Cardinal Financial Corporation

October 19, 2012

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 Capital Proposals

Ladies and Gentlemen:

Thank you for the opportunity to provide comment on the Basel III proposals that were recently issued for public comment by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.

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 may actually harm the American banking system, especially small community banks.

Among the complex rules is a requirement for banks to gather extensive data about their loan portfolios and other assets and perform numerous complicated calculations to determine the applicable risk weights. In particular, this proposal will have a disproportionate negative impact on community banks that don't have the manpower to keep up with tracking loan to value ratios (LTV) on real estate collateral. Although not "systematically" important (not "too big to fail"), community banks will face many of the same complex standards required of larger and riskier financial firms. It would be more appropriate to have an approach that recognizes the difference between "main street banks" and "Wall Street megabanks". Otherwise, this will drive up costs and lead many community banks to stop offering certain core products and services, including nonconforming mortgages, commercial loans, working with borrowers experiencing unexpected financial difficulties, and selling mortgages in the secondary market.

Also, the inclusion of unrealized gains and losses on AFS securities in regulatory capital is a significant change from the current rules and brings new and potentially extreme volatility to bank regulatory capital ratios. A study performed by the investment banking firm of

Sandler O'Neill on Basel III estimates that approximately 20% of regulatory capital will be lost in a 300 basis point increase in interest rates. The potential ramifications of this proposed change include:

- Banks may choose to downsize investment security holdings as a percentage of total assets. This seems contrary to safety and soundness goals, as banks might be incentivized by the new rule to seek out other, possibly higher-risk investment alternatives, such as loans where changes in interest rates would not directly impact regulatory capital.

- Banks may also elect to shorten the duration of their securities holdings to lessen the risk of unrealized losses as shorter-term holdings have less potential to generate unrealized losses. The cost of this strategy would come in the form of reduced income as shorter durations are usually accompanied by lower yields.

- Banks may also choose to transfer or assign new purchases into the 'held-to-maturity" category, which would be an effective strategy at reducing investment security volatility, but it would also reduce or totally eliminate the flexibility of banks to include securities for liquidity ratio purposes and for maximizing total income on securities via sales when market conditions allow.

Additionally, the proposals include troublesome restrictions on mortgage servicing assets, which are a large part of the operations of many banks. Requiring mortgage servicing assets that exceed 10% of a bank's Common Equity Tier 1 (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 servicing problems consumers have had with troubled debt modifications and workouts.

Another of the proposed rules could lead to substantial volatility in regulatory capital ratios due to deteriorating credit quality when evidenced by past due loan status over 90 days and increasing loan-to-values on 1-4 family residential loans. 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, and, during times of economic stress, the higher capital requirement would most likely restrict a banker's ability to lend. This sharply contradicts the public policy behind numerous federal and state laws and regulations adopted in recent years,

Finally, the inclusion of discretionary bonuses to executives in the "capital conservation buffer" payout limits may provide a strong incentive for bank management to build and maintain regulatory capital levels at much higher levels than before. However, look also for banks to restructure compensation packages to reallocate bonus payments to base compensation in order to avoid possible limits.

While the Basel III Proposals place burdens on banks of all sizes, imposing these restrictive requirements on smaller community banks will likely have a severe effect on the traditional community banking system 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. Community banks did not cause the recent financial crisis and 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 banks from the Basel III Proposals

Thank you for your consideration of these comments.

Sincerely,

Mark Wendel

Mark Wendel
CFO, Cardinal Financial Corporation