From: John Nelson [mailto:john@lanarkbank.com]
Sent: Friday, October 19, 2012 9:20 AM
To: Comments
Subject: Basel III RIN 3064-AD95, RIN 3064-AD96

My name is John H. Nelson. I am President of the Exchange State Bank, Lanark, Illinois. Our primary regulator is the FDIC. My bank is located in Carroll County in Northwest Illinois. We are an $82,000,000 bank and we serve a small farming community, population 1,600.

I am writing to you to express my concerns with the new Basel III rules.

I fully support the idea of requiring higher capital levels for all Banks and Credit Unions. However, it seems to me that the Basel III accords were meant for the largest, internationally active banks and are very sweeping in scope and complexity, especially for a very small bank. My bank did not participate in the reckless behavior that contributed to the financial crisis and economic downturn. My bank has a lower risk profile and operates under a less complex, relationship-based business model. Therefore, I feel that the proposed requirements of Basel III should not be imposed on my bank, or other small community banks throughout the country.

I encourage you to exempt small community banks from the proposed Basel III requirements. I would support your efforts to raise general Tier 1 capital requirements under the existing Basel I requirements as long as the levels are the same for all sizes of Banks, Credit Unions, and the Farm Credit System.

We have spent considerable time and effort trying to understand the new rules and in calculating how they affect our capital ratios. We have paid our accountant to help with this process. We used an outline from the Community Bankers Association of Illinois to calculate our position after a +300 point move in interest rates and a 2.5 times increase in our 90 day past due loans. To be honest, I'm not totally confident the report is accurate. The report shows that we would have a decrease of 12.5% in our Tier 1 capital position. Our Tier 1 Common Equity capital level would be 14.4% under the above scenario. Our Tier 1 Common Equity capital position is a little above 16.5% now.

I think it would be a terrible idea to include unrealized gains/losses on Available for Sale securities in the Tier 1 capital calculation. Currently, in this low rate environment, we have a $1,519,274 gain in our $47,370,995 bond portfolio. Should rates rise quickly, that gain could turn negative very quickly. Our Tier 1 capital is now at $7,098,340 (not including the AFS gain). As a small bank, we are not able to quickly raise capital in the event of a 1 or 2 quarter jump in interest rates in order to stay above the new regulatory minimums. Major changes in market interest rates could negatively affect our long term capital plans and significantly affect our ability to grow and serve our community. An unintended result of implementing this portion of the rule would be for us to try to minimize interest rate risk in our portfolio for fear of a negative impact to our capital. We would likely purchase more short term bonds resulting in a decrease in our portfolio returns. As portfolio returns decrease, less capital accumulates. We would also likely shorten our duration making us more at risk for greater earnings volatility during future interest rate cycles.

We carry a considerable amount of mortgage backed and municipal securities in our portfolio. When considering the increased credit risk for municipals and mortgage backs, combined with the longer maturities typical of these two types of securities, the impact of the proposed rules on my small bank would be increased price volatility and the potential for greater unrealized losses, especially in a rising rate environment. These two types of securities are essential for our nation to fund municipal projects and to support our housing recovery. Decreased demand for these two types of securities would result in higher costs for homeowners and government.

For the above reasons, I believe it would be a grave mistake to include the AFS adjustment in the Tier 1 capital calculation.

I do not understand why one area of the proposed rule does not give the bank credit for an ALLL balance of 1.80%. Your proposal suggests 1.25% is adequate. Your examiners already review our loan watch lists to make sure problem loans are identified and properly accounted for under RAAP and GAAP rules. I feel it would be irresponsible for us to lower our ALLL balance to 1.25% as your proposal suggests. Our coverage ratio is very low, at 7.9% as of our last exam. This portion of the rule should not be adopted.

My bank has met the real estate loan needs of our community for many years using balloon payment mortgages. Larger banks have fundamentally abandoned small communities. For many borrowers, balloon mortgages are the only way their loans can be structured without putting the bank in an unacceptable interest rate risk position. The economic consequences of penalizing balloon mortgage loans by increased risk weighting would be severe to small community banks and the communities and people they serve. Regulators have many tools to fulfill their supervision, regulation, and enforcement functions to ensure the safety and soundness of community banks. Reasonable use of these tools should be the primary way to address mortgage lending risks and potential abuses, rather than subjecting all community banks to higher and, in several instances, nonsensical changes in risk weights for mortgage loans. If these rules are adopted, the regulators will have dropped a portion of their responsibility.

I am extremely concerned about the increasing regulatory burden faced by small banks. We simply do not have the staff and expertise to keep up with what seems an endless stream of regulatory mandates under the "one size fits all" theme. Real estate borrowers now face a mind numbing stack of papers - forms that are meant to give the customer more information to make more informed decisions - to read and sign. Often times, the effect of this process is that the customer walks away not sure what they have signed, even after the best efforts have been given by the loan officer to help them through the process. We seem to learn more each month about new regulatory requirements contained in the Frank-Dodd Act. Your proposals will force us to devote more staff time to compute and stress test the complex risk weights and capital calculations to assess current and future compliance with regulations. Your proposals add unnecessary regulatory burden on top of an already crushing regulatory burden that we face on a daily basis.

I do not think it is fair that Credit Unions are not included in the scope of your proposals. I realize there is a jurisdiction problem with the Fed and FDIC, but I am concerned that when the NCUA gets around to proposing their own rules, that they will be less rigorous than those proposed for the banks. Why should the same rules not apply to the Government sponsored entities such as the Farm Credit System?

I do not believe these proposals are wise, just the opposite. I believe that if higher capital levels for small banks are the true objective, then possibly starting over is the best way to produce a better outcome. I ask that you consider the unintended consequences of these proposals and their effect on the viability of small community banks across the country. These proposals are not in the best interests of the United States and will be especially harmful to the economic prospects of hundreds of small banks and the communities they serve.

Thank you for your consideration.

Sincerely,

John H. Nelson
President
Exchange State Bank
Lanark, IL