Valley Bank®

October 12, 2012

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington D.C. 20551

Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 2-3
Washington D.C. 20219

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 Gentleman:

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

Our bank was formed in 1993 in Eldridge, Iowa. Since that time we have grown to over $600 million in asset with offices in Davenport, Bettendorf, Clinton, Ankeny, Ames, Clive, Pleasant Hill, Knoxville, Oskaloosa and Altoona in Iowa and an office in Moline, Illinois. We are primarily a commercial real estate and residential mortgage bank serving small to medium size businesses and individuals in each of our markets. Our mortgage division provided over $291 million in home loans last year to people living in our markets. We are dedicated to the communities we serve and we strive to be a leader in helping to improve each of our communities. We have received awards from the Iowa Housing Authority in our service to individuals in helping them achieve their dream of home ownership.

We like most other community banks want to make sure we are able to continue serving our communities in the way we have in the past. A strong economy is dependent on job growth and job growth is dependent on the availability of capital to fund the small businesses of our communities that produce most of the jobs. We want to ensure that the new rules do not reduce the ability of our community banks to provide this capital.

The following items are the areas of the proposal in which we have concerns:

1. **Requirement that gains and losses on available for sale securities must flow through to regulatory capital.**

   Currently, our bank has a $135 million bond portfolio with approximately $ 500,000 of unrealizable gains. In a "rates up" 3 percent rate shock test, this would mean we would have a $1.5 million loss.

   Most banks have significant gains in their investment portfolios as our country is in an unprecedented period of low interest rates. This proposal would serve to increase regulatory capital in the short term. However, as interest rates begin to rise, this inflated capital would be quickly reversed and could move very dramatically in the other direction. The result would be changing a bank's regulatory capital ratios dramatically even though nothing will have changed in the bank's equity. This proposal will introduce a significant amount of volatility into the system which I believe is opposite of what the goal should be. If the bank has the capability to hold these assets until maturity it should not have to mark those gains and losses creating large swings in capital over normal business cycle changes in interest rates.

Our bank and others will be forced to reduce the size of our balance sheet as the economy begins to improve and interest rates begin to rise. This could serve to undermine an economic recovery as banks reduce lending and concentrate on pulling back to maintain capital ratios. Our small business and individual customers will be impacted by the reduced availability of credit under this scenario.

To avoid market swings, banks will "shorten up" durations of their investments. The outcome will be less yield and thus lower earnings. Banks may elect to reclassify their investments to "held to maturity". This would result in distorted liquidity and liquidity ratios. The bank's ability to manage the investment portfolio in a manner appropriate for liquidity, earnings, and the ability to manage interest rate risk (IRR) will be limited.

The proposed rule should be revised so that unrealized gains and losses on AFS securities that reside in accumulated other comprehensive income do not flow through capital. This would allow unrealized losses due to credit impairment to be reflected in capital, but would exclude the interest rate impact.

2. **Substantial increase in the risk weighted asset amount for residential mortgages.**

Our bank provided 1,919 mortgages in 2011 to people living in the markets we serve. We are one of the largest community bank providers of mortgages in these markets. This proposal threatens to significantly reduce or even drive our bank away from this very important business segment.

Community banks had little to nothing to do with the recent economic debacle largely created by the misuse of sub-prime and Alt A residential loans made primarily outside the banking system and securitized by large investment banks and lenders like Countrywide. According to the American Bankers Association (ABA), approximately 94% of such loans were made outside the banking system. And the community bank model is much different than the larger and systemically important banks. Generally, community banks are far more familiar with their customers and the risks associated with lending to local customers. However, the community banks are being forced to pay dearly for the actions of others.

The risk weighting methodology applies to not only new mortgages, but existing mortgages currently on the bank's balance sheet. To calculate the risk weights applicable to each mortgage would be an administrative nightmare. We would have to hire additional staff or outsource the project to a third party just to examine old records in order to determine mortgage categories and calculate LTV ratios under the proposed framework. In addition, we will not be able to just assign a risk weighting when the loan is booked, but we will have to continually re-evaluate the risk weightings based on changes in collateral values, past due status and other risk factors.

Requiring higher risk rating of those loans thus requires more capital, increasing the cost of the credit and reducing the availability of credit in our markets. Presumably the risk weights in excess of 100% are intended to have the bank hold additional capital as a buffer against the risks associated with the respective loans. This type of capital buffer is not necessary in that the ALLL analysis includes risk analysis of all risk factors including LTVs, the impact of credit scores, delinquencies and local market conditions.

3. **Requirement to hold capital for credit enhancing representations (removal of 120 day safe harbor).**

The representations and warranties in our correspondent contracts as they relate to fraud, misrepresentation or later identified deficiencies in underwriting, are considered life of the loan representations and warranties. Since our bank has sold well over $ 2.2 billion in loans over the last 10 years, we could be required to set aside $ 187 to $220 million in capital for loans which have been sold for a long period of time. This would place us in a capital deficient position we could never recover from.

The representations and warranties which refer to early default or premium refund clauses do not subject the bank to the repurchase of the loan. Our only liability would be to refund the premium we earned along with a processing fee. This would be the bank's only liability for early default on the loan. The proposal seems to state that the bank would have to maintain capital for 100% of the loan versus the actual liability of the premium/processing fee. It seems to me that the capital we maintain should be commensurate with the amount of risk we are assuming.

There is little evidence that the representations and warranties associate with "pipeline mortgages" have resulted in significant losses for regulated banking organizations, even during the most recent housing crisis. This rule as presently drafted threatens to drive every community bank in the country out of the mortgage lending business. We don't believe that is what is intended. We urge the banking agencies to retain the 120 day safe harbor in the current rule.

4. **Phase out of Trust Preferred Securities as Capital Instruments**

Our holding company, River Valley Bancorp Inc., holds $20 million in Trust Preferred Securities. This is a very cost effective source of capital for us and has allowed us to grow our bank and as a result to better serve our customers. The phase out of this source of capital will force our bank and many other community banks to reduce our balance sheets and thus reduce the amount of loans we will be able to provide to our communities to support job growth.

Community banks have much more limited sources of capital than the large banks do and this rule is a critical strike against community banks. Currently, if there is access to capital for a community bank, investors are focused on investing funds to support growth opportunities, not to fill capital holes caused by changes in regulations. This makes it even more difficult for community banks to replace Trust Preferred Securities. It does not appear that Dodd-Frank ever intended for this type of instrument to be phased-out for community banks.

The proposed rule should be revised to fully recognize the intent of the Collins amendment by permanently grandfathering outstanding Trust Preferred Securities for institutions between $500 million and $15 billion.

In conclusion, it is not possible at this time to ascertain the full impact on our bank of this proposal because of the amount of work that we will need to undertake to understand the rules, train our staff on how to apply the rules to our balance sheet, implement the coding of each individual loan in our portfolio with the new risk weights, re-program our core processing system to handle the new coding requirements and then create the necessary reports to analyze the data. We will likely need to hire additional staff or consultants to help us work through the front end of the process to assure that we have accurate data and to assure that our staff fully understands how to code the loans properly.

If the proposal to hold capital on loans we have sold into the secondary market force us to exit the mortgage business, we will lose in excess of $5 million after tax to our bottom line annually which will have a major impact on our overall profitability. This in turn will cause us to need to lay off 55 of our 170 person staff. When you consider that other community banks may be forced to do the same, the number of job layoffs and the loss of income to the industry are significant.

We strongly urge you to consider the impact of the proposal and to consider a possible exemption for most of our community banks from the majority of these rules. Our country's community banks need to be able to continue serving our communities and to support our local economies.

Thank you for your consideration.

Sincerely,

Larry C. Henson
President, River Valley Bancorp Inc.
CEO, Valley Bank