Cashmere Valley Bank

August 31, 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
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Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation,
550 17th Street, N.W.
Washington, D.C. 20429

Re: Proposed Regulatory Capital Rules: Regulatory Capital, Implementation of BASEL III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action (R-1442, Docket ID OCC-2012-0008, RIN 1557-AD46, RIN 3064-AD95)

Proposed Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements (R-1442, Docket ID OCC-2012-0009, RIN 1557-AD46, RIN 3064-AD96)

Ladies and Gentlemen:

Cashmere Valley Bank appreciates the opportunity to submit comments on the above-referenced notices of proposed rulemaking (NPRs).

Cashmere Valley Bank (CVB) is a community bank located in the heart of Washington State. With $1.2 billion in assets, CVB has provided a full range of banking services to small communities in central Washington since 1932. It has 10 branches, over 400 shareholders (90% having ties to the local area), a strong liquidity position and a portfolio of high quality assets, both loans and investments. Thankfully, CVB weathered well the housing and credit crisis of the

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past several years. The primary reasons being the Bank's diversified asset mix and its strong liquidity position provided by its investment portfolio.

CVB fully supports the Agencies efforts to increase regulatory focus on common equity capital and improve the industry's capital framework. CVB is sensitive to the fact that by extending the comment period, the Agencies will now have less time to evaluate submitted responses before the transition period begins on January 1, 2013. For this reason, we are providing a prompt response on certain key aspects of the NPRs that we believe will run counter to the Agencies' objective of more effectively monitoring, managing, and mitigating risk to the nation's banking system.

Proposed Rule: Accumulated Other Comprehensive Income (AOCI) as a component of Tier 1 capital – The Agencies are proposing that AOCI, which includes all unrealized gains and losses on AFS securities, would flow through to common equity Tier 1 capital. This would include unrealized gains or losses related to debt securities whose valuations primarily change as a result of fluctuations in a benchmark interest rate, as opposed to changes in credit risk (for example U.S. Treasuries and U.S. government agency debt obligations).

Cashmere Valley Bank Comments: The proposed inclusion of AOCI as a component of Tier 1 capital will force all community banks like Cashmere Valley Bank to choose between proper liquidity and credit risk management, and capital volatility management.

If Cashmere Valley Bank chooses to continue to maintain a strong, diversified, and liquid investment portfolio by buying securities and holding them as available for sale so that, if and when needed, those securities can be sold for liquidity or lending purposes or to take advantage of superior assets available within the market, the Bank will be forced to calculate alternative ratios in order to determine its true core capital position.

When the AFS securities portfolio has unrealized gains caused by swings in the interest rate environment that will either be reversed or outlived (by holding the securities to maturity which is almost always what community banks do with their AFS portfolios), management would need to exclude the unrealized gain from Tier 1 capital to reflect its temporary impact. Similarly, because interest rates can significantly impact unrealized gains and losses, even when holding an unrealized gain, the Bank would also need to calculate what true core capital could be if market rates suddenly increased and that gain turned to a loss, no matter how temporary.

To avoid what will likely become a very confusing capital ratio landscape, community banks may be forced to reduce their liquidity and funds management position by holding more securities in the held-to-maturity (HTM) portfolio. Naturally, identical securities will be placed by some banks in HTM and by some in AFS. This will result in the ironic situation of banks with higher risks in both liquidity and interest-rate sensitivity being reported as having more stable capital, when in actuality both banks have identical assets and capital.

Another option that community banks will be forced to consider is making shorter-term investment decisions which will reduce capital volatility and increase liquidity, but would significantly reduce the earnings generated (and therefore capital created) by the investment portfolio. This will naturally result in banks being forced to pursue other yield generating options, which will shrink the investment portfolio in exchange for asset classes that aren't penalized in Tier 1 capital as AFS securities would be. These alternative asset classes may hold just as much interest-rate sensitivity risk and would likely hold even more credit risk than the AFS alternatives. To manage capital measurement, community banks will be forced to reduce diversification and liquidity and take on more credit risk.

This raises perhaps the core issue with the AOCI inclusion for AFS securities in Tier 1 capital. It applies a mark-to-market treatment to only one asset type on an institution's balance sheet. Loans, structured liabilities and HTM securities are often very economically similar, if not identical, to positions held within the AFS portfolio. Yet because of their disparate treatment within such an important ratio, the Bank's ability to effectively perform asset-liability management will be radically weakened. Specifically, a very significant capital penalty will be incurred by using the securities portfolio, the most flexible tool available to ALCO, to reduce overall asset sensitivity. No such penalty exists for any other balance sheet component.

Additionally, the impact of the AOCI provision would fall disproportionately upon community banks, due to their limited access to capital markets for funding and temporary equity enhancements, as well as their limited resources available to analyze the potential impact such a systemic change will have on the investment landscape. The provision, in and of itself, will change bank investing behavior, which in turn will affect asset values due to changes in demand. Large institutions will have the resources to quickly detect and analyze those changes and, at a minimum, re-adjust their portfolios, at a maximum, they will benefit from the transaction plays and trading that will result. Community banks will not have the same capacity, flexibility, or ability to capitalize. They will be most harmed by the negative impact the provision would have on the security markets.

Cashmere Valley Bank Recommendation: Cashmere Valley Bank recommends that the Agencies exclude any AOCI adjustments from the regulatory capital calculations and continue to include an addendum in the Call Report to reflect ongoing gains/losses in the AFS portfolio.

Capital ratios cannot be effective measurements of risk when only one class of asset among many is required to recognize ongoing market value adjustments. Financial institutions need to be able to make prudent security investments without a capital penalty. Excluding some types of AFS securities (U.S. agency, U.S. Government, U.S. GSEs, state and political subdivisions) from such capital charges would minimize the impact of the proposed AOCI treatment, but it would not avoid the negative consequences described above.

Cashmere Valley Bank is in agreement that certain assets, including some types of AFS securities, pose more risk to a bank than other types of assets, especially in this current economic and interest rate environment. As a result, such riskier assets should have higher levels of capital held against them. However, that need should be addressed through an appropriate adjustment to the standardized risk weight measurement, not through an ongoing fluctuation in Tier 1 capital ratio.

Conclusion

Cashmere Valley Bank supports enhancing regulatory focus on common equity capital and improving the industry's capital framework. We agree the banking system must have enough capital capacity to absorb losses in times of economic stress. Except for the AOCI provision, the NPRs do not appear to present a compliance concern for Cashmere Valley Bank, nor do we believe, exclusive of the AOCI provision, that they present unreasonable burdens on us or other well-managed community banks.

Thus, we have focused the extent of this letter on the one aspect of the NPRs that is of great concern and has the potential to weaken, rather than strengthen, our banking system.

We appreciate the opportunity to comment on this proposal. If you have any questions or would like additional information, please do not hesitate to contact any of the undersigned through Ms. Cravens at 509-782-2624.

Sincerely,

KJ Martin

Kenneth J. Martin
President and Chief Executive Officer

Jennifer Benton Cravens

Jennifer Benton Cravens
Chief Financial Officer