Commentary on Federal Reserve Proposed Rules to Implement the Basel III

Regulatory Framework

I have been a banker in small towns for almost 40 years and view our economy from a community perspective. Frankly I am saddened at how many small towns have been decimated by our own legislators and regulators who have not understood, been mislead by interest groups, or just ignored basic economic and banking truths. A small number of large U.S. banks now dominate market share and have becoming increasingly complex and difficult to regulate. Many small banks have been mowed over by the attempt to regulate and limit risk exposures that have greatly contributed to the recent boom/bust economic cycles. Many small banks have been forced to merge with larger institutions or close their doors. Consumers and small businesses in these communities are left with fewer options and watch helplessly as their deposits are redeployed in larger cities, many times to support investment banking activities rather than loans. Community banks are crucial to the economic stability of many non-metro areas but they are becoming endangered species. I personally believe that this has had a negative effect on the current economic recovery considering that small business is such an important driver of economic activity.

Basel III is another attempt to reign in the risky activities of the largest banks that will have serious consequences to their smaller competitors. The following is a list of some of the portions of the Basel III framework that are especially problematic for small banks (and my bank in particular):

Inclusion of Community Banks in Basel III

For the most part, banks under a certain asset size were not included in the frameworks under Basel I or Basel II. Most small banks operate using a relationship based model and serve their customers on a long-term basis. This has served them well for decades and offers an attractive alternative to the transaction-driven, quantitative business models of the largest banks. Most community banks do not utilize derivative instruments and generally hold higher amounts of tangible equity capital. These institutions pose a much smaller risk to the stability of the U.S and/or global financial systems. I have yet to see a compelling reason to convince me that these banks suddenly represent an elevated risk that needs to be regulated under Basel III.

Inclusion of Accumulated Other Comprehensive Income in Regulatory Capital

This is one of the more troubling aspects of the Basel III framework for our bank because it encompasses so many factors that are completely beyond our control. The recent recession and slower than average recovery has resulted in a diminished demand for loans as consumers and businesses are focused on de-leveraging their balance sheets. Banks must invest a higher portion of their deposit base in the investment portfolio rather than in higher yielding assets such as loans. This is happening in an interest rate environment that is at historically low levels due to a variety of factors. The flight to the relative safety of U.S. government debt as the world economy struggles has buoyed bond prices and reduced yields. The aggressive monetary policy of the Federal Reserve's Quantitative Easing programs has reduced yields, particularly at the long end of the yield curve. The success of these programs can be debated but the effect on interest rates is clear, they are being held at historically low levels outside of the normal functions of capital markets. This is not a sustainable situation over the long term horizon and rates will eventually begin to climb, possibly at a rapid pace. Increasing interest rates have an immediate, material impact to the fair market values of bank investment portfolios and under Basel III to the level of regulatory capital. This effect has little correlation to the ability of bank management to operate the bank in a prudent manner. Even the most conservatively managed balance sheets will face potentially significant impacts to capital levels before they have the opportunity to take advantage of the higher level of interest rates and improved net interest margins. Community banks do not generally have the ability or expertise to mitigate this risk through derivative instruments and are at the mercy of the markets.

Additional Capital Conservation Buffer

Community banks do not have access to the majority of capital markets to raise additional capital if the growth in retained earnings does not meet regulatory capital levels increased by the conservation buffer. Coupled with the phase-out of traditional capital sources such as Trust Preferred Securities, I believe the new capital regulatory levels will be increasingly difficult to maintain. This doesn't imply that our bank and others like it pose a higher systematic risk, it simply means that they are being held to standards that are created for much larger, more complex institutions.

Revisions to Risk-Weightings for Asset Classes

Complexity has been increased in calculating risk weights for many classes of assets. This will not result in a material benefit toward risk management of balance sheets for community banks. In fact, it will reduce the product offerings to consumers in these markets as community banks are penalized for holding popular products such as residential balloon loans and second liens on real property. Community banks have been successful at managing the risks of these products for many years because of the strong customer relationships they have forged. Arbitrary risk weightings based on national averages do not reflect the risk that most community banks experience for these products.

Significant costs to update software to comply with these regulations will inequitably affect community banks considering the relatively low amount of risk posed to the financial system by these institutions. A seemingly simple regulation such as calculating risk weights for residential mortgages based on loan to value ratios will carry significant costs to community banks to revise accounting systems. To what end? Community banks have had an excellent record managing the risks of their residential mortgage portfolios compared to their larger competitors.

Phase-out of Trust Preferred Securities as Tier I Regulatory Capital

Trust Preferred Securities have historically been a reliable source of capital for community banks. Removing this potential source of capital at a time regulatory capital requirements are increasing unfairly affects community banks relative to larger competitors. As long as these securities are being retired as agreed and no delinquencies exist, why would they suddenly be deemed to be an unacceptable form of capital?

Global Liquidity Standard

Liquidity is undoubtedly an important issue for all banks but monitoring using the liquidity coverage ratio and net stable funding ratio are a direct response to the issues experienced by the largest banks during the financial crisis. Adding another layer of regulation to community banks will primarily result in increased costs of compliance with negligible benefits. Liquidity risk is already a major focus of these smaller banks since they have limited access to liquidity and capital as compared larger banks.

In conclusion, I have reviewed the new Basel III requirements and see no compelling evidence that these should be applied to community banks. Common sense suggests that the overwhelming source of systematic risk resides in the "Too Big to Fail" institutions. Basel I and II were not successful in regulating these banks and I suspect that Basel III's legacy will be that it was replaced by Basel IV, V and so on. Simplicity rather than complexity is the correct response to these issues. Attached is an example of a regulatory capital system I created that represents a straight-forward approach and removes much of the clutter that currently exists. Don't confuse simple with easy to attain and increased risk. In some cases, this system would result in higher capital requirements than prescribed under the Basel III framework. I don't believe that a twenty page calculation of regulatory capital benefits any institution or the regulators assigned to monitor them.

Thank you for your consideration and I sincerely hope that you will reconsider the proposed rules and exempt smaller institutions from the Basel III framework.

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The Main Street and Community Bank
Capital Recovery Program

Swaps and Derivatives	+___%
International Loans	+___%
Liquidity Rating (3,4,5)	+___%
Asset Quality Rating (3,4,5)	+___%
Overall CAMELS Rating (3,4,5)	+___%
Out of State Deposits (Census Tract)	+___%
Lending in CRA defined Market (or vice versa)	+___%
BASE CAPITAL REQUIREMENT	**7.00%**
Asset Quality Rating (1,2)	-___%
Overall CAMELS Rating (1,2)	-___%
Lending in CRA Defined Market (or vice versa)	-___%
ADJUSTED CAPITAL REQUIREMENT: **(TOTAL OF ABOVE)**	___%

If all factors are weighted equally the expected result will be a capital level of 6.25% for community banks <u>and</u> a 8.50% capital level for large banks. Common sense says these ranges are more prudent and will provide a reasonably level playing field based upon risk levels of the institutions.