VILLAGE BANK
You're a neighbor, not a number.

Thomas W. Winfree
President & CEO

October 3, 2012

Ms. 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 Regulatory Capital Ratios Proposal and Risk-Weighted Assets Proposal; Docket No. R–1430, RIN No. 7100–AD87; and Docket No. R–1442, RIN No. 7100-AD87.

Dear Regulators:

The purpose of this letter is to call your attention to the dangers imminent to the Community Banking Industry if the proposed Basel III regulatory capital rules become effective. I would call your attention to the enclosed communication from the Virginia Bankers Association which was prepared on behalf of its 100 + members in Virginia and with extensive communication and collaboration with the member banks. The proposed rules along with the Dodd-Frank act will have a very detrimental impact on community banking, the communities we serve and the economy in general.

At a time when our economy is fragile to say the least, the Basel III rules will in effect, reduce lending to local markets, shrink the balance sheets of community banks, shift ownership from local investors to large institutional investors, drive borrowers to unregulated options and create an environment where the number of community banks will be greatly reduced.

To explain further, I have the following illustrations:

1. Lending to localities served by community banks will be reduced and severely hampered. This is caused by the negative influence brought on by higher capital requirements which include more stringent and extremely complicated risk weighting burdens. As the banks shrink or throttle down their growth, less volume of lending will result in the local communities. As the community lenders struggle with the risk weighting issues, fewer loans will be originated and several categories of loans will suffer reduced volume with perhaps unfair restrictions. This will occur at a time when lending locally throughout our country is very necessary to returning our economy to strength and stability.
2. It will be very difficult for community banks to attract the new common equity currently needed by many banks because the impending Basel III rules will no doubt make it impossible for these financial institutions to attain an attractive return on equity (ROE) necessary to meet the requirements of future common equity investors. They will invest elsewhere as they find a proper return on their investment.

3. The stockholder base of local community financial institutions will shift from local citizen/neighbor investors to larger, institutional investors. The community bank stockholder usually is there to support the community, by helping the bank grow and lend locally and is patient over the long term for a return on investment. With the returns less, the local individuals will be replaced by the larger, out of town business investors who have a different agenda. The institutional investor is less concerned by the ROE. Due to their larger, controlling interest, they have an end game of selling the community bank to a large regional or national financial institution, therefore enjoying a profit from the sale which will provide a control premium to the investor. The number of local community banks will be greatly reduced over our entire nation.
4. Local consumers/borrowers will seek alternative means for obtaining their needed financing. Less regulated financing providers have surfaced recently and this will grow as our society pursues less stringent, time consuming and complicated means to obtain funds. These are generally at a higher cost than local banks charge. And this occurs at a higher risk to our local economies.

I have had the opportunity recently to interact with several of our regulators locally and have gotten the distinct feeling that they do not agree with Basel III and even have expressed their feelings that they would like to see the entire thing scrapped.

Please consider the above and read the information that has been thoughtfully provided by the Virginia Bankers Association. Also, please consider the drowning effect that the recent out of control volume of regulation has had and will have at an accelerated rate on our community lenders across America. Please also consider the effect of the proposed rules. It appears that everything but the kitchen sink has been thrown into these regulations and that you are not giving proper consideration toward how they affect the industry nor the economy and communities. You must apply as much of your resource in evaluating <u>both</u> sides of the coin when drafting these mammoth volumes particularly at the worst time to do it.

I thank you in advance for your consideration of my sincere plea and would appreciate your reply.

Sincerely,

Thomas W. Winfree

Thomas W. Winfree
President and CEO

TWW/dmg
Enclosure
cc: The Honorable Eric Cantor
The Honorable Randy Forbes
The Honorable Mark Warner
Cecelia Calaby, American Bankers Association
Matt Bruning, Virginia Bankers Association

October 3, 2012

Via e-mail: regs.comments@federalreserve.gov.

Ms. Jennifer J. Johnson
Secretary
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Re: Basel III Regulatory Capital Ratios Proposal and Risk-Weighted Assets Proposal; Docket No. R–1430, RIN No. 7100–AD87; and Docket No. R–1442, RIN No. 7100-AD87.

Dear Ms. Johnson:

I write on behalf of the Virginia Bankers Association, whose membership includes nearly all of the banks in Virginia. This letter is in response to the Basel III Regulatory Capital Ratios Proposal and Risk-Weighted Assets Proposal (the "Basel III Proposals"). 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, especially small community banks, will actually harm the safety and soundness of the American banking system by requiring excessive capital, unreasonably limiting qualifying capital, and driving up compliance costs with unduly complex regulations. These factors will drastically reduce lending, hurt consumers, businesses and communities, and critically damage the viability of our community banking system. For these reasons, the Basel III Proposals should be withdrawn and rewritten to address these concerns for all banks and, in particular, to exempt community banks.

The Basel III Proposals impose unreasonable limits on qualified capital.

Particularly troubling are the Proposals' limits on traditional forms of capital that have served well the safety and soundness of the American banking system for generations. These include the exclusion of trust preferred securities from tier one capital, severe limits on mortgage servicing assets in common equity tier one capital ("CET1") and the reduction of CET1 for unrealized losses on available for sale ("AFS") securities.

- **Trust preferred securities.** In recent years, trust preferred securities have been one of the few sources of capital available to many banks. They are also one of the most financially and tax efficient sources of capital available to banks. It is unrealistic to expect many banks to comply with higher capital ratios without counting trust preferred securities. In fact, excluding trust preferred securities violates the clear intent of Congress which, in the Dodd-Frank Act, expressly allowed smaller banks to use current levels of trust preferred securities as qualified capital.

- **Mortgage Servicing Assets.** Mortgage servicing is a large part of the operations of many banks. Requiring mortgage servicing assets that exceed 10% of a bank's 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.

- **Unrealized gains and losses on AFS securities.** With interest rates at historic lows, there is little room for them to decline further, but much risk that they will increase dramatically in the next few years. As interest rates rise, reducing capital for unrealized losses on available for sale securities will have a devastating effect on the banking industry. Many banks may shrink their securities portfolios considerably to maintain capital ratios at desired or required levels. Further, these adjustments will introduce substantial volatility to the calculation of CET1 and Tier 1 capital ratios, which will force banks to maintain ratios substantially above required levels in order to ensure compliance with the ratios and capital conservation buffer.

Each of these capital classes have long been used by banks as stable, reliable sources of regulatory capital. Excluding any one of them will make it more difficult for banks to be adequately capitalized. The combined effect of these and other regulatory capital limitations will be severely reduced bank capital at a time when it is extremely difficult for banks to raise capital. Without adequate capital, banks will need to reduce lending, merge with other banks or close, all of which will harm consumers, businesses and local communities.

The risk-weighted assets regulations are unduly burdensome, complex and costly.

The risk-weighted assets regulations unreasonably penalize the core operations of many healthy, well-managed banks that have provided traditional banking products and services to their local communities for years. These core products and services include nonconforming mortgages, commercial loans, working with borrowers experiencing unexpected financial difficulties, and selling mortgages in the secondary market. Additionally, the unnecessarily complex rules require banks to gather extensive data about their loan portfolios and other assets and perform numerous complicated calculations to determine the applicable risk weights. This will drive up costs and lead many banks to stop offering these products and services.

- **Mortgage assets.** By imposing risk weights of 100%-200% on nonconforming mortgages and subordinate mortgages, ignoring the risk mitigation benefits of private mortgage insurance, and requiring 150% risk weights on many commercial loans, the Basel III Proposals will considerably increase the cost of capital of banks offering these traditional banking services that are critical to many borrowers and communities.

- **Delinquent loans and workouts.** 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. This sharply contradicts the public policy behind numerous federal and state laws and regulations adopted in recent years.

- **Secondary market loans.** Banks sell loans in the secondary market to manage risk in their loan portfolios and raise cash to make new loans. By requiring banks to hold additional capital for loans sold subject to credit enhancing representations and warranties, the Basel III Proposals will make it more difficult and costly for banks to sell mortgages in the secondary market, ultimately reducing these sales. As these sales decrease, loan portfolio risk will increase and cash available for lending will decrease.

- **Excessive compliance burden.** Banks will be required to collect and report a large quantity of very granular information in order to calculate risk-weighted assets. This includes new information about underwriting features and loan-to-value ratios of credit exposures, as well as sufficient information to satisfy due diligence requirements. Existing loans are not grandfathered, and this information will need to be collected on banks' existing loan portfolios. While additional capital may be appropriate for some institutions or products, the requirements for traditional commercial banks and community banks should be simple, straightforward and easy to comprehend and evaluate. Healthy banks, especially community banks, operate on tight budgets, with low margins and do not have excess resources to devote to nonrevenue generating functions that do not efficiently add significant value, such as onerous data collection and analysis solely for compliance with unnecessarily complicated regulations.[1]

Too much capital is a bad thing.

Combined, the higher capital ratios, the capital conservation buffer, the exclusion of many common types of capital, the increased risk-weighted assets, and the volatility of many of the calculations required under the Basel III Proposals, will lead banks to maintain unnecessarily high levels of capital.

- **Excessive capital increases risk in banks.** As capital is increased, return on equity ("ROE") to investors decreases. For a bank to attract outside investors it must provide returns investors expect. By limiting the ability of banks to pay dividends and

In light of the enormously high volume of recently adopted or proposed banking laws and regulations, the VBA sincerely requests that the bank regulatory agencies seriously consider regulatory and compliance efficiency as they draft each new regulation.

distributions to investors, the capital conservation buffer will further hurt banks' ability to attract investors and raise necessary capital. To increase ROE to raise required capital, banks may feel pressure to take on more risk by making riskier loans they otherwise would not make.

- **Excessive capital shrinks competition, hurts customers.** Lower ROEs will mean fewer banks can raise capital to meet ratios that are too high. Those banks will be forced to shrink their lending or to merge with or sell to competing banks – reducing the number of competitors. Less competition among lenders ultimately harms consumers.

- **Excessive capital reduces credit availability.** Requiring more capital to offset increased risk-weighted assets, coupled with the difficulty banks will have raising capital with lower ROEs, will lead many banks to one alternative – reducing the amount of mortgage assets on their balance sheets by reducing lending. For example, for each additional dollar of required capital that a bank cannot raise, it will likely need to reduce its lending capacity by $10. Accordingly, for a community bank with $100 million of assets that experiences a 2.5% increase in required capital ($2.5 million), the local community it serves will suffer a $25 million decrease in available lending.

- **Difficulties attracting talented leaders will damage the competiveness of the entire banking industry.** Lower ROEs and capital conservation buffer limits on executive compensation will hurt the ability of banks and the entire banking industry to attract talented business leaders. These individuals will be lured away to other businesses and industries that are not subject to regulatory restrictions on equity-based and performance-based compensation packages.

- **Pushes consumers to less regulated lenders.** Higher capital requirements and risk-weighted assets will push certain loans out of banks. Demand for these loans will be met only by the "shadow banking" industry, the less heavily regulated nonbanks. This is contrary to the intent of the Dodd-Frank Act and will encourage, rather than protect against, one of the main causes of the recent financial crisis.

The Basel III Proposals should not apply to community banks.

While the Basel III Proposals place undue burdens on banks of all sizes, imposing these overly restrictive and burdensome requirements on smaller community banks will have a crippling effect the traditional community banking system in this country 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.

There will be many unforeseeable adverse consequences from the cumulative effect of the Basel III Proposals and the many other recently adopted and proposed banking regulations.

While many individual regulations designed to protect consumers or the safety and soundness of banks may be well intentioned, the cumulative effect of multiple regulations targeting the same products and services will often make it impossible for banks to efficiently offer those products and services. Banks will need to increase the fees charged for these products and services or stop offering them. In turn, borrowers who relied on those products and services will be deprived of affordable credit for homeownership or business endeavors.

For example, nonconforming loans are subject to multiple new and proposed regulations. Nonconforming loans make up a significant portion of the loans made by many banks, especially banks serving rural communities. More importantly, nonconforming loans serve a large segment of borrowers who cannot satisfy the Fannie Mae and Freddie Mac conforming loan guidelines.[2] These loans provide many borrowers with an opportunity to build equity in their homes and enjoy the other benefits of homeownership while they build or rebuild their credit reputation. As discussed above, nonconforming loans are subject to increased risk weights under the Basel III Proposals, which will greatly increase the capital costs of banks holding these loans. In addition, the new "high-cost mortgage rule" imposes additional restrictions on many nonconforming loans, and the new "ability to repay rule" increases the administrative burden and legal liability of banks that make nonconforming loans that are not "qualified mortgages." Individually, each of these rules makes it more difficult, expensive and risky for banks to make nonconforming loans. Combined, the rules may make it impossible for banks to profitably make these loans at prices consumers can afford, forcing many banks out of this business and depriving many borrowers of credit. This is particularly unwise in the current economic and loan underwriting environment where available credit for borrowers with less than perfect credit is extremely limited.

The Basel III Proposals should be withdrawn and rewritten after careful study.

The Basel III Proposals should be withdrawn and rewritten to address the concerns identified in this letter for all banks and, in particular, to exclude community banks from the most onerous provisions. Before issuing revised rules, we recommend that the regulatory agencies conduct a comprehensive study of the aggregate impact the Basel III Proposals and

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[2] These include individuals with below average credit qualifications; self employed people; people with unstable, infrequent or variable incomes; borrowers wishing to borrow more than 90% of the value of a property; and older borrowers for whom a 30-year repayment term is not appropriate. Nonconforming loans also include loans against properties that do not meet the GSEs' guidelines, such as manufactured homes; farmland and other large tracks of undeveloped land; properties that are subject to certain zoning ordinances, easements or encroachments; and properties with limited access.

numerous other new banking regulations will have on the banking industry and the American economy. We also strongly encourage the banking agencies to slow the pace of change, change one regulatory variable at a time, closely monitor the real-world impact of each incremental change, and be prepared to act quickly to make corrective changes if unintended adverse consequences occur.[3]

Thank you for your consideration of our comments.

Sincerely,

Bruce T. Whitehurst
President and CEO

[3] The nearly simultaneous proposal of numerous intertwined new banking regulations in recent months, all with very short and overlapping comment periods, made it impossible for the VBA, our members and the entire banking industry to determine with any reasonable degree of certainty the aggregate effect and unforeseeable consequences these proposals will have on the banking industry and the American economy. We expect this is true for the bank regulatory agencies as well.