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1st National Bank of Scotia

October 19, 2012

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

Re: Basel III Capital Proposals

Dear Secretary Johnson:

After 45+ years as a bank director, officer, and shareholder of an Upstate New York community bank, founded by my Grandfather and several local businessmen in 1923, we thought we had seen everything. Not so! We survived the Great Depression, World War II, and a 7½ year lawsuit over a Cease and Desist order placed against our Bank, its officers and directors in 1978.

The Bank has grown to $390 million as of June 30, 2012, and is being successfully operated by the 4th generation of our family. In 1965 the Capital District region had approximately 22 commercial banks owned and operated by people in our community. Now we have only three. We survived because we know our customers and they want to bank with us. Our underwriting standards have not changed in 30 years. Our delinquency rate is 0.70% over 30 days past due.

Also as of June 30, 2012, our Bank had a tier 1 leveraged ratio of 7.19%, tier 1 risk-based capital ratio of 9.85%, and total risk-based capital ratio of 11.11% under existing standards.

Now comes Basel III which we were assured would be applied only to the world's largest banks that were responsible for our country's current financial problems. Now the regulators propose that all banks fall under the Basel III capital standards rules and regulations. Both the FDIC and the OCC supported the Fed's decision after initially being in favor of Basel III regulations for banks over $10 billion in asset size.

Our Bank was being examined by the OCC when the three regulators announced to the banking industry that they would be publishing for comment new Basel III capital rules and regulations.

The OCC's memo dated June 7, 2012 (OCC 2012-16), Subject: Capital Planning, did not mention Basel III. It appeared to be for the inclusion of capital regulations for federal savings banks now under federal regulations. It also referred to enterprise risk assessment and their eight OCC-defined risk factors. They were not listed in the memo.

At the exit meeting, the examiner in charge briefly reported on capital but did not state that it would become a Matter Requiring Attention (MRA).

Around July 10th, the OCC informed its banks that a telephone conference call regarding Basel III standards was scheduled for July 19th from 2:00 P.M. to 4:00 P.M. On the call, technical "experts" detailed what was to be required of the banks. Two of the experts were unprepared to answer the bankers' questions. The third "expert" was one who had worked on Basels I, II, and III for the OCC and was not responsive to the bankers' concerns.

The forum provided for the submission of fax and e-mail questions from the banks followed by phone questions. Then the hard questions came. All were opposed to Basel III, citing specific situations that were disastrous to their banks and the communities they serve. No answers were provided that satisfied the callers. At 3:35 P.M., the forum moderator thanked the callers and listeners and abruptly ended the forum. Not until later were we made aware that the program had been changed to conclude at 3:30 P.M.

With 1,500 bankers participating in the telephone conference, it was not fair to the hundreds of banks who are entitled to have their voices heard. Since that time, we have not heard anything further from the OCC scheduling any additional meetings. All we have left is a written comment period extended to October 22, 2012.

It was difficult, to say the least, to obtain copies of the NPRs. After reading them several times, I wondered if our exam was a prelude to Basel III. When we received our exam report, capital was an MRA stating that the MRA is required due to the growth of the Bank and <u>proposed changes to regulatory capital requirements</u>. Why is the OCC examining on a proposed regulation? If you read all three NPRs, you would know that the designers of the NPRs never worked in a bank or talked to bankers before developing formulas that would cause bankers to have to explain to customers why they could not get a loan or will not receive interest on their deposits.

The next memo from the OCC (OCC 2012-24) dated August 30, 2012, stated that comments on the 3 NPRs are due by October 22, 2012, which was hardly enough time to understand the full impact of Basel III.

Now Basel III becomes our new focus. Designed by worldwide regulators, its purpose was to stem actions taken by large international financial institutions that led to the financial crisis of 2009. The result was these "too big to fail" institutions became larger as they were bailed out. Community banks could no longer trust large banks to hold excess funds and the Federal Reserve became the only institution to run the federal funds market. With the Fed paying only .25 basis points per year, banks still had to pay for FDIC insurance leaving little for retained earnings.

There are at least three ways to address Basel III.

First: Nowhere in the Constitution of the United States, does it state any world organization or other country can force the United States to comply with any of their rules and regulations? We have to follow our Constitution, Article I-Section 1, and abide by the laws approved by Congress. <u>Basel III is not a law.</u>

Second: If Glass-Steagall was still the law and if large banks had not acted as investment bankers, most of this disaster would not have happened. "Too big to fail" should not exist. Banks and businesses fail all the time. Bankruptcy, as history has shown, works well at any level without government (taxpayer) aid.

Third: Regulators already possess almost unlimited power through existing laws and regulations to force banks, officers, and directors to do anything they want via Cease and Desist powers. We know. From 1978 through 1985, we survived after being reduced in size from $72 million to $45 million. We were among a few of the approximately 1,300 banks placed under Cease and Desist orders to survive with the same management and ownership. We survived unjust accusations only because the law allowed us to appeal all the way to the Supreme Court. Any change in laws or regulations must include an appeal process; the same as now exists. And we survived because we know our customers and they want to bank with us. Our underwriting standards have not changed in 30 years.

Now, about what is wrong with Basel III. Other than it is unconstitutional, it is also unfair to community banks and their customers. Many small banks will simply give up and sell to larger institutions that will tend to use our communities' funds to invest in projects anywhere they desire in their investment portfolio.

Other bankers will find that changing the risk factors will increase their capital needs. When capital ratios are not met, dividends will not be declared and paid. This will negatively impact a bank's ability to sell stock, to pay competitive salaries and bonuses to maintain the staffing levels necessary to serve the customers' needs, and to comply with constantly changing government regulations.

The risk factor for mortgage servicing rights (MSRs) at the end of the transition period 2018 will be 250%. It is unbelievable unless the regulators want banks out of the MSR business. Banks can service mortgages better because they, in most cases, have the customer accounts and under MSR agreements usually handle all credit problems.

Selling common stock with a capital conversion buffer and dividend restriction in place will be next to impossible in our community. With a board of directors holding 50%+ of the Bank's stock, it is doubtful they will be willing to invest several million dollars with the possibility of having no dividend if the Bank continues to grow. With today's interest rate structure, the chances of raising capital from earnings are slim at best. So, we are left with the option of shrinking the Bank, restricting lending, and refusing deposits. We survived this once; however, without legal recourse, our Bank may not survive.

Adding insult to injury, many individuals and community banks have moved investment portfolios to municipal bonds, a market that has now been taken over by the large banks and brokerage firms who are bidding as low as 34 basis points with a maturity of one year. Car loan rates have dropped to less than 2.50% while 30-year mortgages have fallen below 3.50%. The mortgage loans have to be sold ASAP or community banks will become the savings banks of the '70s.

No one has considered how banks will retrieve the required loan-to-value information from its files if it is even there. How relevant can a value placed on a home 15, 10, 5, or 1 year ago be today? Has this been modeled out to see what it will actually cost in time to obtain the necessary information and what the net effect will be on capital?

The Federal Reserve has pressured banks to lower interest rates to the consumers by holding the Federal Funds Rate to 0.25% and forcing community banks to lower the interest paid to their depositors to almost nothing.

Our analysis of our capital needs under Basel III are almost impossible to predict; however, if we were to allow our growth to continue at the current rate of8.6% annually with no increase in income through at least 2015, as per the Federal Reserve's recent statements, we would have to raise capital of $5 to $7 million!

We are still trying to interpret the full effects that NPRs 1 and 2 will have on our Bank's capital. Without assistance from government sources, it is like learning a foreign language.

The only acceptable solution under Basel III is to exempt all banks under $10 billion as originally proposed. If not, it will kill the lifeblood of small business, community banks, and the economic future of our country!

Sincerely,

Louis H. Buhrmaster
Chairman of the Board