KISHBANK

09/24/2012

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, DC 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 Gentlemen:

Thank you for the opportunity to provide comment on the BASEL III proposals[1] 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").

Kishacoquillas Valley National Bank (Kish Bank) is a community bank headquartered in Bellville, PA with approximately $560 million in assets and has been serving the financial needs in the Mifflin County, Huntingdon County and Centre County central Pennsylvania communities for over one hundred years. We have eleven branches and three financial centers across these counties that offer a wide array of financial products and services to meet the needs of the community. For the sixth consecutive year, we have been ranked as one of the nation's top 200 community banks by *American Banker Magazine*. The ranking is based on three-year average return on equity.

According to the BASEL III proposals approved by the banking agencies, as a mid-sized community bank, we would be subject to the BASEL III requirements of Regulatory Capital Rules on:

1. *Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, and Transition Provisions; and*
2. *Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements*

[1] The proposals are titled: *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, and Transition Provisions*; *Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements; and Regulatory Capital Rules: Advanced Approaches Risk-based Capital Rules; Market Risk Capital Rule.*

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The above rules on BASEL III will have a significant impact on regulatory capital ratios, both from a numerator and a denominator perspective.

Impact on the Numerator

- Unrealized gains and losses (AOCI) on AFS securities to flow through Common Equity.
    - Potential Impact
        - Forcing the recognition of unrealized gains and losses in capital ratios that are temporary in nature and result principally from movements in interest rates (as opposed to changes in credit risks) that are unlikely to be realized and that typically result in no effect on the banking organization would result in substantial volatility in regulatory capital regardless of any real change in risk.
        - Our bank, like other community banks, uses an investment portfolio as a means of Asset–Liability management, with the objective to strengthen asset liquidity and manage interest rate risk. Removing the AOCI filter from regulatory capital will significantly impact our ability to enhance asset liquidity and manage interest rate risk. We would be forced to keep shorter duration securities on our portfolio to reduce the volatility induced by unrealized gain and losses.
        - Combined with the Dodd–Frank requirement of non-reliance on ratings, and assigning risk weightings using a standard approach, it would become extremely cumbersome to invest in many securities products, limiting the ability of the bank to manage a securities portfolio as an alternative and viable means of earning assets.
- Deferred Tax Assets : Any amount exceeding 10% of common equity will be deducted from Common Equity
- Mortgage Servicing Rights: Any amount exceeding 10% of Common Equity will be deducted from Common Equity
    - Potential Impact
        - As the bank achieves its growth objectives in the coming years, both of the adjustments noted above will impact our regulatory capital significantly. We originate mortgage loans and sell them in the secondary market, but retain the servicing so the customer interfaces with the bank rather than the third-party owner of the loans. The ability to service our mortgage loans helps us maintain relationships with our customers; it also generates fee income for the bank. A 15% threshold for combined deferred tax assets, and MSR will severely impact our capital and business model, a model that focuses on our commitment to the development of the communities we serve. Additionally, raising the risk weight of the amount that is not deductible to 250% will have an outsized impact on regulatory capital.

- Phasing out Trust Preferred Securities:
  The intent of the Collins amendment was to grandfather Trust Preferred Securities for institutions between $500 million and $15 billion. However, Basel III requires the phase-out of these instruments for bank holding companies between $500 million and $15 billion in total consolidated assets as of December 31, 2009, permitting the inclusion of 90% of the carrying value of such instruments in 2013, with annual 10% decreases in the includible amount through 2021, until the instruments are fully phased-out on January 1, 2022.
  - Potential Impact:
    - Phasing out 10% of the Trust Preferred Securities each year and holding everything else constant will reduce our Tier 1 Capital to Average Quarterly Assets ratio by 11 bps per year and both the Tier 1 Capital to Total Risk Weighted Assets Ratio and Total Capital to Total Risk Weighted Assets Ratio by 15 bps per year.
    - Holding other variables constant, full phase out of Trust Preferred Securities will lower the Bancorp's capital ratio as follows:
      - Tier 1 Capital to Average Quarterly Assets: down 107 bps
      - Tier 1 Capital to Total Risk Weighted Assets: down 148 bps
      - Total Capital to Total Risk Weighted Assets: down 148 bps
    - Combined with other influences on the numerator as stated above, the impact on capital would be significantly accelerated.

Impact on the Denominator

Increased Risk weightings in many assets and off balance sheet categories would have a considerable impact on increasing the total risk weighted assets, consequently increasing the denominator, leading to lower ratios further.

- Residential 1- 4 Family segregated into two categories
  - Potential impact:
    - Our institution, like many other community banks, offers different types of residential ARM products to the community with the objectives of serving the financial needs of the community as well as to manage the interest rate risk of the institution. Under the proposed rules, all ARM products would fall under "Category II" of Residential 1-4 family lending, which has higher risk weights associated with it. This Rule will have a substantial impact on the total risk weighted assets of the bank. To avoid the impact on capital, the bank would have to keep longer maturity assets on the bank's books, which will increase the interest rate risk in the balance sheet.
    - In combination with the deduction of MSR from tangible common equity and imposition of increased risk weights on 1-4 family residential loans,

based on tiered levels of LTV, the business model for residential lending would need to be re-evaluated to measure its future financial viability.

- Risk weight of non-accrual loans increased
  - Potential impact
    - The inherent risk of non-accrual loans is adequately reflected in the Allowance for Loans and Lease Losses via ASCI 350 analysis and special reserve allocation where needed. The impact is already included in the capital through retained earnings, which are decreased with any increase in loan loss provision. Non-accrual loans are currently weighted at 100%. We believe that increasing the risk weights to 150% is duplicative of the risk management process for non-accrual loans and induces unnecessary pressure on capital.
- Risk weight of Off Balance Sheet items increased
  - Potential Impact
    - Together with the increased risk weighting on non-accrual loans, the increases in risk weights of off balance sheet items will accelerate the risk weighted assets without any real significant risk to the bank and lower the risk based capital ratios artificially.

Administrative Burden

- Complex Calculations: The bank will face the increased administrative burden of tracking different categories of deductions and adjustments to capital and changes to risk weighted assets on a quarterly basis to ensure compliance with the proposed regulation. The cost will also increase because of changes in input to the processing system in order to adequately capture and report information. Additionally, the current software and systems used for regulatory reporting will have to be updated/changed to comply with the provisions of the proposed rules.
- Stress Testing: Though the proposed rules do not make it mandatory for community banks to conduct capital stress testing, they would have a trickle-down effect on community banks by virtue of regulators suggesting stress testing of capital as a part of industry best practices. Unlike bigger institutions, community banks do not have adequate in-house resources to conduct capital stress testing that is meaningful. Therefore, the probability of engaging third-party vendors and increasing the costs of compliance is likely to increase.

Suggestions:

- Current rules already impose a 10% haircut on the fair market value of readily marketable mortgage servicing assets that are included in regulatory capital. Imposing this new requirement would further impact U.S. banks beyond the 10% requirement of Basel III.

- We believe that there should be no deduction from capital for mortgage servicing rights. If the limit is imposed, community banks with less than $10 billion in assets should be exempt from this rule. At the very least, the threshold limit should be increased to at least 25% of Tier 1 capital.
- ARM products should not be treated in category II of 1-4 family residential loans as they provide a significant means of managing interest rate risk.
- Risk weights on residential loans should not be increased beyond 100%.
- The above measures will facilitate growth of the residential housing market, which is critically important to the economic development of our nation.

- Do not remove the AOCI filter from regulatory capital calculations. At the very least, all bank qualified investments should be exempt from this rule, as these do not pose a significant risk to the institution.
- In accordance with the intent of the Collins amendment, Trust Preferred Securities should be grandfathered for community banks below an asset size of $15 billion.

Thank you, again, for the opportunity to comment on the BASEL III proposals. If you have questions or need additional information, please contact me at the address noted herein, or at 814–861–4660 extension 8243.

Sincerely,

Sangeeta Kishore

Sangeeta Kishore
Executive Vice President & Chief financial Officer
Kish Bancorp Inc.