Security Bank

October 22, 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 approved by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (collectively the "banking agencies").

Security Bank is a community bank with total assets of $160 million serving a three county area of Northeast Nebraska with branch locations in five small rural communities. Our primary business lines are agricultural and ag-related businesses. We do however provide 1-4 family residential loans over our trade territory.

We believe the new capital proposals:

□ Do not protect the FDIC Fund;
□ Do not protect community banks from failing; and
□ Do not deter community banks from assuming excessive risk.

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[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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We are also concerned that the implementation of the Basel III proposal will have a dramatically negative impact on the willingness of community bankers to serve their communities especially in many communities where no other banking and credit alternatives exist.

In many Nebraska communities, the local bank is the only source of mortgage credit. These rural mortgage loans are retained by a bank in its portfolio because they cannot qualify for the secondary market, nor do such loans attract the interest of larger institutions. For safe and sound reasons, the bank will not make a 15 or 30 year fully amortizing 1 to 4 family mortgage loan that is held in the bank's portfolio. Therefore, under the Basel III proposal, these loans will not fit within "Category 1" risk weighting. Instead, these soundly underwritten loans (HELOCs, balloon payment ARMs, *etc.)* will be Basel III "Category 2" mortgages with a risk weight of up to 200%.

Additionally, although community banks may hold only 10% of the nation's banking assets, they provide 40% of the small business loans-often secured by second liens and HELOCs. The Basel III risk weighting will eliminate a reliable business line for community institutions and an important source of credit for consumers and small business owners. It will not protect against increased risk to community banks nor will it result in stronger capital for community banks. The reality is that the Basel III risk weighting formula is a reaction by the international community to a real estate bubble that has long since burst and that never existed in Nebraska.

The Impact of Available-for-Sale (AFS) Gains or Losses on Tier 1 Capital

How can one area of the balance sheet have an impact on Tier 1 capital when the rest of the balance sheet is ignored? The proposed treatment of "comprehensive income" in the new capital proposals ignores how community banks balance their risk. In one sense, the regulators have focused directors and management on asset liability management. We are proponents of this focus. Directors and management have learned that interest rate risk on capital, earnings, and liquidity can be balanced in a way that is profitable and has less risk. The new capital proposals, however, ignore the approach of analyzing all assets and liabilities. The new capital proposals focus on the AFS investment portfolio for community banks.

For instance, Security Bank has more than 70% core deposits to total deposits. Our bank has a very stable deposit base. The positive liability structure gives us flexibility within our investment portfolio. When the board of directors reviews this bank's asset liability model, the bank's risk is very balanced in a rising interest rate environment. Its economic value of equity (EVE) capital is very strong and very stable under shocks and interest rate simulations. If the new capital proposals are effectuated, our bank will not be balanced for Tier 1 capital and its board of directors will be forced to manage the investment portfolio in order to manage Tier 1 capital. For our bank, this new capital proposal would potentially reduce our central focus of making loans to members of our communities.

Security Bank is a Sub Chapter S bank. As such we will have the additional impact of not being able to reduce the AFS portfolio losses with a deduction for taxes. If our AFS portfolio is at a loss, the entire loss is deducted from Tier 1capital. Security Bank would be at a disadvantage to other community banks that are able to deduct the tax on any losses on the AFS portfolio.

The new capital proposal for community banks' Tier 1 capital ratios could be very volatile if interest rates change. While this is the case with equity to assets, the volatility has been confusing to the public. If the new capital proposals take effect, the public will be even more confused and may even question a bank's viability. This reputation risk could cause a "run on" deposits and a loss of customers.

The Impact of the Capital Proposals on Longer-Term Investments

Another risk presented by the proposed capital requirements is they could cause community banks to reduce their holdings of longer-term US Agency debt, US Agency mortgage-backed securities, and municipal bonds. As of the second quarter of 2012, community banks with assets up to $5 billion had the following holdings:

US Agency Debt $375,546,812,000;
US Agency mortgage backed securities $269,961,636,000; and
Municipal bonds $114,907,661,000.

Community banks typically purchase the debt of the US Agencies. Community banks may be forced by the capital proposals to reduce or even eliminate the longer-term maturities. This would have the potential to negatively impact earnings. Potentially, the mortgage markets could be impacted because the US Agencies tend to pass on the higher cost of their debt, as well as increase mortgage rates and fees charged to consumers. The community banking industry not only sells mortgages to the US Agencies, but purchases these securities for their investment portfolios. US Agency mortgage-backed securities tend to be longer-term investments with higher market volatility. Community banks may be forced by the capital proposals to reduce or even eliminate these holdings. This would have the potential to negatively impact earnings. As stated previously, there is also the potential that it could impact the mortgage markets and increase the mortgage rates charged to consumers.

Many community banks purchase bank-qualified tax-exempt municipal bonds. These bonds also tend to have longer maturities. Historically, bank-qualified municipal securities have a lower cost than general market municipal securities when issued. This saves small communities on the cost of building their schools, water systems, sewage systems, etc. Community banks purchase bank-qualified tax-exempt securities because the tax savings are inherent to bank-qualified municipal securities versus general market municipal securities. Community banks may be forced by the capital proposals to reduce or even eliminate these holdings. This would also have the potential of reducing their earnings. Moreover, there is also the possibility that the markets could be disrupted leading to a higher cost of debt for our nation's small municipalities.

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What's more, community banks often purchase taxable municipal securities. Again, these bonds tend to have longer maturities. Community banks may be forced by the capital proposals to reduce or even eliminate these holdings with the potential of reducing their earnings. Likewise, the markets may be disrupted leading to a higher cost of debt for our nation's municipalities.

Alternate Capital Proposals

If the regulators consider alternate capital proposals, we respectfully request they consider creating capital requirements which are geared to the community bank business model. The community bank business model is very different than the money center bank, regional bank, or international bank.

Alternate capital proposals for community banks should focus on traditional, conservative community banking. There should be components that include "community banking" credit risk, liquidity risk and earnings at risk. National economic risk and state economic risk should also be considered. If a community bank chooses a business strategy that is an outlier to the traditional, conservative community bank business model, it should be required to have significantly higher levels of capital.

Whatever alternate capital proposal is pursued, regulators should consider eliminating the current minimum capital requirements. All of the failed banks met the minimum capital requirements at some point in time, but as their issues increased, they did not have enough capital to adequately cover their risks.

The central philosophy of an alternative capital proposal for community banks is to foster a wiser, conservative risk management process at each community bank. If a community bank board understands that an increase in risk will mean additional capital will need to be raised, it may not agree to take on that additional risk or will pursue the riskier strategy in a different manner. For instance, there is a "myth" in the community banking industry that making more loans will create more earnings. There is no historical correlation to this strategy. Yet, if a board is faced with raising more capital for this strategy, it may come to the conclusion that the additional earnings and funding of the loan loss reserve will not create the expected return on capital. The point is, the analysis and discussion will result in a higher level of due diligence on behalf of the board of directors with capital being the motivating force.

The regulators should also consider working in concert with community bank directors, management, and outside experts. Considering that community banks contribute to the FDIC Fund, they should have a say in how that fund is protected.

Alternate Capital Proposal 1

EVE is an alternative capital calculation that is approved by the regulators but is not used for regulatory capital. EVE calculations are in place at all community banks. EVE values the entire balance sheet. Based on the type of balance sheets that the failed banks had, the failed banks would have had relatively low EVE ratios as a percentage of capital. On the other hand, conservative community banks with large core deposit bases will have higher EVE ratios.

A minimum threshold for EVE ratios could be set. Liquidity risk and earnings at risk are currently stress tested by most asset liability models and could be incorporated into the EVE ratios. A separate test for credit risk could be utilized with the EVE ratio. This would involve a credit stress test of each community banks loan mix. Once again, a minimum threshold could be set based on the impact of the stress tests.

Alternate Capital Proposal 2

Utilize an independent, third-party assessment of risk. An independent, third party could remove the onus between the regulator and the community banker by providing a risk model with known inputs and results. The model would also have proven back testing to determine how effective it is in predicting bank failures and significant issues with community banks.

Based on the risk assessment, community banks would be required to have minimum capital requirements based on their risk score. The risk score for each bank would be updated quarterly. Community banks and the regulators could monitor the risk scores. Since the inputs would be understood, community bank directors could do "what if" scenarios to determine their future risk scores based on their strategic plan. Actions could be taken to increase or decrease risk accordingly to meet targeted capital levels.

Regulators could monitor risk trends in each community bank, by region, by state, and on a national level.

As an example of an independent, third-party assessment of risk, the Seifried & Brew Total Risk Index ("S&B Risk Index") assesses capital risk, credit risk, earnings at risk, liquidity risk, national economic risk, and state economic risk. Security Bank has been using this tool for several years and has found it a very effective tool for management and the board of directors to monitor risk and performance trends and as an early warning system. The S&B Risk Index gave early warning signs to the banks that failed during the Financial Crisis long before they failed. In 2009, the S&B Risk Index predicted 99.15% of community banks that failed in 2010. The S&B Risk Index accurately determined that these banks were operating with higher risk versus all community banks in the nation that weathered the storm. In fact, going even further back, the S&B Risk Index could predict:

In 2008, 91.4%,
In 2007, 86.4%,
In 2006, 81%, and
In 2005, 71.7%

of those banks that ultimately failed in 2010.

Of all the community banks that failed during the Financial Crisis, the S&B Risk Index predicted approximately 97.5% a year in advance, 90.2% two years in advance, 80.5% three years in advance, and 75% four years in advance! Using the S&B Risk Index would have given these banks insight long before the issues of higher risk resulted in the losses that eroded the banks into failure.

S&B believes that economic risk must be quantified by community banks and, as such, national and state economic risks are factored into the S&B Risk Index. One of the lessons learned from the Great Recession is the erosion of the economy was not consistent nationwide. For example, the Texas economy was relatively unaffected while one state away, in Arizona, the economic downturn was severe. Therefore, a community bank operating in Arizona had different issues than a similar bank operating in Texas. Because the S&B Risk Index incorporates both a national economic weighting as well as a state economic rating, it is a good predictor of risk to banks no matter where they are located. Neither the current minimum capital requirements nor the proposed capital requirements take the economic impact into consideration.

Alternative Capital Proposal 3

Under this proposal, we suggest keeping the current capital regulations the same. Currently, community banks with up to $5 billion in assets have an average Tier 1 capital ratio of 9.69% and a Total Risk-Based capital ratio of 15.49%. Many community bankers argue that this is more than sufficient capital.

We hold that segmenting the banking industry by size and exempting all banks under $5 billion dollars in assets from the new capital standard. The record from the recent past is very clear; the net charge-offs of the largest banks were much higher than those of the community banks. We argue that if the currently existing community banks had insufficient capital levels, the latest economic downturn would have most certainly exposed the deficiencies in the existing capital rules. By imposing the higher capital requirements on all banks, across the board, seems to us to be inappropriate. Further, the higher requirements could lead to the unintended consequence of significant attrition of community banks; with severe economic consequences to the communities they serve.

As in our other alternate capital proposals, we believe that community banks need dynamic risk-based capital requirements that will protect the community banking industry and the FDIC Fund.

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Summary

The new capital proposals are not geared to the community banking industry. The community banking industry needs a risk-based capital system that will protect and nourish each individual community bank. Each community bank must have capital requirements that cover the risk tolerance of the board. Low- risk banks should be awarded with lower capital requirements. Higher risk banks should require more capital. However, the level of capital required cannot remain static; the requirements must be dynamic to support the level of risk taken on by a community bank either directly through its strategic plan or indirectly as a result of economic changes. The risks that need to be properly capitalized are credit risk, earnings at risk, liquidity risk, national economic risk and state economic risk. The new capital proposals do not address these issues.

The AOCI provision is a matter of great concern, both in terms of creating significant volatility and inconsistency in reported ratios and in potentially introducing economically unsound decision-making constraints. As a result, we do not believe that AOCI should be included as a part of regulatory capital. We also believe that the Capital Conservation Buffer should be limited to 2.0 percent and incorporated as part of the existing PCA capital framework. Further, there are several provisions of the second proposal, the Standardized Approach NPR that, if left unadjusted, could also create inaccuracies and inconsistencies in the reported ratios, particularly the risk-based adjustments for mortgage exposures and past-due loans and the potential shortcomings in the securitization valuation approach.

Security Bank appreciates the opportunity to comment on this proposal. If you have any questions or would like additional information, please do not hesitate to contact me at 402-256-3247.

Sincerely,
SECURITY BANK

Keith Knudsen
Executive Vice President

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