From: David Woodcock [mailto:david@farmerstrust.com]
Sent: Friday, July 06, 2012 1:31 PM
To: Comments
Cc: Bean, Bobby R.; David Woodcock (david@farmerstrust.com)
Subject: FDIC Proposed Capital Regulations RIN 3064-AD95 and RIN 3064-AD96

Thanks for allowing us to comment on these 2 proposed regulations. We are a $300 million rural Iowa Community Bank.

I am commenting on two specific provisions of the regulation:

Basel III NPR – RIN 3064-AD95 – I wish to comment on the proposed inclusion of unrealized gains / losses on AFS securities in regulatory capital ratios, as proposed in this portion of the regulation.

Standardized Approach NPR – RIN 3064-AD96 – I wish to comment on the proposed changes to risk weighted assets, as proposed in this portion of the regulation.

<u>Basel III NPR -- RIN – 3064-AD95 -- FIL-25-2012 – Inclusion of unrealized gains / losses on AFS securities in regulatory capital ratios</u>

I am opposed to this proposed rule and the unintended consequences that could happen if implemented.

First, unrealized gains / losses is only a market accounting adjustment, not really capital unless the security is sold. Also, what happens to capital ratios if at some point the entire balance sheet gets marked to market?

If included, this hurts banks with large investment portfolios more than banks running at 100% loan to deposit ratios. Our investment portfolio is at 40% of assets, and is high because of weak loan demand in our area.

It is easy to suggest now that everyone has unrealized gains in their portfolios, however, in a rising rate environment (which you suggest we prepare for), bank capital will be destroyed, further killing lending and a number of other activities, which are not needed in a struggling economy.

By including these unrealized gains / losses in capital, it will be much harder for banks to manage interest rate and liquidity risk. Banks hold high quality investments, so most of the price changes are due to interest rate movements, not credit risk / concerns.

Making or allowing banks to transfer a portion of the portfolio back to “Held to Maturity” even makes these issues harder to manage. Again, the issues are interest rate and liquidity risk, tax planning issues, and the ability to sell securities for a variety of reasons, like changes in credit risk.

However, I do agree there is more credit risk on corporate bonds and non - essential purpose municipal revenue bonds.

Therefore, I propose and recommend:

Remove this entire proposal unrealized gains / losses issue from the regulation.

If not removed, then all 0%, 20% and 50% risk weighted investments be excluded from inclusion in capital ratios.

If you decide to only exclude the 0% and 20% investments, you need to expand the categories to include essential purpose municipal revenue bonds (like sewer, water, electricity, etc.) so that these investments are not included in the capital ratios, and considered as safe as municipal GO credits. Smaller communities need these services and the ability to issue these bonds at the lowest rates possible, and many times the local banks are the buyers of these bonds, and by including these bonds in the unrealized gains / losses adjustment to capital will cause the rates on these bonds issued to increase, which impacts the utility rates that get charged to their customers.

If you think that municipal bonds should not be excluded, please consider that cities and states will survive and will continue to need to issue GO and revenue bonds to support projects in their communities. Less government support will require more local funding issues and will need lower cost opportunities to issue debt for these projects and cash flow needs, therefore, I believe municipal bonds are still a safe investment, just look at the low default rates in GO bonds over the last 40+ years.

<u>Standardized Approach NPR – RIN 3064-AD96 -- FIL-27-2012 – Proposed Changes to risk Weighted Assets</u>

I have never understood how you could lose over 100% of an asset, except for the carrying cost on OREO, until the property is sold. Banks will write off the asset before they will take on additional costs. Therefore, risk weights of 150% and 200% make no business sense, and therefore, I am opposed to any risk weights over 100%. To me, these higher risk weights appear to simply be a penalty and consequently could decrease Risk Based Capital Ratios by 20%.

Also, trying to manage all these risk weights, especially as outlined for mortgages, based on loan to value, will take a lot of effort, time and cost, especially for smaller community banks. As you have already seen, current changes to mortgage lending are driving good banks out of the market place, when they are most needed.

Higher risk weights could potentially lead to increasing interest rates to borrowers on loans, and could impact collateral issues, loan structure and underwriting standards.

There are only so many types of loans available for us in Rural Iowa. We do a lot of Agricultural Lending (which is on your radar screen with the high cost of farmland) and Commercial Real Estate (your present area of concern). We sell most of our Single Family Real Estate Loans (mainly due to interest rate risk with mortgage loans at historical lows), Consumer Loans have become a commodity (Auto Finance arms of car manufactures and some select lenders have a strong hold on this market and sometime compete at rates under our cost of funding) and we only have limited access to a C&I loans in our area. Therefore, we are left with Commercial Real Estate (which you desire to increase risk weights on), and Agricultural loans.

We also customize a majority of our loans to local clients to meet their needs, and many times would not fit into a formal loan policy bucket. Based on our customized loans, as also mentioned above, for a smaller bank, the time, effort and cost to make sure they were risk weighted properly would be a large task, which makes us less productive and less profitable.

We do a small number of very high loan to value real estate loans in our community to help a particular segment of our service economy to attract highly skilled young professionals to our area to fill a very high need. Looking at risk weights in the 150% – 200% range, we will have to rethink this model and if we change the model, it will have a very big impact on our community. To date, all these loans have paid as agreed and we have never lost a dime.

If you decide to approve risk weights over 100%, following are my suggestions:

1) Exempt banks under $500 million in assets, these banks fill a need to support their community, never caused any of the issues facing the economy, are a small piece of the banking industry and pose little risk to the FDIC Insurance Fund. Many times these banks have local ownership and directors, and again are very community focused, and are driven by solid conservative values for the most part, we are not driven by dividend or stock market values. Community Banks have a customer focus vs. a marketplace focus.

2) On any risk weighed assets over 100%, allow the bank to deduct 100% of core capital from those over 100%, to help reduce the damage caused by the higher risk weights, and allow us to continue to serve our community.

3) Allow 100% of loans in authorized State and Federal Loan buckets to be entirely exempt from the high risk weights, and only be counted at a 100% risk weight.

Summary

If these items (Higher Capital Requirements, Inclusion of unrealized gains / losses on AFS Securities in regulatory capital ratios and High Risk Weights), if implemented, will further drive capital out of banks (when it is needed the most), kill lending (which is also needed for an economic recovery) and kill our desire to work with past due clients (appears better to foreclose than try to work out a payment plan).

These rules should not be blindly applied, and must not be one-size fits all. These rules need to be calibrated and adjusted according to bank size, complexity and risk.

Again the cost and time to properly report risk weights and unrealized gains / losses has a greater impact on smaller banks than large banks. This only makes the industry less profitable. These costs get offset by higher loan rates to borrowers and lower deposit rates to savers.

Banks with higher loan deposit rates will see capital ratios decline due to higher risk weighted assets and banks with lower loan to deposit ratios (reflecting weak loan demand), will see their capital ratios decline due to larger investment portfolios and therefore higher unrealized gains / losses adjustments to the capital account.

Banks are getting hit in all major categories: 1) Interest Income through weak loan demand and falling loan to deposit ratios, 2) Fee Income through control of Debit Card Fees and pending OD Fee proposals, 3) increasing costs, including much higher compliance costs, and 4) now higher capital requirements. Higher risk weights and unrealized gains / losses is not the way to go for community banks.

Thanks for allowing me to comment.

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