



CITIZENS
BANK, N.A.

October 21, 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”). Although well intended, I believe the rules as proposed will bring an end to the community banking model.

I am the Chief Financial Officer of a \$265 million community bank located in Southeast Kansas. We are proud of our tradition of supporting our rural communities in Southeast Kansas and this bank has been a pillar in Fort Scott for over 125 years. We support our local communities through lending and help our customers achieve their goals. Our customers, like all bank customers, represent the engine for our local and national economies and we are committed to helping our community grow and prosper. I strongly believe the Basel III proposals will have a detrimental impact on our ability to support this commitment. Although there are many components of the proposal that will negatively influence our institution, I will focus my comments to the two areas that I believe eliminate private investment in the community bank sector.

My first and foremost area of concern is regarding the inclusion of unrealized gains and losses on available for sale securities to flow through regulatory capital. We have utilized government agency securities for a number of years to supplement our bank balance sheet and to enhance our income profile. Over the past three years, we have experienced one of the toughest banking



cycles ever and our investment portfolio has provided tremendous flexibility to our institution in dealing with our share of bad loans. Our investment portfolio exceeds \$120 million and represents over 50% of our bank's earning assets. Our capital profile would be enhanced today with this rule change as we currently have a \$5.3 million unrealized gain on our portfolio.

However, it is extremely important to note we are in an unprecedented low rate cycle that has been heavily influenced by Fed actions to reduce long term interest rates. In an up 400 rate shock scenario under the proposed rules, our Tier 1 Capital will be reduced by \$22 million, or a 64.5% change from our base case today. This is volatility that will destroy our community bank and eliminate the investment portfolio as an earning asset alternative. We simply can not hold the instruments as an alternative when it creates this level of capital volatility.

One might make the argument that a bank can simply change the investment designation to held to maturity ("HTM") to avoid the capital rules. This may solve the capital issue temporarily, but it creates a significant liquidity trap in the future that will develop into a threat to capital. Banks like ours will be unable to respond to liquidity events in an efficient manner. Our contingency funding plan utilizes the investment portfolio in a number of ways to provide liquidity, including security sales if necessary. We would no longer have the ability to sell a security once designated as HTM to respond to a liquidity event without tainting the entire portfolio. The required change in the entire investment portfolio designation due to a sale of a single HTM security would present a threat to capital and would likely eliminate the ability to complete a sale. This uncertainty again forces our institution out of the securities market and limits our ability in responding to liquidity events. By necessity, our funding plan would likely become more reliant on secondary market funding sources to the extent available without the ability to utilize an AFS investment portfolio. I do not believe this is a prudent approach to liquidity management and the proposed Basel III rules will create a significant liquidity trap if adopted.

Community banks like ours continue to suffer from the increased burden of regulation. Our tier 1 capital ratio today is nearly 11% and climbing. We carry loan loss reserves exceeding 2.5% of our loan portfolio. Both represent the highest levels this bank has achieved and we are reaching a point where the inability to leverage creates earnings pressure. We have responded to a significant credit crisis and improved our capital ratio in the midst of this crisis. We would not have been able to achieve these results without the use of our AFS securities portfolio.

My second issue relates to the negative impact expected on community bank lending. The proposed risk weightings to conventional residential mortgage loans will serve to reduce our lending in this arena. I fully expect the proposed rules to result in increased costs for borrowers as a result of increased capital requirements (i.e., higher risk asset warrants higher price). We will also have inherent difficulties in managing our accounting systems to provide the necessary granularity required by the proposal. Approximately 30% of our loan portfolio is residential real estate. Many of our loans are originated in rural markets where the loans will not meet US agency requirements for sale to the agencies or other secondary market buyers. To shift a portion of this portfolio to a 100-200% risk weighting will certainly negatively influence our ability to continue supporting the housing sector in our communities. Basel III does not appear to consider Private Mortgage Insurance in the risk weightings, even though this is a strong loss mitigation tool. If a balloon loan is required to be a category 2 risk weighting, then we lose yet

another tool for interest rate risk management. In my opinion, the changes contemplated related to residential mortgages will significantly curtail our ability to serve this market and will only drive up costs for borrowers. Mortgage lending has been a bread and butter product for most community banks and is threatened by the Basel III proposed standards. The proposed standards are increasing capital requirements associated with traditional bank lending while eliminating the ability to manage interest rate risk (i.e., balloon loans carry category 2 rating).

As I stated at the onset, the community bank business model is threatened by the proposed rules. In my opinion, the proposed capital regulations seem to address larger corporate banks that maintain completely different business models than smaller community banks. Our ability to serve local customers will be negatively impacted, which will also negatively impact the local economies in which we operate. The majority of community banks we see and compete with have increased capital in a very challenging environment. I do not see the need to impose more stringent guidelines that will negatively impact the community bank business model. The inability to leverage, the limitations on mortgage lending, and the virtual elimination of securities investments as earnings alternatives will present severe threats to the community bank earnings potential. In reducing this ability, I believe the stringent capital standards will drive private investment out of the sector and will force additional consolidation. I strongly believe the community bank is best positioned to serve its customers and to support local economies. Basel III does not appear to be supportive of this objective.

Thank you for the opportunity to comment on the proposed capital standards. My hope is that you will reconsider the proposal and the related impact on community banks like ours. I feel strongly the rules as proposed will signify the end of the community bank model.

Sincerely,



Brian Tomstock
Chief Financial Officer