First M&F Corporation

October 19, 2012

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

Officer of the Comptroller of the Currency
250 E Street, SW
Mail Stop 203
Washington, D.C. 20219

Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20219

Re: Basel III Proposed Capital Rules

VIA: Email with Express Delivery follow-up

Ladies and gentlemen,

I want to take this opportunity to comment on the Basel III Proposed Capital Rules for U.S. banks. I will be brief and avoid as much technical language as possible while focusing on what I believe to be the practical effect.....unintended consequences if you will.... of several of the new proposed rules and guidelines. I will be commenting on the new proposed rules on the capital treatment of the following items which I feel will certainly affect our bank in particular and all community banks in general to some extent:

1. Unrealized gains and losses on AFS securities
2. Trust Preferred Securities
3. Residential Mortgage lending
4. Home Equity lending (HELOCs)
5. Acquisition, Construction and Development Lending
6. Services to the under-banked

<u>Unrealized Gains and Losses on AFS securities</u>

According to the new proposed rules, unrealized gains and losses on all available for sale securities would flow through to Common Equity Tier 1 capital (CET1). As you know, most bank-eligible debt securities values vary due to changes in interest rates, not changes in credit risk. This consequence will not only add volatility to capital but also fundamentally change the way in which banks manage their portfolios, significantly affecting the flexibility and balance sheet planning options available.

To add some specific, real-world examples, our bank would currently get a $4 million (25 basis point) boost to CET1 if our unrealized gains were included in capital. However, in a rising rate environment, a rate shock of 200 bps would decrease capital by $17 million (100 bps) and even more with a 300 point shock. Clearly this risk to capital would have to be avoided.

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In response to this change, our bank, and most others, might opt to adopt a "defensive" posture by radically shortening the duration of the investment portfolio to remove as much rate risk as possible. This obviously would be an impediment to asset/liability management and gap structuring of the balance sheet as well as ultimately having a deleterious effect on earnings as banks would be unable to maximize portfolio yields within the constraints of good balance sheet management. The alternative to shortening the portfolio would be to move some portion of the portfolio to held-to-maturity (HTM). In this option, instead of negatively affecting earnings, we would degrade our liquidity position. Neither option is desirable. And one final point: the prospects for lower yielding portfolios in conjunction with the current low rate environment and tepid loan demand might combine to influence a major de-leveraging across the industry.

Trust Preferred Securities

Under the new proposed rules, trust preferred securities (TruPS) would be phased out as CET1 over 10 years – a major mid-term consequence for a long-term capital element. Our trust preferred, issued in 2006, comprises 23% of our consolidated capital and is a critical element in our long-term capital planning. It is self-evident that this change is in direct conflict with the Collins Amendment for banks under $15 billion in assets. This rule change is, unfortunately, akin to changing the rules after the game has started.

This bank would have to replace its TruPS, a very cheap form of Tier 1 capital, with a common equity raise of uncertain success and at a time when micro-cap bank price to book would dictate a very high cost to the new equity, at a very dilutive price to legacy shareholders. Furthermore, in the absence of an "offensive" event available to utilize the new equity, and with returns depressed across the board, the sector could expect further declines in returns on equity.

Many community banks have both TruPS and TARP/CPP (or in our case TARP/CDCI). Dealing with a TARP repayment plan before the coupon is re-priced AND suffering the exclusion of TruPS from capital would be a serious blow to community banks at a critical time.

A final comment on this issue: Lower (phased out) capital in this area, combined with higher asset risk weightings on Acquisition, Construction and Development loans, Home Equity Lines (as Category 2 credits), Residential Mortgage loans and past due loans - all part of the new rules - might also require significant balance sheet de-leveraging with all of the attendant negative effects on the markets and the economy in general. I obviously feel that trust preferred securities should be "grandfathered" into CET1 capital.

Residential Mortgage Loans

Under the new rules (Standardized Approach NPRs), current 1-4 Family residential mortgages with loan to value (LTV) less than 60% do receive a break on risk weighting, going from 50% to 35% (i.e. "low risk category 1 loans), with higher LTV loans still included in category 1 albeit with weightings up to 100%. However, under the proposed rules, loans with balloon payment terms are category 2 loans with risk weightings up to 200% at the higher LTV levels.

For many community banks, balloon payments terms have been offered for years as an important part of their product base. Our bank is no different. This is a popular product with consumers, allowing pricing and down-payment flexibility, and with management, allowing some level of re-pricing flexibility, an important balance sheet management tool. The increase in risk weightings on this product will certainly have a dampening effect on our bank's ability to offer them with a concomitant effect on local mortgage markets. It should be noted that the default or loss profile of these loans in our bank has been low indeed during the recent crisis. It would appear that to some extent, this is a solution in search of a problem. It would therefore seem reasonable to expect, at a minimum, that balloon terms get a reprieve from this rule or, at a minimum, that current loans in this category be grandfathered and only new loans with the balloon feature receive the new treatment.

Home Equity Lending (HELOCs)

The new proposed rules potentially create a very real stifling effect for HELOC lending. It appears that the NPRs would require that HELOCs, most of which have been written without annual or lifetime interest rate caps, would immediately fall into category 2 with much higher risk weightings. Again, our HELOC portfolio has performed very well during the crisis and continues to be a popular product. A exemption of HELOCs from this reclassification would seem to be reasonable but failing that a grandfathering provision for existing loans would soften the blow.

Acquisition, Construction and Development Lending

Acquisition, construction and development lending (AC&D) credit standards have tightened considerably given the role this sector played in the financial crisis. In our bank's experience these new standards are entirely appropriate. The disciplines we've learned and applied to this area such as global cash flow analysis, absorption rate review, real property market analysis, developer equity levels, owner versus non-owner occupancy and concentration risk have and will serve us well in this economic-critical area. These disciplines complement the already prudently applied underwriting standards of debt-service coverage and income producing characteristics. These are appropriate underwriting and risk-mitigation factors but, nonetheless, will have and have had a depressing effect on the market since even those AC&D loans with a high debt-service and other credit-worthy characteristics, absent the exceptions in the new rule, will fall into the High Volatility Commercial Real Estate (HVCRE) category. The creation of the HVCRE loan category with a 150% risk weighting will serve to further dampen this product offering. The current credit-tightening regime, while wholly appropriate, will be exacerbated by the added capital cost to such lending.

Services to the Under-banked

As a Community Development Financial Institution, our bank takes an active role in bringing vital financial services and financial education to markets with low and moderate income households. Many of the proposed rules mentioned above will make it more difficult for this bank to serve these markets, restricting our capacity to offer the broadest array of products. In fact, our capacity to support community development activities will lessen due to newly imposed risk allocation considerations and capital requirements across many product lines important to this sector of our customer base.

Summary

Many of the new proposed rules might be considered as overreactions to perceived credit risks that are already addressed through the proper administration of the reserve for loan losses, in particular the

HVCRE rule and the rules relying on past due status to increase risk weights. This seems to imply a double-counting or double coverage of the risk that is appropriately already addressed in the reserve.

At a higher level, many of the new rules may have a negative impact on bank's willingness to lend. The higher capital standards, the exclusions of certain items from CET1 and the higher risk weights will diminish bank appetites for certain products and may withhold from our communities much needed credit for small businesses and consumers. The effects on job creation and economic development, though uncertain, may be overwhelmingly negative. Furthermore, the implicit depressed appetite for certain products and the CET1 capital adjustments in the proposed rules (Trust preferred and unrealized securities gains and losses) will hamper our ability to manage our interest rate risk and liquidity.

Thank you for the opportunity to comment on these momentous changes. It is my hope that you will consider major adjustments in the new proposed rules.

Sincerely,

Hugh S. Potts, Jr.
Chairman and CEO
First M&F Corporation
M&F Bank