IDAHO INDEPENDENT BANK®

October 16, 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 comments 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. As proposed, Basel III will have a profound impact on the many economic development benefits that community banks provide and will reduce the quantity, variety, and availability and increase the cost of credit for small businesses and individuals. I agree with the intent of Basel III; that is, to provide a more appropriate capital framework for large financial institutions. However, applying the extremely complex Basel III proposal to local community banks is unnecessary, inappropriate, will have negative impact on lending and job creation, and will have a pro cyclical impact. For these reasons the impact of the proposal will be adverse to the primary public policy objectives it seeks to address.

[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.*

401 West Front Street, Boise, Idaho 83702-5122
River Branch (208) 338-8000 ❧ Fax (208) 338-8001
Administration (208) 338-8002 ❧ Fax (208) 947-1159
www.theidahobank.com

Applicability of Basel III to Community Banks

Community banks operate with simple business models when compared to the large financial institutions that Basel III is designed for. The more simple Basel I framework is a more cost effective method of managing community institutions for the regulatory agencies and provides a more certain basis for determining capital adequacy. Because of this, community banks should be allowed to continue using the current Basel I framework for measuring capital adequacy and setting capital requirements.

Basel III was designed to apply to the largest, internationally active, banks and not community banks. Community banks generally do not engage in highly leveraged activities that severely depleted capital levels of the largest financial intermediaries and created panic in the financial markets in 2008. Like many community banks, Idaho Independent Bank, a $450 million community bank in the State of Idaho, operates on a relationship-based business model that is specifically designed to serve customers in the local community over the long-term. The community bank business model contributes to economic development and provides credit to small businesses and consumers. We provide vital funding to small businesses that are the backbone of job creation and innovation that make our economic system the envy of the world. Because we have and maintain direct relationships with our customers we can apply practical, common sense approaches to lending and managing risk. In contrast, the largest banks, money market funds, and investment banks have much more complex business models that rely on low costs, high transaction volumes, regulatory capital arbitrage, and by the numbers risk management models rather than consideration of the customer relationship. In short, they press the advantage of their large scale and ability to game the system and use this unfair competitive advantage to the detriment of consumers, small businesses, and economic growth. This difference in banking models demonstrates the need to place tougher capital standards exclusively on the largest banks to level the playing field and better manage their ability to absorb losses.

Incorporating AOCI as Part of Regulatory Capital

Inclusion of accumulated other comprehensive income ("AOCI") in capital for community banks will result in increased volatility in regulatory capital balances and could rapidly deplete capital levels under certain economic conditions. AOCI for most community banks represents 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 many investment securities held by community banks. Additionally, demand for most types of bank qualified 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 and has artificially increased AOCI levels across the industry. When interest rates rise, fair values will fall and with it the balance of AOCI will 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.

Excluding AOCI is appropriate for community banks as they generally purchase less complex securities that are funded with deposits with the intent to hold them to maturity. Community banks do not have the knowledge or expertise to engage in these transactions and manage their associated risks, costs, and barriers to entry. Including AOCI may encourage them to work to hedge this type of risk with complex transactions they do not understand, thus increasing risk to the system. Community banks should continue to exclude AOCI from capital measures as they are currently required to do today.

Capital Conservation Buffers

Implementation of the capital conservation buffers for community banks will be difficult to achieve under the proposal and therefore should not be implemented. Many community banks will need to build additional capital balances to meet unnecessarily high minimum capital requirements with the buffers in place.

Community banks will not have ready access to capital that the larger banks have through the capital markets due to the permanent increase in capital levels that is not commensurate with the risk on their balance sheets. The primary way for community banks to increase capital will then be only through the accumulation of retained earnings over time. Due to the current ultra low interest rate environment, community bank profitability has been diminished thus further hampering their ability to grow capital. The effect of the proposal will lower capital allocation in the marketplace to smaller institutions. Without access to capital the community bank industry will have less lending capacity, which negatively impacts economic development and job creation. Further, systemic risks will increase because of the reduced access to capital.

New Risk Weights

The proposed risk weight framework under Basel III is too complicated and will be an onerous regulatory burden that will penalize community banks and jeopardize the housing recovery. Increasing the risk weights for residential balloon loans, interest-only loans, and second liens will penalize community banks who offer these loan products to their customers and deprive customers of many financing options for residential property. Additionally, higher risk weights for balloon loans will further penalize community banks for mitigating interest rate risk in their asset-liability management. Community banks will be forced to originate only 15 or 30 year mortgages with durations that will make their balance sheets more sensitive to changes in long-term interest rates. Many community banks will either exit the residential loan market entirely or only originate those loans that can be sold to a GSE. Second liens will either become more expensive for borrowers or disappear altogether as banks will choose not to allocate additional capital to these balance sheet exposures. Community banks should be allowed to stay with the current Basel I risk weight framework for residential loans. Furthermore, community banks will be forced to make significant software upgrades and incur significant additional other operational costs to track mortgage loan-to-value ratios in order to determine the proper risk weight categories for mortgages.

Finally, the increase in capital requirements when a loan becomes past due is pro cyclical in the extreme and will compound problems. Ideally, capital should be building during the good times as a buffer for bad. This will have the impact of understating problems and reducing capital requirements as problems are building with a sharp increase in capital at precisely the time it is needed to address them. At a minimum, this aspect of the proposal should be eliminated.

Thank you again for the opportunity to provide comments on the Basel III proposals. In summary, significant adjustments are necessary to eliminate the unintended and adverse consequences the proposals will have on the economic development benefits that community banks provide and the reduction in the quantity, variety, and availability and increase the cost of credit for small businesses and individuals.

Sincerely,

Kurt R. Gustavel
President