VACB
Virginia Association of Community Banks
Advancing Community Banks

October 19, 2012

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

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

RE: Docket No. R–1430; RIN No. 7100–AD87, Docket No. R–1442; RIN No. 7100–AD87
Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action; and *Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements*

Dear Ms. Johnson:

The **Virginia Association of Community Banks** is an association of 80+ locally owned and operated Virginia banks. We provide advocacy at the federal and state level, educational programming and other services for our member banks and associate members. VACB has strived to improve the lives of employees and customers in community banks across the Commonwealth for more than thirty-five years.

In accordance with VACB's mission and purpose, we submit these comments in response to the requests for comments in the notices of proposed rulemaking (NPR) on minimum regulatory capital and the standardized approach for risk-weighted assets titled: *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action;* and *Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements* on behalf of our member banks, their communities and their customers.
Our sole and overarching comment on these proposed rules could not be more clear: **community banks should be exempt from the Basel III proposals.**

7204 Glen Forest Drive, Suite 101 • Richmond, VA 23226
Phone: 804-673-8250 • Fax: 804-673-8251 • www.vacb.org

The Basel III proposals were intended for large, sophisticated financial institutions competing with others of a similar scale across the globe. We are troubled that our own U.S. regulatory authorities would include community banking in this complex new capital scheme. These new capital proposals are an unnecessary and costly regulatory burden that will result in damaging unintended consequences, including, but not limited to further consolidation of the industry.

Community bankers recognize the importance of appropriate levels of capital as a key component of a safe and sound bank and banking system. Community banks have a vested interest in a healthy banking system. Required maintenance of adequate levels of capital is good for all banks and the country as a whole and community banks are already leaders in maintaining high quality capital. Our concern is the burdensome process and consequences of instituting complex new rules on community banks. Community bankers don't believe it is necessary or appropriate to redefine capital adequacy for all banks, regardless of size or risk profile, to accomplish the goal of adequate capital.

For the very reason that the agencies have proposed these rules –the safety and soundness of the industry –community banks should be exempt from these proposals and allowed to continue to measure capital according to present methodology.

We have **specific concerns** in **six areas.**

1. Compliance with the flood of current and upcoming regulations is and will be taxing community banks for years to come. The ever-increasing level of regulatory burden has stretched community bank resources to the limits. These burdens cause us to wonder how big a bank must be to survive the increasing cost of compliance.

Lawmakers, regulators, and the public all agree that community banks didn't participate in nor profit from the bad behavior that contributed to the financial meltdown. However, the "cure" is making life difficult, if not impossible, for community banks to survive. If these proposals are applied to community banks, many will decide that the barrage of federal law and regulatory overkill has rendered their time-tested business unsustainable.

The agencies' attempts to modify the capital landscape by applying a one-size-fits-all approach for all banks undermines the fact that community banks operate under a very different business model from the larger banks. When reviewing the size, complexity, and scope of community banks, it should be very clear to the regulators that community banks do not have the appropriate resources to be viewed as a large mega bank creating a new series of regulatory burdens in addition to what already exists today.

2. Proposed adjustments in the reporting of Accumulated Other Comprehensive Income (AOCI) would decrease liquidity and restrict the demand for investment securities. The historically low interest rate environment has created issues for a number of our banks. Banks will eventually face potentially significant unrealized losses in their securities portfolios. This could easily create scenarios in which a formerly well-capitalized bank could face severe sanctions due solely to market rate movements. Further, the "mark to market" requirement will require banks to hold more capital to compensate for inevitable swings in interest rates, thus hindering growth and lending opportunities. Community banks can't effectively hedge interest rate risk in their portfolios.

To mitigate the volatility caused by changes in AOCI, some community banks will be forced to hold their investment securities with an amortized cost designation for accounting purposes. Due to the complexity of the accounting rules surrounding these investments, they can never be sold except in the rarest of circumstances without jeopardizing their ability to hold these investments at amortized cost in the future. This action will further decrease available liquidity for the institution while adversely impacting demand for investment securities for all market participants.

3. Risk Weighting will be challenging, expensive, and a disincentive to mortgage lending. Assigning proper risk-weightings to various assets will be an expensive and time-consuming undertaking, which will require additional staff and expensive software. This will serve as a disincentive to mortgage and real estate lending at community banks, especially loans kept in-portfolio" as is common in the community banking model. Particularly harmful to community banks is the punitive impact of changes to balloon mortgage loans and all second liens including home equity lines. These loans provide solid financing alternatives to home loan borrowers in underserved and rural communities and play a large role in shaping the local economies of the communities in which the loans are originated. Additionally, community bank lending, which focuses on tailoring loan products to the specific needs of the customer, is a powerful force in small business formation and growth that fuels job creation. As relationship-based lenders, community banks possess the local expertise needed to complete quality underwriting for these loan products and provide forms of financing that larger banks will not offer. Further, the introduction of "High Volatility Commercial Real Estate" (HVCRE), with a 150% risk weighting and limited exemptions, will in our assessment also limit a bank's willingness to make these loans and raise borrowing costs in this already challenged market. Further depressing residential and commercial real estate lending will result in additional harm to an already shaky rural real estate lending market.

Where does the Allowance for Loan and Lease Losses fit into the mix? Specific allocations of capital are made for higher risk, classified, past due and non-accrual loans. However, the proposal does not allow for adequate inclusion of the allowance in the determination of regulatory capital. We must remember that the allowance represents the first line of defense against harmful credit loss and it properly represents an allocation of capital to meet that objective. Yet the proposal continues to cap the allowance while ignoring its importance by not elevating at least some component as higher tier capital. It appears that with the additional capital requirements, perhaps there will be adjustments in the way this important risk management tool is utilized by banks and evaluated by the regulators.

4. Proposed limits on the counting of Trust Preferred Securities (TruPS) as Tier I capital would further compound efforts to raise capital, and run counter to federal law (Dodd-Frank). Dodd-Frank allows entities with under $15 Billion in assets to count TruPS as Tier 1 capital (via the "Collins Amendment"). This sensible amendment was a major legislative victory for community banks, and they use this regulator-approved hybrid capital vehicle. The proposal appears to directly contradict the will of Congress.

While economic conditions have impacted earnings and ROE potential, much of the challenges community banks face in raising additional capital are a direct result of regulatory and legislative actions. Diminished expectations for earnings results in more difficulty attracting additional capital for our banks, dilutes existing shareholders and makes any capital acquisition significantly more costly. The proposal should follow federal law and allow those entities with under $15 Billion in assets to allow their TruPS to continue to qualify for tier 1 capital and follow their original scheduled maturities.

5. Mortgage servicing asset deductions from capital could impact mortgage availability. Mortgage servicing assets (in excess of 10% of Common Equity Tier 1) will face new deductions from capital. Further, capital would be required against assets with credit enhancing representations and warranties, including mortgages sold to Fannie Mae, Freddie Mac, and third party aggregators. As previously discussed, this is one more potential hurdle and expense that could impact the cost and availability of mortgages. Additionally, this severe penalty is an attack on the high-quality nature of community bank servicing that ignores the fact that community bank servicers work diligently with borrowers to resolve payment problems to achieve a more favorable outcome for the customer.

6. Proposed restrictions and limitations on capital treatment of deferred tax assets, goodwill, and pension accounts would artificially further the need for increased capital. There are new complex restrictions and limitations on capital treatment of deferred tax assets, goodwill and pension accounts. Further, a proposed financial accounting standard requirement to capitalize certain operating leases would increase risk weighted assets, and thus the level of required capital. There have been concerns raised that these proposals "change the rules," and could prove problematic.

In brief summary, the community banking industry is overwhelmed by government regulation, and this proposal unnecessarily piles on additional regulatory burdens. Ultimately, these burdens will lead to higher borrowing costs and diminished availability of both credit and bank services to consumers, small businesses, and local governments.

The logical thing to do is to exempt all but those complex international banking institutions considered "systemically important" from these burdensome and counterproductive capital rules. Community banks should be allowed to continue using the current Basel I framework as they have and will continue to serve banks, customers, and regulators very well.

Thank you for the opportunity to comment on these proposals.

Sincerely,

Patricia G. Satterfield

Patricia G. Satterfield
President & CEO

cc: The Honorable Mark Warner
The Honorable James Webb
The Honorable Robert J. Wittman
The Honorable Scott Rigell
The Honorable Robert C. Scott
The Honorable J. Randy Forbes
The Honorable Robert Hurt
The Honorable Robert W. Goodlatte
The Honorable Eric I. Cantor
The Honorable James P. Moran, Jr.
The Honorable H. Morgan Griffith
The Honorable Frank R. Wolf
The Honorable Gerry Connolly
Commissioner E. Joseph Face, Jr.