FIRST FEDERAL
OF BUCKS COUNTY

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Via email: regs.comments@occ.treas.gov

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
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OCC RE: Docket ID OCC-2012-0008 and Docket ID OCC-2012-0009
FED RE: Basel III Docket No R-1442; RIN No. 7100-AD87 Risk Weights

Dear Sir and Madam:

Thank you for the opportunity to provide comments on the Notices of Proposed Rulemaking regarding Basel III Revised Capital Standards and the Standardized Approach for risk weighted asset calculation revisions. *First Federal S&L Association of Bucks County is a $667 million* mutual community thrift association headquartered in Bristol, Pennsylvania. We are proud of our heritage and tradition of serving the Bucks County community for the past 127 years.

Basel III Capital Proposal

We notice, first, that the proposal is not tiered in any way to distinguish large, complex banks from smaller, more basic ones, despite obvious differences in the sheer scale, risk profiles, product offerings, and capital markets access. As a small bank, we are surprised that the Basel III requirements, especially the proposed capital conservation buffer of 2.5%, would apply to small community banks. While we see that the goal of standardizing capital for all banks may be a noble goal, as far back as 2009-2010, small banks were led to believe that the Basel III capital requirements would apply to larger, complex institutions that inherently contained more business lines and related risks than would be found at a bank such as ours.

We notice, second, that the implementation begins in 2013, right during the time when residential housing and commercial real estate markets are beginning to recover, as evidenced by recent year-over-year changes in the Case Shiller, FHFA, CoreLogic, Zillow, and CoStar real estate price indices, from the crisis that began in 2006 and 2007. As banks begin to build capital and capital cushions, there will necessarily be less lending in general and to real estate assets in particular as risk weights increase on many of these loan types. The economy can suffer harmful effects from the increase in capital requirements, as banks become more conservative in protecting their ratios.

The capital proposal introduces complexity into the capital calculation process that will make capital planning more difficult and subject capital to unnecessary volatility. While deductions from capital are currently few, the number increases to thirteen in the proposal, which must be tracked for reporting purposes and projected for planning purposes. The explicit higher capital requirements will make it harder for the banking industry as a whole to raise new capital, due to what investors may perceive as increased risk from increased volatility, and could have harmful effects on the mergers and acquisitions market for banks.

We have traditionally operated our Bank with internal capital targets that exceed regulatory guidelines for well capitalized banks, because of being a small mutual bank with little access to the capital markets. Instead, we rely on retained earnings for our capital. The changes in the ratio guideline for well capitalized to 8% for tier one capital does not impact us; the other well capitalized guidelines for leverage and risk based capital remain at 5% and 10%, respectively. The addition of the new common equity tier one ratio at 6.5%, to be well capitalized, also does not severely impact us initially, because we operate at a relative spread of 2% to 4% above these ratios. But we feel that over time, we will be forced to widen our relative spread as other banks build capital to meet Basel III. As capital increases, it will mean less lending in the long run, harming the economy.

Capital Conservation Buffer

Originally, we read that systemically important banks would have to hold a conservation buffer such as this; now, it suddenly applies in this proposal to all banks. Limitations are built into the proposed capital rules regarding the capital conservation buffer as to amounts of capital that can be distributed, including stock buybacks, dividends, and bonuses paid to executives and business unit heads. We believe that capital distribution decisions are the purview of the Bank itself, whether allocating capital to business units, investing for the future through equipment, technology, or personnel, or returning it to investors when relative returns are evaluated. Indeed, we have made a decision to make charitable contributions of up to 5% of our net income annually to organizations in our community that better the lives of Bucks County's residents. What if a decision such as this were placed under restriction?

We do not believe that regulators should impose such artificial limitations of capital distributions or intrude on the bank's decisions; it is a situation of putting a particular industry- the banking industry- under capital restrictions and placing them at a competitive disadvantage. Over the long run, investors will undoubtedly respond by taking their capital elsewhere.

Available for Sale Value Change in Capital

For over twenty years, banks calculated risk based capital without including the equity component related to the mark-to-market on Available for Sale, or "AFS," investment securities, which is included in the other comprehensive equity component of equity, or "OCI." Despite FASB's efforts in the early 1990s to begin their mark-to-market campaign by imposing the Trading, Available for Sale, and Held-to-Maturity, or "HTM," designations on securities, regulators chose at that time to exclude the AFS mark from tier one capital calculations. I believe that regulators rightly saw that including the temporary market value change on just one part of the balance sheet into capital did not seem appropriate. Banks must follow the FASB rules and maintain AFS securities because they need to maintain flexibility to manage interest rate risk, liquidity risk, and collateral requirements. The sudden inclusion of this AFS mark into capital, as proposed, would introduce volatility into capital through the marking up and down of temporary market value changes and could discourage decisions by banks to keep this flexibility and manage risks with AFS designations and instead push them into using HTM designations. The latter can be harmful in managing risk in the long run.

In 2007, FASB introduced Fair Value Option, or "FVO," accounting, and imposed disclosures such as Level One through Three that led to much investor consternation. FASB continued its campaign on mark-to-market accounting. Public outcry and Congressional hearings stopped them in their tracks in 2009, when they tried to impose more mark-to-market accounting rules and tried to deny flexibility in calculating price. This was a time of particular disarray in the mortgage markets. Instead, they were forced to allow investors to use judgment in pricing. I still view much of this mark-to-market episode as one of the core causes of the financial crisis, when fair pricing was often elusive and drove many negative changes to earnings as some prices were indeterminable. Many securities held by banks for investment, not trading purposes, became the subject of these negative changes, even though the securities were proving to be sufficient in terms of cash flows. FASB also recently proposed mark-to-market for loan portfolios and again were forced to pull back because of industry outcries. Mark-to-market is a disclosure issue for those who hold assets for investment and is appropriately handled by numerous financial disclosures. It should not be imposed upon us by FASB and should not be included in the calculation of capital, as proposed.

Inclusion of the AFS mark in capital may lead to harmful effects on the economy and unintended consequences. When the economy begins to strengthen, it will be natural for interest rates to begin rising. Couple stronger economic growth with actions by the Federal Reserve to tighten policy from historic lows in rates, and rates may rise quite rapidly. The value of fixed income securities, whether the bank designates them as AFS or HTM, will naturally decline, but the ones designated as AFS will lead to lower capital and capital ratios. At the exact point when consumers and businesses pick up demand for loans, banks in general may be forced to curtail lending to preserve capital ratios. Additionally, banks could shorten duration dramatically, which could reduce interest rate risk, but also reduce earnings and lead to lower capital ratios. This is not the flexibility banks need to support economic growth and I believe that it would be one of the negative unintended consequences of suddenly including the AFS mark in tier one risk based capital calculations.

Other OCI Adjustments

The proposal states that capital will "include OCI in common equity tier one." In addition to AFS marks, the non-credit charges for other-than-temporary-impairment are housed in OCI also; these are related to HTM securities. The proposal does not distinguish these items in a clear manner and all of the discussion seems to relate to AFS securities. We believe that the non-credit component of other-than-temporary-impairment on HTM securities, as well as the AFS mark, should not be included in tier one capital.

The proposal also captures in its pages under capital that will "include OCI in common equity tier one," the pension and benefits related adjustments, dictated by FASB rules, which are currently recognized in the OCI component of capital. We disagree and believe that these components, in addition to the AFS mark and the non-credit impairment, should continue to be excluded for capital calculations as they have been for twenty years.

Limitations on MSRs and DTAs

The proposed limitations on mortgage servicing rights, or "MSRs," which include the deduction of all MSRs greater than 10% of capital from tier one capital seems not to be a change in itself, but coupled with a new limitation of combined MSRs and deferred tax assets, or "DTAs," of 15% could cause stringent capital requirements to be imposed on these items. The mortgage servicing industry, known for its efficiencies and economies of scale could be harmed. The risk weighted asset proposal also includes a much higher risk weighting for amounts of MSRs that are not deducted from capital of 250%, from the current 100%. We are not sure why these would suddenly have 2.5 times more capital. We disagree with the limits imposed on DTAs. Currently, these are not deducted from capital as long as they have a realizable value within a FASB driven time frame. We suspect that this could prove harmful to a certain number of banks with losses that occurred during the financial crisis and its aftermath.

If the proposal proceeds as is and OCI components are required to be included in tier one capital, we would agree with the delayed start, but would point out that 2014 may be right in the middle of the economic recovery and sudden implementation of capital rules could dampen growth at that time, especially if higher rates have impacted AFS marks.

Standardized Approach

Many of the proposed changes to risk weights of assets and off balance sheet items appear to us to be overly complex and punitive toward certain assets. It is obvious that mortgages are the target of harsher treatment in the proposal and that could have unintended consequences of ensuring that a true housing recovery never materializes, keeping our economic growth prospects under potential. By the 2015 implementation date, we expect the recordkeeping burden to increase dramatically for systems changes to track the myriad of risk weights and situations that can cause a loan to change from one risk weighting to another.

Residential Mortgages

At September 30, 2012, we hold $253 million in residential mortgages on our balance sheet, representing 57% of our total loan portfolio. The proposed use of Category 1 and Category 2 loans is overly complex, even for an institution that has specialized in home lending for our entire history, with minimal, mostly non-existent losses on our loans, even during the financial crisis. First, we must track term, payment frequency, credit underwriting, borrower obligations, amortization type, rate caps and variances, along with LTV and then slot the mortgage as either Category 1 or 2, with risk weightings that range from 35% to 200%. Loans may move between categories and the risk weighting will change. Increases in risk weights above the current 50% will inevitably lead to higher mortgage rates for consumers, especially on junior lien mortgages, which may carry risk weights of 150% to 200%. Add that to potentially higher mortgage servicing capital costs and rates could rise even more dramatically, making housing less affordable for many. Risk weighting based solely on Category types and LTVs may not tell the story of the overall credit risk of the loan. Imposing new, higher risk weights on existing loans could lead to higher rates and home prices if the market is restricted in its recovery.

We believe that this proposal on mortgages is overly complex, punitive, and potentially harmful to the entire mortgage market. It will be extremely difficult for the private mortgage securities market to even return, given higher capital requirements and other imposed rules, such as the 5% risk retention rule, dictate by the Dodd Frank Act. Without the return of more outlets for liquidity, the housing recovery cannot be robust. Although implementation is proposed for 2015, we believe that any implementation of revised risk weights should be for new, prospective loans made after the initial date and that existing loan portfolios should be grandfathered; this will allow industry participants to reprice the capital component accordingly.

We disagree with the proposal's premise that private mortgage insurance, or "PMI," should not be considered in determining the asset risk weights based on LTV ratios. Most PMI should be viewed as valid. There could be another unintended consequence where eventually, all borrowers must put down 20% in order to get any mortgage; for higher LTVs, they will pay rates likely much higher than what banks offer with PMI currently.

We disagree with the proposal as it relates to modifications, which states that if the LTV is not "updated," presumably through a new appraisal, then the loan must move into at least a 100% asset risk category. We routinely have provided rate modifications to mortgage loans without "updating" the LTV and may be forced to raise offered rates for modifications, because of the change in the loan from the possibly lower 35% risk weighting to the higher one at 100%. Borrowers may not see the lower rates they had hoped for in a modification.

Commercial Real Estate

The change in risk weights on construction and development, including multifamily, loans to 50% to 150% and on "high volatility" CRE loans to 150% could impede lending in these areas and / or increase the rates on loans, limiting the strength of any recovery for these markets, that were so decimated since 2006 and 2007.

Home Equity Lines of Credit

We currently offer home equity lines of credit to customers based on the Prime Rate. Many of these loans are in a first mortgage position. We see from the proposal that these loans will not qualify as Category 1 loans because they do not have rate caps and will move to at least 100% risk weighting. We disagree with this harsh treatment of this product that has been extremely low risk with little or no loss experience for our Bank.

Past Due and Non-Performing Loans

The risk weighting for a non-performing loan will suddenly increase to 150%, except for mortgages, which could increase up to 200% if the LTV is greater than 90%. We believe strongly that the recognition of the change in credit risk for a non-performing loan belongs, as currently, in the Allowance for Loan and lease Losses, or "ALLL," evaluation process and would be duplicated in the capital calculations. Is your proposal contemplating that we should increase the asset risk category in capital calculations and not handle it in the ALLL process? We should not be expected to double count the handling of a non-performing loan.

Credit Conversion Factors

We noted that the proposal increases several of the off balance sheet credit conversion factors. The one with the greatest implications is the proposed increase from 0% to 20% for unused loan commitment contracts, less than one year in duration, which are not "unconditionally cancellable." Suddenly capital requirements would increase dramatically, yet the ability to suddenly re-write commitments with customers is very limited, as many customers, especially business ones, want some type of time period associated with their lines for liquidity planning purposes and do not want to be subject to sudden cancellation. At a very minimum, if this proposal is implemented, we expect some consideration to be able to grandfather existing commitments on loans.

Mortgages Sold with Recourse

We disagree that mortgage loans sold with recourse should have a 100% credit conversion factor. We believe that the credit equivalent amount should be the lesser of the credit conversion factor if the loan would be associated with a lower risk weight, such as 35%, or the amount of recourse itself.

Non Reliance on Credit Ratings

Of course, we would expect risk weightings of securities to be made more complex now that the Dodd Frank Act has legislated that securities other than governments, Agencies, or general obligation municipals cannot be evaluated based solely on credit ratings alone, but requires some other analysis or criteria to determine creditworthiness and suitability for investment. However, the proposal is needlessly complex in dictating the use of either the Simplified Supervisory Formula Approach, or "SSFA," or the Gross-Up Approach; the latter is close to what we use currently for private label mortgage backed securities. It would seem simpler to provide several risk weights by type of security.

The proposal dictates that banks are required to use the same approach for all of their securities, when the two approaches seem suited to different types of securities, but not all. Since no guidance was provided as to which method to select and why, and we have seen materials in the industry that show the widely disparate results of application of the methods, we are not willing to support the single method requirement.

Summary

In studying materials in an attempt to prepare this comment letter, I came across a letter recently submitted by a bipartisan group of 53 US Senators, including Patrick J. Toomey of Pennsylvania, which urged regulators to consider the impact that rules designed for large, complex institutions could have on small community banks and whether the rules could have significant consequences for community banks, whose balance sheets are not complex.

What may be a well intentioned attempt to address the last crisis could have a harmful effect on 1) the long run prospects of the economy growing at potential, 2) investing in bank stocks, 3) residential housing and commercial real estate market recoveries, and 4) interest rates on loans. In the long run, higher capital requirements mean less lending. Banks have traditionally been the engine for growth in the economy and one of the Federal Reserve's tools to accommodate monetary policy through lending to consumers and businesses. If restrained unnecessarily, economic growth may only be lower.

Finally, as I close, it is impossible to ignore the complexity of the proposals. I was assigned a project in 1988, while working at another bank, of evaluating the new Basel risk based capital rules and calculating our ratios. I had to study 30 pages of rulemaking, along with issued guidance. In 2012, in reviewing the materials for Basel III and the risk weightings, I found there were well over 600 pages of rulemaking and the guidance materials. We all need to think for a minute- is the cost of all of this worth the benefit?

Andy Haldane, an Executive Director with the Bank of England who attended the Jackson Hole, Wyoming meetings in August, said it best: "As you do not fight fire with fire, you do not fight complexity with complexity. Because complexity generates uncertainty, not risk, it requires a regulatory response grounded in simplicity. Less may be more."

We appreciate your consideration of our thoughts and ideas on these very important capital proposals and thank you for the opportunity to comment. If you have any questions, please contact me at 215-504-6560 x 160, or at my email address below.

Sincerely,

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