October 17, 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. After careful review of the proposal, it is my strong opinion that the proposal will have gravely detrimental effects on community banks and on First State Bank in particular.

First State Bank, the oldest state bank in Texas, is a community bank in North Texas and serves suburban and rural areas north of the Dallas-Fort Worth metroplex. We have been run with conservative values and community ownership and management for over 100 years. We provide massive support to our community through small business lending and community support in both dollars and man-hours to area not-for-profit entities. Without our bank, our area would suffer a great reduction in quality of life and economic growth. It is my belief that three provisions in particular, the inclusion of Accumulated Other Comprehensive Income (AOCI), the Dividend Restriction, and the proposed Risk Weighting would greatly reduce our ability to serve our community.

Inclusion of 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

[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.*

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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 First State, if interest rates increased by 400 basis points, my bank's bond portfolio would show a paper loss that would require an additional $17,000,000 in capital for First State to remain Well Capitalized under Basel III. This is a drop of 30% of our capital compared to the current calculation.** 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 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.

Subchapter S banks, like First State, have unique tax treatment compared to other financial institutions. Since income is passed-through to shareholders, many of whom have small income relative to their share of income from their stock, the tax burden can be insurmountable if the bank is not allowed to pay out dividends at least equivalent to the maximum tax liability to the shareholder. This dividend restriction makes sense for publicly traded institutions, but coupled with the above AOCI inclusion could result in a massive wave of community bank sales just to avoid bankrupting shareholders when interest rates return to normal levels. Banks like First State with Subchapter S status 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. I recommend that the capital conservation buffers be suspended during those periods where the bank generates taxable income for the shareholder.

The proposed risk weight framework under Basel III is too complicated and will be an onerous regulatory burden that will penalize community banks like us and jeopardize the housing recovery. Our existing software is not even capable of tracking these ratings, and will require significant investment both upfront and on an ongoing basis. Additionally, 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. 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.

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 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.

Sincerely,

Ryan Morris
Executive Vice President
First State Bank