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Sent: Friday, December 22, 2017 6:19 PM

To: Comments

Subject: October 27, 2017 - FDIC Notice of Proposed Rulemaking: Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996; Comment Request (3064-AE59)

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To Whom It May Concern:

Kitsap Bank is a family owned community bank with over \$1.1 billion in assets, serving its community for nearly 110 years by providing a full range of financial services to commercial and individual customers. These services include providing conservative and well-managed acquisition, development and construction (ADC) loans to credit worthy borrowers.

We appreciate the opportunity to comment on the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), and the Federal Deposit Insurance Corporation (FDIC) (collectively, the Agencies) notice of proposed rulemaking: *Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996* (Capital Rule). While we appreciate the intent of the proposed Capital Rule in simplifying regulations, our comments relate specifically to the HVCRE/HVADC exposure definitions within the proposal. We fully support the simplification of the Community Development exemption definition and appreciate the clearer definition of a “permanent loan”, but do *not* recommend eliminating the exemption for projects with a 15% capital contribution as proposed.

Primary Concerns with Eliminating the 15% Capital Contribution Exemption

- We believe that requiring a 15% cash (or unencumbered readily marketable securities) contribution prior to loan funds being advanced and contractually requiring it to remain throughout the project life is prudent ADC lending;
- We feel having this contribution as part of the regulatory framework reduces the risk within the banking system and serves to level the playing field in ADC lending as under current HVCRE definitions, all banks have to abide by this requirement for 100% risk weighting treatment;
- We strongly believe that eliminating the HVCRE exemption for projects with 15% capital contributions will lead to looser underwriting standards and higher risk lending practices. By setting risk weighing on all ADC loans at 130% and making no distinction between poorly capitalized projects/higher risk loans and well capitalized/lower risk loans; this proposed definition will have the unintended consequence of effectively increasing the overall risk in the banking system.
 - Example: under the proposed HVADC definition, a loan with a borrower capital injection of 50% would be risk weighted the same as a loan with only 1% capital injection, when there clearly is a significant difference in the risk profile of each project – despite the same risk weighting.

- Through the financial crisis, ADC lending without an adequate capital injection from the borrower coupled with high or inflated market values, helped contribute to significant loan losses, leading to numerous bank failures and many FDIC insurance payouts;
- Risk weighting alone does not result in better risk management decisions. However, calibrating the risk weighting for prudently underwritten loans appropriately incentivizes both lenders and borrowers to pursue underwriting higher credit quality projects;
- We believe 100% risk weighting continues to be appropriate for properly margined ADC projects, which are encouraged under the current 15% capital contribution exemption

Alternative Recommendation to Simplifying the 15% Capital Contribution Exemption

An alternative for simplifying the current exemption for projects with a 15% capital contribution is to exempt projects where capital of at least 15% of the **project cost** is injected directly into an ADC project. The current exemption utilizes the ‘*as completed*’ value as opposed to the construction budget as the determinate for qualification under the 15% capital exemption.

Using 15% of the ‘as completed’ value can create a hardship for an owner who purchased a property and held it for a significant amount of time. This essentially penalizes them for making a smart investment in the past. That property has most likely experienced a significant increase in market value due to a relatively low purchase price compared with current market conditions. Additionally, principal payments on acquisition or refinanced debt typically have been made. It can be very difficult and cumbersome to calculate and document the actual amount of cash injected into a property owned for a significant period of time.

To simplify this exemption but still encourage prudent ADC lending practices, the simplified measure could include the following:

- A 15% capital contribution of the *budgeted cost* of the project must be injected by the owners, remain throughout the project life and must be contributed prior to any bank funds being disbursed.
- The Loan to Value (LTV) at origination is at or below maximum supervisory LTV.

Impact to Risk based Capital

An additional concern is the impact to our risk weighted assets as a result of the proposed 130% risk weighting treatment. We follow very prudent underwriting practices and currently do not have any HVCRE loans in our ADC portfolio. Under the proposed Capital Rule and averaging the last three quarters results in an increase of \$5.2 million to our risk weighted assets if we are required to apply the 130% weighting.

Conclusion

We encourage the Agencies to consider the comments and recommendations described above. The 15% capital contribution exemption encourages reasonable lending practices with higher risk ADC projects. Eliminating this benchmark altogether and weighting all ADC loans the same

without some alternative measure for prudent ADC lending would likely result in unsafe lending practices throughout our industry.

Respectfully Submitted,

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