Citizens National Bank Of Texas

Your Bank Since 1868

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.

Citizens National Bank of Texas has been serving Ellis County, Texas for over 143 years and has remained a cornerstone of stability and prosperity for generations of customers. Although we are 35 miles south of Dallas and Ft Worth, we have preserved our rural identity and lifestyles as the massive Metroplex population has moved south into our countryside communities. The bank has grown to $600 million in assets with 13 branches serving over $440 million in direct loans, $125 million in self originated FHLMC loans, 29,000 personal checking customers and 4,900 business customers. We understand banking and live into a vision of clear commitment to relationships that cover generations of customers and communities. We are a community bank that clearly understands its responsibilities and is committed to investing our customers' deposits wisely and preferably in the same markets from which the deposits were derived. A unique difference in our bank verse the big banks is that 10% of the bank is owned by its employees through an ESOP established in 1988 which we believe helps us all to make decisions like owners with accountability rather than just employees. Ownership coupled with a partnership like relationship with our customers and our communities clearly has helped us all make better decisions as is evidenced given our financial and communities' performance over the last 25 years, but this ill-conceived capital proposal jeopardizes our customers and our communities

[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 Rules: 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.*

access to credit and our ability to bring innovative and cost efficient banking products and services to the market.

Community banking is not a "fair weathered friendship" business but instead represents a relationship that works hand in hand with customers in the best and worst of times. Community banking is much more than just the ratios and metrics of a UBPR or what a financial analyst thinks he or she can gleam from the financial records. Community banking is where the majority of small businesses and families across the country find the means and resources to help make their dreams a reality.

Community banks are not what caused the financial crisis and that fact alone should have exempted us from these capital proposals. Capital levels at our bank, as well as the majority of other community banks across the country, have been higher than any of the big banks and now the Basel III proposal wants to increase them even further with little to no evidence that there is a capital crisis in the community banking industry. Had the regulators held big banks to the same capital levels expected in community banks the financial crisis would have been half as bad. CNB of Texas has operated well above all <u>expected</u> capital levels for over 2 decades and has outperformed our peers since the mid-90s, and yet here we have to respond to this overzealous unsupported call for more capital by our regulators.

The Basel III proposal is completely wrong for our bank and we believe all community banks across the nation. Community banks did not engage in the activities that damaged the largest banks and created panic across the nation. Our bank and other community banks operate on a relationship-based business model that is specifically designed to serve customers and the communities on a <u>long-term</u> basis rather quarter by quarter. This model contributes to the success of community banks all over the United States through practical, common sense approaches to managing risk in spite of what the regulators seem to imagine. The proposal should not include community banks, and I am not remotely convinced it will do anything to correct capital inadequacy for the big banks. The analysis used to initiate Basel III seems to be nothing more than a knee jerk analysis with little support or documentation identifying the real problems that impacted capital.

Looking back today it is clear that the banking industry has recovered and paid for it losses just as it did in the 80's financial crisis. The surviving banks in the industry have paid for this crisis through increased insurance premiums to the FDIC just as we did in the financial crisis of the late 80's. The safety net seems to have clearly worked again, and the entire cost has been born by banks not the tax payers.

The simple solution is banks that engage in risky activities should be required to have higher capital levels. Based upon our experience, the OCC has had no problem demanding us or other community banks to keep higher capital levels when they became concerned, however, they don't do the same with the big banks. If the regulators would just apply the existing capital rules and risk analysis techniques to the big banks, we would have considerably mitigated this past financial crisis. For the regulators to propose a new set of capital rules including community banks when they won't apply the current rules they enforce against community banks to operate under, clearly indicates the disingenuous nature of this proposal and or lack of experienced oversight. Another factor could be that the majority of the experienced oversight folks never

anticipated something being conceived in Geneva Switzerland for international banks would ever be proposed to include a community bank which is clearly the case for our bank management as well as the entire community banking industry.

None the less, the new standards will remove sources of capital with the TRUPS phase out and increase capital standards significantly in our bank which will make it even more difficult to continue making good, common sense loans which will negatively impact our customers and the communities we serve. Even in its most simple cause and effect analysis, it is very clear that the burden of more capital will raise costs which will make lending more expensive and less accessible resulting in our customer and communities being hurt even further by the financial crisis and regulatory overreach. Inclusion of community banks into the Basel III proposal is nothing more than punishment being levied against the banks which ultimately punishes our customers our and our communities as a result or justification of poor risk management practices of the big banks and the poor supervision of the regulators.

We will discuss 7 points in greater detail to help substantiate our justification of being exempt from Basel III, but the simple facts are community banks should not be included in the Basel III proposal. Basel III is bad for our customers, our communities and our employees because it makes it even more difficult for small businesses and CNB of Texas to compete against the big banks. This proposal will curtail small business access to loans and capital which will continue to erode jobs and opportunities for customers to pursue their dreams.

Community Banks should be Exempt from Basel III

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. Capital levels across the entire community banking sector already operate at higher levels than that of big banks. The current capital rules have performed well throughout the community banking sector through some very turbulent financial times. Big banks have always been thought to possess higher levels of expertise and sophisticated systems which supported there lower capital requirements but the last 5 years have made it clear that this is a flawed assumption. Basel III may be a step in the right direction for the inadequacies present in big banks but inclusion into community banking strays considerably from the focus Basel III intended for a comprehensive set of international capital standards worldwide. To assume that it will work for smaller banks borders on complete negligence on the part of the regulators. The two business models are very different, and if the regulators truly lived into their comments that they understand community banking, this proposal would have never been published to include community banks.

Incorporating AOCI as Part of Regulatory Capital

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 $2.5 million. This would mean 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, options, and futures contracts. Community banks do not have 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. Again the existing systems in community banks have been more than sufficient to protect the majority of the community banks through this last financial crisis.

Capital Conservation Buffers

Implementation of the capital conservation buffers for community banks will be difficult to achieve under the proposal and therefore should not be implemented. Many community banks will need to build additional capital balances to meet the minimum capital requirements with the buffers in place. Community banks do not have ready access to capital that the larger banks have through the capital markets. The only way for community banks to increase capital is through the accumulation of retained earnings over time. Due to the current ultra-low interest rate environment, community bank profitability has diminished further hampering their ability to grow capital. If the regulators are unwilling to exempt community banks from the capital conservation buffers, additional time should be allotted (at least five years beyond 2019) in order for those banks that need the additional capital to retain and accumulate earnings accordingly.

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. 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. 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.

Proposed Phase-out of Trust Preferred Securities

We object to the proposed ten year phase-out of the tier one treatment of instruments like trust preferred securities (TRUPS) because it is a reliable source of capital for community banks that would be very difficult to replace. We believe it was the intent of the Collins amendment of the Dodd-Frank Act to permanently grandfather tier one treatment of TRUPS issued by bank holding companies between $500 million and $15 billion. Phasing out this important source of capital would be a particular burden for many privately-held banks and bank holding companies that are facing greatly reduced alternatives in raising capital. Our bank would experience a 21% reduction in capital which would significantly reduce lending activity and our ability to serve our community's needs. Couple this reduction with the proposed risk weight increases we would be crippled severely which would significantly reduce our ability to meet our community loan demands as well as force us to severely curtail our community investment activities which are over $300,000 a year as well as considering discontinuation of our $150,000 in annual college scholarships. While we applaud the fact that TRUPS issued by bank holding companies under $500 million would not be impacted by the proposal, consistent with the Collins Amendment, we urge the banking regulators to continue the current tier one treatment of TRUPS issued by those bank holding companies with consolidated assets between $500 million and $15 billion in assets.

Mortgage Servicing Rights

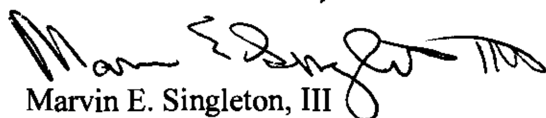
Penalizing the existing mortgage servicing assets under the proposal is unreasonable for those banks that have large portfolios of mortgage servicing rights. Any mortgage servicing rights existing on community bank balance sheets should be allowed to continue to follow the current risk weight and deduction methodologies. Our mortgage servicing portfolio consists of FHLMC and FNMA loans originated to our loan customers unlike the big banks. The community banking model is about relationships not transactions thus our mortgage servicing portfolios are our customers and we should be allowed to continue to count this in capital. The removal of this

takes another $1 million in capital away from our bank which reduces our ability to meet our customers' demands in loans and deposit products.

Subchapter S Community Banks

Imposing distribution prohibitions on community banks with a Subchapter S corporate structure conflicts with the requirement that shareholders pay income taxes on earned income. Those banks with a Subchapter S capital structure would need to be exempt from the capital conservation buffers to ensure that their shareholders do not violate the provisions of the Internal Revenue Code. We recommend that the capital conservation buffers be suspended during those periods where the bank generates taxable income for the shareholder.

Sincerely,



Marvin E. Singleton, III

President/CEO