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Sent: Friday, October 19, 2012 3:31 PM
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Subject: Basel III Must be Reconsidered Due to the Negative Impact on Community Banks and Their Customers

A proposal that was designed in Basel, Switzerland for large multi-national banks has no applicability for the overwhelming number of Ohio banks like mine, Richland Bank.

Issue 1: The standards as proposed are unnecessarily complex and expensive to implement
The Federal Reserve and other federal regulators have gone on record that almost all Ohio banks will meet the new capital standards. Generally, that is tier 1 capital to risk weighted assets of 6 percent (up from 4 percent); a new standard of common equity tier 1 capital to risk weighted assets of 4.5 percent and a capital "buffer" of 2.5 percent in order to make cash distributions such as dividends and bonuses. If most banks already meet this standard, why force the industry to go to extraordinary expense to validate the new capital levels?

As pointed out below, we don't know how the regulators could possibly know the details on individual loans that are required to determine capital levels under the Basel proposal. The real burden will be in the cost of compliance. The proposal is so complex that just to comply will require significant investment in new software and personnel. In fact the software community banks currently use to manage capital is useless in understanding the impact of the capital regulations, making it difficult to even get thoughtful input from an important sector of banking.

This proposal is data driven down to the level of individual loans and *existing loans are not grandfathered.* Since the information required to comply with this proposed regulation was not required or captured at the inception of the loan, banks will have to go back, manually, to analyze their portfolio to properly assign risk weighting to each loan. *This is a monumental task. Banks may not even have sufficient data to assign loans to the proper category.*

It borders on scandalous that banks are required to make these non-productive expenditures at a time of historically low margins and extraordinarily high compliance expenses driven by Dodd-Frank.

The proposed regulation will be more difficult and expensive to implement than initially realized by policy makers. The additional level of safety and soundness implied by these expensive models and complex formulae is illusory and simply not worth the additional cost.

Issue 2: The proposed regulations ignore standards recently stated by Congress in Dodd-Frank
Inconsistent with the intent of Dodd-Frank Section 171, the proposed Basel III capital rule does not grandfather trust preferred securities. Instead, these must be phased out beginning in 2013 and completely removed from capital by 2022.

Issue 3: Requiring unrealized gains and losses from a bank's available-for-sale investment portfolio will not increase safety and soundness and will in fact introduce increased volatility to bank capital levels
The Basel III proposal requires unrealized gains and losses from the available-for-sale portfolio to flow through to common equity tier 1. While current standards require unrealized gains and losses be shown as a part of "accumulated other comprehensive income" it is not included in regulatory capital. We cannot see any safety and soundness benefit from introducing this [daily] volatility to the debate of capital adequacy.

These gains and losses are of course a function of changes in interest rates, not credit risk.

We are currently in a period of historically low interest rates. Rates have one way to go and that is up. If unrealized portfolio gains become losses and flow through to capital, banks that the Federal Reserve believes currently meet the new enhanced capital levels could quickly fall underwater.

This additional volatility will require banks to keep additional capital just to make sure they stay above the new well-capitalized levels (plus any buffer).

Issue 4: Punitive capital charges on all but standardized "plain vanilla" loans strike at the heart of the community banking model. This will have unintended adverse consequences for the economy and for banking

Perhaps the proposal that will have the widest impact is the new treatment for first mortgages. As released, the regulation will qualify each loan into one of six categories based on perceived risk and LTV. The proposal then assigns a different risk weighting to each loan, with some residential mortgages requiring a risk weighting of much as 200 percent. It does not recognize PMI, and as described below, penalizes banks for working with customers and modifying loans outside of government sponsored programs by shifting them to a higher risk category.

Strategies to manage interest rate risk like balloon payments are penalized by requiring greater risk weighting. *Taking away this flexibility is particularly harmful to community banks. The only way banks can retain loans and manage interest rate risk is to make loans with a variable rate or balloon payment provision.*

Finally, HELOC loans as a product are placed in the 200 percent risk weight category and a bank that holds both the first and second mortgage will "taint" the underlying first mortgage, assigning it to a higher category unless the entire combined loan can qualify as a tier one risk.

As a practical matter, residential mortgage loans to marginal credit risks will become more expensive as a result of the required additional capital, or in some cases, will not even be made.

Issue 5: The New Regulation deducts mortgage servicing assets that exceed 10% of an institutions common tier 1 equity
The proposal excludes mortgage servicing assets in excess of 10 percent of CET 1. Also, deferred tax liabilities, mortgage servicing rights and investments in the stock of an unconsolidated financial entity may not exceed 15 percent of CET 1. Worse, the amount of mortgage servicing assets below 10 percent of CET 1 is assigned a risk weighting of 100 percent, but is phased up to 250 percent by 2018, adversely impacting capital twice.

Issue 6: A penalty for piling on. In the future, banks will be penalized for working with troubled borrowers
Currently, when a loan is past due, the additional risk is addressed through ALLL. In the future, these assets will take on a new 150 percent risk weighting. In essence this will require a double charge to capital for delinquent loans. This policy further undermines workouts and encourages fire sales of troubled assets for less than reasonable market value.

Again, this proposal is particularly detrimental to community banks that are closer to their customer and when justified can more easily adjust terms or otherwise work out troubled credits.

Conclusion
To completely appreciate the risk these proposed capital standards pose for community banks, they need to be considered in the context of other costs imposed on banking through new regulations. According to the House Financial Services Committee, there are already 7,365 pages of new regulations that I have to read, understand and educate my staff. Together with the new capital rule, these requirements will make community banking a losing business model for some, unnecessarily encouraging further consolidation.

The current proposal needs to be withdrawn and resubmitted to recognize the reality that most banks are operating with risk profiles that do not justify either the additional capital or the large additional expense of tracking assets to the degree required by these new standards.

Alternatively, regulators should consider carving out banks that either present very small risk to the financial system, or that have a traditional, straight forward, low risk balance sheet; or at least develop a simplified capital requirement for such institutions that will not require the extensive and expensive data required under the current proposal. Banks that are not "too-big-too-fail" should be given additional time to phase in *any* new proposed minimum capital levels because these depositories do not have easy access to capital markets.

Finally, examiners should not be allowed to apply these standards prior to the effective date based on a "best practices" theory.

Thank you for your consideration.

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