



October 18, 2012

**VIA ELECTRONIC DELIVERY**

Ms. Jennifer J. Johnson, Secretary  
Board of Governors of the Federal Reserve System  
20<sup>th</sup> Street and Constitution Avenue, N.W.,  
Washington, DC 20551  
[regs.comments@federalreserve.gov](mailto:regs.comments@federalreserve.gov)  
Docket No. R-1442 and RIN No. 7100-AD87

**RE: Regulatory Capital Rules: (1) Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Correction Act: RIN 3064-AD95; and (2) Standardized Approach for Risk-Weighted Assets, Market Discipline and Disclosure Requirements: RIN 3064-AD96**

Dear Ms. Johnson:

First State Bank is a \$263 million community institution in New London, Wisconsin. As a community banker with First State Bank, I am gravely concerned over the broad approach taken by the Federal Deposit Insurance Corporation (FDIC), together with Board of Governors of the Federal Reserve System (FRB) and Office of the Comptroller of the Currency (OCC), (collectively, the Agencies) to impose a "one-size-fits-all" regulatory capital scheme despite the fact that the industry believed the Basel III proposals were intended for the very large, complex international institutions.

Respectfully, I believe this approach excessively tightens regulatory capital requirements on community banks which is unwarranted, beyond Congressional intent in many respects, and will likely cause a disruption in available credit in our marketplace.

I wish to remind the Agencies that, in addition to the proposed Basel III rules, there are currently at least ten major mortgage related rulemakings in various stages of development (HOEPA, MLO compensation, TILA/RESPA integration, two appraisal rules, ability-to-repay, risk retention, escrow requirements, and mortgage servicing rules under both TILA and RESPA). This, in turn, builds upon at least seven major final rulemakings in the previous 36 months (RESPA reform, HPML requirements, two MDIA implementation rules, appraisal reforms, appraisal guidelines, and MLO compensation).

I am very much concerned about the cumulative burden these rules will have on my institution. It is vitally important that the proposed regulatory capital rules be analyzed together in the context of other rulemakings and regulatory reforms—and be prospective in approach. The Agencies must not create capital requirements that are based upon occurrences in the past, under a different regulatory environment, and without consideration of other rulemakings and reforms.

For these reasons and for the concerns outlined below, the Agencies must withdraw the proposed regulatory capital rules, conduct additional study and analysis, and only propose capital rules which take into consideration the impact other regulatory proposals and reforms will have on risk. The Agencies must recognize that there are many differences between community banks and large, complex international institutions—and must, therefore, not force a community bank into the same capital calculation “peg-hole” as a sophisticated international institution.

If the Agencies do not withdraw the proposals to further study the drastic impact they will have on community banks and on the U.S. financial industry as a whole, I urge the Agencies to take into consideration the specific concerns and recommended changes noted below.

### **Accumulated Other Comprehensive Income (AOCI)**

As proposed, all unrealized gains and losses on available for sale securities (AFS) must “flow through” to common equity tier 1 capital. Therefore, if there is a change in the value of an AFS security (which can occur daily in some circumstances), that change must immediately be accounted for in regulatory capital. I wish to remind the Agencies that unrealized gains and losses occur in AFS portfolios primarily as a result of movements in interest rates—and *not* as a result of credit risk.

If the rules are finalized as proposed, with the inclusion of unrealized losses of AFS securities in common equity tier 1 capital, rising interest rates would put downward pressure on banking organizations’ capital levels. This will potentially cause my bank to reduce our growth or shrink our securities portfolios considerably in order to maintain capital ratios at the desired or required levels.

Additionally, as a community bank, we have been an investor in our local government entities. However, as proposed, the rules would discourage my bank from holding municipal securities, including holding U.S. Treasuries, because of the interest rate impact on such long-duration assets. This, in turn, could lead to a lower return on assets for my bank and less funding for the housing market and national and local governments, collectively.

Currently, our investment portfolio comprises 30% of our assets and consists mainly of municipal securities supporting communities in Wisconsin. Maturities of these securities range from 1 to 12 years. The longer term maturities allow municipalities to lock in low interest rates which in turn allow them to hold down taxes in their respective communities. Should Basel III be implemented in its present form, our bank will be reluctant to purchase longer maturing investments as a rise in interest rates would cause an artificial reduction in Capital. In addition, by shortening our investment maturities, income would be negatively impacted. Reduced earnings will have a direct impact on our customers by limiting the resources we have to support community projects and funding needs of area small businesses.

For these reasons, I greatly oppose this proposed treatment. The Agencies must remove this treatment from the proposals.

### **Capital Risk-Weights for Residential Mortgages and Related Matters, High Volatility Commercial Real Estate (HVCRE), and Home-Equity Lines of Credit (HELOCs)**

The Agencies’ proposals place new significantly higher capital risk weights in several categories of real property-secured loans despite having neither empirical evidence to

substantiate the need for such heightened capital levels, nor a mandate under law. The proposals raise several significant concerns, including the following.

#### *Residential Mortgage Exposures Risk Weights*

The proposals assign risk weights to residential mortgage exposures based on whether the loan is a “traditional” mortgage (Category 1) or a “riskier” mortgage (Category 2) *and* the loan-to-value (LTV) ratio of the mortgage. The current risk weight for a real estate mortgage is generally 50%; however, depending upon the Category and LTV ratio of a particular residential mortgage, the capital risk could rise to 200%. These higher risk weights appear to be arbitrarily set as there is no empirical data presented by the Agencies to support this extraordinary increase in risk weights for certain types of mortgages.

Respectfully, I challenge the Agencies’ assumption that a residential mortgage has a higher degree of risk based exclusively upon the loan having a balloon payment, an adjustable rate, or an interest-only payment, to warrant the substantial increases in capital risk weights that are proposed. In fact, our portfolio of conventional first-lien mortgages has experienced minimum losses with a default rate of only .44% over the past five years during a time when our industry was encountering some of the largest losses in recent history. The Agencies’ proposed capital treatment far outweighs the reality of risk that we have experienced for these types of loans.

In addition, the substantial increase in risk weights will discourage my bank from making these types of loans even though we have experienced minimal losses. The proposed rules will push us to only extend credit to those borrowers that have a low LTV (below 60%), in order to not negatively impact capital. However, lending to only that select group of individuals will curtail home ownership in our communities and continue to depress the real estate market. Lack of funding available for home equity lines of credit would reduce our customers’ ability to invest in home improvement projects, and would further impact our local retail sector and their growth. Taking on the arbitrary risk of lending to those with a higher, acceptable LTV would force our financial institution to make up that perceived negative capital exposure through costs and fees which will inevitably be passed on to the consumer.

The Agencies must not finalize the proposed rules with such severe and unwarranted risk weighted treatment of residential mortgage exposures.

#### *Reclassification to Category 2 for the Restructure or Modification of Mortgages Unless Made Under HAMP*

The proposals would also require a financial institution to re-assess a mortgage after a loan restructuring or modification, unless the modification is made under the federal Home Affordable Mortgage Program (HAMP). Thus, a Category 1 mortgage may become a Category 2 mortgage after modification if the bank does not modify the loan under HAMP. I believe this treatment will, in essence, limit my ability to provide an option to restructure or modify a loan except under HAMP. Given today’s economy and its impact on any particular borrower, it is imperative banks be given flexibility to restructure or modify *any* given mortgage loan to the particular needs of both the bank and the borrower—including not under HAMP. The bank should not be penalized by assigning a Category 2 risk weight to a loan that is modified or restructured in a manner that is not under HAMP.

This provision of Basel III will hamper our ability to assist customers who want to take advantage of lower interest rates on their mortgages, but cannot because the modification is not made under HAMP.

The Agencies must allow for the same capital treatment of restructuring or modification for any mortgage as they would permit a loan restructure or modification under HAMP.

#### *Removal of PMI Recognition When Determining Loan LTV*

The bank's residential mortgage portfolio would also be negatively impacted by the proposed change in treatment of private mortgage insurance (PMI). The proposed rules do not recognize PMI when determining an LTV for a particular loan. Therefore, mortgages would be subject to high risk weights even if PMI reduced the risk of loss for such loans. It is difficult in today's challenging economy for borrowers to come up with 10% downpayment, much less an amount higher than that, thus, PMI continues to be a product purchased to protect against repayment default risks. I recognize the concerns expressed by the Agencies within the proposed rules regarding less financially-sound PMI providers; however, where a bank can demonstrate that a particular PMI provider is financially sound, the bank should be permitted to recognize PMI when determining the particular loan's LTV ratio for capital risk weight purposes.

Our financial institution only offers first-lien mortgages in excess of 80% LTV if the borrower purchases private mortgage insurance. We have experienced minimal default cases with borrowers holding private mortgage insurance (only two cases within the previous three years). In both instances, PMI did subsidize a portion of the total loss realized by the Bank. Under the proposed regulations, we may be forced to reduce our lending to borrowers with an LTV greater than 80%. The impact is likely to reduce the total number of insureds holding PMI, which will increase premium costs for consumers.

The Agencies' proposals must recognize that PMI reduces the risk of loss for such loans, and must, therefore, provide for the recognition of PMI when determining a loan's LTV ratio.

#### *Capital Requirements for Loans with Credit-Enhancing Representations and Warranties*

Under the proposed rules, if a bank provides a credit-enhancing representation or warranty on assets it sold or otherwise transferred to third parties, the bank would be required to treat such an arrangement as an off-balance sheet guaranty and apply a 100% credit conversion factor to the transferred loans while the credit-enhancing representations and warranties are in place. This new requirement would affect any mortgage sold with a representation or warranty that contains (1) an early default clause, and/or (2) certain premium refund classes that cover assets guaranteed, in whole or in part, by the U.S. government or a government-sponsored entity. Currently, the risk-based capital charges do not apply to mortgages once they are sold to third parties, even where the seller provides representations and warranties to take back mortgages that experience a very early payment default—such as within 120-days of the sale of the mortgage.

The proposal would result in substantial additional capital charges for the mortgages we sell and will limit the amount of credit I can make available to potential borrowers. I believe there is little evidence that the temporary representations and warranties associated with these mortgages have resulted in significant losses for a regulated financial institution—even during the financial crisis.

As a result, the Agencies must retain the 120-day safe harbor under the current risk weight rules and not impose this additional capital charge.

#### *High Volatility Commercial Real Estate (HVCRE)*

As proposed, high volatility commercial real estate (HVCRE) is defined as acquisition, development and construction (ADC) commercial real estate loans except: (1) One- to four-family residential ADC loans; or (2) commercial real estate ADC loans in which: (a) applicable regulatory LTV requirements are met; (b) the borrower has contributed cash to the project of at least 15% of the real estate's "appraised as completed" value prior to the advancement of funds by the bank; and (c) the borrower-contributed capital is contractually required to remain in the project until the credit facility is converted to permanent financing, sold or paid in full. Under the proposed standardized approach, each HVCRE loan in a bank's portfolio will be assigned a 150 percent risk weight.

While I recognize the fact that certain types of commercial real estate (CRE) lending may pose a higher risk given today's economic environment, the Agencies' proposals impose a higher risk weight without considering any of the following mitigating factors in connection with a particular transaction: LTV ratio; dollar amount of the loan; other commercial real estate assets of the borrower; any guaranty; or other general risk-mitigating factors of a particular CRE loan request. Just as these risk-mitigating factors are analyzed when we decide whether to approve or deny a particular CRE loan request, the Agencies must also take these mitigating factors into consideration when assigning a capital risk weight to a particular CRE.

Therefore, the Agencies must revise their proposed HVCRE risk weight to take into consideration risk-mitigating factors.

#### *Home-equity Lines of Credit (HELOCs)*

The proposal classifies all junior liens, such as home-equity lines of credit (HELOCs), as Category 2 exposures with risk weights ranging from 100 to 200%. In addition, a bank that holds two or more mortgages on the same property would be required to treat *all* the mortgages on the property—even the first lien mortgage—as Category 2 exposures. Thus, if a bank that made the first lien also makes the junior lien, the junior lien may "taint" the first lien thereby causing the first lien to be placed in Category 2, and resulting in a higher risk weight for the first lien. By contrast, if one bank makes the first lien and a different bank makes the junior lien, then the junior lien does not change the risk weight of the first lien. There is one exception to this general treatment; however, that exception is very narrow and thus, most junior lien mortgages will likely be deemed Category 2 mortgages.

Again, this is another area within the proposals for which the Agencies have provided no data to support their assertion that all HELOCs are risky and warrant such severe treatment. In reality, HELOCs are carefully underwritten—based not only on the value of the home, but upon the borrower's creditworthiness and with some of the strongest LTV ratios.

Our financial institution has only recognized a default rate of 0.78% over the past five years, during a period in which our country experienced some of the most significant levels of charge-offs in recent history. Approximately half of our HELOCs are extended to borrowers with total LTV ratios of less than 80%. However, rather than allow these extensions of credit to maintain the 50% risk weighting for prudent underwriting and acceptable levels of collateral, the risk-weighting is doubled. As previously mentioned above, the proposed regulation would curtail extensions of credit to borrowers for home improvement projects, impacting growth in our local retail sector. Taking on the arbitrary risk of lending to those with a higher, acceptable LTVs would force our financial institution to make up that perceived

negative capital exposure through costs and fees which will inevitably be passed on to the consumer.

The Agencies must remove the treatment that all HELOCs are an automatic Category 2 classification.

### **No Grandfather Treatment for Existing Mortgage Loans**

Finally, the proposed rules do not include any type of grandfather provision. Thus, *all* mortgage loans currently on the bank's books will be subject to the new capital requirements. This will require bank staff to examine old mortgage underwriting files to determine the appropriate category and LTV ratio for each mortgage. This is a daunting task and comes at a time when the industry is also implementing numerous other *substantial* regulatory revisions and reforms previously mentioned. We simply do not have resources necessary to gather all of the information required to properly determine the revised risk weights for existing mortgage loans.

The additional time needed to focus on coding information for the proposed regulatory rules will further increase our costs and reduce our time for our current and new customers and servicing their needs. Additionally, this prevents our institution from having resources available to look into new strategies and technologies to serve our customers in an evolving banking environment. This will result in increased costs for consumers.

The Agencies must grandfather all existing mortgage exposures by assigning them the current general capital risk-based weights.

### **Conclusion**

For the concerns outlined above, the Agencies must withdraw the proposed regulatory capital rules, conduct additional study and analysis, and only propose capital rules which take into consideration the impact other regulatory proposals and reforms have on risk.

The Agencies must recognize that there are many differences between community banks and large, complex international institutions—and must, therefore, not force a community bank into the same capital calculation “peg-hole” as a complex international institution.

I appreciate the opportunity to comment on the Agencies' proposals.

Sincerely,

Michael K. Sullivan  
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Administration and Operations  
First State Bank