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Sent: Monday, October 15, 2012 12:43 AM
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Subject: Re: Basel III Comments from a Community Bank

Follow Up Flag: Follow up
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Hi Sid, I was in Del Rio all this Weekend. I can flame to have brought the rain...

(Comment period is still open on the new rules [until October 22nd](#), so there is a chance that regulators could still exempt community banks from the new rules.) I thus encourage vigorous comments!

I put a WSJ article below that should be helpful, the basic message is that the Basel capital regime proved itself to be a flawed system, and regulators have made it likely that it will increase compliance costs for community banks. Key point is that Basel III is the result of negotiations between the U.S. and Europe -they really don't have community banks in Europe, so all sides have looked at these new standards from a big bank perspective. We shouldn't impose European-style capital rules on small community banks in America.

Last June, regulators surprised a lot of people when they said that essentially every bank in the United States, no matter how big or small, would have to comply with Basel III, which requires banks to make complex calculations regarding their capital.

I share ABA's and TBA's concern over Basel III and i am hearing more bankers (small as well as regional guys now) deep concern over Basel III than on Dodd-Frank or other issues lately. It's a big issue that hopefully the regulators will correct (or maybe even scrap) this fall. Or, take committee/Congressional action.

Small Banks Are Blunt in Dislike of New Rules

It was supposed to be a routine conference call where bankers could ask U.S. regulators about a proposed rule on capital levels.

But then a man who identified himself as fourth-generation banker from central Minnesota started to complain about the possibility of having to set aside much more money when making nontraditional mortgage loans.

As about 1,500 other bankers listened, the banker pressed officials at the Office of the Comptroller of the Currency to justify the proposed changes, saying he had made such loans for 40 years with almost no defaults.

Then came an eight-letter barnyard epithet. OCC officials cut him off to take another question, but the next three bankers in line during the [July 19](#) call said they agreed with him.

It isn't unusual for bankers and regulators to have trouble getting along. But the 45-minute sparring match was a sign of the extreme anxiety and agitation over forthcoming rules by the OCC, Federal Reserve and Federal Deposit Insurance Corp. to implement an international agreement known as Basel III.

Executives at many small banks complain that the rules could force them to cut back on loans to small businesses or homeowners. Camden Fine, president of the Independent Community Bankers of America, a trade group, said he has never heard such blunt talk from bankers. More than 100 emails piled up in his box after the conference call, and similar outreach efforts by other regulators resulted in hundreds of additional messages.

The OCC said there was "very good turnout" for the agency's conference call. The angry Minnesota banker, who didn't use his name, confirmed the comments in an interview with The Wall Street Journal but asked not to be identified.

The current economic malaise has heightened concern about the health of smaller lenders. Smaller banks say they are a bigger driver of growth in their communities—particularly for small businesses—than their bigger, multinational rivals. Lenders with less than \$1 billion in assets made up about 10% of industry assets as of the first quarter but made 37% of small loans to businesses and farms, according to research by the FDIC, which has launched an initiative to better understand the challenges facing community banks.

At a vote to send the draft rules out for comment, Federal Reserve governor Elizabeth Duke raised concerns that new treatment of mortgages and other assets under the new capital rules could hamper legitimate lending by smaller lenders. Republican presidential hopeful Mitt Romney embraced small lenders' plight as well, saying at a fundraiser in London that the burden of the 2010 Dodd-Frank financial law has "caused a lot of community banks to pull back. At the very time we'd like them to step forward and provide financing to small business."

Small lenders say the elaborate Basel III system was designed to rein in the large, internationally active banks that brought the financial system to its knees, not small community institutions.

"We're paying for the sins of others," said Salvatore Marranca, president and chief executive of Cattaraugus County Bank, a 110-year-old institution in Little Valley, N.Y., with about \$185 million in assets, which is a unit of C.C. Bancorp.

Many are particularly upset about the complex system of determining how much capital a bank must hold against mortgage loans they make. The new rules seek to calibrate capital requirements to more accurately reflect the risk of particular assets on a bank's books: The riskier the loan, the more capital a bank must have to cover potential losses. The rules dictate what characteristics determine how risky a particular mortgage loan is.

The practical result is that many of the mortgages these banks make will require significantly more capital than they do now, for loans that community bankers say aren't high risk because of their personal relationships with borrowers. The complexity of tracking and calculating capital requirements under this system is also a burden for smaller banks, they say. And the Basel rules come as a number of Dodd-Frank changes hit them, including mortgage standards being written by the Consumer Financial Protection Bureau.

"Two of the lessons of the recent crisis are the fundamental importance of strong capital and the need to raise capital in banks of all sizes to match the risks of their activities," Comptroller of the Currency Thomas J. Curry said in a written statement. He said he is "sensitive to the burden and challenges faced by community banks." Only 1% to 2% of banks with less than \$175 million in assets would fall below the new capital standards, according to an impact analysis by regulators.

The OCC, the Fed and the FDIC are urging bankers to share their concerns in comment letters, due Sept. 7. The community bankers association, among others, has asked regulators for an extension given the complexity of the rules.

Small bankers say they could have trouble raising the extra capital they will need to meet the proposed rules since most of them don't have access to capital markets.

John Buhrmaster, president of First National Bank of Scotia in Scotia, N.Y., a unit of Glenville Bank Holding Co., with \$390 million in assets, worries the retained earnings won't be enough to boost capital and he will have to sell stock to new investors, possibly costing his family's control of the bank they have been running for four generations. Often, outside investors take over, "the priorities change...and the lending changes and one more option is lost for local businesses," he said.

C.R. "Rusty" Cloutier, president and CEO of MidSouth Bancorp., Inc., of Lafayette, La., said the Basel rules won't affect him as harshly as some smaller banks since he is on the big end of small—about \$1.5 billion in assets—and publicly traded. But his phone is "ringing off the hook" for smaller lenders looking for an exit. "It's good for me, but it's bad for America," he said.

All the best to you,

Always at your service,

Quico Canseco

Sent from my iPad

On Oct 11, 2012, at 10:23 AM, Sid Cauthorn <SCauthorn@thebankandtrust.com> wrote:

After extensive research I have formed some thoughts about Basel III that I want to communicate.

First, there is an incalculable difference between a Community Bank and a mega-bank that I'm certain you either don't understand or don't appreciate. The difference is as wide as that between Walmart and Joe's EZ Mart. You shouldn't treat the two the same. There should be different capital rules in place to mitigate the different risks.

The Bank & Trust, Del Rio, Texas is a \$408 million bank in a generally rural part of Texas. I understand that politicians and regulators are embarrassed that the Great Recession happened and want to affix blame. However, your desire to right the wrong has led to the regulatory pendulum swinging too far and it is hitting the Community Banks who largely had no participation in the problems that created the Great Recession. In the end, Basel III will not improve the Community Banking system in any material

way. **Bad people, bad bankers, bad politicians and bad regulators aren't going away just because you change the math.**

With all of that said, here are my recommendations:

1. **Including Other Comprehensive Income (OCI) in Tier 1 Capital is a mistake and unnecessary.**

- a. The Bank & Trust is a \$408 million asset bank with \$129 million in AFS securities and \$5.9 million in unrealized gains in our AFS bond portfolio. How would you propose we deal with Basel III when interest rates rise again and we have \$5.9 million (or more) in unrealized depreciation in our bond portfolio? And, in a Community Bank, why would unrealized gains or losses in the bond portfolio make any difference any way? This never was an issue before the implementation of AFS/HTM accounting. For regulatory accounting purposes AFS/HTM has done nothing but create an artificial problem because the vast majority of Community Banks aren't active traders of their bond portfolios. I know that in our case, and I'm sure in the case of many Community Banks, bonds are treated as long-term, earning assets (held-to-maturity) even though they are classified as Available-For-Sale. **Do you understand that if interest rates rise materially, and bond values decline accordingly, that you could very well be faced with an artificial financial institution capital crisis of unprecedented scale? The only difference will be how you've chosen to do the math. Why change what has worked perfectly well as it relates to the capital adequacy calculation for true Community Banks?**
- b. **Do you understand the unintended consequences of this rule?** Are you prepared for the headline "**Capital Crisis in the Banking Industry – Take Your Money Out NOW!**"? In the history of banking OCI has never been part of the capital adequacy calculation for Community Banks. By changing the math you are setting yourself (and, more importantly, banks) up for an artificial capital crisis when rates rise. What used to not be a concern at all, and has never been a problem for the true Community Bank, will now become a crisis of immense proportions that will be aired on all the major networks and newspapers across the country.
 1. Are you prepared for a massive run on deposits when the headlines hit?
 2. Are you prepared to close banks because you've changed the math?

This proposal is idiotic. Who thinks up this stuff?

- c. Other concerns include:
 1. Should we limit our investments in longer duration assets? How will this affect local government's ability to issue bonds? What will happen to bank's willingness to make mortgage loans? How will this affect the housing markets?
 2. How many banks will sell a large portion of their current portfolio to book the gain...or reclassify a large portion of their current AFS portfolio to HTM? How will selling for the gain affect future bank earnings? How will selling affect banks future interest rate risk? Have you considered what impact this will have on the markets for those securities?
 3. We are very concerned about how this proposal might impact our asset/liability management function and our liquidity and contingency funding plans. **We are concerned that, for plain vanilla Community Banks, the universe of managing capital, interest rate risk, liquidity and**

contingency funding planning will be unnecessarily, profoundly and irrevocably changed.

- d. Changing your stance on Other Comprehensive Income is problematic in that it only takes into account a small piece of the puzzle. As an example, what about the value of our DDA and other low cost deposits? The “value” of DDA is going to appreciate at least as rapidly as the bond portfolio is going to depreciate in a rising rate environment. Why just adjust for one small part of one side of the equation? Keep in mind that **I’m NOT advocating for complete mark-to-market** as I’ve long believed it to be irrelevant and adds no value to the analysis of a Community Bank’s financial condition. **Mark-to-Market is nothing more than busy work conjured up by some monkey in a box who really doesn’t get how Community Banks operate.**
 - e. Changing your policy to include OCI as part of Tier 1 Capital in no way reflects the real ongoing value of a bank. As a matter of fact, when I write my annual letter to shareholders, I exclude changes in OCI for the purpose of communicating the change in book value of our bank. Changes in OCI pump up capital when rates are low and knock down capital when rates are high and it doesn’t make sense to attribute such importance to those changes in a Community Bank. **Community Banks are not active traders of their bond portfolios. We treat bonds as earning assets over time.**
2. **Why are you making Risk Weighting of mortgage loans so difficult?**
- a. As I mentioned earlier, we are a \$408M asset bank with approximately \$79 million in mortgage assets. Our 125 employees provide mortgages in four communities. **The most likely result of this proposal is that it will cause us to re-think whether making mortgage loans is worthwhile. Allocating a ton more capital to a \$79 million mortgage portfolio that’s realized less than \$100 thousand in losses over the last twenty years is idiotic.** And how much will monitoring costs rise to make sure that we’re accurately accounting for all the different risk-based capital tiers of the proposed plan? Our earnings will be negatively affected and our regulatory burden will increase without adding any real value to you or us.
 - b. This proposal plays into the hands of those who want just a few large, multistate banks because it will squeeze Community Banks out of the market over time. **This sounds like an Obama jobs program.** Rural borrowers in Texas, due to the impact of Dodd-Frank legislation on traditional mortgage lending, are faced with a market in which Community Banks are making fewer mortgage loans. This proposal will only make it worse and make the cost of borrowing more expensive to the consumer.
 - c. If I understand the FDIC’s and Fed’s position, you believe that the best way to account for mortgage portfolio risk is to:
 - 1. require banks to classify loans on the books based on their Loan to Value **at the time of booking rather than their current Loan to Value**, and
 - 2. banks are not allowed to include any amount of PMI in that calculus.

That sounds kind of ridiculous when you say it out loud doesn’t it? And how many community banks have the resources to jump through your mortgage hoops? Or maybe that’s the point. Maybe the unsayable is that you really want community banks to consolidate and that the talk of ending “too big to fail” is just a ruse.

- d. I completely agree that non-traditional and otherwise risky loans, like interest-only mortgages, reverse mortgages and non-amortizing mortgages, should bear a high RBC weighting (and 200% isn't unreasonable). But **conventional, single family, owner occupied mortgages to borrowers with good credit and repayment capacity should not fall in that category. Even 95% mortgages with PMI have been considered safe for a few generations. A complete rewrite of the rules isn't justified simply because some bad actors gamed the system.**
 - e. And finally, wouldn't it be a better idea to actually stop bad lending when you see it happening? Isn't it a better idea to recognize when a relatively few banks are placing the entire financial system at risk by creating odd-ball financial products (ie the aforementioned interest-only mortgages, reverse mortgages, non-amortizing mortgages, etc) that don't make sense. It's interesting to me that the politicians and regulators haven't done a very good job of criticizing themselves when it comes to the recent financial crisis. I remember clearly expressing concern about some of the products we were having to compete against but somehow some banks/mortgage companies were allowed to continue unabated and actually allowed to geometrically expand their sale of these products. That's on you.
3. **Basel III should be amended to expressly allow SCorp banks to upstream shareholder tax liability to their shareholders regardless of the bank's capital level if the bank is profitable.**
- a. It will be detrimental to the Community Banking system to limit an SCorp bank's ability to upstream the shareholder's income tax liability when the bank is profitable. Think about it this way...if an SCorp bank is undercapitalized according to Basel III math but still making money and the SCorp is prohibited from upstreaming tax liability to shareholders...how many shareholders are going to jump to the front of the line to invest new capital if they're uncertain they will receive distributions sufficient to pay their taxes? The last thing everyone wants is for a bank that is capital deficient, but making good money, to have no one standing in line to inject new capital because they are unable to pay their income taxes.
4. **Risk Based Capital calculations aren't meaningful because where the rubber meets the road, in times of financial stress, all you really care about is Tier 1 Leverage Ratio.**
- a. I have first-hand experience with this as a result of the growth of our bank during 2009. That year, other than the Examiner-in-Charge for the FDIC and our State regulator, nobody up the chain of command of the FDIC understood, nor took the time to understand what we were doing and how that impacted our capital. An no one at the FDIC, other than the EIC, gave us credit for the quality of bank that we'd run for 100 years. All they were capable of seeing was the financial world crashing and began assuming the worst of everyone.
 - b. The FDIC certainly wasn't interested in what our Risk Based Capital Position was at the time. All the FDIC cared about was our Tier 1 Leverage Ratio, which is fine, but don't pretend that the Basel III way of calculating capital adequacy is any more meaningful than the old way of calculating it as it relates to Risk Based Capital.
5. **The regulatory burden just keeps growing.**
- a. Our bank has \$408 million in assets and 125 employees. We are already laboring in an environment involving increased regulatory scrutiny in both Safety & Soundness Exams and Compliance Exams through the burdens being placed on us by the Dodd-Frank Act. **Compliance regulations have become so complicated that we've had to allocate the time of three senior executives for compliance oversight, plus keep**

our compliance officer on the payroll, plus engage the services of external audit firms for periodic audits. It appears that as proposed, Basel III will require further change to our internal reporting systems. More than likely we will have to unnecessarily and materially increase personnel hours attributed to compliance matters. The complexity of the data requests, especially as they relate to the various RBC tiers for mortgage loans, probably means that we will also have to purchase new software systems to manage the complexity. **None of these requirements will enhance the quality of service we deliver to our customers nor to our community. The compliance costs will pull money out of capital and earnings rather than help our borrowers.**

- b. All that will be left is for big banks to become bigger because only scale can offset the inefficiencies created by the proposed regulation. Federal regulators may not be troubled by a country that has only a handful of mega-banks. But from my perspective, and from the perspective of our small business and consumer clients, Community Banks serve a vital function in our economy. It would be a shame if these new international capital requirements unnecessarily lead to their demise. **And what the heck are we doing even considering submitting to a regulation that was written for European banks?** Euro nations are nothing like us...and that's a good thing.

In the end, I understand the objective of the proposed changes. And, in principle, I believe changes need to be made. However, the proposed Basel III changes, as they relate to Community Banks, are just dead wrong. And while I'm not smart enough to run a J.P. Morgan Chase, or a Bank of America, or a Citi, I have been pretty successful at running a conservative community bank and holding company for many years. As I learn more about Basel III, I'm struck by how complicated the explanation of the proposed rules is. I heard a smart guy say, during the heat of the financial crisis, that **"if a bank is too big to fail it's too big to manage"**. The same principle applies to Basel III...if it's too complicated to clearly articulate and apply, then it's too complicated for practical use. I believe a simpler, more traditional approach would be a better solution for Community Banks with non-complex balance sheets. The granularity with which Basel III has to be explained makes it obvious that the proposal is more complicated than necessary. My advice to you is to focus on the stuff that really matters, structure it so it's scalable based on complexity and size of the institution, and make it simple to understand. Anything else is a mistake. Let the words **"Keep it simple stupid"** serve as your guide.

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