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October 10, 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 comment on the Basel III proposals 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"). Nichols, Cauley & Associates, LLC is a Georgia based professional services firm providing audit, tax and risk management consulting to community based financial institutions throughout Georgia and the southeastern United States. Our comments are based on items in the Basel III proposals we believe are concerning to the community based financial institution we serve. These institutions are a critical component of many local economies as they provide services to individuals, professionals and small businesses that are the key to economic growth in Georgia and the Southeastern United States.

Issue of Concern: Requiring Unrealized Gains and Losses Flowing Through Capital

The Basel III NPR proposes that unrealized gains and losses on an institutions Available-For-Sale ("AFS") securities to flow through to common equity Tier I ("CET1") capital. Under the current regulatory capital framework, these unrealized gains and losses are not included in the regulatory capital calculations. We believe this change in treatment for regulatory capital purposes would not be in the best interest of safe and sound banking practices.

For the majority of the community based financial institutions we serve, the investment portfolio serves primarily as a source of liquidity. Additionally, community based financial institutions generally invest the majority of their portfolios in instruments issued by the U.S. government, its agencies and government sponsored enterprises. Therefore, the majority of the market value changes reflected in unrealized gain and losses are the result of changes in interest rates, not the credit rating of the underlying security. Since the securities portfolio of community based financial institutions generally represents less than 25% of total assets, this treatment would in essence push the interest rate risk of the securities portfolio through capital while ignoring the interest rate risk of other, more substantial assets.

Additionally, our understanding of the proposed treatment of AFS securities is to reflect in regulatory capital potential credit-related losses in a portfolio. For community based financial institutions, this treatment is inconsistent with the proposals objectives due to the underlying reasons for these unrealized gains and losses being primarily interest rate fluctuation. Furthermore, we believe that the Financial Accounting Standards Boards ("FASB") guidance related to other-than-temporary impairment ("OTTI") addresses the credit-related losses in a community based financial institutions AFS portfolio.

We believe the proposal will add unnecessary volatility to the regulatory capital ratios of community based financial institutions, especially in a rising rate environment, reduce liquidity and flexibility for these institutions as they move securities into the Held to Maturity ("HTM") classification to avoid inclusion in the CET1 calculation, and could cause the institutions to shorten the maturity in their portfolios thereby reducing their ability to manage interest rate risk.

We recommend that the agencies exclude unrealized gains and losses on AFS securities from the CET1 calculation.

Issue of Concern: Residential Mortgage Loans Risk Weights

Under current regulatory guidance, loans are risk weighted primarily based on their type and classification. While we believe the current system of risk weighting loans regardless of credit profile does not address the true economic risks in the loan portfolio, we also believe that the movement of a loan from Category 1 to Category 2 based on individual criteria without consideration of the overall credit profile is not a beneficial improvement.

Specially, for community based financial institutions, the "balloon payment" criteria is most concerning. Common practice in community based financial institutions for 1-4 family loans is to set up the amortization on the loan based on a 15-30 year schedule with a balloon payment in 2-5 years. Community based financial institutions primarily utilize this set up to assist in interest rate risk and liquidity management. The proposal takes the "balloon payment" criteria and elevates its importance over that of prudent underwriting. A loan with low loan-to-value, solid debt coverage ratio, and a balloon payment is inherently less risky than a loan with moderate loan-to-value, adequate debt coverage ratio and a 20 year amortization. The proposal would assign the less risky loan a higher risk weighting.

Additionally, assigning risk weighting based on loan-to-value as a primary criteria can also lead to unnecessary volatility in risk weighted assets during times of falling real estate values without consideration of the strength of the underlying borrower. An institution's allowance for loan and lease losses ("ALLL") methodology is required to consider factors such as loan-to-value declines. By making loan-to-value a primary risk weight criteria, capital is in essence being stressed twice during downturns.

We believe that the affects of this risk weighting model will be overwhelmingly negative for community based financial institutions. These institutions are lending primarily to individuals, professionals, and small businesses and these proposed requirements will raise the cost of borrowing for these borrowers or prohibit lending to certain borrowers altogether, as the institutions will have less capital to deploy into the community. We recommend that loans should not be excluded from Category 1 based solely on the balloon payment feature. We also recommend that the criteria for Category 1 be reexamined to not penalize institutions based on loan-to-value on prudently underwritten loans.

Issue of Concern: Tier 2 Disallowance of ALLL above 1.25% of TRWA

Under current regulatory guidance a financial institution must exclude from Tier 2 regulatory capital ALLL greater than 1.25% of total risk weighted assets. This limitation has survived in the proposal. For community based financial institutions, ALLL plus Common Equity Capital is often considered as their 'loss cushion" If the economic environment declines and losses in the earning asset portfolio increase, capital and the ALLL are there to absorb those losses. Given that all known and estimable losses in the loan portfolio are required to be recognized in the ALLL, and the provisions to the ALLL have already decreased the available capital, Tier 2 capital should not be limited by the 1.25% inclusion. The entire ALLL should be considered in this calculation.

The current proposal risk weights loans based on various criteria to determine total credit risk to the institution. The ALLL methodology also accounts for the risks in the loan portfolio. By limiting the amount of the ALLL that can be included in the Tier 2 capital, the proposal in essence risk weights assets twice by included including amounts in the denominator, while excluding loss reserve amounts from the numerator.

We recommend that the entire ALLL be included in Tier 2 capital.

Under the proposed rules, community based financial institutions will see increased volatility in their capital, increases in risk weighted assets, potential decreases in liquidity, increased borrowing costs for their customers, and decreased credit for small business and consumers securing loans by their primary residence. We acknowledge that changes to the overall capital structures of large institutions within our financial system are necessary given the events of the past few years. However, the rules as proposed were clearly not written with the impact to community based financial institutions in mind. The increased capital burden on these institutions, along with the increased regulatory burden, will drive up the cost of borrowing for customers of these institutions and limit access to credit. As small businesses are the primary customers of community based financial institutions and driver for our economy, these changes will have an effect far beyond the individual institutions.

Respectfully,

Nichols, Cauley & Associates, LLC