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Docket ID OCC-2012-0008 and
Docket ID OCC-2012-0009

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Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
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Docket No. R-1430; RIN No. 7100-AD87 and Docket No. R-1442; RIN No. 7100-AD87

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Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
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RIN 3064-AD95 and RIN 3064-AD96

Re: Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action (the “Basel III Proposal”) and Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements (the “Standardized Approach Proposal”)

Dear Agencies:

The Colorado Bankers Association (“CBA”) provides these comments on behalf of our members on the Basel III Proposal and the Standardized Approach Proposal (together, the “proposals”). We do not address provisions that apply only to “advanced approaches” banking organizations. CBA has a membership consisting of the commercial banks and thrifts that hold well over 90% of all banking assets, offices and employees in Colorado referenced as “banks” herein. Our many associate members who serve the needs of financial institutions in the state also have expressed concerns reflected in this letter.

The proposals seem to be driven by a desire to better position financial institutions to deal with problems faced recently in the financial crisis, and those in the next recession. Our “main street” members have substantial insight to offer on appropriate measures to protect banks from risks of future financial challenges. We conclude that there are serious flaws in the proposals that will have unintended consequences with a large impact on regional and community banks and the customers and communities they serve as well as our economy.

The proposals offer many and varied implications to banks and the economy that are not yet fully identified and certainly not yet understood. In many instances there is potential for a particular aspect of the proposals to change bank balance sheets, the way banks do business and our ability to serve our customers and communities. Simultaneous adoption of the proposals will introduce issues to banks that are not yet fully understood.

Conclusions:
CBA concludes that the regulatory agencies should withdraw the proposals in order to take more time to study the potential impacts of various components of the proposals. We believe the regulatory agencies should then analyze those impacts under a variety of market circumstances, consistent with appropriate industry risk management principles. It is imperative that regulators quantify the impact on banks in an increased interest rate environment. We believe it is critical that the impact on customers and communities be considered, and since there are so many and such deep consequences of the proposals that Congress receive reports from you and have an opportunity to provide further guidance to you prior to rule adoption. Those reports should reflect:

- Immediate consequences to banks of varied sizes and circumstances based on an environment of increased interest rates and reflecting
  - Impact on banks' current capital assets
  - Amount of increased capital to be raised by a variety of banks (e.g., $100M, $500M, $1B. & $5B)
  - Resulting changes in balance sheets for those banks as they adjust size, lending and other items to manage to the new requirements
- Likely changes in bank lending in specific lines based on the application of the proposals and the cumulative impact of regulatory changes from the Dodd-Frank Act (e.g., impact on banks of the varied sizes as suggested above in real estate lending: risk-weighting, Qualified Mortgage (QM), Qualified Residential Mortgage, (QRM), RESPA\TILA Reform, Servicing, Mortgage Loan Origination Compensation, Appraisals, HOEPA Standards For High Cost Loans, drastically increased compliance costs…). Banks will have to deal with the cumulative impact. Regulators should analyze it that way.
- Anticipated impact on consumers and businesses of changes in such lending (availability, amounts, altered customer terms, rates…)
- Overall impact on employment and the economy.

The proposals would take too much authority from experienced bankers and regulators to make rational and customized evaluations of risk. That is undesirable. The most effective and appropriate regulation we think is implemented by bankers and regulators familiar with the institutions and experienced in managing and regulating banks in a variety of economic circumstances and knowledgeable of an institution's risk profile. We think risk weightings assigned by federal agencies cannot be as precise as on-site judgments by examiners. Principled and qualitative measures of risk as monitored by bank management and experienced examiners familiar with on-site circumstances cannot be replaced by risk weighting set in Washington, DC.

Community banks will be hurt especially hard. These institutions, as well as many regional institutions, have simple and traditional balance sheets. Deposits are loaned by banks in their local markets. They generally do not invest in securitizations, do not utilize complex derivatives, and do not engage in substantial off-balance sheet transactions. Community banks lack the operational capabilities to manage the volatility and complexity of bank balance sheets that will result if the proposals are adopted without major changes. Community banks therefore will further limit their product offerings or price them substantially higher than more complex banks in order to mitigate the risks and costs introduced by the proposals. These changes would impact the communities served by these institutions and their small businesses and consumers, and the banks themselves.

In general we believe we will see these results:

- Record capital – Banks now hold record amounts of capital (16%+ total risk-based in Colorado), but the proposal requires more capital, we believe hurting bank customers.
- Capital definition – The proposals change the definition of capital – disallowing forms of capital blessed by Congress just two years ago in the Dodd-Frank Act. For community banks this is very expensive.
- Risk-weighting – We believe risk-weighting will drive how banks lend, incenting banks to focus on certain loans and not others.

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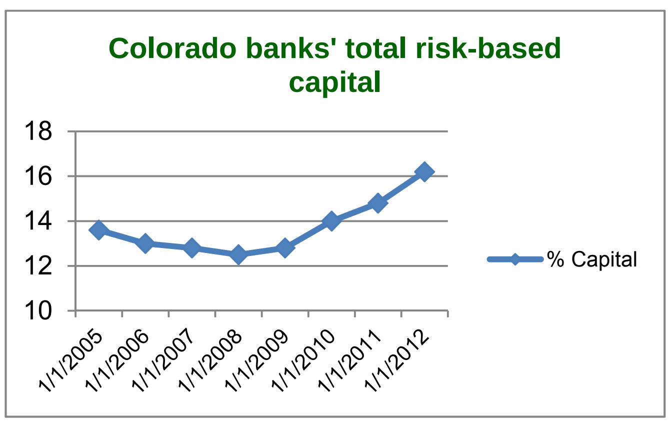
- Less credit available – Less credit and liquidity we think will be available to small businesses, as banks reduce lending to meet higher capital standards; this limits economic activity.
  - Uncertainty/transition – Lenders facing uncertain rules will be cautious and restrict lending until rules are clear; customers will be hurt as banks resist growth and expansion until there is certainty, and during a transition.
  - Targeted credit reductions – By increasing capital requirements the proposals discourage lending for acquisitions, development and construction loans, and certain other short-term loans.
  - Housing – Loans for housing we believe will be harder to obtain – including for residential mortgages, home construction, and land development. Many smaller banks likely would exit residential real estate lending.
  - Community development – The same bad impact could occur in community development lending, including financing of affordable housing (loans, bonds).
- Compounds customers' financial difficulties – Past-due loans are discouraged with higher required capital; banks are pressured to be more aggressive in resolving the delinquency ASAP (quickly calling the note, seizing collateral, foreclosing....) instead of working with the borrower to have the loan brought current and eventually repaid. This provision is not needed and in fact is hurtful to customers and the bank
- Double impact – Basel III requires banks to build capital at the same time GAAP accounting requires bigger loan loss reserves. Reserves aren't allowed to be built in good times; only when the economy and businesses struggle.
- Complexity – The rules' complexity and detail make it expensive for banks to compute and comply, and difficult for investors and others to evaluate the capital condition of banks.
- Risk in bank – As capital increases, ROI decreases. To attract investors, a bank has few tools to increase ROI but to make riskier loans at higher rates. Excessive capital can increase risk in banks by encouraging management to reach to riskier loans in obtain ROI necessary to attract or retain capital. We regard this as unwise.
- Securities, municipal bonds – Gains and losses on securities held for sale will impact capital, providing substantial volatility. It also raises concern about a bank's investment in municipal bonds issued by local governmental entities.
- Shrink/consolidate – As banks find it harder to raise new capital, some banks will be forced to shrink or sell – leading to less credit and/or a more concentrated and ultimately less competitive banking industry

General Colorado Impact

1. Colorado Estimate, Consequences and Economic Impact.

The proposed capital requirements for banks we believe will reduce available lending and drive up loan rates – injuring businesses and jobs, and hurting consumers. Recent efforts in support of small businesses and jobs we fear will be thwarted by the adverse impact on borrowers and the economy. We believe the proposals are unbalanced and damaging to businesses and jobs.



The Colorado Bankers Association estimates a required increase in capital for Colorado banks of \$250M-\$300M, leading to \$2.5B-\$3.0B less in lending in Colorado (a 4.5%-5.5% decrease in total lending).

That means less available credit, and higher priced loans. Colorado banks already have their capital at historic highs (see chart). We regard the increased requirements as unneeded and damaging. Risk-free banks that make no loans don't serve Colorado's needs.

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

1. Increases in Required Capital. We recognize that due to the financial meltdown minimum levels of capital for financial institutions will increase. We contend that the long-term results of raising minimum capital levels in the industry are not yet truly understood. Changes in minimum capital levels should not be implemented until the regulatory authorities study the impact of the proposed risk-weighting rules on the industry, and that Congress has heard reports from the agencies and had an opportunity to provide further guidance on many topics including economic impact. We are concerned that the proposed risk-weighting rules as proposed could have a major impact on the composition of banks' balance sheets. That impacts the profitability of many banks as well as their risk profiles. Only after understanding these changes should the regulatory authorities act – when they truly understand the appropriate minimum capital levels that provide stability to a profitable industry that enables them to attract new sources of capital and that allows them to continue lending in their communities. Multiple banks concurrently in the market for capital negatively impacts both availability and price of capital. This compounds the situation.

2. Capital Conservation Buffer. Excessive restrictions are proposed for banks that fail to keep the full capital conservation buffer required by the Basel III proposals. The existing regulatory framework is more appropriate; it adequately addresses these concerns. As proposed, banks that fail to maintain the full capital conservation buffer will be subject to restrictions on capital distributions and on the payment of executive compensation. Current regulatory framework contains appropriate restrictions on the payment of dividends. Your agencies have existing rules or policies in place that require financial institutions to consult with, or obtain the approval of, the appropriate regulatory agency before paying a dividend that is in excess of an established percentage. We consider these regulations and policies to provide adequate safeguards against the payment of dividends under circumstances that are not appropriate. The proposals' "one size fits all" Washington-dictated rules are destined to cause many problems.

Dividend restrictions for institutions that do not maintain the full capital conservation buffer contain no exception for capital distributions paid by Sub S banks. These banks do not pay income taxes directly. Instead, as you know, the tax liability is passed through to the institutions' shareholders (consistent with the shareholders' percentage ownership in the bank). Traditionally a bank provides a distribution to the shareholders to allow them to fund their respective tax liabilities. Restricting those Sub S capital distributions, the Basel III Proposal is punitive to them because these distributions functionally serve as a substitute for the institution's payment of income taxes. The Internal Revenue Service we don't believe would permit regulatory agencies to preclude non-Sub S banks from paying income taxes directly. Agencies should not attempt to do so for indirect income tax payments. The Basel III Proposal places inappropriate risk on the shareholders of Sub S banks, making them a less attractive investment for investors.

Currently unsafe and unsound banks are subject to supervisory restrictions on executive compensation through regulatory enforcement actions or through the "golden parachute" payment restrictions of the Federal Deposit Insurance Corporation and other similar regulations. These provisions are adequate to prevent the payment of excessive executive compensation for banks that are not in a safe and sound condition. Often troubled banks need good management, even when that means using additional funds to compensate them. Your proposed restrictions unwisely preclude this. We support leaving decisions on restrictions on the payment of executive compensation and capital distributions to the discretion of the regulatory authorities on a case-by-case basis. We are not aware of any instance when excessive compensation practices or excessive dividends led to a stressed financial condition of a bank. The current regulatory protocol allows individuals who are familiar with the circumstances of the individual institution and the current banking and economic environment, to make sound decisions on these matters.

3. Phase Out of Restricted Core Capital Elements. The Basel III Proposal phases out from Tier 1 capital eligibility the proceeds received from certain securities that are considered "restricted core capital elements" under the current rules. Most notably, proceeds from trust preferred securities are phased out from Tier 1 capital eligibility.

We believe that the legislative intent expressed in the adoption of the Dodd-Frank Wall Street Reform and Consumer Protection Act to exclude those institutions with less than $15 billion in assets should be honored. It is clear that Congress made a clear choice to provide relief for institutions of less than a certain size from the impact of this change in law. To then adopt a regulation that goes beyond that exclusion is to ignore that Congressional choice. We believe any changes in the Dodd-Frank Act treatment of trust preferred should be reported to and reviewed by Congress specifically before it is implemented.

Regulators have long recognized that institutions of different sizes should be treated differently in how capital rules apply to them. For example, the Federal Reserve has for years maintained its "Small Bank Holding Company Policy Statement," excluding the smallest bank holding companies from the requirement to maintain consolidated capital ratios. There is no reason that institutions below the size threshold set by Congress should not be excluded from this phase-out.

This phase-out most definitely will have a material impact on the capital ratios of bank holding companies in Colorado. Numerous Colorado bank holding companies have subordinated debentures related to trust preferred securities currently outstanding. They will need to augment their capital planning to find replacement sources of capital, even if the institution's current assets fall below the $500 million threshold for application of the Basel III Proposal to bank holding companies. The reasons that bank holding companies below the $500 million threshold would need to account for the phase-out of trust preferred securities as a source of Tier 1 capital include future plans for expansion and growth and the lack of ability of acquiring banks to assume the trust preferred securities as a source of Tier 1 capital upon an acquisition.

Generally institutions under $15 billion in total assets have far less access to capital markets than those above that size threshold. By modifying the phase-out of trust preferred securities from Tier 1 capital eligibility, the Basel III Proposal would require these institutions to access the equity markets, potentially creating a tremendous challenge for them. The vast majority of institutions that issued trust preferred securities have had no issues with the holders given the limited rights provided to the holders. In these cases, the trust preferred holders have truly conducted themselves as holders of preferred equity of the institution. We see no evidence of need and no reason to phase out the eligibility of proceeds from the issuance of trust preferred securities as Tier 1 capital in advance of the stated maturity of those securities, and in fact we think accelerated phase out is not consistent with the Dodd-Frank Act.

4. Inclusion of Accumulated Other Comprehensive Income in the Calculation of Common Equity Tier 1 Capital. The volatility that would be introduced to bank balance sheets through the inclusion of Accumulated Other Comprehensive Income ("AOCI") in the calculation of Common Equity Tier 1 Capital ("CET1") is troubling. The primary driver of AOCI (or loss) for most institutions is unrealized gains and losses in the available-for-sale securities portfolio. Introducing a rule that causes increased volatility to bank balance sheets during periods of rising and falling interest rates would be harmful to the industry. Rising interest rates in the future are a certainty.

The Financial Accounting Standards Board in 1995 created SFAS 115 which required banks to classify their securities based on their ability and intent regarding how the securities would be utilized in the operations of the bank.

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- Securities purchased for trading purposes to be sold in response to market risk or other market changes – classified as trading securities and required to be included in the financial statements at fair value with changes in fair value recorded through the income statement.
- Securities purchased where the bank had the ability and intent to hold the securities to maturity – classified as investment securities and recorded at amortized cost. Fair value of the securities would be disclosed in the financial statements but not recorded.
- Securities purchased for investment which the bank did not have either the ability or the intent to hold to maturity – classified as available-for-sale securities and recorded at fair value with the changes in fair value recorded in AOCI included in the equity section of the balance sheet.

There also were requirements dealing with other-than-temporary impairments (OTTI) of securities, which required recognition in the income statement of an impairment of value of any security that was considered other than a temporary decline in value. The regulatory agencies also issued a rule in 1995 that stated that unrealized gains (losses) recorded in the equity section of a bank's balance sheet would not be included in Tier 1 regulatory capital.

Including unrealized gains or losses in CET1 creates volatility in a bank's capital base. Interest rate swings create increases and decreases in market value of securities that do not reflect probable or realized changes to value. Available-for-sale securities often are classified in that category so that those securities may be used to strengthen liquidity and to provide flexible resources for prudent balance sheet management.

We believe volatility that the proposed rule would add to bank balance sheets is contrary to sound bank regulation. Banks' balance sheets are managed with a major goal of being neutral to changes in interest rates. Your agencies examine institutions for their sensitivity or lack thereof to market risk. Including AOCI in CET1 causes banks' capital levels to be more sensitive to changes in interest rates. This could lead to a number of problems for banks, including significant variations in their legal lending limits as capital fluctuates. For example there is a community bank in Colorado that would move from well capitalized to very undercapitalized since it would lose 60% of its CET1 capital with no change to its balance sheet as a result of AOCI and the accelerated elimination of trust preferred. This obviously has a profound impact on lending limits, lending, and other matters. We fail to see how introducing such volatility to institutions' capital ratios based on changes in interest rates is consistent with regulating banks to be more safe and sound.

As stated, including AOCI in CET1 causes banks' capital levels to be more sensitive to changes in interest rates. That alone demonstrates why it is critical that the regulators understand and quantify the impact of the proposals in an increased interest rate environment.

When an institution intends to sell securities in response to market changes, those securities are held in a trading account, and changes in value are reflected in the institution's income statement (and therefore its Tier 1 capital). If a security is other-than-temporarily impaired, the impairment most likely is charged to earnings, which again would cause that impairment to be reflected in the institution's Tier 1 capital. Under the proposed rules capital impact would be no different for available for sale securities than for those held in trading accounts, some banks may seek to move securities into trading accounts and become more active in securities trading. We doubt this would be beneficial to the industry.

Under the proposals, smaller banks that do not have the ability to hedge this risk will essentially be left with two options: reclassify available for sale securities as held-to-maturity securities, thereby reducing the liquidity of the institution and its flexibility, or maintain enough capital to meet appropriate capital ratios under all foreseeable interest rate scenarios. If the latter approach is taken, the institution likely will reduce its total and risk-weighted assets in order to obtain the needed capital ratios. By doing this, it will restrict lending in its community, hurting the community and the businesses and consumers in it. Smaller banks

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also will be forced to purchase primarily shorter-term investment securities, putting negative pressure on earnings and potentially having a significant impact on the municipal bond market.

The inclusion of AOCI in CET1 will not promote any desired supervisory objective in our opinion. It increases the volatility of bank balance sheets, contrary to the objectives of the Basel III Proposal. In response, many banks would be forced to either reduce their liquidity or restrict lending in their communities, or some combination thereof. As a result, we urge that this provision of the Basel III Proposal be removed.

5. Phase-Out of Deferred Tax Assets from Tier 1 Capital Eligibility. As a part of the Basel III Proposal limits on inclusion of deferred tax assets in capital, deferred tax assets that arise from operating loss and tax credit carryforwards ("Covered DTAs"), net of any related valuation allowances, are subject to a full deduction from CET1. We believe that the full deduction of Covered DTAs from CET1 is an overreaction and that there are appropriate circumstances under which an institution should be allowed to include the value of its Covered DTAs in its capital.

Under U.S. Generally Accepted Accounting Principles ("GAAP") as well as current regulatory accounting rules, institutions are required to review periodically their deferred tax assets, including Covered DTAs, to assess whether a valuation allowance (a contra-asset) should be established. Management must project earnings of the institution over the next twelve-month period, which already is a much more restrictive approach than the approach under GAAP, which allows for consideration of many more factors. To the extent that the bank does not project earnings over that period that allow it to fully utilize its Covered DTAs, it must establish an allowance against the portion of the deferred tax asset that management does not reasonably expect to utilize over the next twelve-month period. Management's judgment is then reviewed by bank examiners and the institution's accountants.

We believe based upon that rigorous review process that any portion of a bank's net Covered DTAs should continue to be available for inclusion in the bank's CET1. These net Covered DTAs represent only the portion of an institution's Covered DTAs that it anticipates utilizing over the next twelve months based upon projections reviewed by bank examiners and the institution's accountants. Our recent experience indicates that both bank examiners and accountants are conservative in their reviews of deferred tax asset valuation allowances, such that most banks had full valuation allowances against their Covered DTAs throughout the majority of the downturn. It is only now that the economy is beginning to recover that many banks are starting to decrease the valuation allowances against their Covered DTAs. We believe that banks are including their Covered DTAs in capital under circumstances that are reasonable.

Transparency of financial statements is not promoted by exclusion of net Covered DTAs from capital. If an institution has a reasonable expectation of realizing the value of an asset, it should be able to include that asset in its capital calculation. Covered DTAs are quite real: the Internal Revenue Service allows net operating loss carryforwards to be utilized for 20 years, which makes Covered DTAs very valuable assets that are likely to be utilized under appropriate circumstances (i.e., a sound capital position and improving economic conditions). Deferred tax assets also are followed closely by bank stock analysts who understand the value of these assets. We think the recognition of net Covered DTAs in capital is no different in principle from the inclusion of "bargain purchase" gains in capital. Such gains are based upon a valuation of the acquired business relative to the purchase price. The acquiring entity may or may not ultimately realize the value of the acquired business provided in the valuation, but, in order to have transparent financial statements, the gain is included in capital. This goal of transparency was a driver behind the elimination of "negative goodwill" in accounting guidance.

The exclusion of Covered DTAs from CET1 also creates an arbitrary and incomplete representation of an institution's tax planning strategies. A financial institution's tax strategies are complex and involve the utilization of tax planning techniques that minimize the current tax liability. Tax planning for a financial institution involves decisions regarding loan loss reserves, charge offs, depreciation, and investment

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portfolio composition, among other factors. The ability to realize future tax benefits in the institution's capital calculations is vital to allowing a continuation of longstanding approaches to tax planning for the industry.

As a result, we believe full deductions of net Covered DTAs constitute an overreaction in that current accounting rules already address this issue and elimination of net Covered DTAs in capital would lead to less transparent financial statements for banks. If anything, we believe that regulatory accounting principles and capital rules should take into account a wider variety of factors in evaluating the quality of deferred tax assets, as GAAP does.

6. Limitation on Inclusion of Allowance for Loan and Lease Losses in Regulatory Capital. The cumulative impact of the various items in the proposals that force a "double-counting" of numerous risk elements on bank balance sheets makes it appropriate to eliminate the current arbitrary regulatory limitation on the amount of an institution's Allowance for Loan and Lease Losses (ALLL) that is includable in its Tier 2 capital. Removing that limitation, which is currently set at 1.25% of total risk-weighted assets, the double counting impact of the proposed increased risk-weighting of various assets would be offset to some degree, at least regarding the calculation of the total risk-based capital ratio.

In addition, banks face expectations for reserve amounts to continually evolve, generally toward an expectation that banks will maintain higher reserve levels. A factor in limiting ALLL to 1.25% of assets includable in regulatory capital was the perception that banks were managing earnings through over-reserving in times of low credit losses. We believe this issue no longer exists because regulatory and accounting expectations are now that banks will maintain robust Allowances for Loan and Lease Losses during all economic cycles. In addition, we believe the majority of all Colorado banks have ALLL in excess of 1.25% of their total risk-weighted assets as of June 30, 2012, creating excess loan loss reserves that are currently disallowed in total capital calculations for those banks.

7. Limitation of Inclusion of Value of Mortgage Servicing Assets. The Basel III Proposal limits the inclusion of the value of mortgage servicing assets to ten percent of the institution's CET1. The limit is possibly less if the institution has other "threshold deductions." A number of our members originate mortgages, sell the mortgages in the secondary market, and retain the servicing rights to provide a future stream of income. We believe these institutions represent some of the best and most prudent loan servicers available. However, instead of promoting their participation in the industry, the Basel III Proposal further limits their involvement in mortgage loan servicing. We believe limiting the inclusion of the value of mortgage servicing assets in institutions' capital, when combined with other factors, is serving to force banks out of the mortgage industry when we believe that banks are very valuable to the mortgage industry, and that communities are benefitted by community banks being in that business.

8. Small Savings and Loan Holding Companies. As we understand it a result of the Federal Reserve's Small Bank Holding Company Policy Statement is that the Basel III Proposal generally would not apply to bank holding companies with total consolidated assets of less than $500 million. The Small Bank Holding Company Policy Statement does not cover savings and loan holding companies, so there is no similar exemption for savings and loan holding companies of less than $500 million. Smaller savings and loan holding companies face the same challenges that smaller bank holding companies do with respect to raising capital. They generally do not have access to public equity markets and therefore need to rely on alternative sources of capital, such as debt. Because these companies have not previously been subject to consolidated capital requirements, many of them do not presently have capital structures that allow them to comply with the requirements of the Basel III Proposal. We urge you to insert an exemption for savings and loan holding companies with less than $500 million in total consolidated assets if the more general exemption is not adopted. Failing to do so would be unnecessarily punitive to small savings and loan holding companies.

Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements

1. Revised Risk-Weighting Residential Mortgage Exposures. Bankers' concerns about changes to risk-weighting of residential mortgage exposures are consistent and alarming.

A. *Balloon features disqualify category 1 treatment.* The Standardized Approach Proposal requires dividing residential mortgages into two categories (referred to simply as "category 1" and "category 2") for purposes of risk-weighting. Category 1 exposures are generally viewed as having less risk and therefore are assigned more favorable risk weights, depending upon the loan-to-value ratio. Among the eight broad requirements for a residential mortgage exposure to qualify as a category 1 exposure is "The terms of the residential mortgage exposure provide for regular periodic payments that do not: (i) result in an increase of the principal balance; (ii) allow the borrower to defer repayment of principal of the residential mortgage exposure; or (iii) result in a balloon payment."

The requirement set forth in clause (iii) regarding balloon payments will have a detrimental impact on bank balance sheets, particularly for smaller banks. To manage interest rate risk, most community banks structure their residential mortgage loans on the basis of a 15, 20, or 30-year amortization of principal with a balloon payment at the end of two, three, or five years. By doing this, the principal amount of the loan amortizes, but it allows the bank to review the credit and change its terms at the time of maturity. Most importantly, the balloon payment structure allows the bank to shorten the duration of the asset, allowing the bank to better match the durations of its liabilities. That concept of matching durations is critical in managing a bank's interest rate risk. This lending practice also serves the needs of many borrowers.

Other ways of mitigating interest rate risk for longer-term mortgage loans are not practically available to community banks. An institution may enter into swap arrangements or purchase other derivatives to manage interest rate risk. It also may utilize longer-term sources of funding in order to match the duration of longer term assets. Smaller institutions generally do not enter into complex interest rate swap arrangements or engage in other derivative transactions to hedge interest rate risk. They also are criticized by examiners if they rely too much on non-core sources of funding, meaning that these institutions use deposits of local customers for funding. This traditional source of funding typically has shorter durations, prompting community banks to seek assets with shorter durations.

As a result, community banks have three alternatives to avoid the punitive risk-weighting associated with category 2 mortgages:

- Accept interest rate risk by making mortgage loans with longer durations so that they can be fully amortizing;
- Use derivative transactions or rely more heavily on longer-term non-core funding to manage interest rate risk on the liability side of the balance sheet; or
- Stop making residential mortgage loans that will be held in the banks' portfolio.

The first option of accepting interest rate risk was a significant factor in a prior banking crisis; it is our hope that few bankers would accept that alternative now. The next alternative of entering into derivative transactions or relying on non-core sources of funding also seems unattractive given the regulatory criticism of smaller banks' use of non-core funding and the practical unavailability of complex derivative transactions to smaller institutions. Managing the length of the loan is a much more attractive alternative since it is transparent and easily understood by bankers, customers, examiners, and bank directors and shareholders.

The worst alternative for category 2 mortgages probably is the third: reducing or eliminating residential mortgage loans from banks' portfolios. The negative customer impact is obvious. Often borrowers who may not qualify for traditional mortgages include consumers who are self-employed and therefore do not have consistent documented income, notwithstanding the fact that the borrower clearly has the financial ability to repay the loan. The economic impact of the proposed change to the risk-weighting of residential mortgage loans would be real and would directly impact the consumers who need these loans that otherwise would not be available to them.

The proposals have an implication that residential mortgage loans with balloon features are more risky than those without balloon payment features. Particularly when considering those loans that are structured with amortization of principal throughout the duration of the loan, our members have no greater loss history with loans with balloon payment structures than with other loans. Contrary to that, many bankers feel such a structure enhances the protection afforded their bank by allowing the bank to review the credit periodically and renew it if it deems a renewal of the loan to be appropriate. At renewal, the bank may adjust the interest rate and other terms of the loan (including requiring additional principal paydowns) as the circumstances merit. If the credit is stressed at the time of renewal, the risk rating of the loan would be downgraded, and might result in additional loan loss reserves for the bank, thereby reflecting the increased risk of the loan in the bank's CET1 at renewal.

If the balloon structure exclusion from category 1 is not removed and the residential mortgage exposure rules in the Standardized Approach Proposal are adopted, we believe the vast majority of mortgage loans held by community banks will be category 2. So, community banks will be required to hold more capital against those loans, thereby reducing the bank's capacity to make other loans and/or requiring the bank to increase the pricing of those loans substantially, which would have a direct impact on the borrower. We urge elimination of the balloon structure exclusion from the definition of category 1 residential mortgage exposure.

B. *Reliance on LTV measures and appraisals in establishing risk-weighting*. Loan-to-value ("LTV") measures and appraisals play a major role in determining the risk-weighting for residential mortgage exposures. The risk weights applicable to the various residential mortgage exposures are excessive in some cases and we believe that placing such emphasis on LTV measures is a mistake.

For category 2 loans with an LTV ratio of greater than 80% and less than or equal to 90% the risk weighting is 150%, and for category 2 loans with LTV ratios in excess of 90% it is 200%. An unsecured consumer loan has 100% risk-weighting. It makes no sense that any category of residential mortgage loan could present more risk than an unsecured consumer loan. This irrational high risk weighting even applies to mortgage loans secured by junior liens. We see no evidence that a risk-weighting for a residential mortgage loan in excess of 100% should be applied. This is especially true when you consider the impact of higher risk-weightings on customers and the economy.

And it appears to us that LTVs are incomplete and unsuitable measures of loan risk. Good bankers historically have relied upon character (integrity), capacity (sufficient cash flow to service the obligation), capital (net worth), collateral (assets to secure the debt), and conditions (of the borrower and the overall economy – the five C's of credit. The value of collateral is only one factor in determining the risk of a loan. A weakness in one of the five categories can be alleviated by strong performance in the other four categories. Very few bankers or regulators would consider a small first mortgage loan with a balloon payment that is made to a very liquid and wealthy borrower as presenting substantial risk to the bank. The Standardized Proposal provides that if the loan has an LTV of 81%, the credit would receive a risk-weighting of 150%. We don't believe that makes any sense.

The assigned value to be used in calculating the LTV ratio is the smaller of the acquisition cost or the value of the collateral at the time of the origination or modification of the loan. We assume that third party appraisals would estimate the value of the collateral. Since the financial meltdown, it has been common experience that appraisals do not necessarily accurately reflect the market value of real estate. At the peak of the market, appraisals can overstate real estate values by using comparisons to recent sales. The reverse is experienced in tough markets. Colorado currently is experiencing a tough market. The unusually high number of foreclosures has resulted in depressing real estate values, which may not be accurately stated in appraisals. Reliance on real estate appraisals is necessary but we perceive a potential over-reliance in the Standardized Approach Proposal.

The Dodd-Frank Act recently prohibited reliance by financial institutions on the ratings of credit rating agencies. This prohibition was brought about because credit ratings were deemed to be inaccurate and unreliable. The same statement could be made about real estate appraisals. We know that real estate appraisals have an important role in real estate lending. Placing an emphasis on those appraisals as the Standardized Approach Proposal requires is not appropriate. There are many additional factors involved in determining the risk of a residential mortgage loan.

C. *Record-keeping issues*. The Standardized Approach Proposal's risk-weighting of residential mortgage loans will place a tremendous recordkeeping burden on banks. The Standardized Approach requires banks to have systems in place to stratify their residential mortgage loan portfolios based upon various factors. Most banks do not have such systems. This tremendous administrative burden should be alleviated if you move forward with the Standardized Approach.

D. *Overall conclusions on proposed risk-weighting of residential mortgage loans*. The proposed risk-weighting of residential mortgage loans is perhaps the most problematic change in the proposals. This either would shift the interest rate risk management burden to financial institutions, causing them to restrict their residential mortgage lending, or would cause them to drastically increase the pricing of such loans. Neither of these is good for customers or the economy. The proposed risk weightings are inappropriate and the proposed changes rely too heavily on LTV ratios, which partially will be determined by possibly imprecise real estate appraisals.

Various types of residential mortgage loan products that were problematic during the recent financial crisis, including loans that were not properly underwritten, pay-option adjustable rate mortgages, and subprime mortgages, were referenced in the Standardized Approach. The proposed risk-weighting of residential mortgage exposures affects much more than those types of loans. The proposed rules would impact very dramatically the risk weights for many residential mortgage loans that are and have been the safe "bread and butter" of many banks. Rural consumers probably will be hit hardest by the proposed change where rural banks often are the only mortgage lenders available in small towns. We perceive that the combination of impacts from the Standardized Approach's treatment of traditional balloon products and LTV measures are punitive. Changes to the risk-weighting of residential mortgage exposures should be eliminated we believe.

2. Risk-Weighting of "High Volatility Commercial Real Estate" Loans. For similar reasons to those expressed above, the increased risk-weighting for loans deemed to be "High Volatility Commercial Real Estate" ("HVCRE") loans is fundamentally flawed. Financial institutions in Colorado were hit hard in recent years by falling real estate values and the quickly contracting real estate development sector. Our members understand the need to closely monitor poorly managed and excessive concentrations in commercial real estate loans, particularly those commercial real estate loans related to acquisition, development, and construction ("ADC") projects. However, the proposed definition of HVCRE loans is fundamentally flawed, in part because it relies too heavily on the equity injected into the project as a sole determinant of risk.

The Standardized Approach Proposal assigns a risk weighting of 150% to ADC loans that do not meet certain requirements. We stated concerns with what we view as excessive reliance on real estate appraisals to determine risk-weighting in the prior section. This also applies to the proposed risk-weighting of HVCRE loans. Overall we recommend the agencies withdraw the proposals and restudy these issues. Part of that further study by regulatory agencies are those additional factors beyond minimum equity ratios, particularly those based upon appraised "as completed" values, that can mitigate the risk of these loans and thereby remove the loan from the definition of an HVCRE loan. We also believe that there are other appropriate forms of collateral beyond cash and readily marketable assets that can serve as appropriate equity for ADC projects. For example, it could be appropriate to inject real estate as equity into a project, perhaps at a ratio higher than 15%, to remove a loan from the definition of an HVCRE loan.

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The proposed definition of HVCRE loan ignores many risk mitigation techniques employed by seasoned commercial real estate lenders. As a result, the HVCRE definition should be much narrower so as to take into account those other risk mitigation approaches. If the definition is not further limited, banks will be driven out of financing development activity, which will restrain the economy.

3. Risk-Weighting of Past Due Exposures. Risk-weighting of past due exposures in the Standardized Approach Proposal ignores the existing processes by which financial institutions account for past due exposures and therefore we believe it is overly burdensome. The Standardized Approach Proposal requires banks to apply a 150% risk-weighting to assets that are 90 days or more past due or on nonaccrual status when those assets are not secured or guaranteed in accordance with the requirements of the Standardized Approach Proposal.

The risk inherent in past due assets already is reflected on the balance sheets and in the capital ratios of banks per applicable accounting rules. Currently when a loan is 90 days or more past due or on nonaccrual status, it is tested for impairment. When a security is 90 days or more past due or on nonaccrual status it is tested for other-than-temporary impairment as well. If the asset is deemed to be impaired, management makes a judgment as to the portion of the asset that is collectible. If the full carrying amount of the asset is not viewed as collectable (which in the case of a loan is based upon the value of the collateral or anticipated cash flows), the bank makes the appropriate accounting entries. On an impaired loan, an increase in the provision for loan losses is charged directly to earnings and a specific reserve is added to the institution's ALLL. On an impaired security, the amount is included in AOCI or charged directly to the institution's earnings. In any of those instances, CET1 would be reduced under the Basel III Proposal. Based upon that we believe that adding to the risk-weighting of past due assets constitutes double-counting of the risk of the assets. Reducing the numerator of risk-based capital calculations while concurrently increasing the denominator produces a pro-cyclical impact and would strain unnecessarily the capital ratios of banks encountering asset quality problems. This is exacerbated further by the arbitrary 1.25% limitation placed upon the amount of a bank's ALLL that may be included in Tier 2 capital. The existing accounting rules address this issue sufficiently; we don't believe these "past due" changes are needed or justified.

Should you proceed with the increased risk-weighting of past due assets incorporated into the final risk-weighting rules, we urge you to broaden the definition of eligible collateral for mitigating the existence of a past due "exposure." Under the Standardized Approach Proposal, eligible collateral is limited to financial collateral. Financial collateral may be the only appropriate collateral in certain circumstances; we believe that other forms of collateral, such as real estate and equipment, should be allowed as mitigating past due exposures. Banks for many years have liquidated and collected from these forms of collateral in protecting their interests. Because banks are required to update their valuations of this collateral periodically in performing impairment analysis, we believe that banks should be able to offset the amount of the past due exposure by the value of such collateral.

To the extent that the increased risk-weighting of past due assets is incorporated and implemented, as stated above we believe it would be appropriate to eliminate the cap on the amount of an institution's ALLL that is includable in its Tier 2 capital.

4. Off-Balance Sheet Items.

A. *Risk-weighting of unfunded loan commitments*. The regulators' proposed Standardized Approach requires banks to apply a 20% risk weight to unfunded loan commitments with durations of one year or less. Now, such commitments have zero risk-weighting. The proposed change in risk-weighting for these unfunded loan commitments is not warranted. We are not aware of any instance, including banks that were closed, of capital ratios being materially strained through borrowers' drawing down on unfunded loan commitments of the bank. Banks need to and do monitor their unfunded loan commitments on an ongoing basis to ensure that they have appropriate capital and liquidity to fund those commitments. Increasing the risk-weighting to these short-term commitments further increases the risk-based assets of banks, which will in turn causes banks to manage the size of their assets, often through decreasing their use of short-term loan commitments. This reaction by banks would hurt small businesses that rely on these lines of credit for

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liquidity. With the current rough economy confronting small businesses, we do believe action by the bank regulatory authorities to further strain the viability of small businesses is inappropriate.

B. *Risk-weighting of credit-enhancing representations and warranties for mortgage loans sold*. The Standardized Approach Proposal requires banks to use a 100% risk weight to assets subject to a "credit-enhancing representation or warranty," which includes provisions to protect the purchaser from losses resulting from the default or nonperformance of the counterparties of the underlying exposure or from an insufficiency in the value of the collateral backing the underlying exposure.

Many community and regional banks originate conventional mortgages and sell them in the secondary market. Those smaller banks do not have the interest rate risk management capacity to keep 15-, 20-, and 30-year mortgage loans in their portfolios. For those borrowers who desire such longer-term loans, the banks originate the loans, sell them in the secondary market, and earn a fee. For many Colorado banks, this product has helped them generate earnings in an otherwise sluggish banking environment while serving the needs of their customers and community.

Many purchasers of mortgage loans originated by these banks require that the bank repurchase the loan if it defaults within a specified period of time or if the value of the collateral is other than as stated in the documentation. While the early default obligation generally is short in duration, the warranty regarding the value of the collateral often has a rather extensive duration.

The capacity of these banks to make such loans will be greatly limited if they are required to apply a 100% risk weight to mortgage loans originated by them throughout the duration of those warranties. This change to the risk-weighting rules alone could increase banks' risk-weighted assets by ten percent, and the change will be even more drastic for those banks with greater mortgage origination. To provide consumers with the opportunity to own homes under appropriate circumstances, we believe that this rule change is contrary to the public interest. This change will cause banks to curtail their mortgage originations, which would decrease or eliminate the availability of mortgage loans in some communities and force borrowers to work with non-bank mortgage originators more often. Creating an environment that allows banks to expand their participation in mortgage origination is more consistent with public policy. As many in Congress and the Consumer Financial Protection Bureau have noted, non-bank mortgage originators were much more responsible for the imprudent originations prior to the financial crisis. Allowing professional, traditionally-regulated lenders with seasoned underwriting backgrounds, which are found in bank mortgage origination offices to increase their participation in mortgage originations is far preferable to the ultimate impact of this change in the risk-weighting rules, which will force banks out of the mortgage origination business.

We think you should provide further guidance on what constitutes a "credit-enhancing representation and warranty" if these rules are retained in the final risk-weighting rules. Many banks give representations on compliance of the appraisal provided with certain standards. We believe the final rule should make it clear that such a representation regards documentation, and is excluded from the definition of a credit-enhancing representation and warranty, rather than a representation regarding the value of the collateral.

Summary

The proposals present so many potential problems that they should be withdrawn completely. The proposals clearly require substantial modification as indicated above, and additional studies are required in order to develop the most appropriate modifications to the proposals. It is imperative that regulators quantify the impact on banks in an increased interest rate environment, and it is critical that the impact on customers and communities be considered as well. The potential consequences make this too dangerous to put this in place without substantial certainty of the outcome. We don't believe the agencies have even a major fraction of that necessary certainty.

In short, it is not appropriate to gamble with the future of banks, consumers, small businesses, shareholders and others. We also believe this is of such importance that Congress should hear reports from the agencies and have an opportunity to provide further guidance on many topics including economic impact before the proposals are adopted.

There is growing support among bankers and some regulators to withdraw the proposals. That includes FDIC Acting Vice Chairman Tom Hoenig and the Conference of State Bank Supervisors on behalf of the state bank regulators. Following their lead and substituting a simpler and more transparent regulatory capital framework refined to reflect the above issues has great merit. There is much risk in simultaneously finalizing such broad and sweeping changes to the way that banks calculate their capital and risk-weighted assets, increasing the capital ratios they are required to maintain, and creating market turbulence by requiring numerous banks to raise capital concurrently. Notwithstanding various phase-in periods, the proposals currently are planned to be finalized simultaneously, leaving you little time and ability to adjust the rules after seeing the unanticipated consequences of the rule changes, and leaving banks little opportunity to understand the highly complex changes and raise the necessary capital.

We doubt anyone, any regulatory agency, any bank or banker, or any banking association or vendor can truly understand the overall impact of the proposals on the industry. Your examiners constantly remind banks of the importance of enterprise risk management, requiring that the institution identify and understand the risks that it faces and then determine which of those risks are complementary and which offset others. Larger institutions recently were given guidance on how to establish an appropriate stress testing framework. The recent Supervisory Guidance on Stress Testing for Banking Organizations with More Than $10 Billion in Total Consolidated Assets requires testing each individual risk facing the institution, and all the various combinations of those risks, under a variety of likely and even unlikely scenarios. The regulatory agencies should do no less. After all, the stakes are higher since your rules impact a large industry and millions of customers. We believe you should conduct a similar risk analysis of the impact of your proposals on the banking industry and the economy and publish the results of such an analysis and report it to Congress prior to proceeding with the proposals.

Material modifications to the proposals should be made, including an exemption for community and regional banking institutions from some or all of the requirements of the final rules to the extent that the proposals are not withdrawn. We do not believe anyone can project with confidence the overall impact on the banking industry, and the broader economy, that the proposals will have. We believe that the proposals, if adopted without material modification, would result in a substantial withdrawal of banks, particularly community banks, from a variety of lines of business, including:

- Making and holding 1-4 family residential mortgage loans
- Originating and selling mortgage loans
- Financing development activity
- Providing short-term lines of credit to small businesses

We further believe that proposal adoption without major modification would result in industry consolidation and damage to customers and the economy.

This outcome is completely contrary to sound public policy. By adopting rules that force banks to withdraw from participating in economic recovery, businesses and consumers will become increasingly reliant on non-bank lenders to provide funding, or simply will not be able to obtain credit. Most of these non-bank lenders are subject to substantially less regulation than are depository institutions, and they are not as experienced and capable of appropriately underwriting and managing credits. Since they do not have insured deposits as a funding source, they also tend to charge higher rates on loans than banks.

It appears that many of the changes in the proposals were developed in reaction to perceived abuses that are believed to have led to the financial crisis and that sometimes were erroneously attributed to banks. Non-bank lenders and loan originators were substantially responsible for the vast majority of these abuses. The ultimate outcome of adopting the proposals without material modification would be to force businesses and consumers to do business with the very parties that were responsible for the abuses that led to the financial crisis, or to go without credit. We are confident Congress would regard this as contrary to sound public policy.

The Basel Accords were developed for countries without diverse banking systems reflecting many banks of various sizes. The United States is unique in enjoying such a diverse banking environment where many communities are served by local community banks. Basel III's "one size fits all" approach should be modified to take into account the great diversity of business plans, balance sheet compositions, and risk profiles of U.S. banks. By implementing tailored regulation, banks of all sizes can compete and thrive under all economic conditions in a safe and sound manner.

We believe the best regulation is implemented through experienced and principled regulators, rather than complex regulation. To illustrate that, we point to recent results from a regulator-supported survey of banker attitudes regarding bank examinations, the Regulatory Feedback Initiative. Out of responses to dozens of detailed questions in the extensive survey, the 1,600 responses indicated 54% agreeing or strongly agreeing with their current CAMELS rating, 15% neutral, and 30% disagreeing or strongly disagreeing. We think in light of the current challenges in our industry that this is an endorsement of the examination process. We do not want to see that replaced with complex rigid dictates from Washington. Crisp complex regulation of risk, such as LTV ratios, is no substitute for risk assessment by informed and competent bank management that is reviewed by experienced and knowledgeable regulators. Bank management and regulation often require qualitative judgments. Replacing many of those qualitative judgments with inflexible quantitative measures is likely to miss the desired outcome.

Through thoughtful regulation, the U.S. banking industry can fill the needs of businesses and consumers in the U.S. and help us return to full economic recovery.

Respectfully,

THE COLORADO BANKERS ASSOCIATION

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