First Federal Savings of Middletown

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Office of the Comptroller of the Currency
250 E Street, S.W.
Ail Stop2-3
Washington, DC 20219
Delivered via e-mail regs.comments@occ.treas.gov

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Delivered via e-mail regs.comment@federalreserve.gov

Robert E. Feldman
Executive Secretary Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20419
Delivered via e-mail comments@FDIC.gov

Re: Basel III Capital Proposals

Ladies and Gentlemen:

Thank you for the opportunity to provide comments on the Basel III proposals that were recently approved by the Office of the Comptroller of the Currency, the Federal Reserve Board and the Federal Deposit Insurance Corporation.

First Federal Savings of Middletown is a $163 million federally chartered mutual bank established in 1888. We are very proud to be celebrating 125 years in business in 2013. We are a one branch operation with 10 employees. We are a traditional community bank that cares very deeply about our customers, employees and our community. We also pride ourselves on continuing to maintain very high marks from our federal regulators in both safety and soundness and compliance. First Federal Savings of Middletown is considered an extremely well-capitalized bank and no matter what is eventually prescribed, it is our intention to continue to hold capital well above the minimum required levels.

While in broad terms we certainly support the effort to strengthen the quality and loss absorption safeguards in the financial sector, at the practical level in which we operate our business, we have major concerns with the proposed standards. The standards as written appear to be designed primarily for the management of large, complex-risk banks. We feel that an unintended consequence of casting such a broad regulatory net will be the imposition of a largely unnecessary and disproportionate heavy compliance burden on smaller "community banks". We also feel that they will be particularly devastating to mutually-charted institutions because of their limited access to raising capital. Please understand that as a mutual, our capital, for the most part, increases only through the retention of earnings.

Next, we would like to take this opportunity to highlight the proposals' potential effects on First Federal Savings of Middletown and how the implementation of Basel III as proposed, could significantly and negatively alter the way we serve both our customers and our local community.

Our first area of concern has to do with the provision requiring all banks to mark to market their available for sale securities which will flow through to regulatory capital. This proposal would introduce a significant amount of volatility into the banking system which I don't believe is your goal.

Let me provide an example. Currently, First Federal has a bond portfolio of $41 million (25% of assets) with approximately $2.2 in unrealized gains. Gains or losses in an available for sale portfolio are primarily as result of movement of interest rates. While the current gains would serve to increase capital levels in the short run, as interest rates rise the capital levels could move dramatically in the opposite direction. Shock testing our portfolio indicates that a 300 basis point increase in interest rates would create a $ 3 million change in the market value adjustment and dramatically decrease our capital under Basel III. While nothing else would have changed in the bank's equity, our regulatory ratios could change radically.

Alternate investment strategies such as the reclassification of "available for sale" securities to "held to maturity" would interfere with sound liquidity management, while selling long term securities and buying short term securities could result in a shift in the duration of the investment portfolio which will alter the bank's interest rate position from properly balanced to imbalanced and would have an substantial impact on earnings. **In short, this proposal would significantly impair our ability to manage our investment portfolio with regard to liquidity, earnings and interest rate risk through different interest rate and economic cycles.**

Our second area of concern is the substantial increase in the risk weighted asset allocation for residential mortgages, especially home equity lending. First Federal has been actively involved in home equity lending for 26 years and HELOC's now comprise 50% of our loan portfolio. Our underwriting in this area has always been prudent and we have resultantly never experienced a loss on a home equity loan.

With such a stellar history through many economic cycles, the punitive risk weight of up to 200% will serve to both increase the cost of credit to our borrowers and possibly force us to significantly reduce or even drive our bank away from this type of lending. Given the state of the economy, we are confident that the restriction of future lending is a goal no one subscribes to.

In addition to the potential effect on our ability to lend, the change from assigning risk weight to asset classes to individual loans will result in a small institution such as First Federal incurring substantially new costs to comply with the new compilation and reporting of data.

Our final concerns addressing the new Basel III proposals are twofold. First, is the overall complexity that will be required to both understand and follow the rules. Most small banks do not have either the staff, or complex computer systems currently in place to generate the detailed information needed to be reported under the proposed standards.

At a minimum, this will require additional expense on the part of our bank to hire additional personnel and to change our internal reporting systems. The additional compliance burden, change in capital requirements and resulting negative impact on earnings will force us to reassess our lending practices going forward and may possibly have a negative impact on our charitable giving in the future.

Second, we fear that these proposed standards, if adopted in their current form, will likely serve to accelerate the recent trend of consolidation of community banks. This loss of locally involved financial institutions will leave a void far beyond the number of surviving banks. It is important to support the survival of the nation's community banks which continue to play a vital role in their communities.

In closing, we believe that the cumulative effect of all the items we have outlined will have a significant impact on all community banks. We strongly urge you to reconsider the implementation of Basel III as proposed, and consider exempting most of the community banks from the bulk of these standards. The proposed rules are unacceptable if we are to continue to serve our customers and communities as we have done for many years.

Thank you for your time and consideration.

Sincerely,

Margaret Smith

Margaret R Smith
President & CEO