PEOPLES BANK
OF THE OZARKS
Member FDIC

Basel III and Standardized Approach Proposed Regulatory Capital Rules
Comment Letter

Ladies and Gentlemen,

We respectfully submit these comments regarding the proposed regulatory capital rules. We are a $275 million asset community bank, founded in 1917. The majority of our market area is rural communities in southwest Missouri. As we have read through the proposed rules, we have become frustrated and confounded at how we will be able to serve the deposit and lending needs of the citizens of our communities if these changes proceed in substantially the same structure as they have been proposed. Even in good times, a sizeable portion of the population in our rural communities are challenged to qualify for the type of lending structure these proposed regulations set-in as being “normal”.

A recent speech by Thomas Hoenig, formerly president of the Federal Reserve Bank of Kansas City and current FDIC board member best reflects our belief that regulations need to go back to the basics. Regulations have become too granular and strangling for the community banks of this country to properly meet and serve the needs of the citizens in their markets, in a cost effective manner.

Our comments will focus on the Basel III NPR and the Standardized NPR, as our structure and size presumably excludes us from any applicability under the Advanced NPR.

1. Available for Sale (“AFS”) Securities

   The Basel III NPR proposes to include unrealized gains and losses on AFS securities in regulatory capital. While AFS securities categorized in this manner allow them to be sold at anytime, which is presumably the reason for this proposal, I believe you will find the majority of community banks, include us, seldom if ever liquidate their AFS securities other than at their final maturity or when called by the issuer. One option to community banks is to classify these types of securities as held to maturity (“HTM”) going forward, which appears to exclude them from these proposed capital changes. However, classifying these as HTM securities eliminates the ability of these securities to be used as sources of contingency liquidity except in the most extreme cases where a community bank is willing to ignore all accounting and regulatory consequences associated with liquidating HTM securities. In addition, since substantially all of our AFS securities are generally government-backed agencies or government sponsored agencies that have virtually zero credit risk factored into their market value calculations, the fluctuation in value of these AFS securities in our case is solely the result of changes in market interest rates.

   By adjusting capital for market rate changes of AFS securities, you open the door to begin requiring changes in the market value of other assets and/or liabilities due to credit, liquidity, interest rate and other factors into the calculations and effectively make regulatory capital a fair value capital, which is totally in contradiction to GAAP accounting.

If we are required to begin adjusting our regulatory capital for changes in interest rates on these securities, a new complexity will evolve which will potentially mandate a liquidation of a portion or all of these securities at various points in the interest rate cycle, prior to their normal end date, so as to prevent potential future negative impacts on our regulatory capital. With the extended low interest rate environment we have been experiencing, it is almost certain that the majority of these AFS securities in the market now, and to be issued in the foreseeable future, will guarantee their market value will decline over time with virtually no probability that the market value would ever increase any material amount unless our economies face major downward forces as we have seen in recent years. This is in effect guaranteeing that the capital of community banks will be negatively impacted by interest rate fluctuations in AFS securities, which in turn will restrict the capital available to the bank for providing lending support to our communities.

2. Residential Mortgages

To understand the dynamics of true residential mortgage lending by community banks, the source of funding for those mortgages becomes a major factor in determining the terms of the lending side of the equation. Large secondary market lenders like FHLMC and FNMA can make long-term fixed rate residential loans and long-term adjustable rate residential loans with fixed rate caps and effectively manage that long-term interest rate risk by obtaining funding in the market place that allows for the proper matching of rates and maturities of that funding to minimize the interest rate risk exposure. Community banks do not have this same luxury due to the restrictions imposed both formally and informally on the use of non-core funding which is the only true way to properly manage the funding side of the long-term lending equation.

There has always been a strong pressure on community banks to primarily use "core" deposits as the funding source for lending and investing and limit to a small amount, the non-core funding sources in the market place. However, core customer deposits have become increasingly volatile over time, which only magnifies the risks to community banks if the indirect requirement is made through risk based capital levels, to drive community bank residential mortgage lending to be for long-term periods at fixed rates or even to long-term periods at adjustable rate ranges, where the upward rate adjustment is limited to 6 percentage points. This is the effective result of requiring the classification as category 2 any residential loans that do not meet specific guidelines, namely no balloons. We agree that good underwriting standards and annual interest rate caps are sound practices; we do not agree that <u>requiring</u> long-term maturities to receive beneficial risk weighting treatment is a sound practice.

There is no way a community bank can properly manage interest rate risk by lending at long-terms for fixed rates or even for long-terms where the rate can only adjust upward by 6 basis points and also be limited to fund those loans with deposits that can be taken away on any given day be customers with no or minimal penalties. Prudent interest rate risk principals are at the very heart of the reason community banks provide residential mortgages to their customers with long-term amortization periods but also provide for balloon periods to prevent the bank from become locked into the situation of a long-term loan rate that is minimally more or even lower than its core funding rate. It prevents the potential for the type of situation as occurred during the savings and loan crises of only a few decades ago.

The end result could very well be the virtual removal of community banks from the residential mortgage market resulting in a large number of rural communities with no source of providing for their residential mortgage funding needs as secondary market standards are not within their reach.

We have attached a rough calculation of what our best guess is of the change in risk weighting and capital under this area of the NPR. The schedule indicates the $69 million of one- to four-family loans currently in our portfolio would increase from a risk weighting of $37 million currently to $76 million under the new guidelines. This would require our bank to maintain $4 million more in capital (based on a 10.5% capital ratio) than currently required. This is roughly 15% of our current capital and would greatly diminish our ability to provide future lending to the communities we serve. If you look at our historical lending practices, they have not changed materially for many years. Throughout the recent economic crisis, we have a loss ratio of .46% on first lien mortgages and .59% on subsequent lien mortgages. To make a major change in the way we calculate the risk weighting on these credits is not supported by the low risk they have actually presented to our capital in our 95 year history. The majority of these $69 million of loans are on our books because these borrowers, for one or multiple reasons, do not qualify for fixed rate loans in the secondary market. If community banks are unable to make these nonconforming loans due to stricter capital guidelines, where will these borrowers go?

3. Past Due Exposures

The risks of all loans, especially past due, non-accrual and impaired loans are captured in the methodologies used to calculate the Allowance for Loan and Lease Losses (“ALLL”). These calculations result in an immediate charge to capital by way of the provision for ALLL. To take loans that have already had a negative impact on capital by way of the ALLL and then also increase the risk weight levels for capital purposes, there is a duplication of the risk coverage of these loans through capital, which constricts the number of customers we have the ability to serve.

4. High Volatility Commercial Real Estate (“HVCRE”)

If 15% borrower contribution must be in cash or readily marketable assets in all cases, or a project is categorized as a HVCRE and requires the community bank to maintain more capital, local grass roots development that has historically taken place in rural communities will be drastically curtailed.

Many times the land portion of a project has been previously purchased and held by a customer for several years, or in some cases passed down for generations. At other times, the owner is providing “sweat equity” that is a portion of the project value. To ignore these types of borrower injections and place this customer on the same level as a developer purchasing the land and paying to have it developed, places this local community developer at a disadvantage, unless the bank is willing to have a larger portion of its capital tied up.

To demonstrate our understanding of the NPR, assume we have a customer who inherited a piece of bare real estate worth $200,000 and owns it free and clear. If the additional cost to develop the project is $500,000, this customer would have to provide $105,000 of liquid assets for the $700,000 project, even thought they already own the $200,000 of land, resulting in an investment of over 40% of the project and a bank loan of 60%. In a different circumstance, a person would be buying the land for $200,000 and spending $500,000 on the development costs. This would require the same $105,000 cash investment by the developer for this $700,000 project, but is only a 15% investment by the developer with the bank loaning $595,000 or 85%. While it is clear the bank has lest risk in the first set of circumstances versus the latter, the amount of capital under the new guidelines allocated between the two would be reverse of the actual risk.

Another valid structure in the past was to have the developer pledge cash and/or marketable securities to the bank as part of the collateral for the overall project. The reading of the NPR seems to prevent the bank from favorable risk classification if cash investment in the project and cash pledged combined is 15%.

Having a bright line requirement for cash or marketable securities takes away the flexibility of a community bank to balance all the credit analysis points in making a lending decision. While we realize there is nothing preventing us from lending without the 15% cash injection, these tighter risk rules would reduce the level of capital the bank has for other community lending and investing.

5. Non-reliance on Credit Ratings

As a community bank, the majority of our investment portfolio through the years has consisted of government-backed agency or government sponsored agency securities which are not affected by the NPR. However, we also have participated in various areas of our communities by investing in municipal bonds of the cities, school districts, fire departments, water districts, etc. within our markets. While we understand the deficiencies in the rating agency methodologies which arose during the current economic crisis, we feel to place the burden on each community bank to have the expertise to affectively underwrite each municipal security they consider for their investment portfolio creates a burden on those banks that will ultimately lead to less investment in those community entities and ultimately a reduction in the development and maintenance of the services needed in those communities. We recommend ratings on municipal securities be allowed to continue as a key component of the investment decision of community banks.

6. Trust Preferred Securities ("TPS")

At this point, we are unclear as to the affect on our community bank of the TPS portion of the NPR. Our holding company issued TPS in 2005 and contributed substantially all the proceeds to the bank as paid in capital. The securities will mature in 2035. The bank has been discussing the process of beginning to make dividends payments to the holding company in the next few years to have funds available to retire the TPS in 2035. The dividends would obviously reduce the bank's capital each year, eventually reducing capital by the entire amount of the TPS contribution by 2035.

The bank is around $275 million in assets and, other than some minor investments, makes up substantially all of the holding company's assets. Accordingly, the holding company is far less than $500 million in asset size. Our understanding was that there would be no affect on the capital of the bank from the TPS since they are at the holding company level; and since the holding company (consolidated) is under $500 million in size, there would be no requirement for calculation of a consolidated capital, effectively grandfathering our TPS to run their original course through 2035. If we are misunderstanding this correctly and there is a phase-out period where we would be required to begin reducing our capital artificially before 2035, solely due to regulations changing the rules in affect when we obtained the TPS, we are adamantly opposed to that. If the bank were required to reduce capital by the TPS over a period of practically one half the original period, it would most likely put a substantial strain on our bank which has few, if any, alternate sources of capital.

This in turn would require the contracting of lending and deposit gathering activities in the communities we serve.

7. Conclusion

We are a community bank, operated to handle the banking needs of our communities and managing the various risks inherent within those activities. To have substantial changes invoked on various pieces of the lending, investment, deposit, borrowing and/or capital, requires a shift in all the other areas to properly manage the various risks and operate the bank in a safe and sound manner. Each change in one of these components triggers a domino effect, requiring a series of changes throughout the remaining components.

The changes affecting our bank contained within the NPRs would trickle throughout our organization and constrict our ability to operate for the benefit of our community. The majority of the items contained in the NPRs have nothing to do with the risks and challenges that arose in our bank during the economic crisis of the past few years. Over reliance on LTV was probably the most common thread throughout our loan losses. It appears the issues noted in the NPR that attempt to micromanage community bank lending, actually place even more emphasis on the LTV portion of the lending equation.

We appreciate the opportunity to comment and provide our input into these difficult and complex issues. We only hope the regulatory agencies will step back and rethink the entire process, as the granular requirements they are about to undertake, will most assuredly constrict the ability of community banks such as us to serve the overall needs of the people in our communities that have come to rely on us for their banking needs.

With Best Regards,

Richard L. Wilson, CPA
Chief Financial Officer