October 17, 2012

The Honorable Martin J. Gruenberg
Acting Chairman
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Dear Mr.Gruenberg :

Thank you for the opportunity to provide comment on the Basel III proposals that were recently approved by your agency, the Federal Reserve Board and the Office of the Comptroller of the Currency. I have a rather unique vantage point from which to comment as my involvement in the banking industry encompasses many facets. For almost 25 years, I have served as a CPA, tax advisor and business consultant to community banks in the Midwestern states of Iowa, Illinois and Wisconsin. The roughly 50 different institutions I have worked with during that time frame range from $10M to over $1.5B in assets. In addition, I am currently a shareholder and board member of an Iowa-based FDIC-regulated institution. Of course, I also use banking services as a consumer. And finally, throughout my career, I have developed relationships with bankers and CPA's across the United States, in organizations from the very smallest to the very largest, so I have had a chance to discuss and understand these issues from a variety of perspectives.

I am writing this letter today to express concerns about both the Basel III proposal as well as the "Standardized Approach" proposal. I understand the overall goal in the Basel III proposals, that of strengthening capital requirements so banks can weather the storms of downturns economic cycles inevitably bring, but these rules in their entirety are more appropriate for large complex financial institutions competing in a global marketplace than for the business practices of the Midwestern community banks that I have historically been associated with. Regulations like those contained in Basel III will stress even some of the largest and most successful community banks and no doubt pressure many of the smaller community banks that I have worked with to sell, merge or possibly close, due to the increased cost of compliance and/or lack of desire to continue on. Ultimately, as a consumer, fewer choices and fewer institutions will lead to higher costs and, as we have seen over history, those costs being absorbed by the general public in higher fees and/or lower deposit rates. By your own admission at the recent AICPA National Conference on Banks and Savings Institutions in Washington, D.C., you said community banks are very important to the banking system, because even though they only represent 10% of the assets, they are responsible for making 40% of the small business loans. For that general reason and the following more specific reasons, I respectively ask that both the Basel III and the Standardized Approach proposals be repealed:

Basel III Comments

1. **Requirement that gains and losses on available for sale securities (AFS) must flow through to regulatory capital.** This proposed rule requires all unrealized gains and losses on AFS to "flow through" to common equity tier 1 (CET1) capital – which is a new category of tangible capital within the rule. Even daily charges in AFS securities must technically be accounted for in regulatory capital. Because interest rates, particularly on debt securities, can fluctuate frequently, the proposed rules will introduce significant volatility into capital calculations. On one day, a bank could be deemed well capitalized, the next day not and the following day well capitalized again. This volatility will make it not only more difficult for bankers, but also CPA firms that issue GAAP financial statements and your fellow regulators as well.

   The timing of this proposed rule is also greatly compounding the problem, since we are now at a period of historically low interest rates. As interest rates begin to rise, capital under this proposal will move rapidly in a negative direction, as while nothing will have changed regarding the bank's tangible equity, regulatory capital ratios could be reduced drastically. A 300 basis point rise in interest rates for example would reduce the value of many bank's securities portfolios and reduce CET1 significantly – some Iowa banks report by as much as 40-50%. This proposal therefore will introduce a significant amount of volatility into the system, which is the opposite of what the goal should be. This will also cause banks to reduce their balance sheets as the economy improves, simply because of the upward movement in interest rates. Small business, consumer and mortgage customers will be adversely impacted by the reduced availability of credit under this proposal – as it will reduce the central focus of making loans to members of our communities.

As for credit risk taken in the investment portfolio, existing rules for other-than-temporarily-impaired (OTTI) investments provide a mechanism for credit losses to be reflected in capital. A natural reaction to this new proposal will be for banks to either hold fewer securities or reclassify existing portfolio assets to hold-to-maturity (HTM). This philosophical change may reduce the instability of the proposal, but it comes at the enormous cost of eliminating the ability to manage a bank's investment portfolio through different interest rate and economic cycles – and is a core tool to offset the interest rate risk in our loan and investment portfolios. I respectfully ask this section of the proposal be eliminated.

2. **Elimination of trust preferred securities (TPS).** Many financial institutions hold these instruments as a very cost effective source of capital, as most community banks have much more limited access to capital markets than larger regional or national financial organizations. In addition, a number of banks that elected Subchapter S status were handcuffed by tax rules and unable to generate additional capital using preferred stock and other traditional methods. Access to TPS provided S corporation banks a mechanism with which to level the playing field in the capital arena.

   This rule also is a complete re-write of the Collins Amendment to the Dodd-Frank Act (DFA), which would have grandfathered TPS for institutions between $500 million and $15 billion. The DFA never intended for this type of instrument to be completely phased-out for community banks – and will reduce banks' ability to grow the balance sheet to better serve customers if we have to concentrate on filling capital holes caused by changes in regulation, instead of focusing on funding growth opportunities in our communities. This proposal seems to lie in direct contradiction to not only the statue, but also our national goal to spur job growth. I would ask this section to be made consistent with the requirements under the DFA.

Standardized Approach – Notice of Proposed Rulemaking

3. **Increased risk weighting for residential loans.** Under this proposal, the federal agencies can assign risk weights to residential mortgages based on whether the mortgage is a "traditional" category 1 mortgage or a "riskier" category 2 mortgage. Risk weights under the proposal run from 35% up to 200%. Under current law, most prudently underwritten residential mortgages are risk weighted at 50%.

   These proposed residential mortgage rules raise several issues. First, mortgages must be re-assessed after a loan structuring or modification (HAMP loans are exempt). Therefore a "category 1" mortgage could become a "category 2" mortgage if the bank does not modify the loan under HAMP. Many banks modify loans under non-HAMP methods and have a very successful track record for those borrowers who qualify by keeping them in their homes. Why should they be penalized from a capital standpoint for offering these modifications?

   Secondly, similar to the agencies proposal for a "Qualified Residential Mortgage" (QRM) the proposed rules do not recognize private mortgage insurance (PMI) at all to reduce loan to value requirements – so mortgages may be subject to higher risk weights even if PMI reduces the risk of these loans. For example, a bank originating a balloon mortgage (which is now an automatic "category 2" mortgage at any LTV) at 90% LTV would have to risk weight the loan at 150% for capital reservation purposes despite having PMI. This does not reconcile at all with the loan performance many Iowa banks have experienced and may cause them to discontinue balloon mortgages and any loans with PMI. This will have an enormous negative impact on loans to first time homebuyers, as PMI has been used successfully by banks in Iowa for decades with hardly any resulting losses for prudently underwritten loans.

Third, the proposal has no grandfather provision, so all residential mortgage loans on the bank's books would be subject to the new capital requirements – forcing banks to review all existing files to determine the appropriate category and LTV for each loan file. This "granular" approach is going to put enormous pressure on community banks to implement systems for calculating these new reporting requirements or whether software vendors could possibly even implement this new requirement in a timely manner. Further complicating the issue, banks will not be able to just "assign" a weighting when the loan is booked, but would have to continually re-evaluate the risk weightings based on changes in collateral values, past due status and other risk factors. As many Iowa banks strong underwriting has led to a very small loss history on residential real estate loans, this new re-evaluation approach on an asset by asset basis is completely unnecessary and should be eliminated from the proposal.

4. **Credit enhancing representations.** The proposed rules would require banks to hold capital for assets with credit enhancing representations and warranties, including for "pipeline" mortgages in the process of being sold. Under the existing capital rules, banks are not required to hold capital against assets with such representations and warranties. This new requirement would affect any mortgage sold with a representation or warranty containing (1) an early default clause, and/or (2) certain premium refund clauses that cover assets guaranteed, in whole or part, by the U.S. government or government sponsored entity.

   Early default clauses or premium-refund clauses are very common on third party sales of mortgages. They are largely intended to protect the purchaser by providing some recovery in the event of extremely early or unanticipated pay off or refinancing, and are usually targeted at 120 days or less. They are meant to reimburse the purchaser for the expense of acquiring a loan which subsequently did not perform long enough for any expected return on investment. Instances of enforcing this pay off protection are an extremely small percentage of the overall population of loan transactions, and in any event exist to recoup perceived losses and offer some investor protection. These clauses are tied closer to operational transmission of the loan more than any risk protection as it relates to the underlying collateral.

   Requiring off-balance sheet guarantees at 100 percent credit conversion during this initial time period seems onerous in that there is little evidence that these temporary and expiring representations and warranties post any significant financial exposure. In addition, in many cases the reps and warranties referring to early default and premium refund clauses do not automatically subject the bank to the repurchase of the loan. Often the only liability to the bank would be to refund the servicing premium and any other earned fees on the loan. To require capital reservation for 100% of the loan is not at all commensurate with the amount of risk being assumed.

   Any credit enhancements or representations that exist outside of this initial prepayment protection, whether as part of the contractual agreements between the parties, would amply represent the overwhelming amount of any risk on behalf of the seller. Requiring additional balance sheet guarantees for this transitional period would be a significant increase in capital needs that would be much greater than the actual risk that it is designed to represent. This rule if implemented would literally drive many Iowa community banks out of the secondary market and possibly out of the residential mortgage business altogether. I would respectfully ask that this be eliminated from the proposal.

5. **Change in risk weighting for home equity and second lien loans.** This part of the proposal classifies all junior residential liens, such as closed-end home equity loans and HELOC's, as "category 2": exposures with risk weights ranging from 100-200%. More importantly and as is the case most often in many Iowa banks, if they hold both the 1st and 2nd mortgages on the same property, they would be required to treat both mortgages (even the 1st mortgage) as category 2 exposures (much higher risk weight). The exception where both mortgages could be placed into a category 1 mortgage – where the combined exposure meets all of the requirements of a category 1 mortgage, is far too narrow and most of home equity loans and their accompanying 1st mortgage would likely fall into category 2 classifications. This proposal will cause banks to seriously consider discontinuing our home equity loan programs. I also ask this portion of the proposal be eliminated.

6. **Proposal to increase risk weights on delinquent loans.** Most Iowa banks are fortunate with careful underwriting to have a very low delinquency rate currently – but this could change quickly based on economic conditions. This rule, which drastically increases the risk weights for past due loans, causes concerns as banks already sets aside reserves for delinquent loans. By proposing to also increase capital we hold on past due loans, banks are basically being required to set aside capital twice. Risk regarding past due loans should continue to be managed through loan loss reserve guidance and not by layering on an additional capital requirement.

   This rule, if finalized, would require banks to increase aggressiveness in moving loans past 90 days delinquent off of the balance sheet – and make banks much less likely to pursue loan workout strategies and instead proceed directly to foreclosure sale.

Conclusion

In conclusion, banks such as the ones I have worked with for almost 25 years have no way to completely ascertain the full impact of this massive proposal because of the amount of work it will take to understand the rules and how they apply to the balance sheet. Banks, even small banks, will likely be required to hire a team of consultants to implement the re-assessment of each individual loan in portfolios with the new risk weights, re-program core processing software to handle the new coding requirements and then create the necessary repots to analyze the data.

As I stated above, while I support the overall goal of strengthening the financial system by increasing the level and quality of capital that banks hold, these rules are designed much more for large multi-billion dollar global financial institutions than the business practices of Iowa banks. I urge the agency to repeal this proposal so that Iowa banks may continue serving its communities and help strengthen local economies. Thank you in advance for your careful consideration of my comments regarding these proposed changes.

Sincerely,

Jeffrey P. Triplett, CPA