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October 18, 2012

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 2-3
Washington, DC 20219

Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation,
550 17th Street, N.W.
Washington, D.C. 20429

Re: Basel III Capital Proposals

Ladies and Gentlemen:

Thank you for the opportunity to provide comment on the Basel III proposals that were recently approved by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (collectively the "banking agencies"). We have also very much appreciated the opportunities provided by the Federal Reserve and the FDIC to comment on the proposals from a community banking standpoint in recent forums and panels. This type of face to face communication is invaluable.

The board of Howard Bancorp and its subsidiary Howard Bank have been consistently committed to the principle of capital adequacy in excess of today's well capitalized ratios; have articulated that in numerous strategic and capital plans; and, perhaps, more importantly have done what is necessary to maintain those capital levels while also maintaining a commitment to loan growth as one of the best predictors of positive impact on the communities which we serve. We are therefore supportive of the intentions of the Basel III proposals. However we are concerned about the unintended consequences of many of the proposal's specific provisions. We firmly believe that our ultimate shareholder value could be impaired. We believe that our ability to continue to positively impact our communities and to continue to grow employment could be impaired. And we believe that the banking system in this country will be endangered rather than protected by the unintentional reallocation of both capital and credit that will occur after implementation.

Background

Howard Bank is a $368MM community bank founded in 2004 serving the small and medium sized business community in Howard, Anne Arundel, and Baltimore counties in Maryland. We employ 72 bankers. We have been profitable in all but one quarter since 2006, and have maintained consistently high (in excess of well capitalized levels) capital ratios while growing both loan volume and our employee base each year since our inception. The sources of our capital represent a mixture of original equity capital raised in the local communities served, retained earnings, SBLF funds (one of four commercial banks in the state to receive the funding) and new common equity raised both institutionally and locally in the summer of 2012. We raised this last tranche of equity at a price dilutive to our book value even though we were well capitalized at the time of issuance because of the above belief that capital levels are important as is capital quality. Our tangible common equity ratio is well in excess of 7.5%. We strongly agree with this need to focus on both capital levels and capital quality. We also agree that, while stronger and better quality capital does not necessarily lead to strong underwriting and asset management, it is a key to mitigating the effects, if not the re-occurrence, of another economic crisis like that experienced in the last decade.

Our own strategic plan calls for continued growth by serving the small and medium sized businesses in our market area and we have planned that a combination of the new capital and the SBLF funds will allow us to fill some of the gaps left in our targeted marketplace by both the consolidation of the banking industry and the failure/stress levels of other local community banks. This focus on assuring that there is enough capital to permit safe and sound growth is also a critical component of our capital planning. The failure of some recent analyses to fully consider the impact of growth on projections of capital adequacy post a Basel III implementation are one of our primary concerns with the proposal.

Specific Considerations

1. We have a very short term, highly liquid investment portfolio and unrealized gains or losses have never been a factor in our financial statements. However, if capital is a signal of stability – why would we want to run potentially short term/reversible items like AOCI through the capital accounts?

2. Our asset mix is predominantly commercial loans – commercial and industrial (working capital and equipment financing) loans, commercial real estate – both investor and owner occupied, land acquisition, development and construction. We have strategically and intentionally operated as a CRE "concentrated" bank per regulatory guidelines and have managed our portfolio weightings, our acquisition and retention of staff with decades of experience in the local CRE marketplace and our utilization of strong information systems to allow us to manage these portfolios in a safe and sound manner. Our regulatory examinations have focused on our risk management. We recently received an Outstanding for our community development efforts in our most recent CRA performance evaluation.

3. Our ADC lending equals 100% of our capital levels. Our non-owner occupied CRE equals 300% of capital. Our acceptance of the CRE concentrated designation has helped our strategy not hurt it. However, the new HVCRE risk weightings suggest that this is no longer acceptable. We believe that issues with development and construction lending should be addressed at the risk management level and through the supervisory process. The language around HVCRE is confusing and has not been resolved despite numerous meetings with regulators and banking associations. It appears to us that the proposal may not recognize "other acceptable collateral" as capital contributed by borrowers for purposes of the exclusion from HVCRE; and it does not clearly except term CRE loans with compliant LTV ratios nor does it definitively exclude owner-occupied CRE loans from the definition of HVCRE.

4. Our residential loans to local business owners and their employees account for another 100% of capital. Some of these residential mortgages are to local public servants for whom we created a special product in 2005 to allow them to buy a home in the same geographic jurisdiction as their work with a smaller down payment. We also engage in a limited amount of home equity lending to customers and some very small portion of these standard, prudently underwritten HELOC's may be deemed to be category 2 loans because of characteristics such as interest-only periods. Some small portion are also loaned to customers for whom we have a first mortgage in our portfolio as well, thereby doubling the risk weight applicable to the first lien as well per the proposed Basel standards.

5. All of these loans are underwritten conservatively and are underwritten manually; we do not presently utilize algorithms, black boxes, or any computerized scoring system to make loans. Our NPA ratio is below 2% and we have rarely encountered a 90 day past due loan without moving it to non-accrual status. Our management of asset quality is constant and proactive. But our customary recognition of potential capital impairment is through the management of ALLL levels which allows for appropriate granularity.

Conclusions

As we have projected the impact of Basel III on our balance sheet and capital adequacy ratios, we will feel some diminution in the ratios – largely due to the ADC (and perhaps CRE) lending being done locally and some de minimis impact due to the Category 2 residential mortgage related loans resulting from the public servant lending programs. We will, however, candidly, not be as directly and immediately damaged if Basel III as now proposed becomes effective. We believe that many others in the industry will be affected much more. But if even a well-capitalized, conservatively positioned bank such as ours will be negatively impacted, how strong will our industry be immediately after the implementation of these proposed rules? How strong will our economy be?

It is natural and necessary for the agencies to want to address well founded concerns about the poor risk management practices of a few institutions, but as bankers, we do not anticipate that better risk management is a certain corollary of more capital. Capital protects from mistakes in risk management or deleterious shifts in external environments but it does not necessarily prevent those mistakes or that environment. The absence of empirical evidence and the failure to date to undertake a Quantitative Impact Study concern us. Again, we agree that capital ratios must be strengthened and that tangible common equity is the highest form of capital. We also believe that some asset classes can be inherently riskier than others and we believe that the present interest rate environment is causing numerous institutions to place medium term assets on their balance sheets that will eventually look unattractive. However, there is no evidence that injecting capital volatility into capital ratios by the insertion of AOCI into capital calculations will enhance the capital strength of the banking system. It will in the future lead to a haircut in capital but when it leads to a similar gain, will that be a good idea?

Nor is there any empirical evidence that the risk weightings being proposed bear any relationship to long term default and loss records. They bear some relationship to the problem assets of the last five years but those assets grew in some cases to dangerous and unsustainable levels because the above referenced government policy and previous Basel weightings encouraged banks to do more residential lending. And we believe that multiple economic cycles should always be incorporated in this look back. Arbitrarily requiring most capital to be in the form of tangible common equity rather than retaining some long sanctioned mixture of multiple capital tranches will lower the attractiveness of banks to investors and make it harder rather than easier to capitalize the industry going forward.

Consequences

Based on these conclusions, let me tell you how we, a young, healthy, growth oriented bank could be forced to adjust our business model in order to mitigate the depletion effect on our capital ratios:

1. Our growth trajectory will have to be modified downward to some degree as higher than anticipated required capital levels will not support exactly the same level of growth as is now planned.

2. Our compliance costs will, once again, rise as we must find ways to track the new categories of loans created by Basel III. While we have become accustomed to externally imposed overhead in the years of the economic crisis, and understand the good intentions behind many of these regulatory "additions", it is nevertheless important to note that overhead and fixed costs are the greatest enemy of any small company. There may be, understandably, insufficient real life experience of regulators with the level of difficulty that will ensue for us and others especially in re-aggregating and reconfiguring information on existing portfolios organized for today's standards to ensure that we can undertake the tracking that will be necessary to monitor multiple, sometimes conflicting capital ratios and to monitor a greater number of asset classes for risk weighting purposes. The need to add another compliance position will mean that a relationship manager or a branch customer service representative may not be added.

3. We will most likely stop any programs that allow first time home buyers or first time home buyers in a particular geography (near their school, their station house, their fire house, their government office) to acquire a home with lower down payments. Instead we will turn to one or more of the GSE programs. We believe that the proposed risk-weighting framework will push more residential mortgage business like first time home buyer programs and our own public servant loan program into GSE or GSE like entities as most government sponsored mortgage programs receive a low risk-weighting under the proposal. There is some irony in the growing consensus that the dominating role played by government policy in seeking record high levels of home ownership and the role played by government sponsored entities in seeking larger and larger returns on riskier and riskier loans may have unintentionally fostered an environment that was conducive to a bubble and collapse. This is not today a high percentage of our held portfolio but the proposed rules will make it harder for us to create programs designed to help the weakest in the community.

4. We may curb our ADC lending and potential CRE lending (depending on the need to clarify noted above) to a lower percentage level of capital. Alternatively, we will be forced to charge much more to achieve the same ROI – thus impacting the economics of the development and possibly the investor real estate market in our communities. The proposed approach to ADC lending, with a highly punitive risk weight, fails to adequately account for an institution's experience and expertise in this type of lending. It appears to conflict with the much more thoughtful approach taken in CRE guidance for the last few years.

5. We will push our targeted C&I lending to 35-40% of the portfolio rather than the 30-35% now favored and this is arguably riskier lending than some CRE lending. Our bank has decades of experience in this form of lending but we worry about those other community banks with little experience in commercial lending who may turn to this asset class simply because of the less punitive weighting in comparison to home mortgages. "Government decisions to influence the allocation of credit are the province of the fiscal authorities," according to the Joint Treasury and Federal Reserve statement in 2009 but capital re-allocation - out of the banking industry, out of real estate development, out of community oriented home loan programs - will undoubtedly be the end result of these proposals if implemented as proposed. We recognize that is NOT the intention but it will be an unintended consequence.

6. We will avoid any investments longer than 12 months.

7. We will find it even more challenging to work with small businesses in our own communities because of the automatic penalties associated with any past due loan – in order to protect our investors from dilutive returns on their capital. When an exposure becomes past due, there are generally allowance provisions that require institutions to reserve capital for those exposures in case they default, effectively lowering institutions' capital levels. Therefore, increasing the risk-weighting for past due loans will effectively adjust both the numerator and denominator in risk-based capital ratios, compounding the negative effect on the ratio. Combined with the treatment accorded TDR's, the usual economic incentives to work with a borrower because a restructured loan is usually better for all than a foreclosed loan are fast disappearing. There is little incentive to risk capital immediately while engaged in these negotiations.

Request

I appreciate the desire to groan when the banking industry asks once again for a "Hit Pause" so that more studies can be done. However, this new proposal represents enormous change and change driven only by the rear view mirror can be a mistake. Let us together try again for a simpler but more robust capital requirement regime. Let us not move capital out of the banking industry and banking capital out of residential mortgages and local development and into short term investments, less secured lending practiced by inexperienced bankers watching their capital levels, etc.

Let us ask if Basel is really the appropriate vehicle to create the kind of prudent change that we all acknowledge is needed.

Sincerely,

Mary Ann Scully

Mary Ann Scully
President and CEO
Howard Bancorp and Howard Bank

cc: Mark Kaufman, Maryland State Banking Commissioner, DLLR, State of Maryland
Benjamin Cardin, US Senate
Barbara Mikulski, US Senate
Elijah Cummings, US House of Representatives
John Sarbanes, US House of Representatives