October 19, 2012

Board of Governors of the Federal Reserve System
regs.comments@federalreserve.gov
Docket No. R-1430; RIN No. 7100 AD 87
Docket No. R-1442; RIN No. 7100 AD 87

Office of the Comptroller of the Currency
regs.comments@occ.treas.gov
Docket ID OCC-2012-0008
Docket ID OCC-2012-0009
RIN 1557-AD46

Federal Deposit Insurance Corporation
comments@FDIC.gov
RIN 3064-AD95
RIN 3064-AD96

Re: Regulatory Capital Rules

- Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action

- Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements

Ladies and Gentlemen:

Thank you for the opportunity to provide comments on the Basel III proposals 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. Vining Sparks is concerned the Basel III proposals would limit the ability of banks to effectively manage liquidity and interest rate risk because of the inclusion of AOCI in regulatory capital. Additionally, we believe the proposals requiring increased risk weights on lending activities would have a negative impact on the availability and cost of credit, which would put stress on an already fragile housing market and the broader economy.

Applicability of Basel III to Community Banks
Community banks should be allowed to continue using the current general risk-based and leverage capital framework for computing regulatory capital. The complexity of the proposed risk weight framework under Basel III creates an onerous and costly regulatory burden that will penalize community banks and jeopardize the housing recovery and small business lending, while failing to provide a material improvement in safety and soundness. Basel III was designed to apply to the largest international banks, not community banks. The largest financial institutions with “unlimited compliance

resources" will delegate the task of compliance to technical experts who may game the system. An alternative to the current general risk-based and leverage capital framework that should be seriously considered is the simple formula of tangible equity to tangible assets ratio. This simple formula removes the complexity and related cost of the risk based formulas and also captures the impact on regulatory capital in times of economic and financial market stress.

Incorporating AOCI as Part of Regulatory Capital

AOCI for most community banks represents unrealized gains and losses on investment securities classified as available-for-sale (AFS). AFS securities are carried at fair value on the balance sheet and gains or losses due to changes in interest rates are captured in the valuation. Community banks utilize the AFS classification for their investment securities because this classification allows for effective liquidity management if the banks needed or elected to sell the security prior to maturity. Community banks do not engage in trading activities within their investment portfolios. Further, community banks utilize their investment securities portfolios to manage the interest rate risk of their respective balance sheets.

Inclusion of AOCI for community banks will result in increased volatility in regulatory capital balances and could rapidly deplete capital levels under certain economic conditions, notable in a rising interest rate environment. Interest rates have fallen to levels that are unsustainable long-term if the U.S. experiences a healthy economy, inflation pressures push the Federal Reserve to raise short-term interest rates, or the market demands a higher return for debt securities as a result of additional downgrades of the U.S. credit rating. When 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 regulatory capital as the unrealized losses will reduce capital balances. Community banks should be allowed to continue to exclude AOCI from regulatory capital measures. Additionally, including AOCI in regulatory capital in a declining rate environment would lead to increased capital levels that are temporary by their very nature. We believe that regulatory capital should only include capital elements that are more likely to be permanent, thereby better supporting safety and soundness.

A strategy that we are commonly hearing from community banks if AOCI is included in regulatory capital is to reclassify investment securities from AFS to the held to maturity (HTM) classification in an effort to eliminate capital volatility. While this strategy would eliminate the requirement to mark these securities to market through AOCI, the reclassification to HTM would have a negative impact on liquidity and would not alter the overall interest rate risk profile of the bank.

Including AOCI in regulatory capital introduces challenges managing interest rate risk as mentioned previously. Requiring the mark to market of AFS investment securities in AOCI and not other financial instruments such as loans and deposits creates an imbalance in the balance sheet and regulatory capital. A bank could be well balanced or neutral in their asset liability interest rate risk EVE model, but may have excessive capital at risk due to AOCI volatility from the investment portfolio. If the bank were to take action to reduce the capital at risk then the EVE profile of the bank may become unbalanced, exposing the institution to excessive interest rate risk. The economic or EVE impact and regulatory capital impact do not appear to synchronize under the Basel III proposals potentially creating liquidity, interest rate, or capital risks that may not be present under the current general risk-based and leverage capital framework.

Vining Sparks provides bond accounting and interest rate risk management tools for hundreds of bank customers. A representative balance sheet for a $500 million community bank consists of the following: 33% of total assets classified as AFS securities, total price volatility up 300 bps of -12% in the investment portfolio, and a Tier I capital ratio of 10.0%. Under this scenario, the community bank would experience a decline in Tier I capital from 10.0% to 7.58% utilizing an effective tax rate of 39%.

Residential Loan Risk Weights

The proposed risk weight framework under Basel III is too complex, resulting in an onerous and costly regulatory burden that will penalize community banks and jeopardize the housing recovery. Increasing the risk weights for residential balloon loans, interest-only loans, second liens, and HVCRE loans will penalize community banks that offer these loan products to their customers, hold them on their books, and have effectively managed the credit risk historically. It will also deprive consumers and businesses of many financing options. Community banks utilize balloon loan structures to manage interest rate risk, and because of higher risk weights on these type loans community banks may be forced to originate longer duration mortgage loans without balloon structures. This will result in balance sheets that are more sensitive to changes in long-term interest rates placing bank capital and earnings at increased risk and thereby reducing safety and soundness. Community banks may elect to exit the residential loan market entirely (at a time when mortgage originators are declining), or only originate those loans that can be sold to a GSE (at a time when the GSEs account for approximately 90% of conforming single family loan originations, and when FNMA and FHLMC are required to decline at a rate of 15% per year). Residential loans will become more expensive for borrowers, and may all but disappear as banks will choose not to allocate additional capital to these balance sheet exposures. Community banks should be allowed to continue the current general risk-based and leverage capital framework for residential loans to avoid material disruptions to an already weak lending environment.

S Corporation Community Banks

Distribution prohibitions on S Corp community banks conflict with the requirement that shareholders pay income taxes on earned income regardless of cash distributions. Limitations on distributions could severely strain the ability of S Corp shareholders to pay annual taxes on bank earned income that is not distributed by the S Corp. The wherewithal-to-pay concept within the IRS Code generally requires that taxes should be collected when the tax payer can most easily pay the tax, which may not be the case if the capital conservation buffer distribution prohibitions are triggered. S Corp banks should be exempt from the capital conservation buffers to ensure that their shareholders have the cash flow to make timely tax payments to the I.R.S.

Sincerely,

Daniel B. Stimpson
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Vining Sparks