November 9, 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. Though the proposed Basel III guidelines will affect all banks, this letter will focus on the effects to community banks, specifically ours; First Community Bank and Trust headquartered in Beecher, IL.

Our bank is located 38 miles directly south of Chicago, IL. Our local and regional economy was decimated by the fallout caused by the foul play of a handful of mega banks that helped to start the recession in 2008. Local municipalities are witnessing record foreclosure rates, area real estate values have seen some of the largest declines in the country and the consolidation of banks have disadvantaged the consumer due to less competition. Within 10 miles of our bank, two other institutions have been put into receivership by the FDIC. We want to help these consumers, but the increasing regulatory burden harms our ability to do so.

Three areas of the proposed Basel III rules will make it substantially more difficult to engage and bank new (and existing) customers without negative effects. The AOCI, increased weight risks for balloon mortgages and increased risk weights for past due loans.

**Accumulated Other Comprehensive Income (AOCI)**

Bank investment portfolios are structured carefully over many years, even decades. The goal of supporting bank liquidity needs is balanced against interest rate risk management and providing

[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.*

a risk adjusted return that supports the overall profitability of the bank. Including the unrealized gains/losses in a capital ratio will move these very important goals of a bank's investment portfolio behind a new number one goal of managing a bank's portfolio...what impact will it have on my bank's capital ratio? Community banks hold securities as available for sale ("AFS") to maintain maximum flexibility for liquidity needs, not for active trading. In most cases at our institution, securities are owned until their maturity, which means our unrealized gains/losses are never recognized. Under the proposed new rules, in a rapidly rising interest rate environment, unrealized losses would quickly erode bank's capital. Given that this proposal is being offered in a historically low interest rate environment, banks are seeing the best case scenario when modeling their prospective BASEL III capital levels. The capital erosion that would be caused in the next rising rate environment has more to do with the fact that community banks were forced to invest in a market that has seen unprecedented manipulation to keep rates at unusually low levels in an attempt to bring our country out of a prolonged economic downturn. This is the worst possible time to introduce AOCI as a component of risk-based capital.

**Increased risk weights for balloon loans**

Balloon mortgages have been made for many decades to borrowers who own properties that do not conform to traditional secondary guidelines. Mega banks, who focus on transaction based rather than portfolio based mortgage lending, have turned their backs on these types of borrowers, which can be found all over rural America. Community banks thrive on these types of borrowers as they are our neighbors and in many cases, the cornerstones of small town business and residential areas. Community banks do not have the ability to take on the interest rate risk of longer term, fixed rate mortgages. Balloon loans are the only way to avoid this interest rate risk, serve the local customer efficiently and avoid criticism by regulators for taking on the excessive interest rate risk that would be part of holding long term fixed rate mortgages on the bank's balance sheet. In the community banking sector, balloon loans are prudently underwritten and managed. They were not the cause of the significant economic downturn in the real estate markets and as a result, should not be singled out in the proposal with higher risk weights. Community banks provide affordable financing for home and business owners, but if higher risk weights are applied to balloon mortgages, community banks will be forced to reevaluate whether they are able to stay in these business lines due to the increased regulatory capital requirements. Consumers and small business owners will be negatively impacted by this proposal as many of their properties do not fit into the guidelines mandated by the cookie cutter long term mortgage markets.

**Increased risk weights for past due loans**

Increasing risk weights for past due loans assumes bankers are hiding problem assets from their watch list. Loans on a bank's watch list are analyzed individually for impairment and any valuation shortfalls on these loans are specifically impaired and reserved for in the bank's ALLL. By increasing risk weighting for these loans, banks will be "double counting" these exposures as they are already being reserved for in the quarterly ALLL calculation. Community banks are even better prepared to properly account for these risks because we are closer to these customers and the actual property values being used to calculate any impairment required.

A bank needs the ability to properly account for shortfalls in their problem loan portfolio without the fear of having to hold additional capital on these loans. If not, a bank would, in many cases, be better off foreclosing on problem loans instead of trying to continue to help a (perhaps) temporarily, struggling borrower.

Additionally, the 1.25% ALLL disallowance already puts banks that have aggressively contributed to their reserves at a disadvantage. A bank's capital position that is currently being hampered by the ALLL disallowance would be further impacted by the newly proposed risk weights. The historical and specific reserves in a bank's ALLL are the consideration for the risk a bank has in their loan portfolio. Additional provisions to this risk through higher risk weighting are duplicative and unnecessary. To force banks to hold more capital under increased risk weightings while already disallowing the capital they have already reserved is extremely disadvantageous.

**Summary and conclusion**

The NPRs are proposals that do not consider how community banks and larger regional / mega banks differ. Our balance sheets are far simpler and more transparent. Decision making management knows their customer base and can already accurately account for shortfalls in loan portfolios, which are then captured in appropriately set loan loss allowance calculations. The increased staff that would be required to segment the bank's loan portfolio at the level these proposals require would provide limited additional benefit and would be a very significant waste of already strained community bank resources.

These BASEL III proposals were originally intended for large, sophisticated, internationally focused institutions. Applying them to community banks is a grave mistake, and we respectively request that the NPRs are completely withdrawn and reconsidered or at minimum, exempt community banks.

Sincerely,

Greg M. Ohlendorf
President & CEO
First Community Bank and Trust