October 15, 2012

Via Electronic Submission at www.regulations.gov

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

Re: **FDIC RIN 3064–AD95**
Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action
FDIC RIN 3064–AD96
Regulatory Capital Rules: Standardized Approach for Risk- Weighted Assets; Market Discipline and Disclosure Requirements

Ladies and Gentlemen:

The following comments are submitted on behalf of Pilgrim Bank in response to the requests for comments in the notices of proposed rulemaking (NPR) on minimum regulatory capital and the standardized approach for risk-weighted assets. Pilgrim Bank is a community bank with locations in rural East Texas and the Texas Panhandle.

<u>General Observations – Basel III Should Exclude Community Banks and Apply to Only Large, Systemically Important Institutions</u>

Basel III should not be a "one size fits all" proposal. In our assessment, the Basel III proposals were intended for large, sophisticated financial institutions competing with others of a similar scale across the globe. With no frame of reference for, nor apparent understanding of, the unique characteristics of a community banking sector, it is no surprise that the architects of this proposal chose to follow this path. We are troubled that our own U.S. regulatory authorities would include community banking in this complex new capital scheme, and can only assume that this is a result of a major "disconnect" between academic theory and practical reality.

The American banking system is unique in the world, primarily due to a large number of community banks. We believe that community banks – focused on the long-term economic well-being of the towns and cities across America that they serve – have contributed significantly to the creation of jobs and economic activity in this country for decades. Forcing these new capital proposals on this sector epitomizes unnecessary and costly regulatory burden, and will result in what are sure to be damaging (and hopefully) unintended consequences. **If the unstated goal is to encourage further consolidation and concentration in the banking industry, this proposal, if adopted, will provide a major impetus toward that end.**

Community bankers, especially in Texas, understand and appreciate the need for adequate capital. Many of us well remember the trauma of the 1980s, and recognize the importance of appropriate levels of capital as a key component of a safe and sound bank and banking system. According to FDIC data presented by the Texas Department of Banking, equity capital to assets at year-end 2011 for Texas-domiciled banks was a healthy 11.19%. We all have a vested interest in a healthy banking system. After all, it is our industry that pays FDIC premiums to cover bank failures. Our concern is not based on maintaining adequate levels of capital but rather the process and unintended consequences of instituting this complex set of new rules.

We are upset, and justifiably so, over what we believe to be totally unnecessary and inappropriate proposals to redefine capital adequacy for all banks, regardless of size or risk profile.

We believe that this complex and cumbersome proposal threatens the very existence of community banks, and **our plea is for common sense to prevail by exempting community banks from these onerous proposals, and continuing to measure capital according to present methodology.**

Concerns

There are a number of problematic areas for community banks and those they serve contained in the proposed rules. Please consider our thoughts on some of these potential challenges:

Additional Compliance Costs. Community banks are overwhelmed with the volume and complexity of complying with an ever-increasing level of regulatory burden. There is frequent discussion as of late regarding "how big does a bank need to be to survive and absorb the increasing cost of compliance?" The regulatory authorities and Congress should be addressing this disturbing dynamic in a serious way, rather than contemplating new and costly burdens.

Perhaps one of the few positives to come out of the recent challenges in the financial sector is the universal recognition among lawmakers, regulators, the press and the public that "community banks are different," and neither participated in nor profited from the bad behavior that contributed to the meltdown. Sadly, the continued crush of regulatory burden, much of which was and is directed at "fixing" the problems that led to the recent debacle, is making it difficult, if not impossible, for this important sector of the banking system to continue to remain viable for the long term. It is disheartening to think that many longtime community bankers may seek to sell their banks because what was a relatively simple business model is no longer sustainable due to the continued barrage of federal law and regulatory overkill.

A partial list of federal issues and proposals in which Pilgrim Bank has engaged and/or submitted comment letters since last summer include: Reg CC, Availability of Funds and Collection of Checks; Proposed Rule on Preemption; Reg Z, Ability to Repay; Residential Mortgage Loan Risk Retention; Reg E Remittances; OCC's Proposed Overdraft Protection Guidance; Non-Resident Alien Deposit Interest Reporting; HUD Amendments to the Fair Housing Act Rules; Federal Home Loan Bank Community Support Amendments; Alternatives for Credit Ratings for Debt and Securitization Positions; recodification of regulations transferred to the CFPB; CFPB Treatment of Privileged Information; CFPB Overdraft; FinCEN Due Diligence; CFPB Arbitration Clauses; CFPB Ability to Repay Mortgage Standards; and, obviously, this particular capital proposal. Our bank is also dealing with a number of proposals from the CFPB related to the mortgage lending process, including Integrated Mortgage Disclosures (Regs X and Z); High Cost Mortgage and Homeownership Counseling Amendments to Regs X and Z; the 2012 Truth in Lending Act (Regs X and Z); Equal Credit Opportunity Act (Reg B) Appraisals; and Loan Originator Compensation (Reg Z, TILA). The FFIEC rule on Appraisals for Higher-Risk Mortgage Loans is also the topic of an upcoming comment letter and concern. This of course does not include other significant issues, including enhanced fair lending examination procedures, ADA requirements for ATMs and the subsequent spate of lawsuits, redundant signage and notice on ATM machines and related litigation, uncertainty regarding taxation, health care costs and the historic low interest rate environment.

Very few, if any, of the significant number of issues generated by our federal government involve safety and soundness issues, but all are time-consuming and add expense. We have been overwhelmed with the ongoing barrage of changes, and such is front and center in any meetings with our staff and Board of Directors.

Countless hours and expense have already been invested in understanding and evaluating the capital proposal, and assessing the potential impact on community banking going forward. Indeed, the proposal is so complex that the regulatory authorities felt it necessary to provide further information through live meetings and conference calls. Additionally, the comment period was extended until October 22 to provide additional time to more adequately analyze this voluminous proposal. While both the outreach and extension are sincerely appreciated, these actions are indicative of the tremendously difficult and complicated nature of this proposal.

The vast majority of community banks in this country have neither the human nor financial resources to deploy toward compliance with these proposals. The proposals call for very complex collection and reporting of information on various asset categories – on an ongoing basis – to properly determine risk weightings. We seriously question the efficacy of this exercise, and believe that the added cost and burden of compliance with these provisions is reason enough to exempt community banks from this proposal.

Accumulated Other Comprehensive Income (AOCI). We have concerns over various aspects of the proposal, the inclusion of unrealized gains and losses in the Available for Sale (AFS) portion of the securities portfolio in Tier 1 common equity capital has garnered universal anxiety.

The historically low interest rate environment has created issues. As we all are aware, there is little room for downward movement, and when rates move upward, as they no doubt will at some point, all banks will be faced with potentially significant **unrealized** losses in their securities portfolios. This dynamic will not only introduce significant volatility into the capital calculations, but could easily create scenarios in which a formerly well-capitalized bank could face severe sanctions due solely to market rate movements. Further, the "mark to market" requirement will require banks to hold more capital to compensate for inevitable swings in interest rates, thus hindering growth and lending opportunities.

The largest institutions have the ability to efficiently hedge interest rate risk in their securities portfolios. Community banks simply do not have that luxury.

Community banks are historically major investors in issuances of their local governmental entities. The cost of borrowing for these public entities will likely increase as banks will be loath to hold longer maturity securities for fear of rate-driven capital degradation. Thus, there is likely to be a significant negative impact on infrastructure development at the state and local level as well as harm to projects that create jobs locally.

Community banks are not captive to the whims of Wall Street analysts on a quarterly basis. They are long- term investors, and do not actively trade their securities portfolios. **In our opinion, inclusion of unrealized gains or losses in the securities portfolio is only meaningful in a liquidation scenario.** The proposed changes incorporating

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market rate swings into Common Equity Tier 1 capital will result in banks moving to shorter maturities, giving up precious and dwindling earnings opportunities, experiencing limited flexibility in managing their portfolio, sacrificing liquidity by moving securities to the "Held to Maturity" bucket, limiting loan growth, and forgoing expansion.

In a smorgasbord of troubling provisions, this one provision has the potential to have a devastating impact not only on banks across the country, but also on the communities and customers they serve.

Risk-Weightings. As discussed in a prior section, there will no doubt be challenges for community banks to appropriately assign proper risk-weightings to their various assets. This will be an expensive and time- consuming undertaking, and will require additional staff and expensive software. Further, and just as significant, **the proposal creates a disincentive to make mortgage and real estate loans, especially those kept "in-portfolio" as is common in the community banking model.**

Rules already in effect or proposed, including escrow requirements, balloon note limitations, appraisal standards, additional disclosures, "QM" and "QRM," and new "zero tolerance" on the "Good Faith Estimate," among others, have significantly curtailed mortgage lending among community bankers in our state. A number of banks may simply stop making mortgage loans to their customers thanks to regulatory and legislative "overkill" in an attempt to fix problems that we did not create. Higher capital costs imposed by these proposed risk weightings will further inhibit the ability of banks to make mortgage loans, especially in the more "non-traditional" variety so common in many of the more rural areas of our state. The secondary market is not interested in rural homestead loans where the properties are served by local volunteer fire departments and the homes have septic tanks and well water. The mega banks eliminated their rural branches when they came to Texas, and they are not likely to re-engage in those areas. Again, the impact on local economies should not be underestimated or ignored.

Further, the introduction of "High Volatility Commercial Real Estate" (HVCRE), with a 150% risk weighting and limited exemptions, will in our assessment also limit a bank's willingness to make these loans and raise borrowing costs in this already challenged market.

Increased risk-weightings for home equity loans will be problematic for some banks, and ultimately raise costs for our customers. As you are likely aware, the residential real estate market in our state did not experience the same level of volatility evidenced in other areas of the country. Additionally, we have the most restrictive home equity statutes in the country. When utilized responsibly by both borrower and lender, home equity lending is a meaningful and valued product and should not be discouraged.

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With these new proposals, one would need to question where the Allowance for Loan and Lease Losses would fit into the mix. Specific allocations are made for higher risk, classified, past due and non-accrual loans. It appears that with the additional capital requirements, perhaps there will be adjustments in the way this important risk management tool is utilized by banks and evaluated by the regulators.

From a macro perspective, this particular point in the economic cycle would appear to be perhaps the worst time possible for regulatory policies that result in disincentives for banks to fund properly underwritten real estate loans. While apparently well-intentioned from all appearances, many of these changes will limit choices and raise costs for the consumer. Further, the resultant increased market share and concentration of residential real estate mortgage loans in the largest institutions is simply not healthy for our economy.

Trust Preferred Securities (TruPS). One of the hard fought victories in the Dodd-Frank debate was the ability to count TruPS as Tier 1 capital for entities under $15 Billion in assets (the "Collins Amendment"). A significant number of small bank holding companies utilized this regulator-approved hybrid capital vehicle; this proposal not only phases out that treatment, it appears to directly contradict the will of Congress. **Congress passes laws and regulators are charged with adopting rules implementing those laws. This outright disregard for Congressional intent is a troubling precedent that must be corrected.**

Community banks have limited access to additional capital and Sub chapter S banks such as Pilgrim Bank have an even more narrow access to additional capital. While economic conditions have impacted earnings and ROE potential, many of our challenges in this area are a direct result of regulatory and legislative actions. Diminished expectations for earnings results in more difficulty attracting additional capital for our bank, dilutes existing shareholders and makes any capital acquisition significantly more costly.

A large number of community banking companies, including Pilgrim Bank, with the blessing of their regulators, successfully issued TruPS, profitably deployed that capital and continue to "play by the rules." We strongly encourage you to follow federal law on this issue, and allow those entities with TruPS to continue to include that capital in the Tier 1 category.

Other Issues. There are several additional concerns that are worthy of mention.

Banks that are active in the mortgage business. Mortgage servicing assets (in excess of 10% of Common Equity Tier 1) will no longer be counted at Tier 1 capital. Further, capital would be required against assets with credit enhancing representations and warranties, including mortgages in process of being securitized. As previously discussed, this is one more potential hurdle and expense that could impact the cost and availability of mortgages.

Similarly, there are new complex restrictions and limitations on capital treatment of deferred tax assets, goodwill and pension accounts. Further, the requirement to capitalize operating leases increases risk weighted assets, and thus the level of required capital. There have been concerns raised that these proposals "change the rules," and could prove problematic.

Conclusion

While we are obviously concerned about the damaging effects of this proposal on an already overwhelmed community banking industry, **the ultimate losers in this drastic change are consumers, small businesses, ranchers, farmers and local government entities who will face higher borrowing costs and diminished availability of both credit and bank services.** There is never a "good time" for public policy to result in such outcomes, but given the tenuous state of the national economy at this juncture, such seems especially counterintuitive.

We, in the strongest possible manner, implore you to exempt all but those banking institutions considered "systemically important" from these burdensome, complex and counterproductive capital rules. Thank you for your consideration of our thoughts and comments on this critical issue.

Sincerely,

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