Valley State Bank

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September 17, 2012

Mr. 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

Mr. Feldman:

Thank you for the opportunity to provide comment on the Basel III proposals 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.

For the past seven years I have had the privilege to serve as President and CEO of Valley State Bank a small ($130 million) community bank located in rural northwest Alabama. My current capital ratios are Tier One RBC to Risk-Weighted Assets 24.53, Total RBC to Risk-Weighted Assets 25.78 and Tier One Leverage Capital 13.44. I provide these ratios certainly not in a boastful manner but rather to demonstrate my lack of prejudice. I am of the opinion that small community banks should be allowed to continue using the Basel I framework for computing their regulatory capital requirements. My bank did not engage in the extremely risky activities that drained capital levels of the Wall Street banks which helped to bring about the “great recession”. I personally have been a lender in my local market for 37 years. Many of my current borrowers are the grandchildren of some of my initial customers. My customers are people that I associate with on a regular basis. I know most by name and perhaps more importantly they know and trust me. The same can be said regarding all the remaining members of my bank’s management and most of my staff. Our business model is very simple. We receive deposits from our local market (no borrowings and no brokered deposits) we then endeavor to lend those same deposits back to our local market. Excess deposits are conservatively invested in our bond portfolio. I suppose this to be the same business model more or less utilized by community banks all over the United States.

I spent almost 20 years as a Regional President for a large regional bank and know from experience how little attention to the customer relationship was the norm. I believe this difference in banking models demonstrates the need to place tougher capital standards exclusively on the largest banks to better manage their ability to absorb losses.

Capital Conservation Buffers
Smaller community banks do not have access to capital that the larger banks have through the capital markets. Often the only way for community banks to increase capital is through the accumulation of retained earnings. The very low rate environment continues to place additional stress on earnings and impede growth of capital. If you are unwilling to exempt community banks, the allotted time to increase capital to meet the buffers should be increased to a minimum of 12 years. The capital conservation buffers for some community banks will be difficult to achieve.

Incorporating AOCI as Part of Regulatory Capital

The 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 in a rising rate environment. AOCI for most community banks my size represents unrealized gains and losses (mark to market) on bonds classified as available for sale. Because these bonds are held at fair value, any gains or losses due to changes in interest rates are reflected in the valuation. Recently, both short term and long term interest rates have fallen to historic lows generating unprecedented unrealized gains for most bank bond portfolios. Only yesterday the Federal Reserve extended its low rate commitment through mid 2015 and announced QE3 in an effort to drive long term rates even lower. Rates have fallen to levels that are I believe unsustainable long term once an economic recovery gains traction. When interest rates rise, fair values will fall causing the balance of AOCI to 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. At my bank, for instance, if interest rates increased by 300 basis points, my bank's bond portfolio would show an estimated reduction in market value of $6,049,000. This would mean that my bank's tier one ratio would drop by 34% to 8.87. My portfolio is short in average life at 4.17 years with 37% invested in variable rate products. We have endeavored to structure our bond portfolio for increased rates so obviously the impact to some of my peers with longer positions will be even more pronounced. Large banks have the ability to manage this volatility by entering into qualifying hedge accounting relationships for financial accounting purposes with the use of interest rate derivatives like interest rate swap, option, and futures contracts. I frankly do not have the knowledge or expertise to engage in these transactions and manage their associated risks, costs, and barriers to entry. Recent headlines suggest neither do my friends on Wall Street. I believe incorporating AOCI as part of Regulatory Capital will compel small community banks to take increased balance sheet risk to offset increased volatility in their capital accounts and therefore should continue to be excluded from capital measures.

New Risk Weights

Small community banks should be allowed to stay with the current Basel I risk weight framework. The revised risk weight framework under Basel III is too complicated and will present an additional regulatory burden that will be punitive toward community banks and jeopardize the housing recovery. Increasing the risk weights for residential balloon loans and second liens will penalize community banks who offer these loans to their customers and reduce financing options for residential property. Community banks utilize balloon loans as an important component of interest rate risk management. Many would be forced to originate only 15 or 30 year fixed rate mortgages with durations that will make our balance sheets more sensitive to changes in interest rates or either exit the residential loan market entirely. Second liens will become more expensive for borrowers or disappear altogether as some banks will choose not to allocate additional capital to these balance sheet exposures. Finally, community banks will be forced to make significant software upgrades and incur other operational costs to track mortgage loan to value ratios in order to determine the proper risk weight categories for mortgages.

Sincerely,

Jim H. Davis

President/CEO
Valley State Bank