October 19, 2012

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Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

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

RE: Regulatory Capital Rues: Standardized Approach for Risk-Weighted Asset; Market Discipline and Disclosure Requirements"

RE: Proposed Regulatory Capital Rules

Ladies and Gentlemen:

Thank you for the opportunity to provide comment on the Regulatory Capital Rues and Proposed Regulatory Capital Rules that were recently approved by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (collectively the “banking agencies”).

I would like to comment on the proposed regulatory capital rules issued by the federal bank regulatory agencies referred to as the Basel III Proposal and the Standard Approach.

Background

Bankers and bank regulators agree that banks should maintain a safe level of equity for the protection of bank customers, its community and the larger state and national economy. State and federal regulators have set the level and components of bank equity in a responsible manner for most of the United States banking history. A recent exception is evident regarding some of the large multi-national banks who did not maintain sufficient equity leading up to the financial crisis of 2008.

However, as in our past history, bank failures generally are the result of excessive risk taking rather than sound equity levels. We saw evidence of risky behavior in a good number of community banks as well but this activity should have been detected in the normal bank examination process. Their failures were primarily due to the excessive risk taking and not from low equity ratios. We know that no amount of equity will be adequate to prevent failures from risky banking practices.

The recent failures of some of the large nation-wide and multi-national banks (and investment banks) centered in Wall Street were the result of excessive risk taking, poor lending practices and inadequate equity because of regulatory over reliance on the flawed Basel II capital standards. Basel II equity was based on assumptions that the sophisticated risk measurement techniques implemented by these large financial institutions could identify imbedded risk and thereby estimate the amount of equity necessary to cover the risk. The result was that these large institutions were not adequately capitalized when the financial crisis occurred.

Some of the regulatory miss calculations were also based on the flawed belief that the purpose of equity is to protect bank depositors form identifiable and measurable risk. But in reality, equity is required to protect depositors and the financial system from risks that are not known, identifiable or measurable. Banks should provide reserves for known, identifiable and measurable risk such as the reserve for loan losses and other contingency reserves.

It is also self-evident that banks with higher identifiable and measurable risk profiles should maintain more equity than banks with simpler business models. The assessment of the adequacy of equity is the purpose of bank examinations and bank examiners should ask for more capital to cover the risky behavior.

This leads to a conclusion that the historic and traditional equity standards are superior to the proposed Basel III rules for most banks. These standards should begin with minimum tangible equity capital ratios for most community banks and for traditional commercial bank activities. Additional equity above the standard tangible equity ratios should be maintained for higher risk activities and for nontraditional banking activities. Traditional equity standards were abandoned by regulators in Basel II resulting in overly leveraged banks. These banks, combined with nontraditional activity and risky behavior, were at the center of the financial crisis.

Below are my comments on several specific aspects of Basel III. My comments are directed to the impact the proposed equity standards will have on our customers, our bank and our community.

Comment on Specific Sections of Basel III and the Standard Approach NPR

1. **Basel III requires unrealized gains and losses on available-for-sale securities must flow through common equity.**

This is the most dangerous and serious deficiency in the Basel III proposals. Mark to market of AFS securities will create unnecessary volatility in our equity account and it is not consistent with good accounting practices. This part of the rule is especially dangerous given the near zero interest rate environment we are currently experiencing and because we are told by the federal reserve that we will be in this low rate environment for the next few years. Banks will be forced to lengthen their maturities to maintain earnings only to see the market depreciation eat through their equity when rates turn upward.

The banking industry has experienced the consequences of large interest rate increases at least once in the past 30 years, in the early 1980's, when the prime lending rate exceeded 20 percent. Many banks had market depreciation that exceeded their equity but were not closed by their regulator because the depreciation was not marked against equity. Many of these banks continued to be profitable throughout the unusual period.

One reason these banks continued to be profitable was that they earned a lot of interest on their interest free demand deposits and money market accounts at the same time their securities portfolios were under performing. These core noninterest and low interest deposits are a natural earnings hedge to the under market yields that cause depreciation in their securities portfolio. The analysis of rising rates on earnings is included in a bank's asset/liability reports where interest rate risk is measured and economic value of equity is projected. This proposal does not take into consideration the banks normal Asset/Liability analysis which may conclude that they do not have much interest rate risk.

In reality, the value of a bank's core deposits increase with rising interest rates but General Accepted Accounting Practices do not allow banks to write up the value of core deposits as rates rise. However, it does not make sense nor is it good accounting to mark only one portion of a banks' balance sheet to market as interest rates increase or decrease. Yet, this is what is required in the Basel III proposal.

The unintended consequences will be that banks will have a choice between two bad options. Banks could be very reluctant to invest in longer term securities and thereby sacrifice earnings and future capital accumulation which is just the opposite of the result desired by regulators of strong bank earnings and capital accumulation. Or, banks could give in to the temptation to invest in longer term securities and watch their equity disappear as rates rise.

Another unintended consequence is extreme volatility in bank equity and its lending limits. Regulatory imposed legal lending limits are tied to equity so if equity is volatility so will be a bank's legal lending limit. Banks will be forced to loan less to its customs, both in the amount of loans to one commercial customer and the total loans to equity. This will result in a contraction of credit from the banking industry and an inefficient use of capital. It should also be noted that the equity buffer required for the loan limit and lending activity will be in addition to the buffer to the equity in another section of Basel III.

Regarding the buffer for a bank's legal lending limit, assume a bank's lending limit is $5.0 million and it makes a business a loan for $4.5 million for a year. Assume over the next year the depreciation in their securities portfolio reduces their equity by 20% so their new lending limit would be $4.0 million. Now when the loan comes due (or if during the year the business wanted a small loan of $50 thousand) the bank would not be able to renew the $5 million loan or assist in the smaller loan accommodation. And, what if the commercial customer cannot find another bank willing to take on the credit risk because another bank does not know the customer's business plans nor have the same level of confidence in the customer's management.

2. Basel III unfairly eliminates Trust preferred equity for banks between $500 million and $15 billion.

Many community banks have issued trust preferred securities as a means to increase and supplement capital in their banks. Most of this equity is permanent at the bank level. It is debt at the holding company level but is true equity in the subsidiary bank. These instruments were approved by the regulatory agencies in the past and there was an exception in the Collins amendment which intended to grandfather this type of equity. We understand the desire to limit this near equity in the new capital standards (although it is a detriment to community banks) but we do not believe it is appropriate or fair to do an about face and reverse what was previously approved given the difficulty for community banks in getting access to credit markets.

3. Basel III requires a capital conservation buffer that is in reality an elevated minimum capital level which attempts to replaces examiner judgment and duplicates the authority that bank regulators already have.

The buffer appears to be an attempt to regulate banks by the numbers rather than relying on the good judgment of experienced bank examiners and regulators. Further, since banks will be restricted on dividends and bonuses to executives, the minimum equity plus the buffer is really the new minimum and banks will want to keep an additional buffer beyond this amount so they will not slip below the higher level. This buffer, in conjunction with buffer that will be required from the volatility from the mark to market creates a business necessity to keep a significantly larger amount of equity than even this proposed rule appears to require.

The rule also does not allow for the disparate treatment of Sub-S corporations when compared to C-Corporations. Sub-S banks pay their taxes on profit by paying dividends to their shareholders who then pay the tax to the IRS. C-Corporations pay their taxes directly to the IRS before any dividends are paid to its shareholders. This proposal should allow, without restrictions, a Sub-S corporation to pay dividends to its shareholders at the estimated tax rate on net income.

4. The Standard Approach rule will assign complex credit risk weights to assets which will result in a restriction of credit availability and credit cost.

This part of the rule appears to be a response to the past over-lending in the residential lending market which was done primarily by the non-bank unregulated mortgage lending industry. We believe that the new regulatory scheme imposed by Dodd/Frank is adequate to reign in these rogue lenders therefore the new risk weightings are duplicative, not necessary and carry significant negative unintended consequences.

It is a fact that most community bank residential lending practices have been done in a safe and sound manner, have been reasonable and responsive to the needs of their customers. It is also true that community banks fill consumer needs that will not be met by the larger multi-national banks. Further, most community banks make high loan-to-value loans to customers such as young school teachers who do not yet have a good credit history or a down payment, young professionals who have the debt service capacity but not the down payment for a loan. Community banks make residential mortgage portfolio loans to young working couples who have their first jobs but do not yet have enough saving to make the down payment or a credit score acceptable to the secondary market.

Under the proposed rule, banks will be forced to either not make these loans or charge a much higher interest rate (or fees) to accommodate a higher loan-to-value loan given the additional capital required. Consider a normal assumed return on equity of 15% and the pricing required to achieve this return on the additional equity required. The pricing required for the difference between an 80% loan-to-value and a 90% loan to value loan would require a 3.7% increase in interest rate to accommodate the increase in risk rating.

In this regard, we do not think the proposed rules make a distinction between loans originated for the secondary market and those originated to be held in the bank's portfolio. In portfolio lending, we consider all the credit factors, not just the down payment. Most all the problems in residential lending emanated from originators who had no skin in the game i.e. they sold the bad loans into the secondary market for securitization. Community banks put many of these loans in their own portfolio and have their equity exposed to credit risk and market risk so they have an incentive to follow good underwriting practices. Portfolio loans should not be included in this proposal.

Finally, some of the punitive restrictions on adjustable rate loans and balloon loans will significantly restrict portfolio loans to some of the borrowers listed above. Community bankers use these tools to be able to make loans to customers who do not otherwise qualify for the secondary market. Many of these customers are subsequently refinanced into the secondary market once they establish a credit history. Is this the intended consequence of the proposed rule or are these customers just collateral damage?

One additional thought is that by limiting the definition of high risk loans to loan-to-value, the Basel III standards omit other important credit factors such as debt-to-income, capacity and character. And, we know that the characteristic of a bubble is that no one can see it rise because the horizon looks the same. So over reliance on this single measure of high risk may not be effective in preventing the next real estate bubble.

The unintended consequence of this proposed rule is that our bank will be less willing to extend residential loans to the very deserving customers we have served in the past or we will have to charge a significantly higher rate of interest. We do not think this is the result intended by the Basel III rules.

We also note that the regulatory tool box already has the means to control excessive high loan-to-value lending. Regulation H limits this lending to a percentage of equity and bank examiners routinely look at a bank's lending practices.

Summary

In summary, the Basel III and the standard approach equity standards appear to be designed for the very few multi-national financial institutions and the European style government controlled banks. Our free market economy is designed for and requires innovation and entrepreneurial spirits which generally start with new businesses that get their start with a loan from a community bank. Our banking system has historically been well capitalized with a reliance on basic equity ratios supplemented by professional bank regulators to control high risk behavior in the few maverick banks. Basel III appears to be an attempt to take the professional regulators out of the equation and replace bank examiners with complex yet flawed equity restraints. Many of these restraints are duplicative and additive and with significant adverse unintended consequences.

These proposed standards are unnecessary for most banks who follow simple commercial banking models and who do not participate in either high risk activity or a number of higher risk nontraditional banking activities. Capital was deficient for a few very large financial institutions because of the flawed Basel II standards but it was not low capital ratios that caused problems in a good number of community banks. Rather, community banks have failed because of risky lending practices, a real estate bubble and regulatory practices that focused everything but lending.

The extreme volatility in equity will make it difficult for banks to rely on their internally developed equity plans, develop reliable earnings projection given lending restraints, plan for growth or expansion by acquisition, and consistently provide credit to their customers and their community. There is a better, more effective solution. Please heed the advice of 50 state bank regulators, Tom Hoeing, a well-respected and outstanding former president of the Kansas City Federal Reserve Bank and likely every community banker in the United States.

Our first preference would be to discard this proposal and start over with the input of thoughtful and interested economist, community bankers and business interest. If this is not possible, a number of modifications should be made to address the concerns mentioned above. Our focus should be on the base cause of the crisis and not toward fixing problems that do not exist.

Respectively Submitted,

Ken Littlefield
President & CEO

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