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September 20, 2012

Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street N.W.
Washington D.C. 20429

Re: Proposed Regulatory Capital Rules: Regulatory Capital, Implementation of BASEL III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action (R-1422, Docket ID OCC-2012-0008, RIN 1557-AD46, RIN 3064-AD95)

Proposed Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements (R-1442, Docket ID OCC-2012-0009, RIN 1557-AD46, RIN 3064-AD96)

Ladies and Gentlemen,

First Farmers State Bank (FFSB) appreciates the opportunity to submit comments on the above-referenced notices of proposed rulemaking (NPRs). The NPRs were released on June 12, 2012 by the Board of Governors of the Federal Reserve System (FRB), the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC), (together, the "Agencies") and are designed to incorporate the latest revisions to the Basel III capital framework and to implement relevant provisions of the Dodd Frank Wall Street Reform and Recovery Act. The Agencies have stated their belief that the proposals will result in capital requirements that "better reflect banking organizations' risk profiles and enhance their ability to continue functioning as financial intermediaries, including during periods of financial stress, thereby improving the overall resiliency of the banking system." Please consider our thoughts and recommendations.

Proposed Regulatory Capital Rules: Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action (Basel III NPR)

⏩ Proposed Rule: Accumulated Other Comprehensive income (AOCI) as a component of Tier 1 capital – The Agencies are proposing that AOCI, which includes all unrealized gains and losses on AFS securities, would flow through to common equity Tier 1 capital. This would include unrealized gains or losses related to debt securities whose valuations primarily change as a result of fluctuations in interest rates, as opposed to changes in credit risk.

FFSB Comments: FFSB has a number of concerns about the inclusion of AOCI as a component of Tier 1 capital. The Agencies themselves have recognized that the inclusion of unrealized gains and losses on securities could "introduce substantial volatility in a banking organization's regulatory capital ratios." While we recognize the appropriateness of AOCI inclusion in a tangible capital ratio from a market valuation perspective, the introduction of a similar structure to the regulatory capital metric has the potential to create confusion over the adequacy of recorded ratios and could lead to flawed, uneconomic, and even unsound decisions regarding an institution's asset-liability management and investment options. Some of the more troubling aspects of this proposal include the following:

1. Inclusion of AOCI in the standardized regulatory capital ratios would force regulators and financial institution managers to calculate alternative ratios to determine an effective capital position, exclusive of AOCI. Capital ratios bolstered by market appreciation would most certainly be discounted to reflect the potential volatility that might exist in a rising rate environment. At the same time, market depreciation would be counted against capital, even though a declining rate scenario might significantly improve the institution's capital position. In the latter case, institutions would need to hold greater levels of common equity capital to comply with a ratio requirement that reflects a potentially temporary adjustment.

2. To avoid recognition of AOCI, institutions may be incentivized to hold more securities in the held-to-maturity (HTM) account. While the move to the HTM account would no longer require gains and losses on those securities to be recorded in Tier 1 capital, the operational restrictions imposed on the HTM account would greatly reduce management's ability to properly adjust its portfolio for liquidity and funds management purposes. Additionally, when different institutions place identical securities in AFS or HTM, it creates differing capital treatments even though the relative risks involving the securities are the same.

3. To avoid capital ratio volatility, institutions may also be inclined to make shorter-term investment decisions that reduce volatility and increase liquidity. This may help to reduce market risk, but it also could reduce the ability of the investment portfolio to produce income and general capital appreciation. As a result, banks would be forced to pursue other options to generate yield, which could include diverting investment to other asset classes, with higher levels of credit risk and/or greater levels of unrecorded market volatility.

4. The AOCI inclusion for AFS securities applies mark-to-market treatment to only one set of assets on an institution's balance sheet. Other balance sheet components that are economically very similar do not receive the same treatment, such as loans, structured liabilities, and HTM securities. We find two difficulties in this inequivalent treatment. First, this appears to violate the basic accounting principle of consistency. Second, it would in effect weaken an institution's asset-liability management; specifically, it adds a potential capital penalty on using the securities portfolio, the most flexible tool at ALCO's disposal, to reduce overall asset sensitivity while leveling no such penalty on any other balance sheet component.

5. The negative impacts of these effects would fall disproportionately upon community banks, due to their limited access to capital markets for funding and temporary equity enhancements.

FFSB Recommendation: FFSB recommends that the Agencies exclude any AOCI adjustments from the regulatory capital calculations. While the impact on capital should be considered, financial institution

capital ratios cannot be effective measurements of risk when only one class of assets among many and no liabilities are required to recognize ongoing market value adjustments.

⏩ **Proposed Rule: Minimum Capital Ratios, Capital Conservation Buffer, and Prompt Corrective Action Requirements** – Under the Basel III NPR, the Agencies have introduced a new common equity Tier 1 capital ratio and have modified the capital components and ratios for the existing risk-based and leverage capital framework. The Agencies are also proposing limits on capital distributions and certain discretionary bonus payments if the banking organizations do not hold a specified "Capital Conservation Buffer" in addition to the established minimum risk-based capital requirements. The minimum risk-based capital requirements correspond to the minimum thresholds for "adequately capitalized" status under the Prompt Corrective Action (PCA) framework, and the Capital Conservation Buffer is proposed to be 2.5 percent above these minimum requirements. The Agencies are proposing to continue the PCA framework, with existing requirements still in force for organizations that fall below the statutory definition of "well-capitalized", which is 2.0 percent above the minimum requirement.

FFSB Comments: FFSB does not object to the proposed minimum capital requirements, or to the addition of the new common equity Tier 1 capital ratio. However, it is unclear why the Agencies would create a capital conservation buffer that would exceed the minimum thresholds for "well-capitalized" under the PCA framework. In essence, the proposal suggests that an institution needs a 2.0 percent buffer to be "well-capitalized', but it would need a 2.5 percent buffer be "resilient" throughout different financial cycles. By establishing this framework, an institution could be "well-capitalized" and free from any restrictive covenants under the PCA framework, e.g., limitations on brokered deposits, but at the same time still have restrictions on capital distributions and discretionary bonuses if it did not exceed the requirements for the Capital Conservation Buffer. This staggered and somewhat parallel layer of restrictive covenants above the PCA "well-capitalized" framework will create a confusing and contradictory set of standards.

In reviewing the Agencies' justification for Capital Conservation Buffer, it was not clear how the Agencies empirically developed the specific 2.5 percent ratio or how that level, over and above a "well-capitalized" level, would help to "bolster the resilience of banking organizations throughout financial cycles." It was also unclear if the Agencies considered the impact of the proposed changes to risk-weighting requirements in their determination of the 2.5 percent butter. If the proposed changes to the Standardized Approach NPR create a risk-weighting mechanism to better reflect balance-sheet risk, it would seem that the revised capital ratios would automatically be more resilient and better able to absorb cyclical risks at the "well-capitalized" level.

The proposal also did not appear to address the authority that currently exists within the Agencies' enforcement powers to restrict capital distributions when appropriate. If, through the examination process, an Agency determines that capital distributions need to be restricted because of the specific financial condition of the institution, the Agency has the power to restrict those distributions through existing enforcement authority. Codifying this type of restriction in a regulation over-simplifies this issue and could impact the ability to exercise appropriate regulatory flexibility.

We believe the tax related income distributions an "S corp." bank is required to pay to its shareholders could put "S corp." banks at a disadvantage to "C corp." banks. A "C corp." bank is always allowed by regulators to pay their State and Federal income taxes since they are paid at the corporate level prior to

dividend payments. Regulators include income distributions for the payment of income taxes as part of the dividend payout percentage calculation for an "S corp." bank. These tax related distributions then become at risk of being restricted in the event the Capital Conservation Buffer falls short of the regulatory guidelines. We feel the new regulations should address this inequity between the different corporate structures and allow the "S corp." tax distributions to be segregated from any economic dividends that are paid. Only economic dividends should be subject to the Capital Conservation Buffer guidelines.

Proposed Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets (Standardized Approach NPR)

⏩ **Proposed Rule: Residential Mortgage Exposures –** In light of the recent experiences of the U.S. residential mortgage market, the Agencies are proposing a wider range of risk weightings (between 35 percent and 200 percent) for residential mortgages. Mortgage loans would be subdivided into two risk categories based on underwriting criteria (traditional vs. nontraditional) and lien position. Within each category, risk-weights would then be assigned based on standard Loan-to-Value ratios. The current risk-based capital treatment would be maintained for residential mortgage exposures that are guaranteed by the U.S. government or a U. S. government agency.

FFSB Comments: We believe that the Loan to Value criteria incorporated into this classification of assets should be adjustable during the life of the asset to properly reflect the declining loan balance and the improving Loan to Value ratio. Also, we feel that segregating these assets retroactively based on loan to value ratios could put an undue burden on a financial institution that generated these loans years ago before these regulations were implemented. It would seem appropriate to allow some flexibility in bringing a loan portfolio into compliance with these new regulations. This flexibility might include allowing a portion of the loans to be outside of the regulatory guidelines as measured by a percent of capital concentration.

⏩ **Proposed Rule: Past Due Exposures –** The Agencies have proposed that banking organizations assign a risk weight of 150 percent to any exposure that is not guaranteed or not secured (and that is not a sovereign exposure or a residential mortgage exposure) if it is 90 days or more past due or on nonaccrual. A banking organization may assign a lower risk weight to the collateralized or guaranteed portion of the past due exposure if the collateral, guarantee, or credit derivative meets the proposed requirements for recognition.

FFSB Comments: During periods of economic stress, it is expected that banking organizations will have normal cyclical increases in past-due and nonaccrual loans. To account for the potential loss exposure of these problem loans, institutions will make periodic provisions to their respective allowances for loan and lease losses (ALLL). If the ALLL is calculated properly and reflective of the risk of loss in the loan portfolio, there should be no need to create an additional capital charge to reflect temporary and expected fluctuations in the economic cycles of different markets.

Assigning a higher risk weight to past due loans does not appear to be a proactive measurement of risk. Instead, it is a retroactive penalty that has the potential to lower institution capital ratios at a time when a bank would most need to sustain those ratios. In fact, this provision could discourage institutions from working with troubled borrowers and from taking appropriate lending risk during times of economic stress.

FFSB Recommendation: Since loan loss exposures are already reflected in the ALLL, which is limited as a Tier 2 capital component to 1.25 percent of risk weighted assets, we do not believe there is a basis for an additional capital charge based solely on past-due status. In addition, since the ALLL is the first line of defense for losses on troubled loans, we do not feel there should be a restriction on how much of this balance can be counted as capital.

⏩ **Proposed Rule: Securitization Exposures** – The proposed securitization framework is designed to address credit exposures that involve the tranching of the credit risk of one or more of the underlying financial exposures. Mortgage-backed pass-through securities (for example, those issued by FHLMC or FNMA) do not meet the proposed definition of a securitization exposure because they do not involve a tranching of credit risk. For securitizations of U.S. Government or Government Sponsored Entities (GSEs) there are no changes to the risk-based capital requirements. For privately-issued mortgage securities and for all other securitization exposures, financial institutions under $50 billion in assets would determine the risk-based capital requirement by applying either a simplified supervisory formula approach (SSFA), or a gross-up approach. A banking organization would be required to apply either the gross-up approach or the SSFA consistently across all of its securitization exposures. Alternatively, a banking organization may choose to apply a 1,250 percent risk weight to any of its securitization exposures. Also, if a banking organization is unable to demonstrate a comprehensive understanding of a particular securitization exposure to the satisfaction of its primary federal regulator, the banking organization would be required to assign a risk weight of 1,250 percent to the exposure. In all cases, the minimum risk weight for securitization exposures would be 20 percent.

FFSB Comments: By not relying exclusively on credit ratings and the "first dollar of loss methodology", securities would be judged on the characteristics of the underlying loan exposures, allowing for greater risk-weight alignment between securities and loans held on a portfolio basis. That being said, both the gross-up approach and the SSFA overlook key structural features to securitizations that provide credit enhancement, including the purchase price or carrying value of a security. In our view, the discount generated between par and the carrying value of a security provides an additional buffer against potential loss and should receive appropriate consideration.

With regard to the requirement for understanding the securitization exposure, the proposal has set forth specific points of consideration to demonstrate and document for the regulators that an institution has a comprehensive understanding of a specific securitization's risk. We concur with these points of consideration, but have reservations about the consistent understanding and application of these points during the course of ongoing regulatory examinations. We question whether examiners will be able to apply these points consistently across and between all organizations. It is conceivable that two banks holding the exact same security could receive different capital treatments based solely on a perceived management deficiency, rather than the underlying risk of the asset. In such cases, the assignment of a 1,250 percent risk weight appears somewhat extreme, when the actual calculated risk weight could be much lower.

On a parallel issue, we have questions about the Agencies' 2004 Uniform Agreement on the Classification of Assets and the Appraisal of Securities by Banks and Thrifts. This agreement continues to place a great deal of reliance on Nationally Recognized Statistical Rating Organizations (NRSROs), which are now precluded from being a part of Agency regulation. If a bank complies with due diligence criteria and can demonstrate that a security does not meet the definition of a classified asset, will examiners no longer default to NRSROs ratings as the basis for classification treatment during the examination?

FFSB Recommendation: We believe a purchase discount is an important consideration when evaluating the credit risk of a securitization exposure, as it creates a tangible level of credit protection that would not exist in a comparable security purchased at par. For this reason, we believe the level of purchase discount should be factored into the risk-weight formula in some manner to differentiate the potential loss exposure among different instruments.

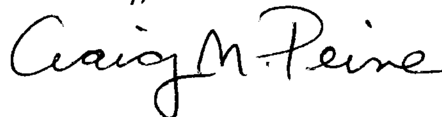
We also would suggest reconsidering the capital penalty of 1,250 percent for failing to demonstrate a comprehensive understanding of a particular credit exposure. The penalty should, at least, correspond to the actual risk weight of the asset and not create capital disparities that are grossly dissimilar for assets of equal risk.

We believe that financial institutions should have the ability to bifurcate securities into performing and non-performing portions and apply the appropriate risk weights of the corresponding underlying assets to the bond.

We also believe that the due diligence points of consideration that are listed in the proposal should be included in examination guidelines for the classification of assets and the appraisal of securities. Financial institution managers should have a clear understanding of the due diligence guidelines and classification criteria that will be relied upon by examiners during the course of their regulatory scheduled examinations.

In summary, as it relates to the Basel III NPR, 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. 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.

Sincerely,



Craig M. Peine
Chairman
Board of Director