The Commercial & Savings Bank

October 22, 2012

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Re: Basel III Capital Proposals

Honorable Addressees:

This letter is respectfully submitted as participation in, appreciation for, and affirmation of, the public comment process on the Basel III proposals recently approved by your agencies. As lead executive of a publicly-held community bank, I have grave misgivings about the requirements as proposed and I urge you to withdraw the current version in its entirety and resubmit a new proposal after careful consideration of all relevant comments and factors raised in this process.

Absent rescission of the current proposal, I urge you to permanently exempt community banks from the proposed capital requirements; and absent permanent exemption, I urge you to provide temporary exemption for as long as required for your agencies to adequately address the distinctive factors and impact of the proposal on the community banking industry.

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The Commercial and Savings Bank of Millersburg, Ohio (CSB) was chartered in 1879 and has maintained independence and the ability to serve its market area for over 130 years. Over the past four years, our bank has supplemented its organic growth by successfully completing two acquisitions, one of a smaller bank and the other a purchase and assumption of two branches. In both cases, the transactions were unassisted as the bank deployed accumulated capital in order to complete these strategically important initiatives.[1] Our bank, like all other community banks, must capably balance the interests of our stakeholders – shareholders, customers, employees and the communities we serve. We know that the strength of the banking system is fundamentally important to the economic health and well-being of our nation, and that the safety and soundness of our bank is vitally important to the constituents we serve.

I am concerned that the proposed new capital rules will have adverse effects on our bank's ability to provide needed products and services to the communities we serve. I believe the same detrimental impacts will occur across much, if not all, of the community bank sector if these rules are enacted. The rules are overly complex and will be more costly than prudent to implement, especially for community banks. We would be forced to comply with the rules if implemented, but the proposed approach is misguided and risks severe unintended consequences harmful to communities and the economy as a whole.

That is to say, while the proposed rule seeks to enhance the safety of the banking system in order to perpetuate reliable banking services for everyone, it will result in the diminished ability of community banks to meet constituents' needs because of the requirement to set aside more capital in order to be able to sustain regulatory compliance. Such an outcome will impede economic growth by restricting the flow of credit and making it more difficult for individuals and businesses in communities across the nation to have access to needed funds. The banking industry has been roundly criticized for restricting credit through the present economic cycle, even though the lifeblood of almost every community bank is the continuous process of making good loans. Paradoxically, these proposed rules will enshrine by statute even further limitations on community banks' ability to extend credit.

The following comments summarize my key specific concerns:

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[1] CSB currently has sixteen banking centers in Holmes, Tuscarawas, Wayne and Stark counties of Ohio and offers a wide range of financial services to households, businesses and organizations in the area. The Bank has total assets in excess of $560 million and employs over 150 people in our four county area. Additionally, we service approximately $46 million in mortgage loans (primarily sold through federal agencies) and provide trust and brokerage services for assets under management exceeding $100 million.

At June 30, CSB's assets were comprised of approximately 12% cash and deposits with other banks, 23% securities, 60% loans, and 5% other assets. Our securities portfolio contained 27% U.S. agencies, 11% tax-exempt municipals, 55% mortgage-backed and collateralized mortgage obligations, and 7% other securities. Our loan portfolio was comprised of 40% one-to-four family residential loans (24% first mortgage, 3% second mortgage, 13% revolving), 31% commercial real estate (CRE) loans (26% owner-occupied CRE, 5% non-owner occupied CRE), 15% commercial and industrial (C&I) loans, 7% construction and development loans (primarily of a commercial nature), and less than 5% each of various consumer and installment loan types.

The Bank's capital ratios at June 30, 2012 were 7.70% Tier 1 Leverage, 12.16% Tier 1 Risk-based Capital, and 13.41% Total Risk-based Capital. Each of these ratios were slightly lower than historical norm for the Bank, given the deployment of capital for the two unassisted acquisition transactions completed by the Bank in the past four years.

Issue 1: The requirement that unrealized gains and losses from a bank's available-for-sale investment portfolio must flow through regulatory capital will not increase safety and soundness but will increase volatility of computed capital ratios.

I cannot see any practical safety and soundness benefit from introducing measurement of this naturally occurring daily volatility to the recognition of a community bank's capital adequacy.

The national economy is currently in a period of historically low interest rates. If unrealized portfolio gains become losses when interest rates go up and such losses flow through regulatory capital, banks that currently meet the new enhanced capital levels could quickly fall underwater. This could then trigger actions called for in the bank's capital maintenance plan, when in fact the likelihood of the bank incurring any real loss on the applicable securities is quite remote (our bank like most community banks does not trade actively in securities but rather maintains a generally stable posture as it relates to the holding of securities as an outgrowth of managing liquidity, cash flow and interest rate risk. Our bank has stress-tested the impact of a 300 basis point immediate increase in interest rates, and as of June 30 our modeling indicates the impact on total earning assets would be a net decrease in the stated value of those assets.

The additional volatility will require banks to keep additional capital just to make sure they stay above the new well-capitalized levels (plus any buffer). In our bank's case, I envision that we would at various times under various realistically foreseeable scenarios experience the following:

- Reduced ability to meet borrower needs. Because of demonstrated core-competence with our in-market lending, we have a long-standing practice of lending up to our legal lending limit. This has permitted us on many occasions to fully meet the borrowing needs of in-market commercial customers. Increased capital measurement volatility would force us to reduce the maximum amount of credit we can extend per borrower relationship. This would introduce increased complexity and reduced agility in meeting borrower needs and existing credit relationships.

- Shortening of maturities in order to reduce exposure to capital measurement volatility. This would place additional pressure on income. It would also reduce our flexibility to manage interest rate risk, and would limit the scope of municipal securities purchases that our bank can support.

- Constraint on our bank's asset liability management, reducing vital flexibility in managing interest rate risk because of an arbitrary recognition of mark-to-market fluctuations with no practical application to the conduct of our operations.

Issue 2: The proposed risk weighting rules will have an oppressive effect on home mortgage lending.

Risk weighting will become a challenging and expensive process, resulting in disincentive for banks to engage in mortgage lending activities. More importantly, the proposed risk weighting rules would raise a huge obstacle to the community bank model of sustaining local home lending products kept within the bank's loan portfolio. This, in turn, will deny solid financing alternatives to home loan borrowers in underserved and rural communities – a service that plays a large role in supporting the local economies of these communities.

The proposal's treatment for first mortgages will classify each loan into one of various categories based on perceived risk and LTV, then assign a different risk weighting to each loan, with some residential mortgages requiring a risk weighting of as much as 200 percent. The proposed treatment does not recognize PMI, and penalizes banks for working with customers and modifying loans outside of government sponsored programs by shifting them to a higher risk category.

Balloon payment provisions are penalized by requiring greater risk weighting. Taking away this flexibility is particularly harmful to community banks as we can retain loans and manage interest rate risk by making loans with a variable rate or balloon payment provision.

HELOC loans as a product may be assigned a 200 percent risk weight category and a bank that holds both the first and second mortgage may "taint" the underlying first mortgage, assigning its full value to a higher category unless the entire combined loan can qualify as a tier one risk. *In our bank's case, this is a critical concern due to its significant impact, as 13% of all loan balances on our books fall into this "Tier II" category.* We are comfortable with this lending; we conduct it within our markets with prudent underwriting, and have experienced minimal loan losses on this type of loan for decades, including the past six year downturn in the housing cycle. Further, as proposed, the rules create some capital requirement anomalies, such as requiring that a high loan-to-value HELOC whose borrower has a very low debt-to-income ratio and/or a high net worth be assigned a higher risk weighting than a low loan-to-value loan for a borrower who has a high debt-to-income ratio.

All told, the proposed risk rating rules thus create a situation where residential home loans will become more expensive to all but those with the strongest credit standing. As a practical matter, our bank, and many others, will need to rethink and to some degree curtail some home mortgage lending that has historically been profitable for the bank and beneficial for the borrowers and the communities we serve. Many of these risk rating changes will thus limit choices and result in higher costs for both the consumer and the bank alike. There is little doubt that a considerable portion of consumers in our market will experience reduced credit availability to make improvements to their homes, send children to college, or obtain funds for other capital needs even though they have a track record of fulfilling their credit obligations according to the terms of their agreements.

Issue 3: The impact of Credit Enhancing Representations and Warranties on 1-4 Family Residential Home Loans Sold into the Secondary Market on required capital levels is cause for concern.

At this point, we cannot be sure what representations and warranties will cause our bank to have to set aside capital. We have a significant portfolio of loans that we have originated and sold to Freddie Mac. We also service some Fannie Mae loans that were part of an acquisition transaction. Our bank's involvement in origination, sale and service of secondary market loan products to our market has expanded dramatically in the past five years as customers have chosen to take advantage of historically low rates on long term fixed mortgages. In the past two years, we have assisted many households in refinancing their existing mortgages with secondary market products. Throughout our bank's involvement with these products, we have maintained a stellar record in regards to foreclosure activity or repurchase requirements related to sold loans. Yet, this rule has the potential to greatly reduce our participation in a core part of our business, creating the dual adverse effects of taking away a tool that we use to manage interest rate and liquidity risk and at the same time reducing the availability of credit for home borrowers in our market.

Issue 4: The rules will be a disincentive for banks to work with troubled borrowers

Currently, when a loan is past due, the additional risk is addressed through ALLL. In the future, these assets will take on a new 150 percent risk weighting. In essence this will require a double charge to capital for delinquent loans. This policy further undermines workouts and encourages fire sales of troubled assets for less than reasonable market value. In the case of our bank, and I believe most community banks, knowledge of the customers and communities we serve is a core strength, and that knowledge permits us to prudently determine the appropriateness of adjusting terms or otherwise working out troubled credit situations. However, with the additional hit such credits would entail on risk weighted capital calculations, we would experience a higher cost of working with borrowers in great need of this assistance.

Conclusion:

The proposal as currently written will adversely impact our bank in the following ways:

1. This proposal will significantly increase the amount of capital that we hold – and its impact goes well beyond a simple increase in regulatory capital ratios. The proposal will increase our risk weighted assets with no change in our risk profile.

2. This proposal will result in significant costs and administrative changes to properly compute regulatory capital ratios. Very few community banks possess the staff or software necessary to compile or analyze this data. These increases in costs will in themselves have a negative impact on our capital through reduced earnings.

3. This proposal will reduce our ability to comprehensively manage all areas of risk in our institution by reducing earnings and adding administrative burden. It will force our bank to carry more capital as a safety cushion, thereby proportionally reducing the amount of earning assets the bank may hold while meeting today's well-capitalized status requirements.

4. The proposed capital rules would constrain our ability to execute various capital initiatives like the two growth acquisitions we have completed within the past four years. We would be forced to keep more capital on the sideline and possibly raise capital, an oftentimes inefficient proposition for community banks.

Effective bank operation and regulation entails the proper identification and management of a variety of risks. These risks intertwine and cannot be managed in isolation. Similarly, over-concentrating on any one area of risk is dangerous. This proposal places an undue amount of focus on capital at the expense of other areas of risk. Capital is not a panacea for solving all inherent risks.

The regulatory structure evaluates and assigns scores to financial institutions based upon the CAMELS framework. The proposed capital rules will reduce our options to address other components of risk – namely asset quality, earnings, liquidity and sensitivity. In fact, complying with this proposal may result in an increase in the overall risk profile of our institution.

Existing regulatory structure allows regulators to require higher levels of capital based upon the risk profile of an individual institution. This presumes an effective regulatory supervision process. I contend that the rules existing today provide the structure needed for effective regulatory oversight and supervision of community banks. The proposed Basel III capital rules will not enhance the safety and soundness of the community banking industry. Indeed, I sincerely believe that enactment of the proposal will imperil some of the very institutions it is designed to help safeguard, while at the same time increasing cost and decreasing availability of credit to many in need of loans currently provided by community banks.

In summary, while the proposed rule is intended to help safeguard the banking industry, its approach is overly restrictive as it relates to our bank and to the traditional community bank model in general. A one size fits all approach to bank regulation is becoming less and less effective given the rise of a variety of increasing complexities, including systemic risk, systemically important financial institutions with concentration of risk, globalization, unregulated and under-regulated providers of financial activities competing directly with banks, and historically unprecedented economic challenges.

As it pertains to regulation of the community bank sector, adequate and effective regulatory tools are already in place. I respectfully urge you to exempt the community bank sector from the entirety of the proposed Basel III capital rules. If the regulatory agencies are of like mind that tools beyond the existing regulatory framework are necessary for the community bank sector, a separate process of assessment and consideration of such requirements should be undertaken.

Sincerely,

Eddie Steiner
President and Chief Executive Officer
The Commercial and Savings Bank of Millersburg, Ohio

Cc: U.S. Representative Bob Gibbs
U.S. Representative Jim Renacci
Senator Sherrod Brown
Senator Rob Portman
Mr. Michael Van Buskirk, Ohio Bankers League
Mr. Robert Palmer, Community Bankers Association of Ohio