COMMUNITY BANK

Partnership Banking®

DAVID P. MALONE
PRESIDENT
CHIEF EXECUTIVE OFFICER

October 18, 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
250 E Street, SW
Mail Stop 2-3
Washington, DC 20219

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

Re: **Basel III FDIC RIN 3064-AD95, RIN 3064-AD96, and RIN 3064-D97**

Ladies and Gentlemen:

Thank you for the opportunity to provide comment on the Basel III proposals that were recently distributed by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (collectively the "banking agencies").

Community Bank is a state chartered, nonmember business bank, incorporated in 1945 with assets totaling $2.9 billion. For over sixty-five years, Community Bank has been serving the financial needs of the Southern California communities, with 17 business centers in Los Angeles, San Bernardino, Riverside, Ventura and Orange Counties. But more than that, we've committed ourselves to giving each customer the kind of responsive, personal attention that really makes a difference.

We are fully supportive of strengthening the quality and loss absorption safeguards in the financial institutions sector. However, while Basel III may be appropriate for systemically vital and international financial institutions it loses some of its practicality when applied to a community bank's structure and ability to access markets. This letter covers our concerns, as listed below, not only from Community Bank's perspective and how the proposals may affect our ability to serve our customers and shareholders but also how it will affect our industry and its ability to promote economic growth.

1. Requiring Unrealized Gains and Losses to Flow Through Capital
2. Allowance for Loan and Lease Losses
3. Attacks on the Residential Mortgage Market
4. Impact of Exclusion from capital of certain Deferred Tax Assets
5. Treatment of Cash Flow Hedges
6. Increase to risk weighting on delinquent loans
7. Implementation Timeline

1. Requiring Unrealized Gains and Losses to Flow Through Capital

The Basel III NPR proposes that unrealized gains and losses on a banking organization's Available-For-Sale (AFS) securities to "flow through" to common equity Tier 1(CET1). Under the current risk-based capital rules, unrealized gains and losses that exist in accumulated other comprehensive income on AFS debt securities are not included in regulatory capital.

Allowing unrealized gains and losses to flow through capital would:

- Force the recognition in capital ratios of unrealized gains and losses that are temporary in nature and result principally from movements in interest rates as opposed to changes in credit risks, that are unlikely to be realized and that typically result in no effect on the banking organization (therefore raising or lowering regulatory capital regardless of any real change in risk);

- Negatively impact the ability of banking organizations to contribute to the economic recovery in a rising interest rate environment. With the inclusion of unrealized losses of AFS securities in CET1, rising interest rates would put downward pressure on banking organizations' capital levels, potentially causing banking organizations to reduce the growth of or shrink their securities portfolios considerably to maintain capital ratios at desired or required levels.

- Because of the substantial volatility introduced into CET1 and Tier 1 capital, it would force banks to maintain ratios of both CET1 to risk-weighted assets and Tier 1 capital to risk-weighted assets substantially above the levels that would otherwise apply in order to avoid the sanctions applicable to banks that fall into the capital conservation buffer.

- Discourage banks from engaging in routine activities used as an important asset-liability management tool.

The proposed inclusion of unrealized gains and losses inevitably will affect banks' behavior. The behavioral changes will become more pronounced as the date for implementation of Basel III in the United States approaches, and they will have collateral impacts that are important not only to the affected banks, but also to the economy more broadly. In that regard, it is likely that:

- Banks will limit their investments in longer duration assets, including 15, 30-year Fannie Mae and Freddie Mac mortgage-backed securities and debentures.

- Banks will shorten the maturities of debt instruments in their securities portfolios including U.S. Treasury securities to reduce the impact on regulatory capital of unrealized gains and losses (both positive and negative) resulting from changes in interest rates.

- Some banks such as Community Bank will shy away from longer-term municipal debt offerings in particular in an effort to reduce capital volatility. This likely will have the effect of increasing borrowing costs for municipalities and reducing the liquidity of municipal debt markets.

This proposal introduces volatility in capital driven by interest rates and external credit spreads and will make it difficult for Community Bank to implement a capital planning program. While the large international banks for which Basel III was created can hedge the impact of interest rates, smaller banks such as Community Bank, do not have the same access to these markets nor do we have the expertise or cost efficient resources to properly maintain or account for these types of hedges.

Since interest rates are likely to move higher, banks will see significant capital deterioration, all from rate movements that are temporary in nature, and not likely to be realized. Based on Community Bank's investment portfolio position as of September 30, 2012, a 300 basis point parallel rate shock scenario would result in an unrealized loss position of $60 million pre-tax, compared to excess capital of $120 million (pretax), essentially reducing excess capital in half, at a time, that the Bank has both the ability and intent to hold its portfolio to maturity without incurring any losses. Since rates are at historical lows it is not unreasonable to expect a 300 basis point rate increase in the foreseeable future. Acceptance of the proposed standards would have significant ramifications on investment strategies, portfolio composition, earnings performance, capital contingency plans, contingency funding plans and interest rate risk management. The Bank would have to consider the option of shortening the duration of the securities portfolio by selling some of its longer duration municipal securities and modifying the reinvestment strategy, inclusive of deleveraging alternatives.

These actions would lead to lower returns for Community Bank and less funding for the housing market and local governments.

We understand that the proposed treatment of AFS securities reflects an attempt to accelerate the recognition of potential credit-related losses in regulatory capital. Yet, the joint development of an expected loss approach to the recognition of other than-temporary impairment ("OTTI") of securities and loans by the Financial Accounting Standards Board ("FASB") and International Accounting Standards Board ("IASB") substantively addresses this perceived problem for banks. Thus we believe the proposed rule should be revised so that unrealized gains and losses on AFS securities that reside in accumulated other comprehensive income do not flow through capital. This would allow unrealized losses due to credit impairment to be reflected in capital, but would exclude the interest rate impact.

However, if the Agencies are determined to require all unrealized gains and losses to flow through capital, we strongly suggest that unrealized gains and losses that predominantly result from changes in interest rate risk should be carved out. In other words, the Agencies should consider filtering unrealized gains and losses for securities that do not have credit risk. This approach would exclude from regulatory capital unrealized gains and losses resulting from such low-risk securities as U.S. government and agency debt obligations and U.S. GSE debt obligations. In addition, alternatives should remain available for banks to place other securities in a held-to-maturity bucket.

2. **Allowance for Loan and Lease Losses**

   Under the Basel III Standardized proposal, the allowance for loan and lease losses in total capital is capped at 1.25% of assets.

   Limiting the capital allocation for the allowance for loan and lease losses combined with the proposal to require a "capital preservation buffer" does not appear to give adequate consideration as to reserves already in place to absorb losses. This proposal, in essence, is duplicating the requirement for reserves. We would suggest that the 1.25% limit on allowable reserves be removed or that the "capital preservation buffer" be reduced.

3. **Attacks on the Residential Mortgage Market**

The U.S. residential mortgage market has been very slow to recover from the economic downturn that began in 2007. The health of this sector of the economy will be critical to sustaining a broad economic recovery, yet there are at least three Basel III requirements that will constrain the recovery in the residential mortgage market. These requirements include

- the removal of 120 day safe harbor for mortgage loans sold to the U.S. agencies with certain "credit enhancing" representations and warranties,

- the deduction of investment in mortgage servicing rights ("MSRs") above 10% of an Institution's Common Equity Tier 1, and

- the increase in risk weighting associated with mortgages with higher LTVs or loans that qualify as Category 2 loans,

There may be value in the each proposed requirement, but combined these factors could materially impair the business model for creating residential mortgage credit in the U.S., resulting in increased cost to the consumer and/or limited access to funding.

First, under the general risk based capital rules, a banking organization is subject to a risk-based capital requirement when it provides credit-enhancing representations and warranties on assets sold or otherwise transferred to third parties because such positions are considered recourse arrangements. But these recourse rules exclude early payment default clauses, premium refund clauses that cover U.S. government or agency guaranteed assets, and warranties that permit the return of the asset due to fraud, misrepresentation, or incomplete documentation.

Representation or Warranty	Current	Basel III
Early Payment Default	Excluded	Included
Premium Refund Clauses	Excluded	Included
Fraud, Misrepresentation or Inc. Docs.	Excluded	Unclear

However, the Agencies appear to be proposing that in cases where credit enhancing representations and warranties are provided on assets sold (or otherwise transferred to third parties) with early default clauses or premium refund clauses, a banking organization would treat this arrangement as an off-balance sheet guarantee with a 100% credit conversion factor ("CCF") applied to the exposure amount. The NPR wording is silent on whether warranties that permit the return of assets in the instances of fraud, misrepresentation, or incomplete documentation would be considered off-balance-sheet guarantees with 100% CCF, an issue that should be clarified. The

NPR wording is also silent on whether the CCF would be removed at the time of expiration of a representation or warranty, although it is logical to assume so.

We understand the concerns with "credit enhancing" representations and warranties; however, there appears to be little evidence that the temporary representations and warranties associated with "pipeline mortgages" have resulted in significant losses for regulated banks. In that regard, we suggest that the 120 day safe harbor provision be retained. We also suggest that the credit conversion factor remain in place for the applicable rep and warranty period rather than the life of the loan.

Another critical component of the residential mortgage banking business model is the value of the MSRs created at the time of loan origination. Under the proposed rule, institutions are required to deduct all mortgage servicing assets (net of deferred tax liabilities) that exceed 10% of its common equity tier 1

(15%, when aggregated with deferred tax assets and investments in common stock of an unconsolidated financial entity). In addition, the amount that is below the 10% threshold will receive a 100% risk weight (and eventually 250% beginning 2018). Servicing loans is a specialty of many banks, including many community banks, and the mortgage servicing asset oftentimes will exceed 10%.

Deduction of MSRs above 10% CET1 capital after adjustments means that servicing will become less attractive as a bank asset and more likely move to nonbank investors that require higher unleveraged returns on investment. If banks were forced to sell these assets due to their deduction from CET1, then such banks might be compelled to charge higher origination fees. If banks cannot pass along these price increases to the consumer, then this could result in a reduction of mortgage originations and profitability. We suggest that the permitted amount of MSRs be increased to 25% of CET1, and MSRs be excluded from the current 15% aggregate basket that applies to deferred tax assets. These steps would lessen the impact of the MSR deduction. If these actions are not taken, the market for investment in MSRs will likely continue to shift from banking organizations to non-bank investors that do not face the deduction of MSRs from capital.

Lastly, the Standardized Approach NPR introduces higher risk weights for residential mortgage loans reflecting the borrower credit profile based on various criteria that could cause a loan not to be characterized as a Category 1 loan. These factors include term, payment frequency, credit underwriting, maximum annual rate variance, HELOCs underwritten to maximum contractual exposure, payment status of less than 90 days past due, and single banking organization holders of senior and junior lien mortgages with combined LTV ratios below threshold levels.

The concern with this methodology is that it does not taken into consideration a combination of relevant factors. The single factor is not necessarily representative of the true credit exposure. On the other hand, the cost associated with implementing a multi-factor approach may be excessive and not justifiable.

- We suggest that a methodology be developed that incorporates a cumulative view of credit factors for risk weighting.

Community Bank is contemplating the residential mortgage lending business to better serve our customers. If not modified, these regulations will create additional costs to this business line which we will have to pass along to our customers. These changes will also cause us to readdress our strategy, and possibly modify our product offerings, underwriting standards and system requirements.

4. Impact of Exclusion from capital of certain Deferred Tax Assets ("DTAs") on our ability to service our customers and communities' needs?

The proposal adds complexity and restrictions on the amount of DTAs can be included in capital. DTAs arising from carryovers of net operating losses and tax credits are required to be fully deducted from capital. DTAs arising from temporary differences, which cannot be realized through carryback to prior years, are subject to strict limits: DTAs of this type cannot exceed 10% of CET1 capital, and, when combined with mortgage servicing rights and certain other assets, the aggregate amount of such assets cannot exceed 15% of CET1. Banks will need to carefully monitor the combination of the entire group of assets, including DTAs, to insure that required capital levels are maintained

This proposal does not present a significant issue for our Bank due to the continued generation of profits with a deferred tax asset that can be realized through carry-back ability. It is our position that the allowability of deferred tax assets should not be limited to a one year look forward period and that mortgage servicing assets should be measured independently, discussed above.

5. Treatment of Cash Flow Hedges

Under the Basel III proposal, banks would be required to deduct any unrealized gain and add any unrealized loss on cash flow hedges included in accumulated other comprehensive income to CET1, net of applicable tax effects, which relate to the hedging of items that are not recognized at fair value on the balance sheet.

This proposed deduction would negatively impact a proven and reliable tool that banking organizations have used for years to manage interest rate risk in a safe and sound manner. The result of the proposed deduction would therefore be a reduction in the amount of safety and soundness-enhancing cash flow hedges, which could potentially lead to increased interest rate risk in the banking system.

Cash flow hedges potentially subject to deduction present little or no economic risk to the bank – in fact, they are used to decrease economic risk to the bank. In light of the potential for increased risk and in light of the potential inconsistency with the safety and soundness-enhancing nature of the activity, the Agencies should eliminate this proposed deduction.

6. Increase to risk weighting on delinquent loans

The proposal under Basel III would require increased risk weighting on past due loans from 100% to 150%. The impact of this proposal to Community Bank is not significant; however, it appears that the impact of this change does not consider the potential loss exposure, or the adequacy of reserves already established to recognize the increased risk on these credits.

We suggest that this increased risk weighting be eliminated.

7. Implementation Timeline

Timeline is too aggressive for community banks especially for private banks such as, Community Bank, if the proposal to include unrealized gains and losses on AFS securities is not removed or significantly modified. Community Bank has established a comprehensive investment strategy, designed to take advantage of current market conditions while providing a laddered cash flow stream that compliments the Bank's overall balance sheet position. This specific proposal would have significant ramifications that would require an extended amount of time to restructure its balance sheet composition and strategy.

Conclusion

We appreciate the opportunity to provide these comments and be part of the constructive dialogue on the implementation of Basel III. We acknowledge the difficulty of conforming the Basel III rules with the Dodd-Frank framework. We hope that the federal government can strike an appropriate balance in meeting its objectives and ask that you carefully consider the unintended consequences of the proposed regulations on community banks across the country.

Sincerely,

David P. Malone
President and Chief Executive Officer
Community Bank