BANK
OF DUDLEY

Member Federal Deposit Insurance Corporation

To: Board of Governors of the Federal Reserve System

From: The Bank of Dudley, Dublin, Georgia

RE: Comments regarding implementation of the new Basel III Capital Regulations

Throughout the economic downturn starting in 2008 and continuing through the present date, Financial Institutions have seen unprecedented struggles, including loss of income, depleting capital ratios, and tightening net interest margins. All of these factors combined have led to the failure of many community banks, of which our local state of Georgia has probably been hit the hardest. Out of the rubble of the economic collapse have come tremendous increases in regulatory burden, such as Dodd-Frank, which is making it harder than ever for community banks to adhere to their traditional lending models which benefit the local business people and consumers, and have also made it harder than ever for community banks to remain profitable to a point where shareholder value is maximized.

With the new implementation of the Basel III capital calculations, these issues, which have crippled banks for the past few years, will only progress. While community banks are working so hard to improve capital levels, the thought of penalizing these banks by changing the way capital is calculated and disallowing a number of items from 0% risk weighted assets will surely place a new unneeded burden on them. Of the proposed new rules, we would like to discuss a few.

- The removal of the Accumulated Other Comprehensive Income (AOCI) filter from capital calculations will greatly affect a bank's behavior when it comes to investing in securities. The concept FASB was trying to create when it implemented "Mark to Market" accounting was to exclude from income, those changes in security values which will not likely happen in the near term if an institution had the wherewithal and intention of holding the security to maturity or until changes in market conditions warranted the security to then potentially be sold. The current capital calculation takes this concept into play as it allows banks to deduct the unrealized gains and losses from their securities portfolio out of the capital calculation and thereby excludes an unrealized factor in the calculation. Although this may negatively affect capital if a bank has an unrealized gain, it does create a fair way of calculating capital as the unrealized gain is in fact unrealized at that point in time. If a community bank is required to start including this AOCI portion in its capital calculation, it will inevitably cause a change in the types of securities that it purchases. It will most likely limit the investments in mortgage backed instruments to longer duration assets and possibly shorten the maturities of U.S. Treasury debt securities in order to help reduce the impact of unrealized gains and

losses resulting from interest rate fluctuations. It may also limit the amount of municipal bonds community banks will purchase as these generally have longer maturities. If Banks had been required to include unrealized losses in capital calculations during the severe recession of 2008 and 2009, it undoubtedly would have caused many to suffer much lower capital ratios, caused an undue pressure from regulators to increase capital and in turn not allow banks to hold the securities until the point when the loss may return to a gain which did happen as the market began to rebound in 2010 and 2011. In summary, the current capital calculation of excluding gains and losses from capital due to their highly volatile nature should be continued. Including these exaggerates the impact of temporary market movements on the bank's capital.

- The changes regarding the capital calculations for 1-4 Family mortgage loans will lead to even less lending by community banks. When the federal government introduced the TARP program in late 2008 in response to the mortgage crises, the idea was to inject capital into financial institutions to allow continued lending and to keep access to lending funds available to the American consumer. Although the program didn't exactly work the way it was intended, the overall concept of continuing access to these funds cannot be denied. With the passage of Dodd-Frank, it has become harder and harder for community banks to continue lending to the small business and the average consumer due to the legislative (compliance) requirements that must be adhered to. Were the Basel III standards relating to 1-4 family lending to pass as they stand now, it would make it even harder for community banks to grant access to loans that it would normally make as second nature. Under the current capital format, a 1-4 family first mortgage loan is assigned a 50% risk-weight if it is "prudently underwritten". Under the new Basel III standards, if that LTV is between 80% and 90%, then that risk weighting rises to 75%. If the LTV is above 90%, the capital reserve rises even higher to 100%. What regulators do not realize, is that many consumers who don't have access to long-term funding in the secondary mortgage market, come to community banks to finance the purchase of their homes. The term may be structured over a 15 to 20 year amortization, but due to the bank having to protect itself from interest rate risk, it may balloon the loan in 3 to 5 years. For these balloon type loans, which are common in community banking, the risk weighting may go as high as 200% for an LTV over 90%. Let's say, for example, a community bank made a home loan in 2008 to a borrower on their home with a 3 year balloon, and the LTV was 75% at the time the loan was made. Under the current format, the Bank would include this loan in the 50% risk weighting category. But since that loan is on a 3 year balloon, the borrower must renew the loan at the end of that 3 year term which is now year 2011. Due to regulatory changes, the bank must obtain an updated appraisal for valuation of the property. At this point, due to the dramatic decrease in the value of housing, the loan, although paying as agreed and performing well under the term of the original loan, now stands at 91% LTV simply because of the change in market conditions and decrease in the value of housing. Based on the new LTV and the "balloon" type product, this loan could now be assigned a 200% risk weighting although it was only assigned a 50% risk weighting before the re-appraisal

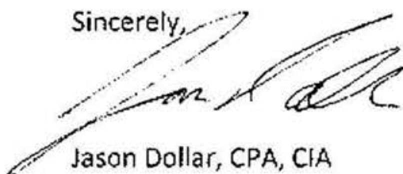
and the overall condition of the loan has not changed. Now while this one loan may not seem to have a large impact on capital, multiply it by the large number and dollar volume of loans that community banks make for 1-4 family housing, then increase the capital reserve by 25% to 150%, and you can see how this will greatly affect these institutions. In turn, it will cause community banks to make fewer 1-4 family loans and make it even more difficult for the consumer to fulfill the dream of home ownership. The side effect is that community banks will now have an even smaller pool of qualified applicants, making loan volumes decrease and earnings continuing to tighten. This would be the complete opposite effect of what the federal government had in mind when the TARP program was introduced. In with these same rule-making guidelines is the feature that changes the risk weighting on 1-4 family junior liens from 100% to 200% risk weighing if the LTV's are greater than 90%. What this means is that either community banks will not offer second mortgages or these products will be very expensive and hard to obtain. As you may know, many small business owners get the needed capital for their small business by taking second mortgages on their homes. With this new structure, the access to this capital would inevitably dry up. Not mentioned in all of this is the new regulatory burden on community banks to track these LTV ratios and ensure they are always up to date each quarter for reporting purposes. Regional and National banks will have the personnel and resources to implement the tracking and costs of data collection associated with these changes, but for small community banks, the regulatory burden just gets heavier while the number of individuals at the bank to implement the new standards does not change.

- Our third comment is in relation to the new treatment of trust preferred securities. When implemented in the previous decade, these instruments were given a type of debt and equity treatment. They were debt at the holding company level and equity at the individual bank level. Many banks and holding companies issued these types of instruments to strengthen their capital and now due to the recent economic situations and reduction in earnings or losses in recent years, are now relying on these instruments as a source of capital. While the underlying principle of the treatment of these instruments may be questioned as debt or equity, the fact that they were allowed for equity treatment cannot be denied. To change that factor at this point in the game is not reasonable or equitable. While the Basel III rules do allow for a phase out over a 10 year period, many community banks, still reeling from the effects of the recession and still struggling to improve earnings, do not have the sufficient access to capital to pay these instruments off in that period of time. Our Bank will be directly affected by this change as our holding company issued $4 million in trust preferred securities in December 2005. If the phase out begins in 2013, our Bank would automatically lose $400,000 worth of Tier 1 capital each year if the securities are not paid back. Payment of these securities would come from Bank dividends or capital infusions. Capital is the community banking environment is currently very limited, and as you are aware, regulations limit the amount of dividends a bank may approve for payment to its holding company to ½ of prior year earnings without special regulatory approval. With

limitations on raising capital and our current earnings levels still not where they need to be due to shrinking margins and continued increases in overhead costs (most of it caused by regulatory burden), our dividend capability and therefore our ability to begin repayment at this time would be much more difficult. Per our latest call report, the reduction in $4,000,000 in capital treatment would decrease our Tier 1 leverage ratio from 10.22% to 8.05% and our Tier 1 risk based ratio from 17.55% to 13.83% This reduction in the amount allowed as Tier 1 capital treatment along with the other increased capital thresholds will undoubtedly cause many community banks' capital level to suffer and for some may cause undo regulatory action from the FDIC or State Banking agencies. We propose that either the Trust Preferred treatment be grandfathered in for those banks presently holding these instruments or that the phase out period be extended allowing more time for earnings to replenish and a more reasonable period of time for pay back of the instruments.

The immediate affect that the Basel III changes will have will most likely be the failure of even more community banks. Many institutions, which have recently experienced unprecedented losses and have seen capital depleted, but which have made it through the worst part of the recession by shrinking their balance sheets, raising capital and attempting to comply with all imposed sanctions, will now have to fulfill the impossible burden of complying with the new standards. They will also be required to maintain capital ratios at levels far above what that they were once told were satisfactory. In turn, more community banks will be forced to close their doors, larger banks will takeover in these small market communities and access to funds for the middle class consumer and small business owner will be even harder to come by. This will lead to less jobs and more unemployment in a time where the nation is trying to reverse that trend. In short, we encourage the FDIC to carefully examine the effect that the Basel III standards will have on community banks before progressing forward with its implementation. We further ask that it perform specific calculations on a number of Community Banks with trust preferred securities and large amounts of 1-4 family loans to determine the overall implications that it will have on these institutions. As it stands now, the new standards will change the banking model as we know it and as it has worked so positively for the main street American and small business person in the past. We hope you will carefully consider our comments and the comments of other community banks before proceeding with the full effects of these new changes.

Sincerely,



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