September 26, 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 Capital Proposals

Ladies and Gentlemen:

Thank you for the opportunity to provide comment on the Basel III proposals[1] that were recently issued for public comment by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation. We own and operate an independent community bank located in the southwest corner of Arizona. Our region is rural and somewhat isolated as we are half way between Phoenix, AZ and San Diego, CA along Interstate 8. Due to our geography our community is heavily reliant upon agriculture as the primary force driving our local economy. As such, our local agricultural industry must rely upon migrant and seasonal labor forces. It is within this context that I write this letter to adamantly oppose the proposed Basel III capital rules.

From my perspective, community banks should be allowed to continue using the current Basel I framework for computing their capital requirements. Basel III was designed to apply to the largest, internationally active, banks and not community banks. Community banks did not engage in the highly leveraged activities that severely depleted capital levels of the largest banks and created panic in the financial markets. Community banks operate on a relationship-based business model that is specifically designed to serve customers in their respective communities on a long-term basis. This model contributes to the success of community banks all over the United States through practical, common sense approaches to managing risk. The largest banks operate purely on transaction volume and pay little attention to the customer

[1] The proposals are titled: *Regulatory Capital Rules; Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, and Transition Provisions; Regulatory Capital Rule: Standardized Approach for Risk-weighted Assets; Market Discipline and disclosure Requirements; and Regulatory Capital rules: Advanced Approaches Risk-based Capital Rules; Market Risk Capital Rule.*

relationship. This difference in banking models demonstrates the need to place tougher capital standards exclusively on the largest banks to better manage the ability to absorb losses.

Incorporating AOCI as Part of Regulatory Capital

Another issue of extreme importance to our bank is the effect the AOCI provisions of the Basel III proposal will have on our institution. Inclusion of accumulated other comprehensive income (AOCI) in capital for community banks will result in increased volatility in regulatory capital balances and could rapidly deplete capital levels under certain economic conditions. AOCI for most community banks represents unrealized gains and losses on investment securities held available-for-sale. Because these securities are held at fair value, any gains or losses due to changes in interest rates are captured in the valuation. Recently, both short-term and long-term interest rates have fallen to historic lows generating unprecedented unrealized gains for most investment securities. Additionally, demand for many implicitly and explicitly government guaranteed securities has risen due to a flight to safety and government intervention in the capital markets. This increased demand has caused credit spreads to tighten further increasing bond valuations. Interest rates have fallen to levels that are unsustainable long-term once an economic recovery accelerates. As interest rates rise, fair values will fall causing the balance of AOCI to decline and become negative. This decline will have a direct, immediate impact on common equity, tier 1, and total capital as the unrealized losses will reduce capital balances. At my bank, for instance, if interest rates increased by 300 basis points, my bank's bond portfolio would show a paper loss of over $1,800,000. This would mean that my bank's tier one ratio would drop by over 3.00%.

Large financial institutions have the ability to mitigate the risks of capital volatility by entering into qualifying hedge accounting relationships for financial accounting purposes with the use of interest rate derivatives like interest rate swap, option, and futures contracts. Community banks do not have the same level of access to these types of risk mitigations and sometimes lack the knowledge or expertise to engage in these transactions and manage their associated risks, costs, and barriers to entry. Community banks should continue to exclude AOCI from capital measures as they are currently required to do today.

New Risk Weights

The proposed risk weight framework under Basel III is too complicated and will be an onerous regulatory burden that will penalize community banks and jeopardize the housing recovery. Increasing the risk weights for residential balloon loans, interest-only loans, and second liens will penalize community banks who offer these loan products to their customers and deprive customers of many financing options for residential property. As previously indicated, our community and particularly our local agricultural industry, rely heavily upon a transient and seasonal workforce. These people are members of our community and well know to our bank. Regrettably, many of this particular workforce will not qualify for conventional Freddie Mac and Fannie Mae mortgages and rely upon our bank as a source of financing. The risk weighting treatment of certain types of mortgages will substantially elevate the capital requirements at our bank and will simply force us out of this type of lending.

Additionally, higher risk weights for balloon loans will further penalize community banks for mitigating interest rate risk in their asset-liability management. Community banks will be forced to originate only 15 or 30 year mortgages with durations that will make their balance sheets more sensitive to changes in long-term interest rates. Many community banks will either exit the residential loan market entirely or only originate those loans that can be sold to a GSE. Ours will likely be one of those banks. Second liens will either become more expensive for borrowers or disappear altogether as banks will choose not to allocate additional capital to these balance sheet exposures. Community banks should be allowed to stay with the current Basel I risk weight framework for residential loans. Furthermore, community banks will be forced to make significant software upgrades and incur other operational costs to track mortgage loan-to-value ratios in order to determine the proper risk weight categories for mortgages.

As these issues continue to be debated, it is my hope that you will take these thoughts into consideration. My greatest fear is no longer the struggling national or local economy. My greatest fear now is our own regulatory environment and the rules being proposed.

With the guidance coming from the CFPB on mortgage lending and the proposed Basel III rules, I see no way to continue with our current community banking business model. We will be forced to make decisions regarding our investment portfolio mix, the amount and types of lending we engage in, and our long term asset/liability management practices that are completely different from what we have done in the past. Our ability to service our community will be in drastically diminished. Our customers and our local economy will suffer the consequence of the agencies failure to consider the global ramifications of the recommendations that are being made.

Further, as evidenced by a recent Global Financial Stability Report published by the International Monetary Fund (IMF), Basel III proposed regulatory capital standards might allow large banking organizations to become even more prominent and further concentrate the banking sector. The report finds that large banks with advantages of scale may be better able to absorb the costs of the regulations, which would apply to all U.S. banks unless changed by policymakers. The IMF also wrote that the new banking standards might encourage certain financial activities to move to the nonbank sector. I urge you to reconsider the course you are on and to scrap the Basel III proposed rules for something much simpler and that takes the vastly different banking business models into consideration. Please don’t continue down the path of ruining the country’s community banking industry.

Respectfully submitted,

Terry W. Frydenlund
President/CEO
1st Bank Yuma