loans because I am especially worried about the negative impact the proposed Basel III standards could have on community banks' ability to make these needed non-conforming mortgage loans.

The credit we extend, mortgage and otherwise, is crucial to the long-term economic health of the communities banks like mine serve. In normal economic times, many of the areas my bank serves struggle to provide jobs and housing to individuals living in the community. During the recent economic downturn, community banks have been, in many ways, a life-line to communities that without them might not recover. I strongly ask you to consider these needs in your decisions on how to enforce any new standards.

The following issues raised in the proposal are the specific items with which I have concerns:

1. Requiring Unrealized Gains and Losses on Available for Sale (AFS) Securities to Flow Through Capital

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This requirement will likely increase a bank's regulatory capital requirement in the short term due to nothing more than changes in the interest rate environment. We are currently in a low interest rate environment. At some point in the near future, we will likely be in a period of rising interest rates. The inclusion of unrealized losses on AFS securities in Common Equity Tier 1 Capital will put downward pressure on a bank's capital levels in a rising interest rate environment. We would be forced to maintain our capital to risk-weighted assets ratio at artificially inflated levels to compensate for the effect of interest rate changes. This would all happen while nothing would have changed in the bank's equity. This proposal will introduce a significant amount of cyclicality and volatility into the system which will be contradictory to the stated intent of Basel III to provide for stable, adequate capital in the banking system. It could also negatively impact my bank's interest rate spread.

To meet this proposal, my bank and others like it could be forced to reduce the size of its balance sheet as the economy begins to improve simply because interest rates begin to rise. Banks would be forced to reduce lending and concentrate on pulling back in order to maintain capital ratios. Doing so could serve to undermine economic growth at a time when credit is most needed to further economic growth and avoid a new recession.

One possibly unanticipated reaction of many banks to this scenario could be to sell all of their AFS securities and place all future purchases in "Hold to Maturity." Banks may do this to minimize cyclicality caused by the changing interest rate environment's effect on required capital levels. A side effect is that it will also reduce community banks' ability to manage their investment portfolio through different interest rate and economic cycles, a core tool to offset the inherent rate risk in a bank's loan and investment portfolio.

2. Phase Out of Trust Preferred Securities as Capital Instruments

Approximately 25% of my banking system's capital has been funded through trust preferred securities. We obtained this capital over the course of the last 15 years through a sound process sanctioned by our regulators. Capital has not been easy to come by in the markets we serve, which, as I have stated before, are relatively economically depressed. We do not have the same types of access to capital as larger institutions in money-center population centers. Many individuals in the communities we serve live paycheck to paycheck and there is not a large group of investors to provide much needed capital to us and the other community banks in our market areas. Furthermore, my bank is not publicly traded, making access to capital even more of a challenge. Phasing out trust preferred stock will further reduce available capital and require us to reduce the amount of loans of all types in our communities.

3. Increase in Risk-Weighting for Residential Mortgage Loans

As I've stated earlier, mortgage lending is one of the main products we offer to our communities. We are proud that, up until now, we've been able to offer the types of mortgage credit borrowers in our communities want, including that which would not be sellable on the secondary mortgage market. We are also proud that we've experienced minimal losses on these mortgage loans because we have been able to structure loans to meet the needs of customers we know well. During the past three years, my bank's losses on our mortgage loans have averaged 0.72%.

We find that our customer base in our more rural markets is more likely to not qualify for the traditional 30-year mortgage types of loans than more affluent borrowers in larger population

centers. A major impairment for many rural mortgage loan applicants in obtaining long-term, conventional mortgages is the value of the home they are attempting to purchase. In many of our depressed rural markets, average housing values are in the $25,000 to $50,000 range. No conventional lender is interested in purchasing smaller loans such as those that would need to be extended on homes in this price range. In addition, our rural markets typically do not have sufficient comparable sales to support the stringent appraisal standards mandated by the secondary market for 30-year loans. However, we are able to meet the needs of customers in these depressed, rural markets by extending shorter-term, balloon-payment loans in a way that protects our institution against interest rate changes without having to incur the additional documentation and operational costs of offering adjustable-rate mortgages

This proposal, along with others by the Consumer Financial Protection Bureau, threaten to significantly reduce mortgage lending or even force my bank to stop offering this extremely important type of credit to our customers. This proposal would require additional collateral risk-weighted capital on loans on which we have never experienced anything but minimal losses. It seems to me that the risk-weighted standards imposed by the proposed rules are designed more for secondary market loans sold on the national mortgage market rather than the type of mortgage loans small, community banks like mine extend.

We attempted to gauge the impact the new residential lending risk-weighting standards would have on my institution's capital requirements. We estimate[1] an increase in capital needed to maintain our current capital levels of at least $4,732,000 if these new proposed rules are implemented as they are currently stated. We further estimate that the absence of employable resources represented by this additionally-required capital would curtail our mortgage lending by approximately $57 million. Our communities cannot afford to lose $57 million in housing credit.

I can tell you just from the exercise we performed in attempting to estimate the impact that the calculations required by the proposed rule will also strain many financial institution's staff. The information necessary to perform the calculations is not easily available and the calculation process is cumbersome. The additional hours needed to comply will likely further encourage banks to just give up and stop offering mortgage credit.

4. Requirement to Hold Capital for Credit-Enhancing Representations and Warranties on 1-4 Family Residential Home Loans

This proposal appears to be saying that a bank will have to treat any credit-enhancing representation or warranty on a loan sold in the secondary market as an off-balance sheet guarantee and apply a 100% credit conversion factor to the transferred loans while the representations and warranties are in place. I say "appears" because I am having a difficult time understanding that this is truly what is meant in the case of loans such as those my banking system sells on the secondary market to mortgage investors. Most of the representations and warranties we give are considered "life-of-loan" and we are subject to a repurchase agreement.

If the rule more contemplates early default and premium refund warranties, it is requiring a bank to maintain capital for 100% of the loan amount when the bank's only liability is the potential dollar amount of the premium refund which will likely amount to only a few thousand dollars. Why not require capital in the amount of the bank's real potential liability rather than the entire

[1] Our estimate was predicated on changing the risk-weighting assignment for all non-conforming residential mortgages from 50 percent for all to 100 percent for one third of the dollar volume of these loans, 150 percent for an additional third, and 200 percent for the final third.

loan amount? Or why not simply implement a rule that restricts a bank from selling a problem loan?

My banking system has experienced very few repurchases in the mortgage loans we have sold on the secondary market in the past five years. I do not see the logic in requiring us to maintain capital for a risk that simply has not been there for us. I believe this rule is another attempt to address issues raised by practices of larger, national banks without making exceptions for the smaller banks who did not cause the issue and will be crippled by the solution devised for the larger, problem banks.

Additionally, the implementation of this rule could make my banking system and many others like it realize that the cost of holding capital for these loans just because they have representations and warranties will be too much for us to afford. This could lead us to discontinue our successful Mortgage Loan Operation that has originated over $300 million in loans over the past three years. Our withdrawal from the market would not only have a negative impact on the communities we serve, but would materially impact our income and require us to cut fifty-two (52) jobs. All mortgage lending would probably migrate to big banks. Given that it is widely accepted that the mortgage crisis resulted from the implicit actions of the big banks, this eventual consequence seems to fit squarely in the unintended category. Competition would lessen and the consumer would be left paying higher mortgage rates because community banks could no longer afford to offer these loans.

5. Proposal to Increase Risk Weights on Delinquent Loans

   My bank experienced relatively lower delinquencies through the recent economic crises and delinquency levels have shown further declines in the past year. Our overall delinquency ratio for the past three years has averaged 3.20% . We set aside reserves to insulate our capital from the impact of delinquencies, including a portion for impairments. By also increasing the amount of capital we hold based on the past due status, we will be required to set aside capital two times. I feel that the risk related to problem loans should continue to be managed through the loan loss reserve requirements and not by adding an additional capital requirement.

   This requirement will cause us to increase our aggressiveness in moving loans that become 90-days past due off the balance sheet. It will reduce our willingness to work as long with the borrower to remediate issues.

To summarize my concerns, I believe the proposal as currently stated will negatively impact my bank in the following ways:

1. It will cause my bank to reduce our balance sheet and constrict lending in order to maintain adequate capital levels;
2. It will limit our ability to manage our investment portfolio by forcing us to manage our portfolio to lessen interest rate movement impact;
3. It will further limit the resources we have for obtaining capital;
4. It will force us to consider limiting or even leaving the mortgage-lending business due to increased risk-weighted residential lending percentages and the additional representations and warranties requirements; and,
5. It will require us to "double-reserve" for delinquencies through both the allowance for loan and lease losses and through additional capital requirements.

Please understand that I agree with the goals of Basel III in terms of ensuring that banks are adequately capitalized. However, I'd like to point out that community banks have met the stringent capital requirements the U.S. federal banking agencies have placed on us these past several years. The requirements of Basel III would go beyond the level of prudence already dictated by the U.S. Congress. I feel the United States is already "ahead of the curve" in ensuring its banks have sufficient capital to weather economic downturns. The Basel III rules seem more attuned to large, European banks than small American community banks.

Why are we who did not cause the financial crises being asked to shoulder what is really a greater burden than those large national and international banks who did cause the crises? The burden is greater for us because we have more limited capital resources. These capital rules will break the backs of small community banks and damage the communities they serve. I ask you to consider the following:

1. Revise the proposed rule so that unrealized gains and losses on AFS securities that reside in accumulated other comprehensive income do not flow through capital;
2. Revise the proposed rule to fully recognize the intent of the Collins amendment by permanently grandfathering outstanding trust preferred securities for institutions between $500 million and $15 billion;
3. Revise the proposed rule to remove or reduce the risk-weighting requirements on residential mortgage loans;
4. Revise the proposed rule to remove the additional capital requirements for representations or warranties or, at least, make the amount of capital required more in line with the bank's actual liability; and,
5. Revise the proposed rule to limit the procedure banks follow for reserving for loan losses to the actual loan loss reserve.

Sincerely,

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Vice President
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