Bayport
950 N. Hwy 95
Bayport, MN 55003
p) 651.439.5195
f) 651.439.4027

Oak Park Heights
5891 Neal Ave. N
Oak Park Heights, MN 55082
p) 651.439.2655
f) 651.351.3745

Stillwater
125 New England Pl
Stillwater, MN 55082
P) 651.439.7072
f) 651.275.1060

Trust Services
p) 651.351.3760
f) 651.439.3835

Boutwells Landing
Oak Park Heights
p) 651.275.5050
f) 651.275.5051

Hudson
219 2nd Street
Hudson, WI 54016
p) 715.808.8183
f) 715.808.8179

October 19, 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.

While oversight and regulation of the financial institutions industry is a key component for a stable and viable economy, over regulation as well as burdensome compliance requirements on community banks can hinder economic growth specifically to small and local businesses.

After reviewing the proposed standards, we believe implementation of certain proposed Basel III standards will have a significant adverse effect on community banking organizations. As a stable and long standing community bank, we see firsthand the benefits our bank provides to our community including local business owners and individual customers. Implementation of the proposed Basel III regulations would create significant barriers and will restrict community banks from providing competitive and local services to local communities. Specifically, as outlined on subsequent pages, we believe the following components of the Basel III proposal will have the greatest negative impact on community banking organizations:

[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.*

- **Inclusion of other comprehensive income in capital.** By including changes in other comprehensive income within capital ratio calculations, Basel III will add a significant amount of volatility to capital ratios of community banks. Added volatility will add uncertainty to the market and may result in noncompliance outside of the bank's control. Inclusion of unrealized gains and losses will penalize community banks for macroeconomic changes. Currently, the most significant component of other comprehensive income for many community banks is the investment securities portfolio. Generally, community banks take a conservative approach to their investment securities portfolio with investments comprised of government backed and high quality municipal securities. Most of the changes in market value related to these investments are the result of interest rate changes and not credit risk changes. As a result, it seems inappropriate to include market changes in capital ratios for high quality/low risk securities. Additionally, we believe there are current safeguards in place to mitigate risks to capital related to volatility in components of other comprehensive income. Community banks are generally subjected to regulatory examinations on a minimum 18 month cycle. As part of these examinations, regulators evaluate each bank's sensitivity to market risk as well as asset quality. Both of these components consider risks within the investment securities portfolio. In the event sensitivity to market risk or asset quality is not satisfactory, a community bank may be required to maintain higher capital levels. Inclusion of other comprehensive income components within capital ratios will add a second layer of regulation to affected assets and liabilities that does not appear to be necessary. Additionally, inclusion of other comprehensive income will encourage banks to elect "held to maturity" designations for investment securities. As you are aware, this accounting provision eliminates the other comprehensive income component within equity and will prevent capital volatility for banks under the Basel III proposal. However, the downside of this designation is that "held to maturity" investment securities cannot be sold for general liquidity purposes. Therefore, allocation of bank assets for community lending purposes will decease as banks are unable to liquidate investment securities portfolios in the event of an increase in lending demand. Volatility related to macroeconomic changes, particularly interest rates will subject community banks to excessive liquidity management and may further reduce already tight interest margins through reliance on more liquid investments.

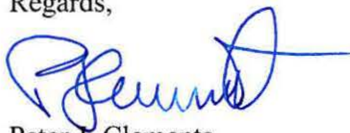
- **Changes in risk weights.** Our bank prides itself on providing stable and local mortgage products to our customers. When customers borrow from us, they are using local funds to purchase local products. We have invested significant time and energy in the development of mortgage products that keep our bankable funds local. Our main mortgage product includes a "balloon" feature at loan maturity. This balloon feature was developed for both internal and external reasons. Internally, a balloon feature allows our bank to better manage interest rate risk as well as have more regular contact with our customers. The balloon feature also provides us with the opportunity to review and reunderwrite mortgages at maturity date. We believe this provides us with a better ability to recognize and adjust lending practices to mitigate losses due to macroeconomic changes including unemployment and real estate prices. This product provides benefit to our customers in that they have a local resource to obtain funds and have flexibility to regularly change or redesign their mortgage needs. 30 and 15 year fixed rate mortgages, while providing stable interest rates, often do not allow homeowners with the flexibility to make changes to outstanding loans during the repayment period. Balloon mortgages provide flexibility to homeowners to adjust or modify lending needs on a more frequent basis. Under the Basel III proposal standards, our bank will be penalized from a capital standpoint for offering these types of loan products. This penalty will result in a significant change in our loan products offered and will most likely increase the cost of these products which would result in higher interest rates charged to customers. Our economy just went through one of the toughest economic times in the history of the U.S. During that time, our bank

was not exempt from mortgage defaults and losses. However, in evaluating our bank's performance as compared to peer data, we noted that our losses were significantly less on our real estate loan products. We believe this is partially due to the development of our balloon loan product that provides us with greater flexibility to reprice and reunderwrite each loan on a more frequent basis. By penalizing balloon products within capital ratios, you will require us to develop new longer term mortgage products. This will result in higher interest rates and loss risk in the event of another economic downturn. Additionally, it will subject our organization to long term interest rate risk. We believe balloon loan products are prudent lending products that provide communities and banks with many benefits.

- **Past due and non-accrual loans.** Under the Basel III proposal, loans over 90 days past due or on non-accrual will be assigned higher risk weightings for capital purposes. While we do agree that higher risk loans should have higher capital requirements, we believe the proposed standards fail to recognize the current accounting rules and regulations to manage higher risk loans. Currently, we complete a detailed allowance for loan loss analysis which specifically evaluates higher risk loans. In the event we deem a loan to be impaired, we adjust our allowance accordingly to reflect the estimated loss. Generally, our impaired loans are loans that are significantly past due or on non-accrual. These estimated losses are provided through a reduction to our current year earnings which in effect reduces our regulatory capital ratios. Under the Basel III proposal, not only will we continue to be required to evaluate loans within our allowance for loan losses and provide for losses through current year earnings, but we will also be penalized through higher risk weightings on these problem loans. It appears this component of the standard adds a "double taxation" to problem loans. As a result of this "double taxation", we will be required to maintain significant excess capital levels that are not necessary to cover expected losses.

Based on our comments above, we are requesting that you reconsider and/or modify several component of the Basel III proposal. Full implementation of Basel III will have an adverse effect on community banks and will lead to higher borrowing costs for small businesses and individuals.

Regards,



Peter J. Clements
President/CEO
First State Bank and Trust
Bayport, Minnesota

Andrew Rollwagen
Senior Vice President
First State Bank and Trust
Bayport, Minnesota

Jason Howard, CPA
Vice President
First State Bank and Trust
Bayport, Minnesota