From: John Swaim <jswaim@fsnb.net>
Sent: Tuesday, October 09, 2012 1:36 PM
To: Comments
Cc: Cabinet; Debra Stamper (dkstamper@kybanks.com); Jill Martin

Subject: Basel lll FDIC RIN 3064-AD95, RIN 3064-AD96, and RIN 3064-AD97

FDIC
Washington, D.C.

Ladies and Gentlemen:

As the Chief Executive Officer and the Chief Financial Officer of First Southern National Bank, we write to address the broad topic of Basel III and the detrimental effect its implementation will have on Community Banks such as ours.

First Southern National Bank has assets of approximately $700,000,000 and serves 11 largely rural markets across the state of Kentucky. The bank maintains Tier 1 Capital between 9% and 10%. The bank's asset quality and liquidity are considered sound. We are involved, both corporately and individually, in a variety of initiatives and activities that support the local communities in which we live. This includes financial generosity as well as investments of time and energy.

In its current form, Basel III will have material negative consequences for consumers, shareholders, and local communities. For the typical Community Bank, Basel III goes beyond prudence. If adopted, Basel III will suffocate Community Banks as they seek to be good corporate citizens and fill their traditional role as financial anchor of the community.

It is not our intent to address Basel III in its entirety – the issues are too numerous. Following is the broad impact of just one portion of Basel III as proposed, and its impact on our bank.

Broad Impact
Proposed Basel III rules require, among other things, that unrealized gains and losses on AFS debt securities flow through to capital as it is redefined (CET1).

Requiring gains and losses on AFS securities to flow through to capital calculations, when said gains and losses are merely the result of market interest rate fluctuations, is an inaccurate portrayal of both risk to capital and shareholder equity.

While gains are always more comforting to see on the balance sheet than losses, rate driven gains and losses bear minimally on the true capital strength or franchise value of the bank as a going concern. If liquidity is being managed properly and the bank is otherwise in a sound capital position, such swings are normal and irrelevant to capital strength as a practical matter.

Given the present extended trough of low interest rates, there would seem to be more potential for rates to rise in the future than to decline. Unless banks materially change investment patterns, many will have their capital negatively impacted if this rule is put into effect.

In its present form, this feature of Basel III will cause Community Banks to suffer a material decline in earnings (cause) with several unintended consequences (effect), to wit;

- Banks will tend to shorten the duration of investment securities to minimize the impact on capital caused by fluctuations in market rates. Given a normal yield curve, shorter duration bonds mean lower earnings in the investment portfolio;

- Lower earnings will reduce the bank's ability to build core capital, and will limit the pool of funds from which the bank could invest in local communities;

- Lower earnings will erode the bank's ability to price competitively, eventually leaving the consumer in a position of being poorly served;

- Lower earnings mean banks will be unable to provide an attractive return to investors, and said investors will eventually flee and take their capital with them;

- Lower earnings mean less revenue for local, state, and federal tax collectors.

Traditionally, banks have been significant institutional investors in municipal debt. Many municipal bonds carry a longer duration. Why would banks buy these longer duration bonds, knowing they will have to potentially sacrifice capital to do so?

It is likely that banks will be much less inclined to buy longer duration Bank Qualified investments of any kind. This would leave local, state, and the federal government either forced to pay more to attract investors, or perhaps do without needed funding.

Impact on Our Bank
In today's market, our bank has approximately $5mm in gains in a $174mm portfolio, all of which is classified AFS, with an average life of 3 years and no material credit risk. Investments are virtually all Agency bullets, Municipals, and short final Mortgage Backed securities.

Taking unrealized gains to Capital, given current market rates, would add .75% to common equity. In an up 300bps rate shock those gains would become losses that would deduct 1.3% from common equity. This is a dramatic swing, but not nearly as dramatic as it would be for a bank that is heavily weighted in longer municipals or Agencies.

Again, these swings are purely market driven, not credit driven. Taking the gains/losses to capital has no realistic bearing on the true risk to capital and liquidity in a well-run community bank. If liquidity is sound and the bank is well managed, this is an unnecessary and counter-productive maneuver. If liquidity is not sound and the bank is not well managed, regulators should take appropriate action; in such cases, moving unrealized gains/losses straight to capital changes nothing but the math.

We argue for a complete exemption from Basel III for Community Banks.

Thank you for considering these comments. They are intended as constructive and we trust that is the spirit in which they are received.

Sincerely,

W. Tommy Roberts, CEO
First Southern National Bank

John. R. Swaim, CFO
First Southern National Bank

With hard copy to:

Senator Mitch McConnell
Senator Rand Paul
Congressman Hal Rogers
Congressman Ed Whitfield
Congressman Brett Guthrie
Congressman John Yarmuth
Congressman Ben Chandler

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