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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 Capital Proposals

Ladies and Gentlemen:

Thank you for the opportunity to provide comment on the Basel III proposals 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 want to thank you for the opportunity to submit this comment letter in the BASEL III NPR and the Standardized Approach NPR.

The first thing that strikes you when you read through the combined 500 pages of these two NPRs is the complexity. In fact, in 35 years in banking, this is the first time I recall regulatory agencies releasing a model to assist institutions in evaluating their compliance with a proposed regulation. That complexity places a significant compliance burden on small community banks. In addition, we find it hard to imagine the level of education that will need to be delivered to the safety and soundness field staff for them to understand a capital regulation with this level of complexity. We also feel that much of the complexity is unnecessary.

A good example is the proposed Capital Conservation Buffer that begins to take effect in 2016 and is fully phased in by 2019. This buffer grows on top of the adequately capitalized minimums for the three capital measures with risk assets in the denominator. The buffer doesn't break through the well capitalized minimum for the three risk based capital ratios until 2019 and then only by ½ percent. Given that institutions generally strive to stay above well capitalized minimums, we recommend elimination of this buffer entirely and grant regulatory agencies the authority to impose restrictions on dividends, discretionary management bonuses, and actions aimed at retiring stock if an institution falls below well capitalized minimums. In fact, such restrictions are already being imposed by field examination staff in individual situations when merited. The buffer is an unnecessary addition to the complexity of the Basel III NPR and serves little useful purpose.

When I first began to read these two NPRs, I found it very frustrating to attempt to visualize the combined effect of all its moving parts. I quickly decided that the only way to gain a sense for the interactions was to build a model that modeled the proposed regulation. We provided that model (The FARIN Capital Speedboat) at no cost to institutions attending a two part webinar on the proposed regulations. At least 100 institutions have used that model to evaluate their compliance with the proposed regulation. What sets it apart from the regulatory model and one other we have been exposed to is that it has planning capabilities.

1. Institutions can enter annual assumptions for growth, earnings (ROA) and dividends to project growth in assets and retained earnings as the regulation phases in.
2. Institutions can take capital actions like issuing new stock and retiring stock (like TARP).
3. Balance sheet mix can be changed to reflect shift from lower risk weight assets like securities top higher risk weight assets like loans as the economy recovers.
4. The effect of upward movement in rates on gains/losses on AFS securities can be used to stress test capital compliance under all four standards.
5. Capital goals can be established for each of the four ratios above regulatory minimums as called for under the proposed regulations.

The point of this discussion is that the majority of predictions, opinions and recommendations expressed in the remainder of this comment letter are based on modeling of real banks using the capabilities of the Speedboat model.

<u>Including the AOCI as an adjustment to Common Equity Capital</u>

In our eyes the most onerous part of the proposed regulations is the fact unrecognized losses to AFS securities are included in (deducted from) common equity capital (and through extension all other forms of capital).

We ran a consulting workshop for the FHLB Atlanta in September. Four banks were in attendance ranging in size from $300 to $500 million. A portion of the workshop was spent in a capital planning exercise using our model. In addition, we had the ALCO reports for all four shops including the results of EVE testing for their most recent quarter. All four had large AFS investment portfolios in the range of 30% to 40% of assets. Durations in rising rate environments on those AFS investments ranged from 3 to 5 years. We ran a 300 bp stress test on each. Losses to AFS portfolio values ranged from 9% to 15%. Assuming 40% of the balance sheet in AFS securities, pretax hit to the Tier 1 leverage ratio would range from 3.6% to 6%.

In all four cases, their interest rate risk analysis indicated positive asset sensitivity. In all four cases their model projected increases in EVE in rising rate environments. Yet regulatory capital dropped appreciably with rising rates because of the AOCI treatment. We do not consider these institutions to be atypical. Large AFS investment portfolios are common in community bank balance sheets at this point in time. Some of these AFS investments are in longer duration assets in order to enhance yield and offset loss of interest income from the loan portfolio. Yet positive asset sensitivity in those shops leading to increases in EVE with rising rates is also common.

Financial institutions have been asked to perform EVE testing since guidance documents issued in the late 1990s. While it took a while for EVE testing to materialize in the field, the majority of community banks today are running EVE tests. Examiners are reviewing results, and, when appropriate, challenging data and assumptions. In light of all the regulatory work in this area including new interagency interest rate risk guidance issued in the last two years, it seems inappropriate to mark a major portion of a bank's assets to market without doing the same with the funding supporting the assets.

It could be argued that investments are the most valuable and dependable source of bank liquidity in a stress event and as a result the AOCI treatment is appropriate. We would expect that updated liquidity guidance and regulations expected in 2013 will use some form of the Basel Liquidity Coverage Ratio to set minimum levels of highly liquid unencumbered marketable securities. Once an institution passes the LCR test, why would it matter whether other assets are in loans or in AFS securities? The unintended consequence of this portion of the proposed regulation is that it strongly suggests that banks should take their interest rate risk in the loan portfolio, not the investment portfolio. The natural reaction by banks hearing this message would be to portfolio long term fixed-rate consumer, commercial and agricultural real estate loans. Why that activity would be encouraged in the Basel III NPR as opposed to holding the same assets in securitized form escapes me.

Impact of Changes to Risk Weights Under the Standardized Approach NPR

The first issue in this section is the complexity and cost of regulatory compliance. You don't need to look any further than the model recently issued by the regulatory agencies for evidence of the complexity of these changes, especially the treatment of mortgage products. There is a fair amount of supplemental data required to do these calculations in the regulatory model that is not currently gathered on call reports. In my experience in supporting institutions attempting to use our model to perform the same calculations, I found that nearly all found it impossible to come up with accurate breakdowns of mortgage products between Category 1 and Category 2, then by risk weight within each category. Significant changes will be required to call reports and to core systems to support accurate reporting of these breakdowns. That's a big cost given that in many cases the proposed changes are not well thought through and will have significant unintended consequences. These cost increases will be disproportionately punitive to smaller banks.

Finally, we have found the effective date of these changes, which are fully implemented on 1/1/2015, places a huge hurdle in front of institutions struggling to comply. January 1, 2015 is also the date when the new Common Equity to Risk Based Assets Requirement and the changes to the Tier 1 Capital to Risk Based Asset Requirement are fully phased in. Should the risk weight changes in the Standardized Approach NPR be imposed on community banks, they should be phased in gradually over time rather than all at once on 1/1/2015.

An example of a change in risk weights that is not well thought through and will have unintended consequences is the fact mortgage positions other than the first are automatically Category 2 if the institution does not control all the superior positions. The majority of first mortgages originated in this country are sold in the secondary market, meaning the institution taking any second mortgage position is likely to find that position classified as Category 2. Category 2 risk weights range from 100% to 200%.

Capital requirements under Total Risk Based Capital Minimums for well capital status on Category 2 positions would range from 10% to 20%. These capital requirements are commonly used as the denominator by institutions using loan pricing models to calculate ROEs (Risk Adjusted Return on Capital) on various kinds of loans in order to optimize the institution's use of its capital. Double the capital requirement and you cut the

ROE (RAROC) in half. Doing so will cause the bank to take one of two actions. Many will stop offering the loan entirely. Others will raise interest rates and/or fees significantly to hit the ROE goal. Of course to the extent the bank is up against non-bank competitors not subject to the same capital standards, significant increases in rates to meet ROE goals will cause the bank to be non-competitive and to lose the loan. That would be acceptable if the risk weight changes were well thought through and supported by studies on actual loss experience. Let's look at a few situations where the standardized approach changes will cause adverse effects on banks and their customers that would be difficult to justify based on increased losses.

It is a common practice in small business lending to take a second mortgage position on the entrepreneurs home as additional collateral. That position is typically unlimited, running up to the full value of the home. It would be rare for the institution to hold all superior positions when taking the 2nd mortgage position to further collateralize a small business loan. As I interpret the proposed regulation, that would cause the unlimited Category 2 second mortgage position to have a 100% LTV and a 200% risk weight. And the regulation states that if any position of a loan is Category 2, the entire loan is category 2. I fail to see the logic behind penalizing the bank for taking additional collateral on a small business loan by doubling the risk weight of the loan from 100% to 200%. I don't see how taking additional collateral could lead to higher losses. This provision in the Standardized Approach NPR will have a chilling effect on small business lending. Because small businesses create the majority of new jobs in this country it is likely to have a chilling effect on growth of employment and the economic recovery we so badly need.

Of course, this second mortgage position issue leading to Category 2 designation also will have a negative effect on home equity lending. Institutions will be very reluctant to go beyond an 80% LTV in making home equity loans. I'm sure that is the intent of the proposal. However, the consequence will be to limit the consumer's ability to access home equity to deal with a child's college education expense, a medical emergency, the loss of a job, the desire to start a business, and all the other legitimate uses of home equity. Yes, there were some abuses with high LTV home equity lending. But I fail to see how imposing a capital penalty is the best way to approach this issue. It makes little sense that an unsecured loan to a consumer carries a 100% risk weight, while one backed by home equity would have a risk weight of 150% or 200%. Regulators have a reputation for closing the barn door after the cows are gone. But gentlemen and ladies, let's not torch the barn!

This portion of the standardized approach NPR also effectively kills the balloon mortgage by increasing its risk weight to at least 100%. Balloon mortgages are commonly used by banks to manage their interest rate risk in portfolio mortgage lending. I have seen no evidence presented to back up the assumption that balloon mortgage lending leads to significantly higher credit losses in community banks. It certainly leads to reduced interest rate risk!

A factor the regulatory capital model fails to consider is the effect of economic recovery on risk based capital requirements. As the economy recovers assets are likely to move out of the security portfolio (typically 20% risk weight) into the loan portfolio (typically 50% to 100% risk weight). That is a good thing for the economy as increased lending fuels economic recovery, job creation, and a stronger housing market. Combine the natural changes to balance sheet risk weights during economic recovery with the regulatory estimate that risk assets will increase by an average of 20% across the industry on 1/1/2015, a new common equity risk based capital standard, and a significant increase in the Tier 1 Risk Based Standard, and you have a recipe for chilling economic recovery by suppressing loan growth.

We strongly recommend that small to medium sized banks be exempted from the risk weight changes. If that recommendation is set aside in the final regulation, we strongly recommend that changes in the risk weights be phased in gradually rather than suddenly on 1/1/2015. We finally recommend that some of the obvious anomalies in the risk weights be cleaned up so they don't have the unintended consequences laid out in this section.

<u>Will the proposed regulations bring capital into the industry or drive it out?</u>

I have taught Bank Performance Analysis at one of the largest national banking schools for 25 years. In that time, I have never seen anyone refute the financial equation (ROE = ROA x Leverage). There is no question this regulation reduces leverage in the industry, causing a corresponding drop in ROE. It does so in a number of ways.

1. It changes the definition of capital by eliminating some forms of capital and reclassifying others.
2. It imposes a new common equity capital standard. Common equity capital is leverage capital.
3. It increases the Tier 1 Risk Based standard.
4. It further effectively increases the three capital requirements with risk assets in the denominator by significantly increasing the risk assets.

Because I have had the opportunity to look over the shoulder of a fair number of banks as they wrestled with the strategies (growth, earnings, dividends, capital actions, etc.) needed to meet these proposed capital requirements, I've arrived at a number of conclusions.

1. At least among community banks over the first 3-4 years of phase-in, these proposed regulations are likely to lead to suppressed growth rates and possibly shrinkage, reductions to dividends, and an increase in pressure to take on significant risk to improve ROA. In many cases, that follows three straight years of having to take similar actions to deal with asset quality problems.
2. It will be very difficult and in most cases impossible to retire TARP and Small Business Capital. Will that lead to regulators auctioning TARP funds, further diluting the community bank's current stockholder ownership?
3. Community banks will have a very difficult time raising new capital because some forms of capital are eliminated and they will not be able to deliver the returns on common equity capital desired by potential stockholders. Some might argue that all the institution needs to do to offset deleveraging is to improve ROA. Of course those suggesting such a solution fail to consider the loss to net interest margin caused by the shift of assets from loans into investments, the reduction to fee income caused by loss of interchange and ODP income, and the increased operating expenses driven by rising compliance costs.

I fear all this will lead to less capital in the industry rather than more. I find it ironic that in some cases field examiners are telling banks to communicate to their investors that they will need to lower their ROE expectations. Those recommendations show a lack of understanding of capital markets. Capital seeks return. It will be very difficult for banks to compete for capital given the above factors. This set of proposed regulations could well drive capital out of the industry. Regulators need to walk a very fine line between increasing capital requirements to improve the safety and soundness of the industry as opposed to the corresponding negative effect on stockholder return.

My most significant fear is that there will be a very significant decline in the number of community banks in this country because of regulatory burden and the above return to stockholder issues. The offshoot will be fewer small institutions and a greater “too big to fail problem.” Regulators have been asking institutions to reduce concentration risk in their loan portfolios. Yet at the same time the tremendous reregulation of the industry is likely to lead to a much higher level of concentration risk causing our national economic health to become more and more dependent on the health a handful of very large financial institutions.   The risk associated with high levels of concentration was aptly demonstrated by the failure of some very large financial institutions at the beginning of the financial crisis.

But there is another issue associated with increasing consolidation that could have adverse effects on smaller communities. Community banks invest both human and financial resources in the development of their communities. Big banks are far less likely to do so. It is crucial that community banks not suffer significantly more adverse effects from these proposed regulations than big banks. Yet based in these proposed regulations, I fear that is how things will play out due to disproportionate compliance burdens, lower ROEs, and loss of access to capital. Small communities are likely to pay the price.

Regulators need to level the playing field by reducing the burden of these regulations on community banks.

Respectfully,

Tom Farin

President & CEO

FARIN & Associates, Inc.