WIPFLi LLP
CPAs and Consultants

Wipfli LLP
10000 Innovation Drive
Suite 250
Milwaukee, WI 53226
414.431.9300
fax 414.431.9303
www.wipfli.com

October 15, 2012

Office of the Comptroller of the Currency
250 E Street S.W.
Mail Stop 2-3
Washington, D.C. 20219

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue N.W.
Washington, D.C. 20551

Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street N.W.
Washington, D.C. 20429

RE: Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action

Ladies and Gentlemen:

We appreciate the opportunity to comment on the Basel III proposals approved by the Office of the Comptroller of the Currency, the Federal Reserve Board, and the Federal Deposit Insurance Corporation in June 2012. Our comments are limited to the notice of proposed rule regarding Basel III and the notice of proposed rule regarding the Standardized Approach, which we will collectively refer to as the Basel III proposal.

Wipfli LLP is a public accounting firm serving over 600 financial institutions throughout the country, but primarily in the Midwest. We provide tax, audit, and accounting services to our financial institution clients as well as a variety of consulting and advisory services.

The crisis experienced in the financial institution industry since 2008 has highlighted an apparent need for more safeguards in the industry to help prevent similar fallout in the future. The Basel III proposal would put in place higher capital requirements for all financial institutions as one of those safeguards to cover unexpected losses in times of financial crisis. In this comment letter, we wish to highlight some of the provisions of the Basel III proposal that may have unintended consequences, especially for community financial institutions.

Inclusion of Accumulated Other Comprehensive Income in Capital

The Basel III proposal would include accumulated other comprehensive income, which primarily consists of unrealized gains and losses on securities available for sale at most community financial institutions, as a component of capital. As you know, a community financial institution's securities portfolio generally consists of debt securities whose fair values fluctuate over time as interest rates change. These securities are maintained for liquidity purposes and may be sold when necessary, but are often held until maturity or call. When a security is sold, the gain or loss is included in capital by recognizing the gain or loss in income. We believe unrealized gains and losses on securities available for sale should not be included in capital for the following reasons:

- Unrealized gains and losses on securities are never realized by the financial institution unless the security is sold, at which time the gain or loss is recognized in income and included in capital, as it should be. Consequently, we do not believe they should impact capital unless they are realized or it is probable they will be realized (e.g., because of other-than-temporary impairment).

- Unrealized gains and losses on other financial instruments that are generally held to maturity and subject to changes in fair value related to interest rate fluctuations, such as loans, borrowings, and certificates of deposit, are not included in capital.

- While larger institutions can manage the impact of interest rate volatility on comprehensive income through different hedging instruments and strategies, community financial institutions often do not have the resources or expertise to manage this volatility as effectively. Thus, the negative impact of increasing interest rates will be felt much greater by community institutions.

We believe this rule will push community financial institutions to: (1) classify securities as held to maturity, which will provide less opportunity for institutions to manage liquidity; (2) invest fewer funds in securities, which could negatively impact earnings, and thus capital, of the institutions; or (3) maintain higher-than-required capital reserves for the potentially significant volatility created by this rule, further hampering growth in local communities.

Therefore, we recommend the final Basel III rule remove the provision to include accumulated other comprehensive income in capital. At a minimum we recommend the rule provide for removal of unrealized gains and losses from traditional, lower-risk securities held by financial institutions to provide liquidity and earnings support, such as US Treasury securities, US agency securities, and municipal securities.

Increased Risk Weightings for Certain Residential Mortgage Loans

The Basel III proposal would generally increase the risk weightings of residential mortgage loans based on the loan-to-value ratio at the time of origination and whether it falls under Category 1 or 2. We agree that increasing the risk weighting of a loan as the loan-to-value ratio increases is appropriate, but the proposed increase in risk weighting for Category 2 loans appears excessive for some loans that would be classified as Category 2. For example, loans that have a balloon payment do not appear to have inherently more risk than a first lien loan without a balloon payment. The additional capital requirement for a balloon loan seems to reflect a disparity in the perceived risk and the way these loans are actually utilized by community institutions. Most community institutions do not expect the balloon loan to pay off at the end of the term and generally utilize the short-term nature of the loan product simply to manage interest rate risk more effectively.

We believe the consequence of this rule will be to unnecessarily limit traditional lending options currently available to borrowers, such as balloon loans, that would not seem to add significantly more risk to the institutions.

We agree that loans with nonstandard terms, such as interest-only payments, 40-year amortization schedules, etc., or loans that are not properly underwritten should have a higher risk weighting, thus the Category 2 classification makes sense for such loans. However, we recommend properly underwritten balloon loans with normal terms be classified as Category 1. We also recommend junior lien loans with a loan-to-value ratio below a certain percent (e.g., 60 percent) be classified as Category 1.

Trust Preferred Securities

Many community financial institutions have issued trust preferred securities as a long-term, low-cost source of capital they understood would be counted as Tier 1 capital. Under the Collins Amendment of the Dodd-Frank Act, holding companies with total assets under $15 billion were allowed to have their trust preferred securities continue to count as Tier 1 capital. If trust preferred securities will no longer be classified as Tier 1 capital, most of these institutions, which are already at a disadvantage compared to large institutions when it comes to raising capital, will need to find new sources of capital at higher costs, further restricting the ability of such institutions to lend money to their customers.

We recommend trust preferred securities issued prior to the effective date of Basel III by holding companies with total assets less than $15 billion be grandfathered and continue to qualify as Tier 1 capital.

Mortgage Servicing Rights

Community financial institutions generally are not large enough to appropriately manage risks associated with 15- to 30-year fixed rate residential mortgages, which is why the vast majority of such institutions sell these types of loans to larger institutions or government-sponsored entities. However, institutions greatly value the relationships they develop with their customers, and many of them have chosen to retain the servicing on residential mortgages sold to continue developing these relationships.

The increased capital requirements under the Basel III proposal for mortgage servicing rights would encourage more community institutions to sell the servicing rather than maintain more capital. Creating an incentive for community financial institutions to reduce their customer relationships through increased capital requirements seems contrary to the current mission and purpose of community banking.

We recommend leaving the limitation of capital inclusion of mortgage servicing rights as it exists under the current capital standards since the proposed rules would unnecessarily discourage servicing of loans by community institutions.

Restriction on Dividends and the Capital Conservation Buffer

We understand the purpose of the capital conservation buffer for larger institutions and the effect of improving capital by decreasing dividend payments when capital falls below the capital conservation buffer measures. Capital is generally needed to cover unexpected losses, which in our experience are more frequent and more significant as an institution takes on more risk. Since smaller institutions do not carry the same level of risk on their balance sheets, we do not believe the larger capital requirement is necessary for community financial institutions.

If the capital conservation buffer is ultimately effective for community financial institutions, the rule should consider the dividend obligations S-corporation banks have to their shareholders to cover income taxes owed by the shareholders for bank taxable income.

We recommend the regulatory agencies include provisions in the final Basel III rule that allow S-corporation banks to make dividend payments for the purpose of covering shareholder income tax obligations when capital conservation buffers are not met.

Other Comments

It is apparent that the Basel III proposal will stifle many institutions' desires to make new loans, at least in the near term, as the institutions prepare to meet the increased levels of required capital. This is contrary to the U.S. Administration's stated goal of having the financial institution industry increase its lending to citizens and businesses in the current economic climate. We also believe it will be significantly more difficult for community financial institutions to raise capital in a cost-effective manner, especially if much of the industry will be looking for capital at the same time.

It may be necessary for institutions with more risk and, thus, more potential for unexpected losses to maintain higher levels of capital than current standards require. The risks inherent in a larger institution's balance sheet are typically much greater than those at a community financial institution. Consequently, we believe capital requirements should be lower for community institutions to reflect these differences.

Concluding Thoughts

We appreciate the regulatory agencies' desire for a consistent capital framework for all financial institutions. However, community financial institutions are significantly different from larger institutions in many ways. For example, community institutions have opportunities to: (1) develop lifelong relationships with members of the communities they serve because of their physical proximity; (2) be the first to help a small business get on its feet; (3) and serve smaller communities that may not be profitable for larger institutions. They also face challenges larger institutions have more control over, such as raising capital and managing interest rate and other market risks. Because of this, we believe the capital rules for community financial institutions should reflect the unique opportunities and challenges of community institutions.

We hope our comments are helpful to the regulatory agencies as they consider appropriate changes to the final Basel III rule.

Sincerely,

Wipfli LLP

Wipfli LLP
Milwaukee, Wisconsin