Community Guaranty Savings Bank

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September 28, 2012

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 Proposals

Ladies and Gentlemen:

Thank you for the opportunity to provide comment on the Basel III proposals[1] 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").

Community Guaranty Savings Bank is a $106 million independent community bank with offices in Plymouth and Campton New Hampshire, providing a wide range of quality banking services to residents, small businesses, and towns in the Pemi-Baker Region, including fifteen communities.

The proposed rules require that all unrealized gains and losses on available for sale securities (AFS) must "flow through" to common equity tier 1 (CET1) (a new measure under the proposal). Unrealized gains and losses occur in AFS portfolios primarily as a result of movements in interest rates as opposed to changes resulting from credit risk. Interest rates, particularly on debt securities, can fluctuate frequently, and therefore the proposed rules will introduce significant volatility into capital calculations.

Our current AFS investment portfolio has a net unrealized gain, which in a rising interest rate environment would become a net unrealized loss, requiring us to hold more capital as a cushion against this volatility. With a 2% increase in rates, we would need 14% more in capital. We would have to limit investments in longer duration assets, which could negatively impact the funding of housing markets through the reduction in purchases of longer term mortgage backed

[1] The proposals are titled: *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, and Transition Provisions*; *Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements; and Regulatory Capital Rules: Advanced Approaches Risk-based Capital Rules; Market Risk Capital Rule.*

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bonds, as well as having a negative impact on bank earnings. We would likely consider selling part of our AFS portfolio or reclassifying some of it to HTM, in either case this would reduce our liquidity and impact our asset liability and contingency funding abilities. Additionally, the HTM classification would limit our ability to manage these securities should they be downgraded. The options we might utilize would most likely hurt earnings, weaken the Bank's balance sheet, adversely affect liquidity and would not strengthen the Bank's true capital position.

Under the proposed rule, banks may not count as part of their CET1 capital measure any mortgage servicing assets (net of deferred tax liabilities) that exceed 10% of their CET1. The amount of mortgage servicing assets that is below the 10% threshold will receive a 100% risk weight (and eventually a 250% risk weight beginning in 2018)

It would most likely not be practical to continue to retain servicing on mortgages sold, given the risk weighting, which would remove a product that is very popular in our market. Since the beginning of the mortgage crisis, a large proportion of consumers have been moving their mortgages out of the big banks with the huge servicing portfolios that provide poor customer service, to community banks that retain the servicing on the loans they originate. The effect of Basel III will be to take this very valuable financing option away from the consumer. Additionally, the CFPB is so concerned about the quality of loan servicing that they have proposed amendments to the Truth-in-Lending and RESPA regulations to strengthen loan servicing practices. However, the effect of this piece of Basel III will force many community banks to eliminate their servicing portfolios, pushing servicing back to the largest banks, in direct contradiction to the CFPB's goals. Eliminating this product would also negatively impact our earnings by approximately 2% to 3% and reduce the number of personnel required to originate and process loans.

Inconsistent with the Collins amendment in the Dodd-Frank Act that grandfathers Trust Preferred Securities (TruPS) for banks between $500 million and $15 billion in assets, the Basel III proposal requires the complete phase-out of TruPS. Bank holding companies having between $500 million and $15 billion in total consolidated assets as of December 31, 2009, would be permitted to include 90% of the carrying value of such instruments in 2013, with annual 10% decreases in the includible amount through 2021, until the instruments are fully phased-out on January 1, 2022.

Although we are not subject to this provision, this could affect a financial institution such as ours. Should TruPS be eliminated for capital purposes, and we were subject to the provisions, our bank would experience 2.2% annual capital erosion over the ten year period of the phase-out. Overall, TruPS elimination would negatively impact capital by 22%; potentially require us to reduce our size, or consequently, reduce lending, the primary justification of a community bank. Given that we are a $100 million community bank in a rural area, raising additional capital to replace TruPS would be extremely difficult as we are too small and unable to go to the capital markets.

The proposal assigns risk weights to residential mortgages based on (1) whether the mortgage is a "traditional" category 1 mortgage or a "riskier" category 2 mortgage; and (2) the loan-to-value (LTV) ratio of the mortgage. The proposed residential mortgage rules raise several additional issues. Under the proposed rule, a bank is required to re-assess a mortgage after a loan restructuring or modification, unless the modification is made under the federal Home

Affordable Mortgage Program (HAMP). Thus, a category 1 mortgage might become a category 2 mortgage after modification. Considering the significant capital penalty for carrying Category 2 loans, a bank may not opt to help a troubled borrower and instead look to sell the loan (most likely to a private, unregulated purchaser), or foreclose.

In addition, the proposed rules do not recognize private mortgage insurance (PMI) at all. Mortgages are therefore subject to high risk weights even if PMI reduces the risk of loss on such loans. While it is understood that MI companies faced their own challenges during this mortgage crisis, for the most part, banks are now required to obtain mortgage insurance only from the highest rated companies, thereby eliminating any need to require higher capital levels against such loans. Additionally, increasing capital requirements on PMI loans may remove loans with LTV's above 80% altogether, hurting an already underserved population in the mortgage market; low income borrowers, borrowers that the Community Reinvestment Act and Fair Lending laws encourage banks to loan to. Finally, the proposed rules do not include any type of grandfather provision, so all mortgage loans currently on bank books will be subject to the new capital requirements. As a result, banks would be required to examine old mortgage underwriting files to determine the appropriate category and LTV ratio for each mortgage.

Residential mortgages comprise nearly 50% of our loan portfolio. This proposal would require us to limit the type of residential loans we provide, reduce our ability to modify loans and work with our customers having difficulties. We service a niche market of non-traditional loans for people with special financing needs. We would no longer be able to do this and our customers would find it more difficult to obtain mortgages. Since current loans would not be grandfathered it would require a significant amount of personnel time, and be extremely cumbersome to examine all old mortgages for proper classification. Vendors would need to come up with new codes to process, which would increase software costs, again reducing our ability to service our customers at a reasonable cost and in a reasonable time frame. This would likely negatively impact capital as increased risk weightings are calculated on our current portfolio of loans. The final result of this portion of Basel III is that customer costs will increase and their choices will decrease.

The proposed rules will require banks to hold capital for assets with credit enhancing representations and warranties, including "pipeline" mortgages in the process of being sold. Under the existing capital rules, banks are not required to hold capital against assets with such representations and warranties. This new requirement would affect any mortgage sold with a representation or warranty that contains (1) an early default clause, and/or (2) certain premium refund clauses that cover assets guaranteed, in whole or in part, by the U.S. government or government-sponsored entity.

Our bank sells mortgages into the secondary market under certain representations and warranties, including an early default clause. We also participate in the State of New Hampshire Business Finance Authority (BFA) program and various Small Business Administration programs, which provide credit enhancements for commercial loans. Offering these types of programs would become problematic and would likely be eliminated when otherwise they make good business sense and provide valuable opportunities for New Hampshire consumers and small businesses. This would negatively impact our earnings and increase costs to customers who have to go elsewhere or are completely unable to secure this type of financing. In particular, our participation in the BFA loan guarantee program provides valuable financing opportunities for

small businesses that are just getting started or are expanding, businesses that have had difficulties obtaining financing over the last five years and that have traditionally been the backbone of economic growth in this country. Eliminating this program and similar programs in other states will have significant economic repercussions nation-wide.

The proposal classifies all junior liens, such as home equity loans and lines of credit, as category 2 exposures with risk weights ranging from 100 to 200 percent. In addition, a bank that holds two or more mortgages on the same property would be required to treat all the mortgages on the property even the first lien mortgage as category 2 exposures. Thus, if the bank that made the first lien also makes the junior lien, then the junior lien may "taint" the first lien into a category 2 mortgage, which results in a higher risk weight for the first lien mortgage. By contrast, if one bank makes the first lien and a separate bank makes the junior lien, then the junior lien does not change the risk weight of the first lien.

The proposal provides one exception to these general rules: the first and junior lien may be combined into one category 1 mortgage exposure only if the bank holds both the first and junior lien on the same property, no party holds an intervening lien, and the combined exposure meets all the requirements of a category 1 mortgage. This exception is very narrow, and most junior lien mortgages likely will be deemed category 2 mortgages.

Home equity loans comprise 8% of our loan portfolio, and with a potential increase to our risk weighted assets under the new proposal, along with the potential tainting of first liens, this could have a dramatically negative capital impact on our bank. We would likely eliminate these types of loans or severely limit the combined loan-to-value of first and second liens.

Under the proposed rules, "High Volatility Commercial Real Estate" (HVCRE) is defined as acquisition, development and construction (ADC) commercial real estate loans except:
1) One- to- four family residential ADC loans; or 2) Commercial real estate ADC loans that:
a) meet applicable regulatory LTV requirements; b) the borrower has contributed cash to the project of at least 15 percent of the real estate's "appraised as completed" value prior to the advancement of funds by the bank; and c) the borrower contributed capital is contractually required to remain in the project until the credit facility is converted to permanent financing, sold or paid in full.

HVCRE would include, assuming the exceptions described above are not applicable, to all ADC loans including owner-occupied properties, borrowers with debt service coverage well above 1.0 and income-earning loans. Under the proposed standardized approach, each HVCRE loan in a bank's portfolio will be assigned a 150 percent risk weight. Today, under existing rules, these loans are risk-weighted at 100 percent.

We would have to discontinue these types of products without significant borrower contributions, which would severely hamper economic development for large and small business customers in our rural community. Much of our existing ADC portfolio would be assigned the higher risk weight, regardless of historical performance, again negatively impacting capital ratios. Further reduction in loan product offerings would cause us to reduce staff.

Under existing rules, the risk-weight of a loan does not change when the loan becomes delinquent. Instead, the additional risk is addressed through the Allowance for Loan and Lease

Losses. The proposal would change this approach significantly assigning nonresidential loans over 90 days past due a risk-weight of 150%.

This would currently increase risk weighted assets by 1%. We would be less inclined to work with customers and would initiate foreclosure procedures more quickly, so as to avoid the 90 day delinquency and increased risk weight requirement.

The proposal adds complexity and restrictions on how much of DTAs can be included in capital. DTAs that result from carryovers of net operating losses and tax credits are required to be deducted from capital. In addition, limitations are placed on certain assets as a group (DTAs, mortgage servicing rights, goodwill and pension accounts). Thus, banks will need to carefully monitor the combination of the entire group of assets, including DTAs, to insure that capital levels are appropriate.

We currently have DTAs resulting from net operating losses and tax credits. As with all the proposals the proposed deduction of these assets from capital would negatively impact our capital ratios. As a result we would no longer participate in new markets tax credits or New Hampshire state tax credits, which are extremely important to our local economy, hampering valuable services to our community.

The proposal will require institutions to collect and report new and in many cases, very granular information in order to calculate the risk weights of assets. Banks will be required to obtain, maintain and report new information about underwriting features and LTV ratios of credit exposures, and sufficient information to satisfy due diligence requirements. Further, in most cases, existing loans are not grandfathered and therefore the new information will need to be collected on the bank's existing portfolio. Existing information may also need to be maintained and reported on in different ways and forms and with greater frequency.

We would need to change internal reporting systems and provide additional employee training. Data would need to be collected manually on existing loans and require new systems or modifications to our existing systems going forward. With all the reductions in capital ratios, we would be unable to hire additional personnel or a third party to assist with meeting the new requirements. The time needed to meet all of these requirements would rely in part on software providers and would take several months to a year to comply with. All the while adversely impacting the products and services we are able to offer our customers. The consumers will be greatly disadvantaged by all of these changes.

It is also our understanding that the NCUA will not require credit unions to adhere to Basel III. This uneven standard when combined with the credit unions' tax exempt status and the recent legislative decisions to lift caps on commercial lending of credit unions will push more bank customers to credit unions, depriving the industry of large numbers of customers and the revenues associated with such customers, while also decreasing federal tax revenues as those earnings will migrate to the tax exempt credit unions.

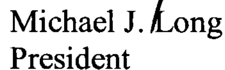
It has always been our understanding that Basel III was built to strengthen the largest banks that carry the greatest systemic risk to the global economy, while also maintaining a level international playing field so those largest banks don't migrate to countries with the weakest regulatory standards. Unfortunately this proposal to include all banks regardless of size and risk

to the financial system will cripple the very banks that continued to provide much needed financing and liquidity to our communities during the financial crisis that ultimately kept this country's economy afloat. The pressure on earnings and capital, and the loss of customer choice will remove many valuable consumer products from the market place. Therefore, within a very short time after Basel III is implemented the country will be faced with a sharp increase in banks with weakened capital positions due solely to the new revenue pressures placed on banks by Basel III and will further consolidate the banking industry, increasing the size of those systemically risky financial institutions that Basel III was initially meant to regulate. We strongly urge the Federal Reserve, OCC and the FDIC to recognize the unintended and financially devastating effect this proposal will have on the economy of this country and exempt community banks under $10 billion from the requirements of Basel III.

In closing, I hope that you will take all of this into consideration before your final decision. These proposals will greatly hurt the banking system, especially the community banks, for which Basel III was never intended.

Thank you for you consideration.

Very truly yours,



Michael J. Long
President

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