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 issued for public comment by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.

I believe that small community banks like ours should be allowed to continue using the current Basel I framework for computing their capital requirements. In our business the vast majority of our real estate portfolio is originated as three year and seven year balloon mortgages. The main reason for this is to help mitigate interest rate risk in our portfolio. We also originate secondary market loans for our customers that prefer a fixed rate mortgage product. This type of mortgage is sold into the secondary market as we are unwilling to add this type of interest rate risk into our balance sheet. This has been a good balance for us but with the additional burden of the risk weights in the balloon category, I fear that we will have to seriously consider changing our business model when it comes to mortgage lending. I do not believe this will serve our local market well. In practice the mortgages that we originate to be sold onto the secondary market are cookie cutter loans. One size does not fit all. For the population of customers that do not fit into this very specific mold the bank has been able to fill this void and accommodate our customer's needs. I fear that the addition of Basel III with the increased burden on balloon mortgages will eliminate the viability of continuing in this type of lending which has served our customer base well for several years.

Under the proposed rules for Basel III there is also a new treatment of non-residential loans that are over 90 days past due. This type of loan will impact the bank on two levels. Under the current rules, the risk weight of a loan does not change when the loan becomes delinquent and the risk is addressed through the allowance for loan losses. Through this process the bank incurs

---

[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.*

additional expense to fund the reserve because of the delinquency. The new proposal would change this approach by assigning non-residential loans over 90 days past due a risk weight of 150%. There does not appear to be any rules or regulation that will take away this treatment of reserve for loan losses so in essence we are paying for the delinquent loan on two levels. The ALLL and the higher risk rating will discourage our bank and other community banks from underwriting some loans that we now are willing to take on. It would also make it more difficult to pursue workout strategies in difficult situations.

I spent a considerable amount of time using the FDIC's estimation calculator to try to gauge the effect that will be produced on the banks capital structure. I must say the that effort involved in trying to pull this data on our existing core application software was extremely tedious and I found for the most part the data that was produced from my analysis was not very meaningful or estimates at best. To accommodate Basel III there will undoubtedly be several thousands of dollars spent on man power and software to implement procedures to accommodate 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. 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.

The inclusion of accumulated other comprehensive income in our capital mix will greatly increase the volatility in regulatory capital balances and under a period of rapid interest rate growth we could see a considerable amount of capital depletion in a very short period of time. Accumulated other comprehensive income for our bank is 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.

In summation I think it comes down to this. In our recent past we have seen some very poor practices that have led to devastating results to our financial system. There needed to be a reaction to the recent financial collapse and rightly so. I appreciate the efforts that our

government officials are making to prevent this problem from occurring again. With that said what I find very disturbing is that the regulations are having a sweeping affect on all financial institutions lumping the small community bankers into a group with the very large highly complex financial institutions. This simply is not right. Basel III was meant to be implemented for highly complex institutions to put measures in place to try to prevent another financial meltdown. I do not believe that our legislatures meant for this wide sweeping approach and I ask that you consider allowing small community banks to continue to use Basel I when computing their capital requirements.

Respectfully,

Jamie Collier
President and CEO
Federation Bank