October 22, 2012

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W. Washington, D.C. 20551
regs.comments@federalreserve.gov
Docket R-1430 and R-1442; RIN No. 7100-AD 87

Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 2-3
Washington, DC 20219
regs.comments@occ.treas.gov
Docket ID OCC-2012-0008 and OCC-2012-0009; RIN 1557-AD46

Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation,
550 17th Street, N.W.
Washington, D.C. 20429
comments@fdic.gov
RIN 3064-AD95 and RIN 3064-AD96

Re: Basel III Capital Proposals

Dear Sirs and Madam:

DCG appreciates regulatory efforts to improve the level and quality of capital in the U.S. banking system. There was little doubt as the recent financial crisis gained momentum that there would be a meaningful revision to the rules governing the management of risk in the financial system, and the Notices of Proposed Rulemaking (NPR) issued by the Federal Reserve are certainly a large component of that effort.

We write this response letter from the perspective of a community bank (which is the space that DCG primarily serves as an asset / liability management advisor), and the constituent communities these organizations serve. Each quarter, we have the opportunity to meet with over

300 community banking institutions and discuss business issues they face in the current market place. This interaction serves as the basis for this comment letter, which we hope will help shape a final rule that is effective and fair to the various interests the banking system serves.

While our comment letter addresses a few specific elements of the NPR, it refrains intentionally from delineating an exhaustive list of our concerns, if for no other reason than one of practicality. More importantly, it stems from a fundamental belief that attacking complexity with complexity is not a good strategy. In fact, we believe that simplicity and understandability will produce materially more favorable results.

Accordingly, we are concerned that the law of unintended consequences will become a stark reality if the NPR are implemented as proposed. We believe that elements of the proposed rulemaking will, among other things:

- reduce the availability of credit, especially in the housing sector,
- increase the cost of credit to the consumer,
- reduce the capacity of the banking industry to lend as the economy improves and the demand for credit increases,
- add substantial cost burden to community banks in order to comply , and
- result in substantial loss of jobs throughout America as banks are forced to merge and/or reduce operating costs.

In essence, our recommendation is that Basel III should, at the very least, be put on hold for community banks until a more pragmatic solution can be developed. If the regulatory community feels a pressing need to get the ball rolling, then why not start with the more systemically important financial institutions (e.g. target the largest 25 banks), and see how that plays out in the field? Why experiment with the 95% of banks that fall well below any radar screen designed to monitor/control a relatively few national and global banking institutions?

Shock Absorber Concept / Dividends & Compensation

Interestingly, if the proposed rules were in place pre-crisis the result likely would have been more bank closures at a much faster pace. As credit conditions deteriorated, the risk weighted capital requirements and deferred tax asset changes alone would have exacerbated problems without allowing time to recover (which given the most recent problem bank list, many banks appear able to do). The unintended death spiral of the affected banks would have increased pressure on other banks' capital and liquidity, likely worsening the overall economic impact, the exact opposite of what the NPR is intended to do.

Notwithstanding, the general framework of a capital requirement system as proposed by the Basel committee and the Federal Reserve is one that we feel most community bankers can appreciate. For the most part, they have been unofficially living within that framework for years. The reasoning has been that it is difficult for a smaller bank to raise capital relative to larger and more systemically important banks. Therefore, community banks have typically operated with sizeable capital buffers well in excess of those technically required for a regulatory "well capitalized" designation.

Operating in this fashion highlights the conservative nature of the majority of community banks. While it is true that most of the recent bank closures consisted of community banks, many appear victims of a perfect storm of events in their geographic areas and would have been closed even if their starting levels of capital were well in excess of those required under the proposed rules.

So while the general concept is not foreign and the desire to raise the minimum requirements for capital standards were anticipated, a very real concern voiced has been the "red line" approach to payment of dividends and potential impact on compensation packages.

The issue of dividends is of special concern to subchapter S banks, whose investors require a dividend to, at a minimum, cover tax liabilities related to the pass through of corporate earnings. And while we understand the public perception on payment of executive compensation for institutions that are in difficult financial shape, we point out that institutions that find themselves in that situation often make changes to the executive suite (and often at the urging of their regulatory partner). It becomes potentially difficult to attract talented replacement leaders to navigate the waters back to capital strength with overly stringent governors on compensation packages.

<u>Capital Levels Versus Risk Appetite</u>

Even had these newly defined capital buffers been in place, many community banks would have failed due to credit concentrations or otherwise weak credit risk management practices. Based on autopsies conducted by the Office of Inspector General (OIG), it is unlikely that capital ratios of even > 25% would have served as an adequate buffer to insulate the FDIC against losses from many of the failures that occurred.

Truth be told, many of these banks practiced reasonable care and diligence with respect to credit management. Unfortunately, even loan to value requirements of 50% would not have saved these institutions due to the dynamics specific to their geographical location and a rapid burst of the housing bubble in those markets.

Again we point to the OIG failed bank reports and the disclosure of CAMELS ratings awarded these institutions as they built the very balance sheets that resulted in their demise. Most garnered composite "2" ratings prior to the outbreak of the financial crisis and demise of Lehman Brothers Holdings Inc. In some cases, those ratings subsequently dropped two or three full points in less than six months. This would be understandable in the case of fraudulent activity to deceive analysts and regulators, but those instances appear rare.

DCG | 260 Merrimac Street | Newburyport, MA 01950 | 978.463.0400 | Fax: 978.465.6033 | darlingconsulting.com

The point we make is that even under close examination by trained examiners, there was little to suggest that many of these failed institutions were acting in an unsafe or unsound manner. The housing bubble did not simply deflate as many had hoped it would. Rather, it popped loudly and in a spectacular and costly fashion. Accordingly, a reasonably higher level of capital alone would not have prevented a large number of the bank failures.

As such, we support the proposed desire of the regulatory community to implement countercyclical reforms to build capital in "good times". This will slow the flow of credit in a more speculative period, and hopefully result in fewer bubbles that will be less impactful on the broader economy.

Risk Weighting Asset Changes: The Law of Unintended Consequences on Credit Costs...Housing Credit in Particular

The banks that remain today are ones that likely operated in a less risky manner. These banks continued to serve the credit needs of their communities in the face of the crisis even as larger banks (forced to deal with their own capital issues) reduced available credit and abandoned smaller borrowers. The community banks have suffered collateral damage for the action of others, and are currently struggling under the weight of a low rate and weak economic recovery environment, as well as the increasing costs associated with complying with what appears to be an endless spate of new regulation that continues to result from Dodd-Frank.

And now these banks must bear the burden of elements of these proposed new capital rules, many of which appear intended to punish those institutions that are already "dead" but with potentially dire unintended consequences for those that successfully weathered the worst financial storm since the Great Depression.

Some of these unintended consequences will adversely affect the availability of credit in many markets and drive up the cost of that credit for consumers and businesses. This leads us to question why the Federal Reserve, which has in recent years gone to great lengths to keep interest rates and the cost of credit low, would throw water on the flickering flame of economic recovery that we see today. This is particularly true for credit extended to home buyers and the desired recovery in housing.

There is a profound desire on the part of the US government to "child proof" the issuance of housing credit. Consumers see the effects of this at loan closings; the "sign here...initial there" demands that get borrowers to state that they understand what they are agreeing to, even if they do not. Bankers have seen it in the form of new regulation resulting from Dodd-Frank and the CFPB, the compliance burdens and costs of which have led many to begin to formulate plans to exit the market. And now, the proposed rescoring of risk weights for mortgage related assets will require a higher allocation of capital to support a business line with increasing compliance risk and higher costs of doing business. For example, banks in many rural markets can demonstrate that balloon mortgages are not any riskier than a hybrid ARM. Yet, the exact same

DCG | 260 Merrimac Street | Newburyport, MA 01950 | 978.463.0400 | Fax: 978.465.6033 | darlingconsulting.com

credit in a fixed balloon would be risk weighted 100%-200%, while the hybrid ARM would be 35% to 100%. Why? Washington may feel otherwise, but we can assure you that this confluence of political and regulatory "improvement" will lead to a reduction of credit availability and higher costs that will be passed on to the consumer.

Unrealized Bond Losses

As noted above, there are many concepts in these proposals we support as a result of lessons learned from the financial crisis. There are also a number that are difficult to justify. Most of these issues relate directly to the U.S. banking market, which differs greatly from those abroad.

A significant example is the proposed inclusion of the Other Comprehensive Income (OCI) adjustment for all securities in the calculation of Common Equity Tier One (CET1). Based on discussions with analysts that cover larger international banks, investment portfolios abroad tend to be short in duration but have a fairly high degree of credit exposure. This runs counter to the investment portfolio of the typical community bank, which runs longer in duration but is generally comprised of Treasury, GSE grade debt, and higher quality municipal bonds.

While it may be appropriate to include the unrealized loss of more credit sensitive bonds in CET1 as there is a higher probability of true loss, it makes little sense when the bond lacks meaningful credit risk. This is especially true given current accounting practices for determining the extent to which a bond's unrealized loss is due to temporary factors (such as interest rate movements) versus more probable unrecoverable losses (such as credit impairment). When the facts suggest an unrealized loss is unrecoverable, it results in a charge off that runs through the P&L and reduces retained earnings.

Why then does this aspect of the proposal make sense when there is a clear difference in investment portfolio composition domestically versus abroad, and accounting rules are already in place for dealing with the real matter at hand (credit impairment)? This issue is not something that makes a large difference now, but will be needlessly harmful when rates rise and unrealized losses build.

In effect, inclusion of OCI will reduce bank capital ratios (and therefore their capacity to lend) at a time when businesses and consumers will be looking to banks for increased credit support. This relates to the logical expectation that the next economic growth cycle will likely be preceded by or concurrent with rising interest rates.

Let's consider an example of a $1 billion bank with a 10% Tier 1 Capital ratio and an investment portfolio of 20% of assets with a duration in the range of 3 - 3.5 years in the current rate environment. In an up 300bp environment, the duration is expected to extend to 5 - 5.5 years; therefore the expected loss of value in the portfolio would be in a range of roughly 15.0% to 16.5%. Using the average loss of 15.75% the pre-tax loss on the portfolio would be $31.5 million (assuming an average tax rate of 30%, the after tax loss would be $22.1 million).

DCG | 260 Merrimac Street | Newburyport, MA 01950 | 978.463.0400 | Fax: 978.465.6033 | darlingconsulting.com

Changing nothing else, this reduces the capital ratio of the bank by 22.1%. Multiply that type of decline throughout the banking world, and the presumable economic recovery that caused rates to rise has just been thwarted by massive capital write down forcing banks to curtail their lending activities.

In addition, there may be sound reasons to add duration in an investment portfolio from an interest rate risk perspective. If banks are forced to shorten the duration of their investment portfolios due to the impact of the new rules, they will less likely to purchase mortgage backed securities and municipal bonds; resulting in higher borrowing rates for mortgage borrowers and municipalities. With the disincentive to buy longer term bonds, asset sensitive banks may go into longer term loans versus securities, and increase their use of derivatives. Liability sensitive banks may add short credit sensitive securities to their portfolio. These changes would exacerbate credit and or liquidity risk on bank balance sheets, and potentially lead to actual losses due to credit instead of "paper losses" from interest rate movements.

This will not lead to a safer financial system. It will instill a trading mentality among those that manage community bank investment portfolios, which are typically used to hedge balance sheet risk positions and decrease the cost of carry on liquidity. Again, community banks cannot simply absorb these costs as many are already struggling to support increasing overhead cost burdens. By default, the reduced profitability will be passed on to the consumer.

Accelerated Disallowance of Trust Preferred in Tier One Regulatory Capital

Lastly, we wish to comment on the proposed 10 year phase out of trust preferred securities from Tier One regulatory capital for domestic banks under $15 billion in assets. We do so with an appreciation for the reasons the Federal Reserve outlined in the NPR. However, we feel there is more damage that will be done by now closing the barn door years after the horse left the barn.

For many small banks, this is the equivalent of Lucy pulling the ball away as Charlie Brown expects to kick it. Those that currently count TRUPS in tier one capital would face many issues replacing the capital.

Sub Chapter S banks that can only have one class of stock have extremely limited options to replace it, and can only do so in a dilutive / costly way that unfairly punishes existing shareholders for utilizing a previously regulatory approved capital strategy to support balance sheet growth. Mutual holding companies are even more restricted, likely having no option other than converting to a stock company and completely changing priorities of their mission statements at a time when long tenured depositors of the bank will least benefit from the conversion process.

Additionally, we have seen no sign that the Federal Reserve has given consideration to the fact that many companies have utilized interest rate swaps to convert floating rate TRUPS to a fixed rate for long periods of time. The reason this was done was to lock in a cost of capital at an

DCG | 260 Merrimac Street | Newburyport, MA 01950 | 978.463.0400 | Fax: 978.465.6033 | dar ingconsulting.com

acceptable (even low) level; in most cases this required a bank to forgo current earnings to ensure costs would remain stable. As the low rate / recessionary rate environment has extended longer than most economists ever expected, those hedges are under water from a valuation perspective. Even a partial unwinding of those TRUPS would eliminate hedge correlation and require a holding company to immediately recognize the unrealized loss on the swap, exacerbating the capital hole that must be filled.

The use of TRUPS by community bank holding companies became common place in the early 2000's and was ratified by the Federal Reserve in 2005. The market for issuing TRUPS died on its own in the late 2000's, and the future use of these instruments other than those outstanding was eliminated with the adoption of the Collins amendment. Given all this, it does not seem fair or logical that the Federal Reserve would accelerate the unfavorable capital treatment of the grandfathered TRUPS for small banks that by virtue of their existence today are less culpable for the financial crisis than those that have failed. At a minimum, the phase out should be done in concert with the ruling in Dodd-Frank in terms of an exit timeline (25 years versus the proposed 10 Years).

Complex / Confusing / Overkill

We can understand the need for more comprehensive rules for financial institutions that are considered systemically important and/or that operate on an international stage. We also understand the need to "beef up" regulatory capital requirements for the industry.

However, the newly proposed rules and the implementation timeline are troublesome when applied to less complex community sized institutions that have demonstrated the discipline to avoid overloading on bad asset strategies that produced so many bank failures, and are now committed to fighting through the aftermath.

Combined, the NPR exceed 750 pages of text and have thoroughly confused many community bankers. Despite the volumes of text, regulatory roundtables to better explain them, and existence of templates attempting to estimate the impact the changed capital rules will have, many struggle to find clear answers to simple questions such as "how often do I have to reassess the value of a residential property to determine the risk weighting of the loan on it?"

We know that banks that have been deemed "too big to fail" are treated differently. This is logical. They are more complex in their operations and more difficult to resolve if they fall on hard times (thus the mandate for "living wills"). However, community banks have lived under the mantra of being "too small to save" for the reason that their closure would not move or threaten the market.

Given the disparities of importance to the financial system and business model, is there another way? Is there a simpler and better way of achieving the goal of "improving the level and quality

DCG | 260 Merrimac Street | Newburyport, MA 01950 | 978.463.0400 | Fax: 978.465.6033 | darlingconsulting.com

of capital in the financial system" without forcing smaller banks to hire full time employees to keep the score and ensure compliance with needlessly complicated and confusing capital rules?

In Closing

We feel that it would be appropriate to delay the implementation of the capital NPR, at least in the community bank space, given all the questions that are still circulating without clear answers readily available for them. This has already occurred in other countries struggling with similar, albeit in many cases fewer, issues with the Basel proposal.

Extending the timeline would afford the Federal Reserve and the other regulatory agencies a better opportunity to reconsider the potential unintended consequences of the NPR, make adjustments in order to reduce unexpected adverse results, and/or devise a less complicated approach to meeting the capital improvement mandate; especially for community banks.

Due to the issuance of the NPR and new rules and regulations enacted by the CFPB, we are aware of a number of banks exiting business lines (e.g. residential lending due to the treatment of mortgage servicing assets). One can only assume that if the NPR are implemented in their current form, other profitable business lines will take a similar path, ultimately making banks less profitable with two certain outcomes: 1) banks will be forced to take on additional risk to offset the loss of income; and 2) credit for consumers and small businesses will be significantly less available and more expensive. Another likely outcome will be an increase in bank mergers.

We all share a common goal of an improved economy with a safe, healthy banking system. You cannot have a vibrant economy without a healthy community bank system! Small business lending and the consumer still have tremendous impact on the economy in this country. Both of these groups will be adversely affected by the proposed rules, further complicating and prolonging an exit to this financial crisis. The very things the NPR is trying to prevent could actually be made worse due to unintended (yet very real) consequences.

We are obviously biased to the views of the community banks we serve. However, we also feel the collateral damage to consumers will be very real.

We respectfully ask for your consideration on the points raised in this letter, and appreciate your time in reading it.

Sincerely,

DARLING CONSULTING GROUP, INC.

DCG | 260 Merrimac Street | Newburyport, MA 01950 | 978.463.0400 | Fax: 978.465.6033 | darlingconsulting.com