FIRST WESTERN BANK

October 12, 2012

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Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
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Re: Basel III Capital Proposals

Ladies and Gentlemen:

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.

While I am supportive of the regulatory agencies' efforts to improve capital standards internationally and for systemic institutions, I have significant concerns about the current proposals as they relate to community banks. Basel III was designed to apply to the largest, internationally active banks and not community banks. Community banks did not engage in the highly leveraged activities that severely depleted capital levels of the largest banks and created panic in the financial markets. Community banks operate on a relationship-based business model that is specifically designed to serve customers in their respective communities on a long-term basis. This model contributes to the success of community banks all over the United States through practical, common sense approaches to managing risk. The largest banks operate on transaction volume and pay little attention to their customer relationships. This difference in banking models demonstrates the need to place tougher capital standards exclusively on the largest banks to better manage the ability to absorb losses.

First Western Bank is a $280 million financial institution originally chartered in 1910 as Citizens Bank of Booneville, Arkansas (a town of approximately 4,000 people now). We entered the Northwest Arkansas market approximately 20 years ago and now serve two markets, one in Western Arkansas and the other in Northwest Arkansas. Our Western market consists of many individual and farm customers while our Northwest market consists mostly of small business customers (less than 50 employees). We are committed to our customers and we strive to be a leader in helping to improve the quality of life for everyone in the markets we serve. In addition to providing a full line of quality financial services to our customers, we give back to the communities we serve through significant donations, contributions, and volunteer hours from our staff.

Like most community bankers in this country, we want to make sure we are able to continue to serve our communities as we have in the past. A strong economy is dependent on job growth and job growth is dependent on the availability of capital to fund small businesses that produce most of the jobs in this country. We want to ensure that the new rules do not reduce the ability of community banks to provide this capital.

Here are some of the specific areas of concern with the new proposals:

Incorporating AOCI as part of Regulatory Capital

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 under certain economic conditions. AOCI for most community banks represents unrealized gains and losses on investment securities held available-for-sale. Because these securities are held at fair value, any gains or losses due to changes in interest rates are captured in the valuation. Recently, both short-term and long-term interest rates have fallen to historic lows generating unprecedented unrealized gains for most investment securities. Additionally, demand for many implicitly and explicitly government guaranteed securities has risen due to a flight to safety and government intervention in the capital markets. This increased demand has caused credit spreads to tighten, further increasing bond valuations. Interest rates have fallen to levels that are unsustainable long-term once an economic recovery accelerates. As 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 First Western Bank, for instance, if interest rates increased by 400 basis points, the bank's bond portfolio would show a paper loss of $4,863,000 which means the tier one ratio would drop by 1.77%.

Large financial institutions have the ability to mitigate the risks of capital 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. Community banks do not have the knowledge or expertise to engage in these transactions and manage their associated risks, costs, and barriers to entry. Community banks should continue to exclude AOCI from capital measures as they are required to do today.

Capital Conservation Buffers

Implementation of the capital conservation buffers for community banks will be difficult to achieve under the proposal and therefore should not be implemented. Many community banks will need to build additional capital balances to meet the minimum capital requirements with the buffers in place. Community banks do not have ready access to capital that the larger banks have through the capital markets. The only way for community banks to increase capital is through the accumulation of retained earnings over time. Due to the current ultra low interest rate environment, community bank profitability has diminished, further hampering their ability to grow capital.

New Risk Weights

The proposed risk weight framework under Basel III is too complicated and will be an onerous regulatory burden that will penalize community banks and jeopardize the housing recovery. Increasing the risk weights for residential balloon loans, interest-only loans, and second liens will penalize community banks that offer these loan products and deprive customers of many financing options for residential property. Additionally, higher risk weights for balloon loans will further penalize community banks for mitigating interest rate risk in their asset-liability management. Community banks will be forced to originate only 15 or 30 year mortgages with durations that will make their balance sheets more sensitive to changes in long-term interest rates. Many community banks will either exit the residential loan market entirely or only originate those loans that can be sold to government-sponsored enterprises. Second liens will either become more expensive for borrowers or disappear altogether as banks will choose not to allocate additional capital to these balance sheet exposures. Furthermore, 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.

Community banks should be allowed to stay with the current risk weight framework for residential loans.

Mortgage Servicing Rights

Penalizing the existing mortgage servicing assets under the proposal is unreasonable for those banks that have large portfolios of mortgage servicing rights. Any mortgage servicing rights existing on community bank balance sheets should be allowed to continue to follow the current risk weight and deduction methodologies.

Regulatory Burden

In general, the number of new regulations and the complexity of these regulations are major concerns for the banking industry. There is no way at this time to ascertain the full impact of the Basel III requirements on our bank because of the amount of work that will need to be undertaken to fully understand the rules, train staff on how to apply the rules, implement the coding of each individual loan in the portfolio with new risk weights, re-program or purchase software to handle the new coding requirements, and then create the necessary reports to analyze the data. Again, this is especially burdensome on community banks which operate with limited resources compared to larger banks.

In summary, I fully support an increase at some level in the amount of capital that banks hold. However, the cumulative effect of each of the items above will have a severe impact on most community banks in this country. I strongly urge you to consider this impact and to consider an exemption for community banks from these rules. The national economic recovery depends on community banks being able to continue to serve their communities in a way that strengthens the local economies.

Sincerely,

Steve Gramling

Steve Gramling
President