VIRGINIA BANKERS ASSOCIATION

October 19, 2012

Via e-mail: regs.comments@federalreserve.gov.

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

Re: Basel III Regulatory Capital Ratios Proposal and Risk-Weighted Assets Proposal; Docket No. R–1430, RIN No. 7100–AD87; and Docket No. R–1442, RIN No. 7100-AD87.

Dear Ms. Johnson:

I write on behalf of the Virginia Bankers Association, whose membership includes nearly all of the banks in Virginia. This letter is in response to the Basel III Regulatory Capital Ratios Proposal and Risk-Weighted Assets Proposal (the "Basel III Proposals"). The Basel III Proposals were crafted to protect the safety and soundness of large international financial institutions offering complex financial services and products well beyond traditional commercial banking. However, applying the Basel III Proposals to banks focused on traditional banking activities, especially small community banks, will actually harm the safety and soundness of the American banking system by requiring excessive capital, unreasonably limiting qualifying capital, and driving up compliance costs with unduly complex regulations. These factors will drastically reduce lending, hurt consumers, businesses and communities, and critically damage the viability of our community banking system. For these reasons, the Basel III Proposals should be withdrawn and rewritten to address these concerns for all banks and, in particular, to exempt community and regional banks.

The Basel III Proposals impose unreasonable limits on qualified capital.

Particularly troubling are the Proposals' limits on traditional forms of capital that have served well the safety and soundness of the American banking system for generations. These include the exclusion of trust preferred securities from tier one capital, severe limits on mortgage servicing assets in common equity tier one capital ("CET1") and the reduction of CET1 for unrealized losses on available for sale ("AFS") securities.

- **Trust preferred securities.** In recent years, trust preferred securities have been one of the few sources of capital available to many banks. They are also one of the most financially and tax efficient sources of capital available to banks. It is unrealistic to

expect many banks to comply with higher capital ratios without counting trust preferred securities. In fact, excluding trust preferred securities violates the clear intent of Congress which, in the Dodd-Frank Act, expressly allowed smaller banks to use current levels of trust preferred securities as qualified capital.

- **Mortgage Servicing Assets.** Mortgage servicing is a large part of the operations of many banks. Requiring mortgage servicing assets that exceed 10% of a bank's CET1 to be deducted from CET1 (combined with the punitively high risk weights assigned to these assets) will severely impact many banks, perhaps even lowering their capital levels below well capitalized status. Some banks may choose to exit the mortgage servicing business, damaging long-standing customer relationships and reducing fee income. A system wide reduction in mortgage servicing will further exacerbate the problems some consumers have had obtaining access to servicers to address debt modifications, loan workouts and foreclosure issues. A concentration of servicing among a few large servicers will reduce competition among servicers, further harming consumers.

- **Unrealized gains and losses on AFS securities.** With interest rates at historic lows, there is little room for them to decline further, but much risk that they will increase dramatically in the next few years. As interest rates rise, reducing capital for unrealized losses on available for sale securities will have a devastating effect on the banking industry. Many banks may shrink their securities portfolios considerably to maintain capital ratios at desired or required levels. Further, adjusting for unrealized gains and losses will introduce substantial volatility to the calculation of CET1 and Tier 1 capital ratios, which will force banks to maintain ratios substantially above required levels in order to ensure compliance with the ratios and capital conservation buffer.

Each of these capital classes have long been used by banks as stable, reliable sources of regulatory capital. Excluding any one of them will make it more difficult for banks to be adequately capitalized. The combined effect of these and other regulatory capital limitations will be severely reduced bank capital at a time when it is extremely difficult for banks to raise capital. Without adequate capital, banks will need to reduce lending, merge with other banks or close, all of which will harm consumers, businesses and local communities.

The risk-weighted assets regulations are unduly burdensome, complex and costly.

The risk-weighted assets regulations unreasonably penalize the core operations of many healthy, well-managed banks that have provided traditional banking products and services to their local communities for years. These core products and services include nonconforming mortgages, commercial loans, working with borrowers experiencing unexpected financial difficulties, and selling mortgages in the secondary market. Additionally, the unnecessarily complex rules require banks to gather extensive data about their loan portfolios and other assets and perform numerous complicated calculations to

determine the applicable risk weights. This will drive up costs and lead many banks to stop offering these products and services.

- **Mortgage assets.** By imposing risk weights of 100%-200% on nonconforming mortgages and subordinate mortgages, ignoring the risk mitigation benefits of private mortgage insurance, and requiring 150% risk weights on many commercial loans, the Basel III Proposals will considerably increase the cost of capital of banks offering these traditional banking services that are critical to many borrowers and communities.

- **Delinquent loans and workouts.** Assigning 150% risk weights to nonresidential loans over 90 days past due, and requiring banks to re-assess a mortgage's risk weight after a modification, incentivizes banks to be more aggressive with delinquent borrowers and less willing to consider loan modifications. This sharply contradicts the public policy behind numerous federal and state laws and regulations adopted in recent years.

- **Secondary market loans.** Banks sell loans in the secondary market to manage risk in their loan portfolios and raise cash to make new loans. By requiring banks to hold additional capital for loans sold subject to credit enhancing representations and warranties, the Basel III Proposals will make it more difficult and costly for banks to sell mortgages in the secondary market, ultimately reducing these sales. As these sales decrease, loan portfolio risk will increase and cash available for lending will decrease.

- **Excessive compliance burden.** Banks will be required to collect and report a large quantity of very granular information in order to calculate risk-weighted assets. This includes new information about underwriting features and loan-to-value ratios of credit exposures, as well as extensive information necessary to satisfy due diligence requirements. Existing loans are not grandfathered, and this information will need to be collected on banks' existing loan portfolios. While additional capital may be appropriate for some institutions or products, the requirements for traditional commercial banks and community banks should be simple, straightforward and easy to comprehend and evaluate. Healthy banks, especially community banks, operate on tight budgets, with low margins and do not have excess resources to devote to nonrevenue generating functions that do not efficiently add significant value, such as onerous data collection and analysis solely for compliance with unnecessarily complicated regulations.[1]

[1] In light of the enormously high volume of recently adopted or proposed banking laws and regulations, the VBA sincerely requests that the bank regulatory agencies seriously consider regulatory and compliance efficiency as they draft each new regulation.

Too much capital is a bad thing.

The combination of higher capital ratios, the capital conservation buffer, the exclusion of many common types of capital, increased risk-weighted assets, and the volatility of many of the calculations required under the Basel III Proposals, will all lead banks to maintain unnecessarily high levels of capital.

- **Excessive capital increases risk in banks.** As capital is increased, return on equity ("ROE") to investors decreases. For a bank to attract outside investors it must provide returns investors expect. By limiting the ability of banks to pay dividends and distributions to investors, the capital conservation buffer will further hurt banks' ability to attract investors and raise necessary capital. To increase ROE to raise required capital, banks may feel pressure to take on more risk by making riskier loans they otherwise would not make.

- **Excessive capital shrinks competition, hurts customers.** Lower ROEs will mean fewer banks can raise capital to meet ratios that are too high. Those banks will be forced to shrink their lending or to merge with or sell to competing banks – reducing the number of competitors. Less competition among lenders ultimately harms consumers.

- **Excessive capital reduces credit availability.** Requiring more capital to offset increased risk-weighted assets, coupled with the difficulty banks will have raising capital with lower ROEs, will lead many banks to one alternative – reducing the amount of mortgage assets on their balance sheets by reducing lending. For example, for each additional dollar of required capital that a bank cannot raise, it will likely need to reduce its lending capacity by $10. Accordingly, for a community bank with $100 million of assets that experiences a 2.5% increase in required capital ($2.5 million), the local community it serves will suffer a $25 million decrease in available lending.

- **Difficulties attracting talented leaders will damage the competiveness of the entire banking industry.** Lower ROEs and capital conservation buffer limits on executive compensation will hurt the ability of banks and the entire banking industry to attract talented business leaders. These individuals will be lured away to other businesses and industries that are not subject to regulatory restrictions on equity-based and performance-based compensation packages.

- **Pushes consumers to less regulated lenders.** Higher capital requirements and risk-weighted assets will push certain loans out of banks. Demand for these loans will be met only by the "shadow banking" industry, the less heavily regulated nonbanks. This is contrary to the intent of the Dodd-Frank Act and will encourage, rather than protect against, one of the main causes of the recent financial crisis.

The Basel III Proposals should not apply to community and regional banks.

While the Basel III Proposals place undue burdens on banks of all sizes, imposing these overly restrictive and burdensome requirements on smaller community and regional banks will have a crippling effect on the traditional commercial banking system in this country and the consumers, businesses and local economies they serve. The international organization that drafted the Basel III standards designed them to apply to, and address issues unique to, large internationally active banks offering complex financial products outside the realm of traditional commercial banking. Traditional commercial banks did not cause the recent financial crisis and most do not have the resources to comply with these complex and burdensome requirements. And yet, the Basel III Proposals apply the same rigid, complex standards to banks of all sizes and types regardless of the riskiness of the products and services they provide. This should be fixed by exempting community and regional banks from the Basel III Proposals.

The unintended consequences of too many regulations.

While many individual regulations designed to protect consumers or the safety and soundness of banks may be well intentioned, the cumulative effect of multiple regulations targeting the same products and services will often make it impossible for banks to efficiently offer those products and services. Banks will need to increase the fees charged for these products and services or stop offering them altogether. In turn, borrowers who relied on those products and services will be deprived of affordable credit for homeownership or business endeavors.

For example, nonconforming loans are subject to multiple new and proposed regulations. Nonconforming loans make up a significant portion of the loans made by many banks, especially banks serving rural communities. More importantly, nonconforming loans serve a large segment of borrowers who cannot satisfy the Fannie Mae and Freddie Mac conforming loan guidelines.[2] These loans provide many borrowers with an opportunity to build equity in their homes and enjoy the other benefits of homeownership while they build or rebuild their credit reputation. As discussed above, nonconforming loans are subject to increased risk weights under the Basel III Proposals, which will greatly increase the capital costs of banks holding these loans. In addition, the new "high-cost mortgage rule" imposes additional restrictions on many nonconforming loans, and the new "ability to repay rule" increases the administrative burden and legal liability of banks that make nonconforming loans that are not "qualified mortgages." Individually, each of these rules makes it more difficult, expensive and risky for banks to make nonconforming loans. Combined, these rules may make it impossible for banks to profitably make these loans at prices consumers can

[2] These include individuals with below average credit qualifications; self employed people; people with unstable, infrequent or variable incomes; borrowers wishing to borrow more than 90% of the value of a property; and older borrowers for whom a 30-year repayment term is not appropriate. Nonconforming loans also include loans against properties that do not meet the GSEs' guidelines, such as manufactured homes; farmland and other large tracks of undeveloped land; properties that are subject to certain zoning ordinances, easements or encroachments; and properties with limited access.

afford, forcing many banks out of this business and depriving many borrowers of credit. This is particularly unwise in the current economic and loan underwriting environment where available credit for borrowers with less than perfect credit is extremely limited.

Quantitative analysis of the Basel III Proposals.

We asked the Federal Home Loan Bank to assist us with a quantitative analysis of the issues discussed in this letter. We looked at three banks of different sizes with various asset mixes. The following bullet points provide a brief summary of our analysis, and Schedule A attached to this letter provides a detailed and modeled explanation of the impact the Basel III Proposals will have in three typical bank scenarios.

- **Bank 1 (Assets: $470 million) – Models the impact of (i) losses on AFS securities when interest rates rise and (ii) risk-weighted balloon mortgage loans.** The bank in this example opened in the summer of 2008 and has maintained high credit standards and, as a result, did not have a high level of classified assets or write-offs. From 2008 until 2012, the bank increased its AFS securities portfolio to offset a decline in loan demand in order to redeploy cash flows from shrinking loan portfolios. During this time period, rates dropped to historic lows and the bank's other comprehensive income increased due to unrealized gains in the AFS portfolio.

  This bank has 40% of its assets in AFS securities and a portfolio of five year jumbo balloon mortgages. Currently, its Tier 1 leverage ratio is 9.14%. If the Basel III Proposals are implemented and interest rates rise 300 basis points starting in 2015, the bank's Tier 1 leverage ratio will drop to 7.58%. Additionally, while the interest rate risk in the AFS portfolio is appropriately hedged, the accumulated other comprehensive income ("AOCI") treatment in the proposed regulations will cause capital to significantly move in the opposite direction of that predicted by the institution's asset-liability analysis. The AOCI treatment in the proposed regulations and the change in risk weights on balloon mortgages will have an excessive impact on the bank's capital ratios.

- **Bank 2 (Assets: $375 million) – Models the impact of (i) the phase out of trust preferred securities and (ii) risk-weighted SBLF loans, which result in a reduced portfolio of mortgage loans and have an adverse effect on homeownership and community development.** The bank in this example is located in a growing city with a robust economy due to the fact that it is the headquarters for three large corporations. The bank's performance from 2008 to 2012 has been steadily improving and is considered healthy in comparison to its peers. In 2009, as with most other banks at the time, the bank had an increase in problem loans followed by subsequent charge-offs in 2010. By mid-2012, asset quality had improved and allowance for loan and lease losses to non-performing loans has returned to historical levels.

  While this bank can continue to portfolio loans at levels required to attain small

business lending fund ("SBLF") debt with interest rates at 1%, the impact is seen as the bank's risk based capital ratios declining due to the increased risk weighting these assets will have under the Basel III Proposals. In this scenario, the bank will also need to address the phase-out of trust preferred securities ("TruPS") required when the institution's assets are greater than $500 million. This could occur as early as 2015. When layering in the repayment of TruPS over a 10-year period, the bank's risk based capital ratios decline below well capitalized from 2017 to 2019. While the Basel III Proposals require the bank to increase the risk weights on residential mortgages with LTV greater than 80%, this discourages refinancing, as well as, lending to first time homebuyers. Housing is simply an inventory of potential loans. If bankers are required to hold additional capital against the higher LTV loans, then many borrowers will not qualify for mortgages originated and portfolioed at a bank. It seems conflicting to have the SBLF program encourage banks to make more loans to small business while the Basel III Proposals raise the risk weights on these assets and mortgage related loans.

- **Bank 3 (Assets: $130 million) – Models how the Basel III risk-weighted capital ratios will make if very difficulty for a bank to repay TARP funds.** The bank in this example offers a diversified selection of loan products. The bank weathered the recent economic recession and ensuing recovery and has continued to experience moderate loan growth and strong credit quality over the past four years. During this time period, they continued to make construction loans for 1-4 residential mortgages and commercial real estate construction loans in their community. Deposit growth was also robust during this time period, while net income was near breakeven from 2008 to 2012.

  In addition this bank took down $4.7 million in Troubled Asset Relief Program ("TARP") funds. The bank has three options to pay off the TARP funds: (1) grow earning assets and net income to build up retained earnings; (2) raise capital; or (3) shrink the assets. Given its marginal growth in net income, the bank will be challenged to build up retained earnings or raise capital to repay its TARP debt while dealing with the forecasted impact of the higher capital ratios phased-in in 2014 and 2015.

  Regardless of which approach it chooses, the Basel III Proposals will make it extremely difficult for the bank to repay the TARP funds. Instead, the bank will need to deal with a significant increase in the cost of these funds. This creates a problem in 2014 and 2015 as the new CET1 and tier one capital ratio thresholds are phased in. In addition, the change in risk weights take effect in 2015, causing risk weighted assets (denominator of the three risk based capital calculations) to increase dramatically.

The Basel III Proposals should be withdrawn and rewritten after careful study.

The Basel III Proposals should be withdrawn and rewritten to address the concerns identified in this letter for all banks and, in particular, to exclude community and regional banks from the most onerous provisions. Before issuing revised rules, we recommend that the regulatory agencies conduct a comprehensive study of the aggregate impact the Basel III Proposals and numerous other new banking regulations will have on the banking industry and the American economy. We also strongly encourage the banking agencies to slow the pace of change, change one regulation at a time, closely monitor the real-world impact of each incremental change, and be prepared to act quickly to make corrective changes if unintended adverse consequences occur.[3]

Thank you for your consideration of our comments.

Sincerely,

Bruce T. Whitehurst
President and CEO

[3] The nearly simultaneous proposal of numerous intertwined new banking regulations in recent months, all with very short and overlapping comment periods, made it impossible for the VBA, our members and the entire banking industry to determine with any reasonable degree of certainty the aggregate effect and unforeseeable consequences these proposals will have on the banking industry and the American economy. We expect this is true for the bank regulatory agencies as well.

Schedule A

Community Bank Examples in Support of State Banking Associations' Responses to the Basel III Capital NPR

Overview

In evaluating the impact of the Basel III Capital Regulation and Standardized Approach Notice of Proposed Rulemaking (NPR), we assessed the effect on 3 different representative community bank profiles.[4]

Summary of Issues

- Model Bank #1 (Assets: $470 million) – Issues with losses on available for sale (AFS) securities when rates rise (40% of portfolio in securities) and maturing jumbo balloon mortgage loans because of the effect of the new risk ratings (100%, 150% and 200%) under the Basel III proposal.

- Model Bank #2 (Assets: $375 million) – Trust Preferred Securities (TruPS--needs to go away when assets reach $500 million) and SBLF get phased out. Portfolio of mortgage loans will also reduce in size, having an adverse effect on homeownership and community development.

- Model Bank #3 (Assets: $130 million) – TARP that can never go away because of common equity limitations.

Model Bank #1

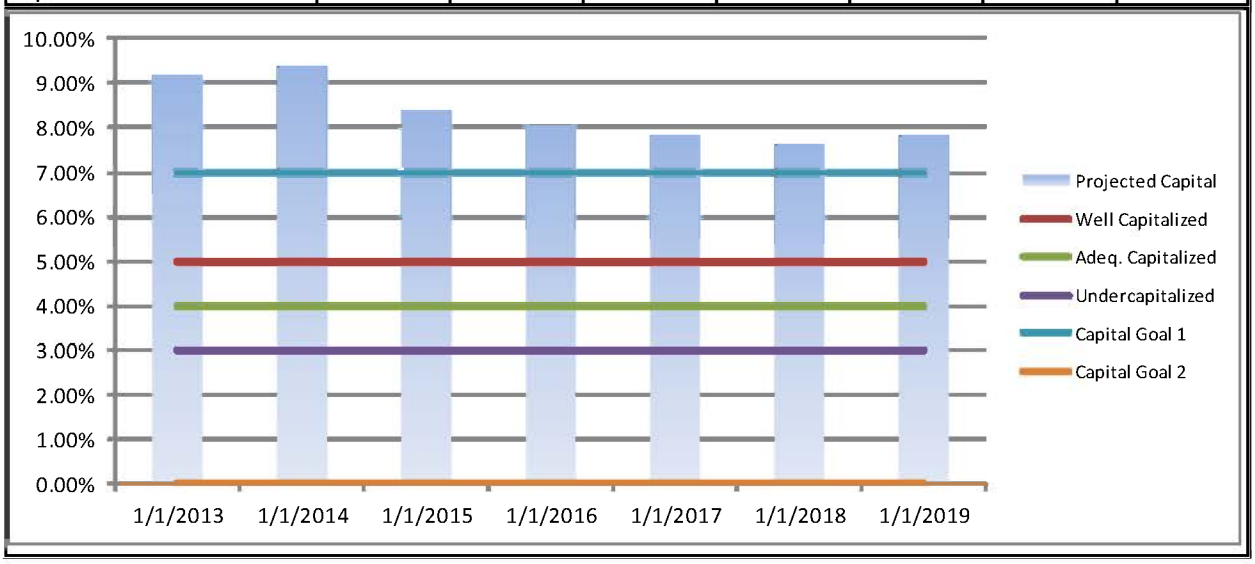
In this example, the hypothetical community bank opened in the summer of 2008 and has maintained high credit standards and thus did not have a high level of classified assets or write-offs. From 2008 until 2012, the bank increased its Available For Sale ("AFS") securities portfolio to offset loan demand declines, as was not uncommon for financial institutions to do in order to redeploy cash flows coming off shrinking loan portfolios. During this time period, rates dropped to historical lows and their Other Comprehensive Income increased due to unrealized gains in the AFS portfolio.

In modeling this institution, the balance sheet mix was held constant and we assumed ROAs of .75%, annual growth of 7%, and a dividend payout of 0% of net income. We established capital goals of 2% over regulatory minimum capital requirements. The binding capital constraint for this institution was the Tier One Leverage ratio.

[4] The assessment was performed using Farin & Associate's Capital Speedboat Model, an Excel model that evaluates the effect of phase-in of the proposed capital regulations.

The BASEL III NPR has a provision to recognize unrealized gains and losses on all AFS securities in common equity tier 1 capital. In this bank's case, they currently have an unrealized gain of $1.7 million on its AFS portfolio which totals around $180 million (or roughly 40% of assets). Assuming a portfolio duration of 2.9 years and a market rate rise of 300 basis points, the market value is estimated to drop 8.7%, at which time the unrealized gain of $1.7 million becomes an unrealized loss $13.9 million. Currently, the bank has Tier 1 Leverage capital of 9.14% and if the NPR provision is implemented and rates rise 300 bps starting in 2015, **their Tier 1 Leverage capital would drop to 7.58%**.

Tier 1 Leverage	01/01/2013	01/01/2014	01/01/2015	01/01/2016	01/01/2017	01/01/2018	01/01/2019
Projected Capital	9.14%	9.34%	8.35%	8.05%	7.79%	7.58%	7.81%
Well Capitalized	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%
Adeq. Capitalized	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%
Undercapitalized	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%
Capital Goal 1	7.00%	7.00%	7.00%	7.00%	7.00%	7.00%	7.00%
Capital Goal 2	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%



Ironically, the institution's interest rate risk reports show it as being asset sensitive with EVE increasing in a rising rate environment. In other words, the interest rate risk in the AFS portfolio is more than hedged, yet the AOCI treatment in the proposed regulations causes capital to make a significant move in the opposite direction of that predicted by the institution's asset-liability analysis.

Another challenge is that when the bank in this hypothetical example opened, they started to portfolio 5 year jumbo balloon mortgages. At the time, these loans offered attractive yields and borrowers were very creditworthy. These loans are now maturing and many of them will be renewed. The new BASEL III NPR rules would require that balloon mortgages fall into category 2, which requires them to be risk weighted 100% if LTV <=80, 150% if LTV is between 80 to 90 and up to 200% if LTV is >90. Depending upon the current market values of the underlying properties at the time of renewal into a new 5 year balloon and the original amortization schedules, many of these refinanced loans may

require higher risk weightings, leading to a decline in all capital ratios as a result of risk weighted assets increasing in the denominator.

We conclude from this test that both the AOCI treatment in the proposed regulations and the change in risk weights on balloon mortgages potentially will cause excessive impacts to capital ratios that are inconsistent with financial institutions' actions to hedge interest rate risk and undeserved based on the actual underwriting of balloon mortgages.

Model Bank #2

The hypothetical community bank in this example is located in a growing city with a robust economy due to the fact that it is the headquarters for three large corporations. **The bank's performance from 2008 to 2012 has been steadily improving and is considered healthy in comparison to its peers**. In 2009, as with most other banks at the time, the bank had an increase in problem loans followed by subsequent charge-offs in 2010. By mid-2012, asset quality had improved and Allowance for Loan and Lease Losses to Non-Performing Loans has returned to historical levels.

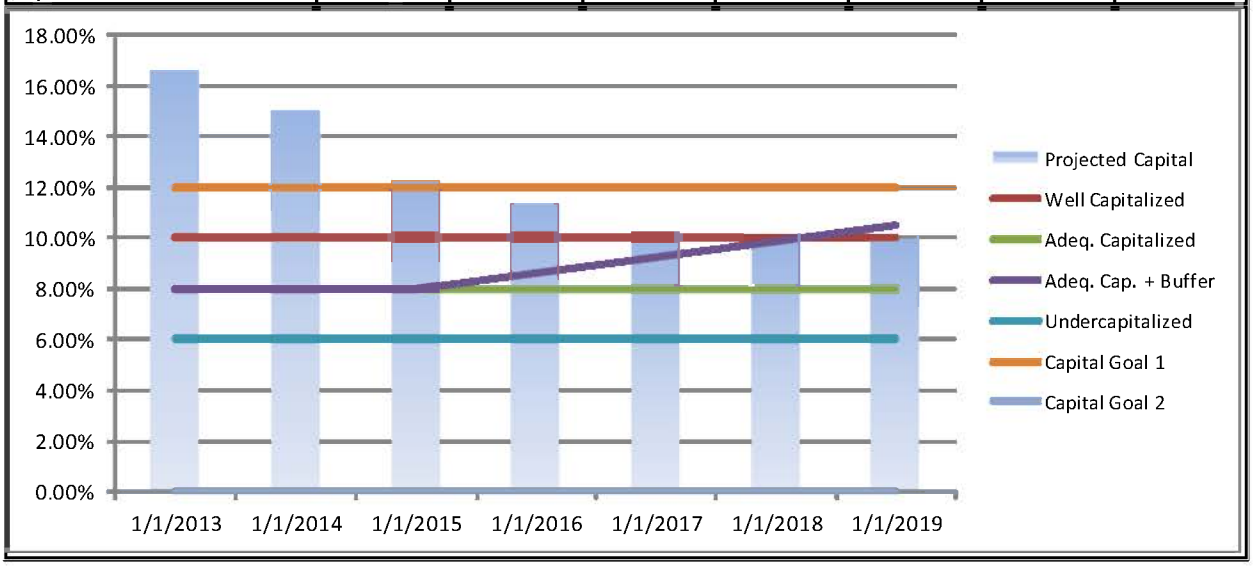
The challenge this bank faces with the new Basel III Capital Regulations relates to the phase-out of trust preferred securities (TruPS) from tier 1 capital over a 10-year period. As of June 2012, the bank has $8 million in TruPS outstanding. The bank currently has total assets of $375 million and the phase-out period to remove TruPS from tier 1 capital is accelerated when total assets are over $500 million.

The bank also has Small Business Lending Fund (SBLF) debt in the amount of $15.5 million and this currently counts as tier 1 capital. The SBLF was created as an incentive for banks with total assets less than $10 billion to make loans to businesses with less than $50 million in annual sales. The bank took down the SBLF debt 12 months ago at a rate of 1%. SBLF debt must be paid back in 10 years and has a variable rate of 1 to 9% depending upon the banks' increase in originations of qualifying small business loans. If lending does not increase in the first 2 years, the rate on the SBLF increases to 7%. The rate on the SBLF debt will automatically increase after 4.5 years to 9%.

In modeling this institution, we held the balance sheet mix constant and assumed ROAs of .80%, annual growth of 10%, and a dividend payout of 20% of net income. We established capital goals of 2% over regulatory minimum capital requirements. The bank's total assets reach $500 million by mid-2015 and they still have $8 million in TruPS outstanding. The SBLF debt pays down from $15.5 million to $3.25 million by mid-2015 and is completely paid off by 1/1/2017. The binding capital constraints during the forecast period for this institution were their Tier One Risk Based and Total Risk Based Capital Ratios. The following graph shows an example of capital growth relative to minimum requirements and the capital goals established for the institution.

Total Risk Based Capital Ratio drops below their Well Capitalized and Adequately Capitalized plus buffer thresholds in 2019.

Total Risk Based	01/01/2013	01/01/2014	01/01/2015	01/01/2016	01/01/2017	01/01/2018	01/01/2019
Projected Capital	16.58%	15.01%	12.21%	11.31%	10.21%	10.09%	9.94%
Well Capitalized	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%
Adeq. Capitalized	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%
Adeq. Cap. + Buffer	8.00%	8.00%	8.00%	8.63%	9.25%	9.88%	10.50%
Undercapitalized	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%
Capital Goal 1	12.00%	12.00%	12.00%	12.00%	12.00%	12.00%	12.00%
Capital Goal 2	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%

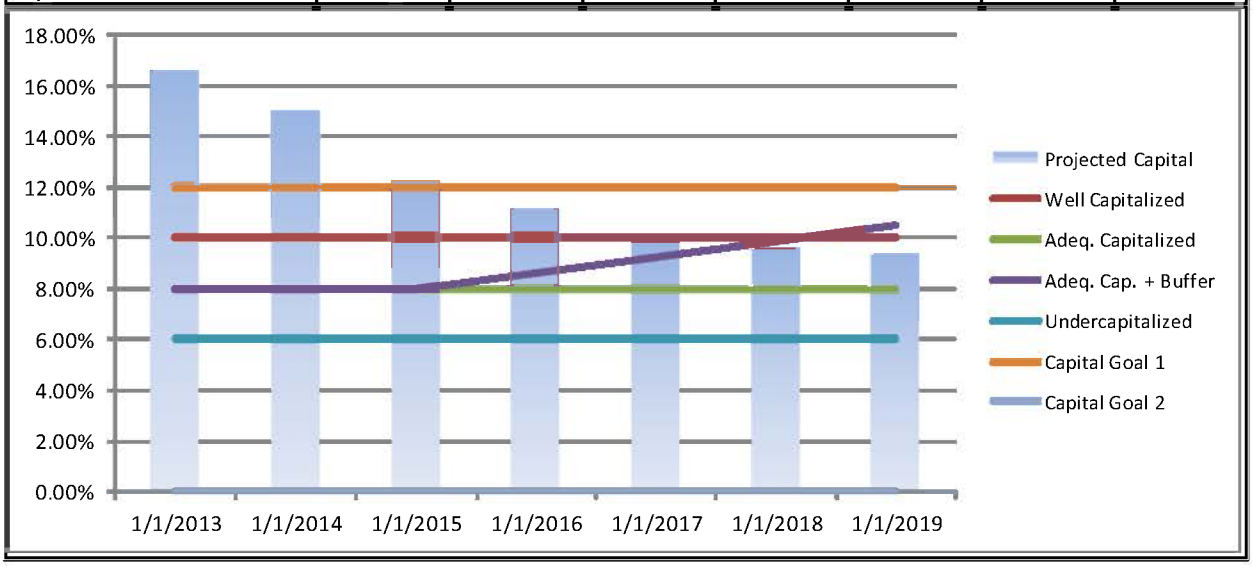


In summary, this forecast does allow the bank to continue portfolioing loans as part of the agreement to attain the SBLF debt at 1%, however the impact can be seen in **risk based capital ratios declining due to the volume and increased risk weighting these assets will have under Basel III**. In this scenario, the bank will also need to address the phase-out of TruPS required when the institution's assets are greater than $500 million.

We'll address paying off the TruPS in the following example by modeling the assumption that the bank begins to pay off the TruPS when they reach $500 million in total assets. All other assumptions used were the same as described earlier. The bank's total assets reach $500 million by mid-2015 and, at that time, the bank pays off $800,000 in TruPS per year for 10 years. TruPs is completely paid off by 6/30/2025.

The binding capital constraints during the forecast period for this institution were their Tier One Risk Based and Total Risk Based Capital Ratios. As shown below, the Total Risk Based Capital falls below their Capital Goal in 2016 and then below Well Capitalized in 2017 through 2019.

Total Risk Based	01/01/2013	01/01/2014	01/01/2015	01/01/2016	01/01/2017	01/01/2018	01/01/2019
Projected Capital	16.58%	15.01%	12.21%	11.12%	9.86%	9.61%	9.36%
Well Capitalized	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%
Adeq. Capitalized	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%
Adeq. Cap. + Buffer	8.00%	8.00%	8.00%	8.63%	9.25%	9.88%	10.50%
Undercapitalized	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%
Capital Goal 1	12.00%	12.00%	12.00%	12.00%	12.00%	12.00%	12.00%
Capital Goal 2	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%



In summary, when layering in the repayment of the TruPS over a 10-year period, the bank's risk based capital ratios decline below well capitalized from 2017 to 2019.

While the proposed Basel III capital regulations require the bank to increase the risk weightings on residential mortgages with LTV greater than 80%, this discourages refinancing, as well as, lending to first time homebuyers. Housing is simply an inventory of potential loans. If bankers are required to hold additional capital against the higher LTV loans, then many borrowers will not qualify for mortgages originated and portfolioed at a bank. It seems conflicting to have SBLF that wants and encourages banks to make more loans to small business while Basel III raises the risk weightings on these assets, as well as, mortgage related loans.

This bank has a portfolio of 1-4 residential mortgages that represents 22% of total assets. The impact of the increased risk weighting of category 1 residential mortgages with LTV of 80% or greater has a material impact on their capital ratios. That impact can be seen in the above Total Risk Based Capital chart as a significant reduction in the ratio from 15.01% in 2014 to 12.21% in 2015 when the changes in the risk weights become effective. Growing communities need to have healthy banks, able and willing to make these loans available to qualified borrowers.

Model Bank #3

The hypothetical community bank in this example offers a diversified selection of loan products. The bank weathered the recent economic recession and ensuing recovery and has continued to experience moderate loan growth and strong credit quality over the past four years. During this time period, they continued to make construction loans for 1-4 residential mortgages and CRE construction loans in their community. Deposit growth was also robust during this time period. Net income was near breakeven from 2008 to 2012.

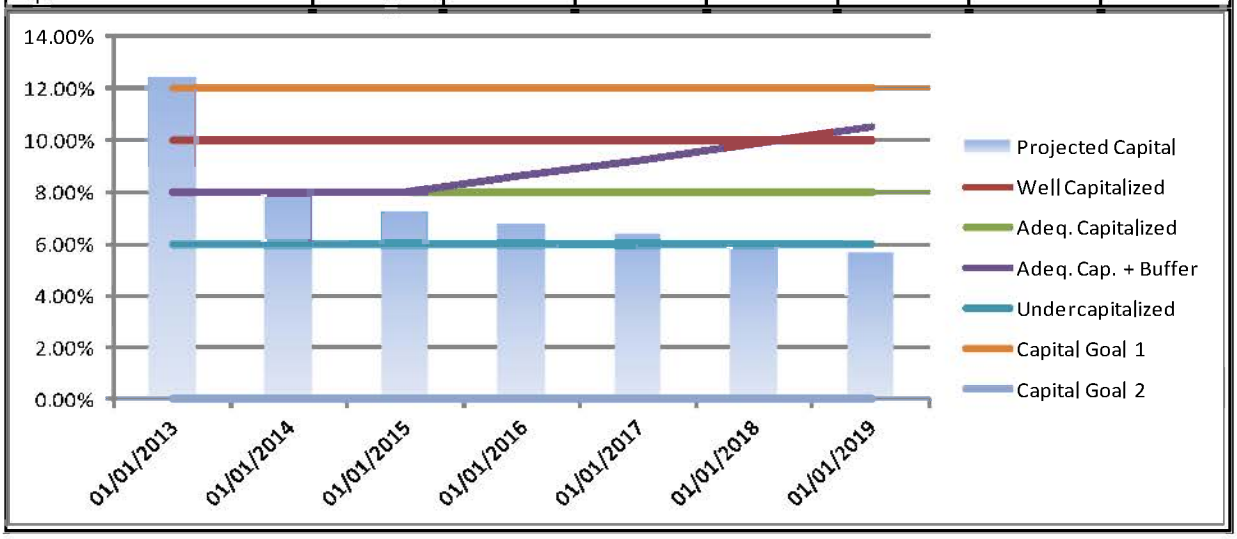
In 2009, they took down $4.7 million in TARP and, given their marginal growth in net income, they will be challenged to build up retained earnings to pay off this debt while dealing with the forecasted impact of the higher capital ratios phased-in in 2014 and 2015. The bank has three options to pay off the TARP: 1) grow earning assets and net income to build up retained earnings; 2) raise capital; or 3) shrink the assets. These three options are evaluated below.

Option 1: Grow Assets and Net Income

In modeling this institution, we held the balance sheet mix constant and assumed ROA of .50%, annual growth of 10%, and a dividend payout of 60% of net income (Sub S). We established capital goals of 2% over regulatory minimum capital requirements. They currently have a netted Surplus and Retained Deficit of $1.3 million available to pay off TARP. In the first example, we pay off the entire TARP by the end of 2013.
Each of the four Basel III capital ratios is challenged in remaining above Well and Adequately Capitalized status during the forecast period. The following graph shows Total Risk Based Capital relative to minimum requirements and the capital goals established for the institution.

Total Risk Based Capital – Falls below Adequately Capitalized in 2014

Total Risk Based	01/01/2013	01/01/2014	01/01/2015	01/01/2016	01/01/2017	01/01/2018	01/01/2019
Projected Capital	12.38%	7.94%	7.18%	6.74%	6.34%	5.98%	5.66%
Well Capitalized	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%
Adeq. Capitalized	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%
Adeq. Cap. + Buffer	8.00%	8.00%	8.00%	8.63%	9.25%	9.88%	10.50%
Undercapitalized	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%
Capital Goal 1	12.00%	12.00%	12.00%	12.00%	12.00%	12.00%	12.00%
Capital Goal 2	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%



Option 2: Raise Capital

This institution is located in a community that has a growing economy and a capital raise is possible. However, given the lack of earnings growth, existing shareholders may be reluctant to infuse additional capital. The dilutive nature of a capital raise is another issue existing shareholders will need to consider. Delaying the capital raise until 2014 or later may prove to be costly. When the minimum capital levels increase in 2014 and 2015, the cost of capital will increase and finding additional investors may prove to be difficult. A well thought out growth plan with additional capital should be created and management and the board should follow through with the capital raise sooner rather than later.

Option 3: Shrink Total Assets and Expenses

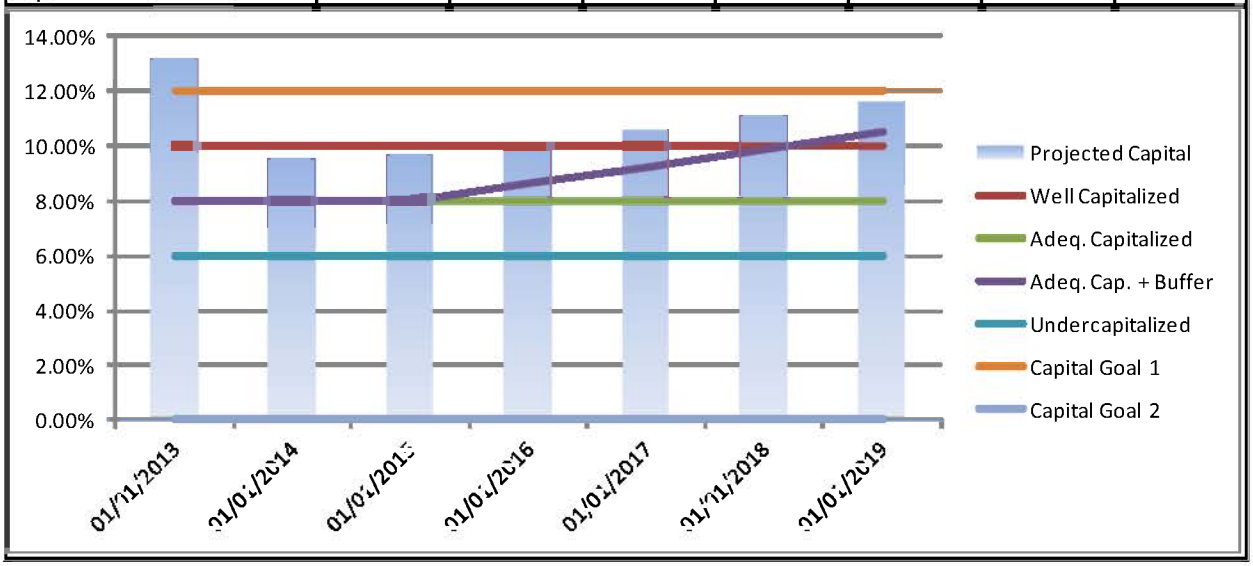
In this strategy, we held the balance sheet mix constant and assumed ROA of .60% (increased from .50% because of expense reduction), annual growth of minus 2%, and a dividend payout of 60% of net income (Sub S). We established capital goals of 2% over regulatory minimum capital requirements. They currently have a netted Surplus and Retained Deficit of $1.3 million available to pay off TARP. As in the previous example, we assume the entire TARP is paid off by the end of 2013.

In the following graph, you will notice that the Shrinking Strategy is successful at keeping the bank above the regulatory minimums except for Total Risk Based Capital in 2014 and

2015. In which case, it dips slightly below Well Capitalized. The Shrinking Strategy reduces Total Assets from $138 million (2013) to $121 million (2019).

In the Shrinking Strategy, the bank's Total Risk Based Capital falls below Well Capitalized in 2014 and 2015.

Total Risk Based	01/01/2013	01/01/2014	01/01/2015	01/01/2016	01/01/2017	01/01/2018	01/01/2019
Projected Capital	13.16%	9.49%	9.62%	10.09%	10.57%	11.06%	11.56%
Well Capitalized	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%
Adeq. Capitalized	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%
Adeq. Cap. + Buffer	8.00%	8.00%	8.00%	8.63%	9.25%	9.88%	10.50%
Undercapitalized	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%
Capital Goal 1	12.00%	12.00%	12.00%	12.00%	12.00%	12.00%	12.00%
Capital Goal 2	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%



In the 10% Growth Strategy, ROE increases from 7.79% to 10.89% during the seven year period compared to the Shrink Strategy in which ROE decreases from 9.06% to 6.74%. The growing bank has $500,000 more in retained earnings by 2019.

The Shrinking Strategy includes cuts in Salary, Benefits and Personnel and is impractical in the current banking environment that is saddled with rising compliance and technology costs. In order for this bank to serve its customers and compete in the marketplace, it will need to grow assets, which leads to more income to pay for compliance and technology. If loan problems surface and classified loans increase, a smaller bank has less capital to protect against loan losses. Smaller banks also have a harder time raising additional capital than larger banks.

The Shrinking Strategy also could result in key personnel leaving the bank because of the fear of job loss or lack of compensation growth.

As illustrated by this example, the components of the Basel III NPR will make it extremely difficult to pay off TARP funds. Instead, the bank will need to deal with a significant increase in the cost of these funds. This is a particular problem in 2014 and especially in 2015, when Risk-based requirements for Common Equity Tier 1RBC and Tier One RBC are being phased in. In addition, the change in risk weights take effect in 2015, causing risk weighted assets (denominator of the three risk based capital calculations) to increase by an amount across the industry of 20% (as estimated in the Standardized Approach NPR).