October 15, 2012

The Honorable Martin J. Gruenberg
Acting Chairman
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Dear Chairman:

Thank you for the opportunity to provide comment on the Basel III proposals that were recently approved by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation. I represent the interests of Citizens First Bank, a $150 million bank headquartered in Clinton, Iowa. I am writing this letter today to express concerns about both the Basel III proposal as well as the “Standardized Approach” proposal.

I understand the overall goal in the Basel III proposals of strengthening capital requirements so banks can weather the storms of downturns economic cycles inevitably bring, but these rules in their entirety are more appropriate for large complex financial institutions competing in a global marketplace than for the business practices of our local bank. We respectively ask that both the Basel III and the Standardized Approach proposals be repealed for the following specific reasons:

Basel III Comments

1. Requirement that gains and losses on available for sale securities (AFS) must flow through to regulatory capital. This proposed rule requires all unrealized gains and losses on AFS to “flow through” to common equity tier 1 (CET1) capital – which is a new category of tangible capital within the rule. Even daily changes in AFS securities must technically be accounted for in regulatory capital. Because interest rates, particularly on debt securities, can fluctuate frequently, the proposed rules will introduce significant volatility into capital calculations.

The timing of this proposed rule is also greatly compounding the problem, since we are now at a period of historically low interest rates. As interest rates begin to rise, capital under this proposal will move rapidly in a negative direction, as while nothing will have changed regarding the bank’s tangible equity, regulatory capital ratios could be reduced rapidly. A 300 basis point rise in interest rates for example would reduce the value of many bank’s securities portfolios and reduce CET1 significantly. This proposal therefore will introduce a significant amount of volatility into the system which is the opposite of what the goal should be. This may also cause our bank to reduce our balance sheet as the economy improves, simply because of the upward movement in interest rates. Our small business, consumer and mortgage customers will be adversely impacted by the reduced availability of credit under this proposal – as it will reduce our central focus of making loans to members of our communities.

As for credit risk taken in the investment portfolio, existing rules for other-than-temporarily-impaired (OTTI) investments provide a mechanism for credit losses to be reflected in capital. A natural reaction to this new proposal will be for our bank (and many others) to either hold fewer securities or reclassify existing portfolio assets to hold-to-maturity (HTM). This conversion may reduce the volatility of the proposal, but it comes at the enormous cost of eliminating our ability to manage our investment portfolio through different interest rate and economic cycles – and is a core tool to offset the interest rate risk in our loan and investment portfolios. We would respectfully ask this section of the proposal be eliminated.

Standardized Approach – Notice of Proposed Rulemaking

2. Increased risk weighting for residential loans. Under this proposal, the federal agencies can assign risk weights to residential mortgages based on whether the mortgage is a "traditional" category 1 mortgage or a "riskier" category 2 mortgage. Risk weights under the proposal run from 35% up to 200%. Under current law, most prudently underwritten residential mortgages are risk weighted at 50%. These proposed residential mortgage rules raise several issues. First, mortgages must be re-assessed after a loan structuring or modification. Many banks, including ours modify loans and have a very successful track record for those borrowers who qualify by keeping them in their homes. Why should we be penalized from a capital standpoint for offering these modifications?

Secondly, similar to the agencies proposal for a "Qualified Residential Mortgage" (QRM) the proposed rules do not recognize private mortgage insurance (PMI) at all to reduce loan to value requirements – so mortgages may be subject to higher risk weights even if PMI reduces the risk on these loans. For example, a bank originating a balloon mortgage (which is now an automatic "category 2" mortgage at any LTV) at 90% LTV would have to risk weight the loan at 150% for capital reservation purposes despite having PMI. This does not reconcile at all with the loan performance we have experienced and may cause us to discontinue balloon mortgages and any loans with PMI. This will have an enormous negative impact on loans to first time homebuyers, as PMI has been used successfully by banks in Iowa for decades with hardly any resulting losses for prudently underwritten loans.

Third, the proposal has no grandfather provision, so all residential mortgage loans on the bank's books would be subject to the new capital requirements – forcing banks to review all existing files to determine the appropriate category and LTV for each loan file. This "granular" approach is going to put enormous pressure on our bank to implement systems for calculating these new reporting requirements. It is uncertain if software vendors could possibly even implement this new requirement in a timely manner. Further complicating the issue, we will not be able to just "assign" a weighting when the loan is booked, but would have to continually re-evaluate the risk weightings based on changes in collateral values, past due status and other risk factors. As our bank's strong underwriting has led to a very small loss history on residential real estate loans, this new re-evaluation approach on an asset by asset basis is completely unnecessary and should be eliminated from the proposal.

3. Change in risk weighting for home equity and second lien loans. This part of the proposal classifies all junior residential liens, such as closed-end home equity loans and HELOC's, as "category 2" exposures with risk weights ranging from 100-200%. More importantly and as is the case most often in our bank, if we hold both the 1st and 2nd mortgages on the same property we would be required to treat both mortgages (even the 1st mortgage) as category 2 exposures (much higher risk weight). The exception where both mortgages could be placed into a category 1 mortgage – where the combined exposure meets all of the requirements of a category 1 mortgage, is far too narrow and most of our home equity loans and their accompanying 1st mortgage would likely fall into category 2 classifications. This proposal will cause our bank to consider discontinuing our home equity loan programs. We also ask this portion of the proposal be eliminated.

4. Proposal to increase risk weights on delinquent loans. Like many Iowa banks, we are fortunate with careful underwriting to have a very low delinquency rate currently – but this could change quickly based on economic conditions. This rule, which drastically increases the risk weights for past due loans, causes concerns as our bank already sets aside reserves for delinquent loans. By proposing to also increase capital we hold on past due loans, we are basically being required to set aside capital twice. Risk regarding past due loans should continue to be managed through loan loss reserve guidance and not by layering on an additional capital requirement. This rule if finalized would require us to increase our aggressiveness in moving loans past 90 days delinquent off of our balance sheet – and make us much less likely to pursue loan workout strategies and instead proceed directly to foreclosure sale.

Conclusion

In conclusion, our bank has no way to completely ascertain the full impact of this massive proposal because of the amount of work it will take to understand the rules and how they apply to our balance sheet. We will likely be required to hire consultants to implement the re-assessment of each individual loan in our portfolio with the new risk weights, re-program our core processing software to handle the new coding requirements and then create the necessary reports to analyze the data.

As I stated above, while I support the overall goal of strengthening the financial system by increasing the level and quality of capital that banks hold, these rules are designed much more for large multi-billion dollar global financial institutions that the business practices of Iowa banks. We urge the agency to repeal this proposal so we may continue serving our communities and help strengthen our local economies.

Sincerely,

Kathryn A. Forrest

CFO