VALLEY BANK and TRUST COMPANY Member FDIC
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September 18, 2012

Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
Via email at comments@fdic.gov

Re: FDIC RIN 3064-AD95, FDIC RIN 3064-AD96, and FDIC RIN 3064-AD97

Dear Mr. Feldman:

This letter is written in response to the proposed Basel III Notices of Proposed Rulemaking issued in June 2012 requiring all banking organizations to comply with Basel III pronouncements and standardized approach NPR.

First, I would like to emphasize that I am completely in favor of strengthening the quality and loss absorption safeguards in the financial institutions sector. Our bank presently has more than 9 percent tier 1 capital, risk-based capital of more than 13 percent, and we are building our loan loss reserves (capital conservation buffer) to 2 percent of total loans. Our intentions are to hold capital well above the minimum required levels even when loan demand recovers. I don't have a problem with the proposed increases in minimum capital requirements. However, several areas are troubling and I believe unworkable, especially for community banks that have limited access to capital and, in most cases, have high concentrations in certain asset types.

A major area of concern is the inclusion of gains and losses on available-for-sale debt securities in the common equity tier 1 computation. Currently, our bank has a $50 million bond portfolio with approximately $1 million of unrealizable gains. In a "rates up" 3 percent rate shock test, this would mean we would have a $3 million loss. This loss from bonds would effectively negate our entire earnings addition to capital. In the years in which the capital buffer restrictions are employed, our bank would not be able to pay its bank stock debt (dividend restrictions) or disburse any discretionary bonuses. In addition, increases in the rate cycle generally correspond to increases in economic activity (loan demand). Therefore, with increased loan totals and losses in "available for sale," a bank could shrink its capital ratios for several years. (Obviously, a bank would then cease lending entirely, causing our local economy and community to contract.)

Further outcomes could be as follows:

- In order to avoid market swings, banks will "shorten up" durations of their investments. The outcomes will be less yield and thus lower earnings.
- A bank will have to understand how different asset classes react to interest rate swings (i.e., mortgage-backed securities versus Treasuries or municipals versus Treasuries). This will cause stress in certain markets and may shut off credit completely to certain groups and maturities. Our bank is a big purchaser of nonrated, bank-qualified, local municipal bonds. Many times we purchase the longer-term, 10- to 15-year bonds. If the troubling provisions stay in place under this proposal, a likely scenario would be to no longer support "long maturity or local bond issuances."
- Given the precarious position our government is in, a downgrade in the federal government credit rating appears likely. The result could be devastating on bank capital.

- Non-recognition of the "tax effect" of both gains and losses distorts the true gains or losses as they relate to capital.

- Banks may elect to reclassify to "held to maturity." Liquidity and liquidity ratios would be distorted if this occurs.

One issue in particular continues to befuddle me, and that is the limitation of 1.25 percent of risk-based assets in the loan loss reserve. Why would limitations be placed on an allocation of capital that serves as a "capital conservation buffer"? Banks should be encouraged to act in a countercyclical fashion, building reserves with pretax dollars during good times. This entire proposal is about more capital. For community banks, this is the best way to accumulate total capital. It should be encouraged, not discouraged.

The capital conservation buffer and its restrictions are probably the most devastating to community banks and the communities in which they operate. I am going to utilize the fully implemented transition period of 2019 which requires a total capital ratio of 10.5 percent in my scenarios. The following are some observations and likely scenarios for community banks.

Scenario #1
The majority of banks in Nebraska have major concentrations in agriculture. Today, agriculture is in a boom phase. In fact, several regulators have expressed concern that agriculture may be the next bubble. Any change in the risk rate would be devastating to our banks and communities. A change in risk rate from 1 to 2 would double the size of a bank's portfolio. Therefore, a $100 million bank with 9 percent, or $9 million, in tier 1 capital, a 12 percent risk-based ratio, and a $50 million agriculture portfolio would be devastated by the change. By increasing the risk rate from 1 to 2, the bank then would have $100 million in risk-weighted assets. The bank's capital ratios would be cut in half and would no longer be considered "well capitalized." The bank's reaction would be to shut off agriculture loans and reduce its exposure in this area. Obviously, this would hurt rural communities and the entire agricultural industry.

Scenario #2
A $10 million increase in loans would require a $1,050,000 offset in capital. Again a $100 million bank could easily see loan totals increase by this amount. If the bank makes 1 percent ROA ($1 million), the bank would not be able to dividend for its bank stock loan or pay bonuses under the proposal. Additionally, if you obtain a 4 percent spread on these loans, it would produce $400,000 in pretax income. Depending on your effective tax rate, your after-tax add to capital would be approximately $250,000, or a four-year payback.

Many banks in Nebraska have exposure in the livestock industry. It would not be uncommon for several requests to come in for tax-planning purposes. I can envision a scenario where a bank would say "no" to good loan requests due to these restrictions. Also, in any growing area you would be restrictive as to type and volume of loans.

Scenario #3
A bank wishing to grow through acquisition or to diversify through the use of an LPO will be limited in its ability to grow and diversify.

Scenario #4
A bank could have a great year, growing loans with record profits, but under the capital conservation restrictions, the bank would be unable to pay bonuses or pay its stock loan. This would be bad not only for the bank stock lender but also for key employees in the bank. Our ability to attract and retain good employees is difficult enough in today's environment. Why put another serious impediment in front of us?

The requirement for more capital with restrictions on growth, dividending, and bonuses coupled with bond volatility will have a negative long-term effect on earnings, attracting and retaining quality personnel, and capital formation. We do not want to move in this direction. Community banks are the heart and soul of our local communities. Restricting their activities will have a seriously negative impact on our communities.

Lastly, risk-rating asset groups are picking winners and losers. I don't believe regulators should be determining which sectors receive funding.

As stated at the opening of this letter, I am not opposed to increasing the minimum capital requirements. I also acknowledge that each bank can have different risk profiles and should have sufficient capital to provide the safeguards needed. I also think our examiners have done a reasonably good job identifying problem areas and management deficiencies. Having been in the banking industry for more than 35 years, I have seen several severe business cycles and I can tell you that in some cases having more capital would not have helped. When you have values chopped in half over night, you are going to lose some banks. Basel III was meant for large complex banking structures, not smaller community banks. The proposed restrictions are too punitive and the timing could not be worse. Right now we need banks to lend, not restrict lending.

After experiencing the last downturn and the resultant and current slowdown, I am sure the majority of banks are overcapitalized, which may lead one to conclude that most banks are in compliance and the NPR to revise and replace current capital rules should not be a problem. I believe, however, that this viewpoint is very short-sighted as we all have built capital at the request of our regulators. We are also at a low point as it relates to loan demand. A better scenario would be to review past recoveries to help determine what is needed to get our economy moving again and to measure necessary restrictions against more robust economic times.

In summary, the implementation of Basel III as proposed would significantly and negatively alter the way community banks serve their customers and communities and is unacceptable as we strive to improve and grow the American economy. Thank you for your time and consideration.

Respectfully submitted,

John P. Stinner

John P. Stinner
President & CEO, Valley Bank & Trust Co.
Chairman-Elect, Nebraska Bankers Association

cc: Reps. Jeff Fortenberry, Lee Terry, and Adrian Smith
Sen. Mike Johanns
Esther George, President & CEO, Federal Reserve Bank of Kansas City

JS/tm