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Sent: Friday, October 12, 2012 6:22 PM
To: Comments
Subject: Basel III FDIC RIN 3064-AD95, RIN 3064-AD96, and RIN 3064-D97
Attachments: Basel III Comment letter -FDIC.doc

October 12, 2012

VIA ELECTRONIC DELIVERY

Mr. Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.,
Washington, DC 20429
comments@FDIC.gov
RIN 3064-AD95 and RIN 3064-AD96

RE: Regulatory Capital Rules: (1) Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Correction Act; and (2) Standardized Approach for Risk-Weighted Assets, Market Discipline and Disclosure Requirements: Docket No. R-1442 and RIN No. 7100-AD87

Dear Ms. Johnson:

Commerce State Bank is a \$305 million community institution in West Bend, Wisconsin. As a community banker with Commerce State Bank, I am gravely concerned over the broad approach taken by the Board of Governors of the Federal Reserve System (FRB), together with Office of the Comptroller of the Currency (OCC) and Federal Deposit Insurance Corporation (FDIC), (collectively, the Agencies) to impose a "one-size-fits-all" regulatory capital scheme despite the fact that the industry believed the Basel III proposals were intended for the very large, complex international institutions.

Respectfully, I believe this approach excessively tightens regulatory capital requirements on community banks which is unwarranted, beyond Congressional intent in many respects, and will likely cause a disruption in available credit in our marketplace.

I wish to remind the Agencies that, in addition to the proposed Basel III rules, there are currently at least ten major mortgage related rulemakings in various stages of development (HOEPA, MLO compensation, TILA/RESPA integration, two appraisal rules, ability-to-repay, risk retention, escrow requirements, and mortgage servicing rules under both TILA and RESPA). This, in turn, builds upon at least seven major final rulemakings in the previous 36 months (RESPA reform, HPML requirements, two MDIA implementation rules, appraisal reforms, appraisal guidelines, and MLO compensation).

I am very much concerned about the cumulative burden these rules will have on my institution. It is vitally important that the proposed regulatory capital rules be analyzed together in the context of other rulemakings and regulatory reforms—and be prospective in approach. The Agencies must not create capital requirements that are based upon occurrences in the past, under a different regulatory environment, and without consideration of other rulemakings and reforms. As proposed, Basel III will drop Commerce State Bank's total capital ratio by nearly 1.5%.

Increased capital ratios will reduce the return on equity. That is simple math. When investors compare the potential return on a bank investment vs. other alternatives, it will put banks at a disadvantage relative to those alternatives making it more difficult to attract investors and capital. Banks will have few alternatives. One alternative is always to shrink the bank. That comes with its own set of problems. Smaller banks require smaller staffs. Smaller banks generate less income requiring it to reduce costs, which again will point directly at reducing staffs or eliminating

jobs. Trust preferred securities will no longer be available to banks; in fact it is already effectively gone based on market forces. With reduced interest by common equity investors, that leaves income investors – either preferred stock or subordinated debt. What price must banks pay to attract those investors? There are already regulatory limits on the amount of a bank’s capital that can be borrowed. Therefore, this will not likely provide good source of ready capital to a growing bank. That leaves earnings to support growth.

Because maintaining strong capitals levels is so important, I see mergers and acquisitions being done on a dollar-for-dollar capital basis. If my bank is at 13% risk-based capital, the bank I am merging with or acquiring must be at 13% risk-based capital for it to be a viable transaction. Why would a bank merge with a less-capitalized bank only to weaken its capital position? This is likely to be viewed very critically by regulators and may not receive approval. The combined business plan had better demonstrate a very quick path to restoring the original capital level with little to no risk, based on cost reductions or other tangible efficiencies. That may require the bank being acquired to have its ownership team contribute capital to get the deal done.

In my opinion it is difficult to raise capital in any environment; and I say that after having successfully conducted 4 common equity and 2 subordinated debt raises. Today it is more difficult than ever to raise capital. The bank must rely on its current ownership to contribute additional equity, or they can look to their employee base to implement an Employee Stock Ownership Plan (ESOP). Beyond that you are subject to the demands of the market for either subordinated debt/preferred stock or common equity. Sub-debt or preferred stock are driven by the income rate of return provided via the interest rate or dividend. Common equity is being driven by the many banks stocks available today at below current book value. Despite how well you are performing, these market forces impact your ability to price and raise capital.

For these reasons and for the concerns outlined below, the Agencies must withdraw the proposed regulatory capital rules, conduct additional study and analysis, and only propose capital rules which take into consideration the impact other regulatory proposals and reforms will have on risk. The Agencies must recognize that there are many differences between community banks and large, complex international institutions—and must, therefore, not force a community bank into the same capital calculation “peg-hole” as a sophisticated international institution.

If the Agencies do not withdraw the proposals to further study the drastic impact they will have on community banks and on the U.S. financial industry as a whole, I urge the Agencies to take into consideration the specific concerns and recommended changes noted below.

Accumulated Other Comprehensive Income (AOCI)

As proposed, all unrealized gains and losses on available for sale securities (AFS) must “flow through” to common equity tier 1 capital. Therefore, if there is a change in the value of an AFS security (which can occur daily in some circumstances), that change must immediately be accounted for in regulatory capital. I wish to remind the Agencies that unrealized gains and losses occur in AFS portfolios primarily as a result of movements in interest rates—and *not* as a result of credit risk.

If the rules are finalized as proposed, with the inclusion of unrealized losses of AFS securities in common equity tier 1 capital, rising interest rates would put downward pressure on banking organizations’ capital levels. This will potentially cause my bank to reduce our growth or shrink our securities portfolios considerably in order to maintain capital ratios at the desired or required levels.

Additionally, as a community bank, we have been an investor in our local government entities. However, as proposed, the rules would discourage my bank from holding municipal securities, including holding U.S. Treasuries, because of the interest rate impact on such long-duration assets. This, in turn, could lead to a lower return on assets for my bank and less funding for the housing market and national and local governments, collectively.

Commerce State Bank’s investment portfolio is made up of only treasuries and municipal securities.

For these reasons, I greatly oppose this proposed treatment. The Agencies must remove this treatment from the proposals.

Treatment of Trust Preferred Securities (TruPS)

The Agencies' treatment of trust preferred securities (TruPS) under the proposals must not be finalized as proposed. Presumably out of concern for such a debt instrument being treated as "capital", Congress, as part of the Dodd-Frank Act (DFA), prohibited any new issuances of TruPS; however, under the Collins amendment in DFA, TruPS are grandfathered for institutions between \$500 million and \$15 billion. Nonetheless, the Agencies' proposals ignore the Collins amendment by requiring a complete phase-out of TruPS beginning in 2013.

Many Wisconsin community banks hold TruPS as capital on their books. The proposed complete phase-out of TruPS creates a significant problem for community banks that are privately held as they will have little access to capital. Investors in community banks are motivated by the growth opportunities such an investment affords rather than a desire to fill capital holes caused by changes in regulation.

Commerce State Bank's holding company does not currently hold TruPS, because of the uncertainty surrounding them. Rather, we chose to offer unsecured notes at the bank level, at higher interest rates, increasing our capital costs

I strenuously oppose the Agencies' treatment of TruPS beyond that which Congress intended under DFA. The Agencies must preserve the full intent of the Collins amendment to DFA by *permanently* grandfathering outstanding TruPS for institutions between \$500 million and \$15 billion.

Capital Risk-Weights for Residential Mortgages and Related Matters, High Volatility Commercial Real Estate (HVCRE), and Home-Equity Lines of Credit (HELOCs)

The Agencies' proposals place new significantly higher capital risk weights in several categories of real property-secured loans despite having neither empirical evidence to substantiate the need for such heightened capital levels, nor a mandate under law. The proposals raise several significant concerns, including the following.

Residential Mortgage Exposures Risk Weights

The proposals assign risk weights to residential mortgage exposures based on whether the loan is a "traditional" mortgage (Category 1) or a "riskier" mortgage (Category 2) *and* the loan-to-value (LTV) ratio of the mortgage. The current risk weight for a real estate mortgage is generally 50%; however, depending upon the Category and LTV ratio of a particular residential mortgage, the capital risk could rise to 200%. These higher risk weights appear to be arbitrarily set as there is no empirical data presented by the Agencies to support this extraordinary increase in risk weights for certain types of mortgages.

Respectfully, I challenge the Agencies' assumption that a residential mortgage has a higher degree of risk based exclusively upon the loan having a balloon payment, an adjustable rate, or an interest-only payment, to warrant the substantial increases in capital risk weights that are proposed. In fact, our portfolio of residential mortgages has experienced minimum losses compared to our commercial portfolio. The Agencies' proposed capital treatment far outweighs the reality of risk that we have experienced for these types of loans.

In addition, the substantial increase in risk weights will discourage my bank from making these types of loans even though we have experienced minimal losses. As a community bank, we make loans that are 3- or 5-year balloon mortgages with payments amortized over 30 years. We provide such loan products in order to offer loans to good borrowers and to protect against interest-rate risk. However, the new risk weights will discourage us from making such loans. For example, if we make a 5-year balloon loan with a LTV of 81-90%, the capital risk weight skyrockets from the current rule of 50% to 150% under the proposals. This type of treatment will detrimentally impact just how many loans I can offer my community and customers, will reduce or eliminate a traditional credit product that customers seek, and will also reduce our ability to protect against interest rate risk.

The Agencies must not finalize the proposed rules with such severe and unwarranted risk weighted treatment of residential mortgage exposures.

Reclassification to Category 2 for the Restructure or Modification of Mortgages Unless Made Under HAMP

The proposals would also require a financial institution 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 may become a Category 2 mortgage after modification if the bank does not modify the loan

under HAMP. I believe this treatment will, in essence, limit my ability to provide an option to restructure or modify a loan except under HAMP. Given today's economy and its impact on any particular borrower, it is imperative banks be given flexibility to restructure or modify *any* given mortgage loan to the particular needs of both the bank and the borrower—including not under HAMP. The bank should not be penalized by assigning a Category 2 risk weight to a loan that is modified or restructured in a manner that is not under HAMP.

The Agencies must allow for the same capital treatment of restructuring or modification for any mortgage as they would permit a loan restructure or modification under HAMP.

Removal of PMI Recognition When Determining Loan LTV

The bank's residential mortgage portfolio would also be negatively impacted by the proposed change in treatment of private mortgage insurance (PMI). The proposed rules do not recognize PMI when determining an LTV for a particular loan. Therefore, mortgages would be subject to high risk weights even if PMI reduced the risk of loss for such loans. It is difficult in today's challenging economy for borrowers to come up with 10% down payment, much less an amount higher than that, thus, PMI continues to be a product purchased to protect against repayment default risks. I recognize the concerns expressed by the Agencies within the proposed rules regarding less financially-sound PMI providers; however, where a bank can demonstrate that a particular PMI provider is financially sound, the bank should be permitted to recognize PMI when determining the particular loan's LTV ratio for capital risk weight purposes.

The Agencies' proposals must recognize that PMI reduces the risk of loss for such loans, and must, therefore, provide for the recognition of PMI when determining a loan's LTV ratio.

Capital Requirements for Loans with Credit-Enhancing Representations and Warranties

Under the proposed rules, if a bank provides a credit-enhancing representation or warranty on assets it sold or otherwise transferred to third parties, the bank would be required to treat such an arrangement as an off-balance sheet guaranty and apply a 100% credit conversion factor to the transferred loans while the credit-enhancing representations and warranties are in place. 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 classes that cover assets guaranteed, in whole or in part, by the U.S. government or a government-sponsored entity. Currently, the 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 a very early payment default—such as within 120-days of the sale of the mortgage.

The proposal would result in substantial additional capital charges for the mortgages we sell and will limit the amount of credit I can make available to potential borrowers. I believe there is little evidence that the temporary representations and warranties associated with these mortgages have resulted in significant losses for a regulated financial institution—even during the financial crisis.

As a result, the Agencies must retain the 120-day safe harbor under the current risk weight rules and not impose this additional capital charge.

High Volatility Commercial Real Estate (HVCRE)

As proposed, 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 in which: (a) applicable regulatory LTV requirements are met; (b) the borrower has contributed cash to the project of at least 15% 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. Under the proposed standardized approach, each HVCRE loan in a bank's portfolio will be assigned a 150 percent risk weight.

While I recognize the fact that certain types of commercial real estate (CRE) lending may pose a higher risk given today's economic environment, the Agencies' proposals impose a higher risk weight without considering any of the following mitigating factors in connection with a particular transaction: LTV ratio; dollar amount of the loan; other

commercial real estate assets of the borrower; any guaranty; or other general risk-mitigating factors of a particular CRE loan request. Just as these risk-mitigating factors are analyzed when we decide whether to approve or deny a particular CRE loan request, the Agencies must also take these mitigating factors into consideration when assigning a capital risk weight to a particular CRE.

Therefore, the Agencies must revise their proposed HVCRE risk weight to take into consideration risk-mitigating factors.

Home-equity Lines of Credit (HELOCs)

The proposal classifies all junior liens, such as home-equity lines of credit (HELOCs), as Category 2 exposures with risk weights ranging from 100 to 200%. 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 a bank that made the first lien also makes the junior lien, the junior lien may “taint” the first lien thereby causing the first lien to be placed in Category 2, and resulting in a higher risk weight for the first lien. By contrast, if one bank makes the first lien and a different bank makes the junior lien, then the junior lien does not change the risk weight of the first lien. There is one exception to this general treatment; however, that exception is very narrow and thus, most junior lien mortgages will likely be deemed Category 2 mortgages.

Again, this is another area within the proposals for which the Agencies have provided no data to support their assertion that all HELOCs are risky and warrant such severe treatment. In reality, HELOCs are carefully underwritten—based not only on the value of the home, but upon the borrower’s creditworthiness and with some of the strongest LTV ratios.

The Agencies must remove the treatment that all HELOCs are an automatic Category 2 classification.

No Grandfather Treatment for Existing Mortgage Loans

Finally, the proposed rules do not include any type of grandfather provision. Thus, *all* mortgage loans currently on the bank’s books will be subject to the new capital requirements. This will require bank staff to examine old mortgage underwriting files to determine the appropriate category and LTV ratio for each mortgage. This is a daunting task and comes at a time when the industry is also implementing numerous other *substantial* regulatory revisions and reforms previously mentioned. We simply do not have resources necessary to gather all of the information required to properly determine the revised risk weights for existing mortgage loans.

The Agencies must grandfather all existing mortgage exposures by assigning them the current general capital risk-based weights.

Conclusion

For the concerns outlined above, the Agencies must withdraw the proposed regulatory capital rules, conduct additional study and analysis, and only propose capital rules which take into consideration the impact other regulatory proposals and reforms have on risk.

The Agencies must recognize that there are many differences between community banks and large, complex international institutions—and must, therefore, not force a community bank into the same capital calculation “peg-hole” as a complex international institution.

I appreciate the opportunity to comment on the Agencies’ proposals.

Sincerely,

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