October 22, 2012

Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
(R 7100, RIN AD87)

Office of the Comptroller of the Currency
250 E. Street, SW
Washington, DC 20219
(RIN 1557-AD46)

Federal Deposit Insurance Corporation
550 17th St, NW
Washington, DC 20429
RINs 3064-AD95, 3064-AD96, and 3064-AD

RE: Basel III Capital Proposal

Ladies and Gentlemen:

We appreciate the opportunity to comment on the Basel III proposal. Overall, it is our opinion that the proposed rulemaking makes it much more difficult for the public and outside directors to understand the true health of a financial institution, places Community Banks at a competitive disadvantage, and will have significant unintended consequences related to many of the provisions.

While there are multiple provisions in the proposal that seem overburdening and fraught with unintentional consequences, we would like to focus on the following:

1) Credit-enhancing representations and warranties of 1-4 family loans originated and sold required to be included in the total risk based assets
2) Inclusion of securities unrealized gain or loss in common equity tier 1 capital
3) Other issues

Peoples, Inc. is a holding company representing three subsidiary community banks: Peoples Bank, Peoples National Bank and Peoples National Bank Leadville. Collectively the total assets of the three institutions are approximately $700,000,000. This is a 125 year old family owned bank operating in a retail footprint that includes Kansas, Colorado and Northern New Mexico. The bank has been providing 1-4 family loans to customers in a safe and responsible manner for 30 years. It is a core activity of the bank.

Credit-enhancing representations and warranties of 1-4 family loans originated and sold required to be included in the total risk based assets

The proposal requires the application of up to 100 percent credit conversion factor to credit-enhancing representation and warranties. These representations and warranties generally have a limited life as in the case of early payment default clauses. Banks reserve for their exposures of these representations and warranties. A primary concern is the dramatic increase in capital requirements for 1-4 family mortgage loans sold on the secondary market. While the language is ambiguous, it is presumed an institution would be required to increase risk weighted assets by an amount equal to the early payment default and premium refund warranties. As a matter of practice, banking organizations already reserve capital on-balance sheet for both indemnified loans and loans sold with recourse in the form of reserves.

- **It seems reasonable that some amount should be set aside to cover the early payment default and premium refund warranties**
- **It is unreasonable to require an institution to increase risk based assets as if all loans would be repurchased when historical figures show that this happens to less than 1% of loans sold (for our institution).**

The rules do not take into account if and to what level a bank actually keeps a reserve set aside to cover such losses. A resulting consequence is it makes it very difficult for a community bank to originate and sell 1-4 family loans, thereby reducing competition in the market place. The rule provides a competitive disadvantage to community banks that engage in mortgage originations as a core business when compared to larger banks where the requirement has a smaller impact and independent mortgage lenders who are not subject to the same capital limitations as a bank.

Peoples, Inc. is originating and selling an average of $240,000,000 per month. As such it is estimated the bank in any given month may be required increase risk based assets by as much as 720,000,000 assuming an average risk weighting of 75%, this is an increase of 165%. This is not justified given 1) the reserve to cover losses and 2) the historically low occurrences of a loan being required to be repurchased.

We recommend the continuing existing 120 days "safe harbor" for credit enhancing representations and warranties and removing the application for the credit conversion factor. Regulators can then perform periodic examinations of the adequacy of related reserves and reserve process as part of the regular examinations. Should the proposal continue, the proposal must allow for reserves to be added to Tier 2 capital as is currently the case for comparable on-balance sheet exposures and related allowance for loan and lease losses.

Inclusion of securities unrealized gain or loss in common equity tier 1 capital

An additional concern is the inclusion of unrealized gain or loss on securities in common equity tier 1 capital. The effect to regulatory capital due to movements in interest rates has the potential to be disastrous at the individual bank level and to the banking system in general. In addition, the unintended

consequence on the securities market and therefore borrowing rates for consumers could be substantial. This creates unnecessary volatility in the banking organizations regulatory capital ratios.

The fear of regulatory action because of lower regulatory capital driven by an interest rate move, given no other adverse credit or other negative performance of a bank, could drive banking institutions to invest in securities on a short term. A result could be the increase in mortgage borrowing rates due to less demand in mortgage pass through securities. In addition, the concept of lower capital ratios and severe regulatory actions on banks due simply to a movement in market interest rates and due to no change in the actual credit risk or profile of a bank is very concerning.

A larger institution will be able to provide protection to its capital position through complicated derivatives or other actions to offset this risk. This not only provides a competitive disadvantage to community banks, which typically do not have the staff or expertise to hedge this risk, but also has the potential to introduce more complication, confusion and risk into the banking system.

The concept of fair value reporting on the balance sheet has been discussed in great detail in recent years. While it seems appropriate for institutions to provide a picture of its balance sheet marked to current market it is inappropriate to mark a single class of assets to market (historically the assets with the highest credit quality in a bank) and include that in regulatory capital. Furthermore, while these assets are typically held "Available for Sale" for liquidity purposes the reality is that the majority of banks hold these investments to maturity. While not as liquid as securities, bank loans can easily be transferred to other institutions if liquidity is needed yet these are not required to be marked to market.

Other issues

Risk weight increase of loans – Risk weights for properly underwritten mortgage loans are currently more than sufficient. The increase in risk weights of loans, particularly 1-4 family loans, is a blanket approach for what should be more directed and focused. While increased risk recognition of some loans is needed, such as increases in risk weights for substandard or nonaccrual loans, a blanket policy could potentially increase lending costs for consumers and small businesses or decrease lending appetites for banks. In addition, private mortgage insurance should be included in the calculation of the LTV given that banks would not make these loans and investors would not purchase these loans if the private mortgage insurance was not considered.

Limitations on mortgage servicing right valuations – The structure of mortgage servicing is unique to the U.S., as is the importance of MSFs for banks. The existing treatment of MSRs is appropriate for the U.S. system and should continue. If regulators insist upon limiting MSRs on the balance sheet of banks, we would ask that the proposal be changed to increase the allowable ratio of MSRs to Tier 1 capital to at least 50 percent for 1-to-4 single family mortgage servicing as opposed to the proposed 10 percent. The reduction in allowance of MSRs in regulatory capital will push mortgage servicing further into the private sector leaving borrowers dealing with unregulated companies and further limiting banks' ability to generate net income and bring additional capital into the banking industry. Furthermore, this could

serve to reduce a bank's customer base and create another competitive disadvantage to the banking industry.

Competitive disadvantage of community banks – As is inevitable with a massive increase in regulation requiring much improved data gathering systems smaller banks are at a major disadvantage. Larger, more complex and risky institutions with more resources will be able to find the loopholes and engineer new financial assets to avoid the negative capital effects. Community banks with less inherent balance sheet and systematic risk will not be able to compete and will be required to hold much more capital. The result is the opposite of what was envisioned; larger, more complex institutions holding less capital than community banks which are typically more risk adverse and always less complex.

In conclusion, the Basel III proposal will work to take capital out of the banking system through reduced earnings by forcing profitable products and services to be taken over by private equity, independent mortgage banks, or foreign investors. Oversight of these groups is less comprehensive than banks creating potential consumer issues and unregulated systematic economic risks. The disadvantage to community banks is substantial and at a minimum the level of required participation in Basel III should be substantially increased. Many sections of the proposal should be reviewed for reasonableness and unintended consequences. The policies will work to force smaller banks to be merged with larger institutions creating more "to big to fail" institutions, a substantial reason why these new, more robust capital requirements were developed.

Thank you for the opportunity to submit comments and provide input on this important issue. We would welcome any additional discussion if so desired.

Sincerely,

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