October 9, 2012

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

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 2-3
Washington, D.C. 20219

Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

FirstSecurity Bank

RE: Basel III Capital Proposals

Ladies and Gentlemen:

We appreciate the opportunity to comment on the proposed Basel III and Standardized Approach NPRs. We're First Security Bank, a locally owned Arkansas (NO TARP) bank representing thirteen Arkansas communities with 71 branches and total assets of $4.2 billion. We're fortunate to be a healthy bank with strong earnings, efficiency, asset quality, and capitalization. We're a community bank. We don't participate in any form of derivatives, no interest rate swaps, and no complex securities. Most of our lending is fixed rate five years or less. Our primary funding is long term non-maturity deposits and short term time deposits with long term bank customers. We've had significant deposit growth during the recession while some of our competitors have struggled. Far more growth than we could reasonably absorb through loan growth. As a result, we have a significant investment in municipal bonds.

The recession has been a challenge for our management team. We had a surge in asset quality issues like most of our banking neighbors, but we were able to limit the impact of loan losses. Asset quality has improved and the remaining loan quality issues are covered by the ALLL. We've continued to grow capital and loan loss reserves because of economic uncertainties. When the economy improves, we had planned to deploy excess capital through acquisitions, de novo branches, and technology driven product enhancements. However, the proposed capital limitations have added a new level of uncertainty. We will be well capitalized under the new rules, but they will increase overhead, reduce long term profitability, and increase the cost of growth in the future.

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As we understand it, the new rules were originally designed for large multi-national money center banks, not community banks. Large banks already have the staff and technology in place to manage the new reporting requirements. We do not. Arbitrarily pushing the new rules down on community banks will increase the competitive advantage of large banks. It's hard to understand why the large banks would be given the advantage over community banks when community banks are performing much better from a capital and asset quality perspective, but that's not as obvious as it should be using the industry standard total risk based capital ratio.

Risk weighted assets is a poor substitute for the actual risk profile of a bank. The following charts illustrate the performance of the large banks (total assets greater than or equal to $100 billion) and community banks (total assets less than $10 billion) with two different ratios. Chart 1 is tier 1 plus tier 2 capital to risk weighted assets ("risk weighted capital"). Chart 2 is tier 1 plus tier 2 capital less non-current loans to tangible assets ("total tangible capital"). We're using that ratio as a risk adjusted alternative to the risk weighted capital ratio. OTS banks are not included in the totals.

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The charts communicate dramatically different views of capital trends. The risk weighted capital ratio implies that capital coverage has improved dramatically during the recession. That's very misleading. The total tangible capital ratio tells the real story. Capitalization has not returned to pre-recession levels. And community banks entered the recession with significantly higher tangible capital levels than the large banks and continue to lead the large banks by a wide margin.

The risk weighted capital ratio does not reflect changes in asset quality. The risk factors don't change with changes in asset quality. And they're the same for all banks, from Atlanta, Georgia to Searcy, Arkansas. Capital has increased in chart 1 but the denominator in the calculation does not reflect the impact of the recession on credit risk. The risk weighted capital ratio is the theoretical equivalent of a derivative. Its several layers of assumptions removed from reality. The new rules add several more layers of assumptions making the ratio even more complex.

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To further illustrate the point. The risk weighted and total tangible capital ratios are illustrated in Chart 3 below for the banks that have failed since 2006. The risk weighted capital ratio was clearly misleading.

The large banks have been managing capital with more "flexible" Basel capital rules. **As we understand it, the Basel committee rules were designed to allow the large banks to do more with less capital.** In the case of a large publicly traded bank, doing more with less capital is the means by which they maximize ROE and leverage up EPS growth. They have made a significant investment in financial management and analysis resources since Basel I was rolled out. RAROC (risk adjusted return on capital) models have been developed to minimize capital and maximize the benefits of more flexible Basel capital allocation rules.

That's not the way community banks manage capital. Our business model is simple. We manage capital to survive the hard times and grow with our communities in good times. We don't need complicated ratios to manage capital. We have yet to see any argument put forth to support more complex capital calculations for community banks. The argument

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has been made that more capital is needed. That may or may not be true, but that doesn't mean the rules have to be complicated and expensive to calculate and regulate. In fact, more complicated rules may be misleading as we've illustrated with the current risk weighted capital ratio. The proposed capital rules are taking a risk weighted ratio that's already misleading and making it more complicated, and then cramming it down on better capitalized community banks.

We know a lot of work has gone into developing new capital rules for the large banks. Maybe the new rules are needed for those banks. We're not going to comment on that. We're not smart enough to understand how you hedge a mega bank balance sheet with the sovereign debt of bankrupt countries or derivatives three times removed from a tangible asset. But we do know how to run a community bank successfully. We don't need complicated capital calculations.

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Pushing the complexities of large bank capital theories down on community banks increases their competitive advantage over community banks. The one thing that the Dodd Frank legislation made very clear is that everyone now understands that a large bank could actually fail. The legislation will not prevent that. But it does confirm that the risk is looming out there. The domino effect of a large US bank failure would put the full weight of the US economy on community banks. It is not in the best interest of the American taxpayers to allow big banks to get bigger and force community banks out of business.

We urge you to exclude community banks from all the new rules and set easily calculated tangible capital limits you deem to be appropriate for community banks.

The proposals should be withdrawn based solely on the fact that the risk weighted capital ratio is misleading, complicated, and expensive to calculate and regulate. We will share a few specific comments about the NPRs, but we don't want to imply that tweaking the new rules would make any meaningful difference. The problem with risk weighted capital ratios is the complexity of the rules. That can only be fixed by eliminating rules, not tweaking them.

Unrealized Securities Gains and Losses

It's counterproductive to include unrealized securities gains and losses in tier 1 capital. At a minimum, that takes community banks out of the municipal bond market when our communities could benefit from lower borrowing rates. As of year-end 2011 municipal bonds are 18.6% of total community bank securities and growing. The large banks are back up to 4.5% after temporarily reducing their municipal bond portfolios in 2009. See chart 4. Community banks hold 54% and large banks 35% of total municipal bonds owned by banks. Community banks hold more municipal bonds, but the large banks have been increasing their share up from 16% in 2003 to 35% in 2011. See chart 5. The new rules favor large bank municipal bond investments. Unrealized municipal bond losses in a rising rate

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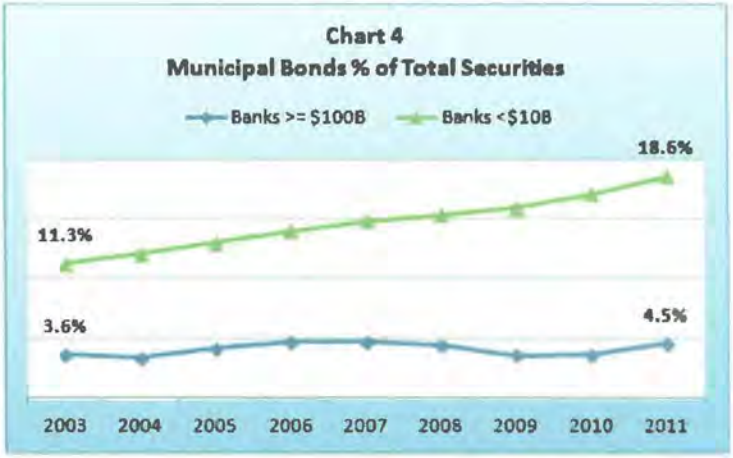
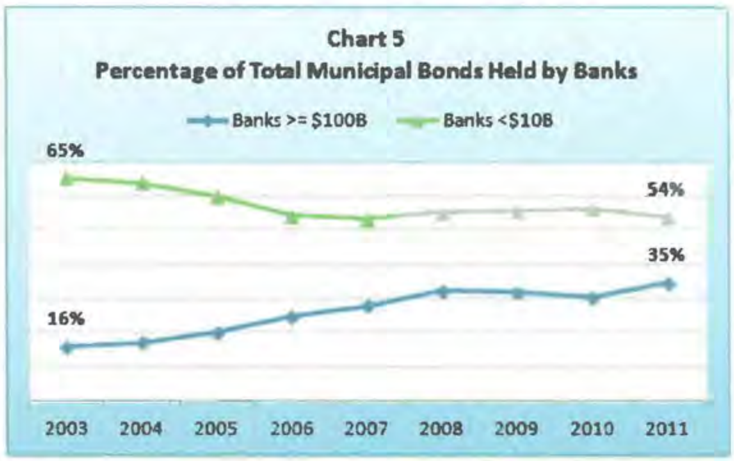
environment will be a much greater percentage of total capital for community banks than for large banks.





The alternative to including unrealized losses in tier 1 capital is to reclassify securities from AFS to HTM. But we would be limiting access to funds that may be needed in a liquidity crisis, or more likely, funds needed to grow the loan portfolio when the economy improves.

There is no material benefit to including unrealized securities gains and losses in tier 1 capital. To illustrate, table 1 below summarizes total **realized** gains or losses for community banks from the bottom of the last rate cycle in 2003 through 2011. Actual securities gains and losses were not significant as a percent of total assets at any point during the rate cycle. Even the credit quality related CDO and CMO losses booked in 2008 were not significant for community banks in total. The vast majority of the unrealized losses that would be included in capital under the new rules would be interest rate related, not credit quality issues. <u>Community banks rarely, if ever, recognize interest rate related securities losses.</u> If we rarely ever recognize interest rate related losses, there's no reason to include unrealized losses in tier 1 capital.

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Table 1 Securities Gain and Losses (000s) Banks < $10B				
Year	Total Assets	Unrelaized Securities Gain (Loss) (AOCI)	Realized Securities Gain (Loss)	% of Total Assets
2003	2,709,275,877	3,039,295	3,471,352	0.13%
2004	2,739,823,862	793,830	3,088,805	0.11%
2005	2,858,293,187	(3,542,164)	1,122,895	0.04%
2006	2,893,645,130	(2,359,669)	386,576	0.01%
2007	2,928,990,408	102,878	141,994	0.00%
2008	3,032,769,819	(1,975,008)	(4,411,178)	-0.15%
2009	3,001,974,541	732,719	(133,432)	0.00%
2010	2,889,110,980	(158,782)	1,366,053	0.05%
2011	2,851,920,994	5,089,773	1,515,642	0.05%

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Risk Weights Greater than 100%

Punitive risk weights of more than 100% are duplicative. The implication is that credit quality issues have been overlooked in the ALLL analysis. That should never be the case with management, internal audit, external audit, Board, and regulatory reviews all keenly focused on ALLL adequacy.

We can't even begin to figure out the logic behind some of the proposed punitive risk weights. A perfect example is the proposed risk weights for 1-4 family real estate first lien balloons. That's a staple product for a community bank that's rarely ever an asset quality problem. When a new doctor moves to town they buy a starter house. Every community bank in town is chasing that deal. It's a rare opportunity to bank a profitable deposit account from day one and the loan is a five year fixed rate balloon to keep the doctor's rate short and low until they build that dream home. That's a profitable long term relationship from day one and a AAA credit. It's doesn't get any better than that in the life of a community banker. It may be the only chance a community bank gets to bank a wealth management client before the large banks entice them with free services. The new rules would penalize a community bank for booking that deal. That's a small percentage of a community bank's loan portfolio. It's about 1% of our total 1-4 family residential loans. The capital allocation for our 1-4 family real estate balloon loans will double under the new rules to over 15% including the ALLL. That's excessive. The large banks will make a few adjustments to their RAROC model and work around the penalty. This is another case of the new rules favoring the large banks.

We may be overlooking something, but it appears that the large banks lead the country in non-current 1-4 family residential loans by a wide margin. See chart 6 below (excluding loss share portfolios). Their non-current portfolio is almost four times larger than the community banks. You've probably already read several letters from frustrated community bankers. The preceding charts in this letter illustrate the reasons for that frustration in

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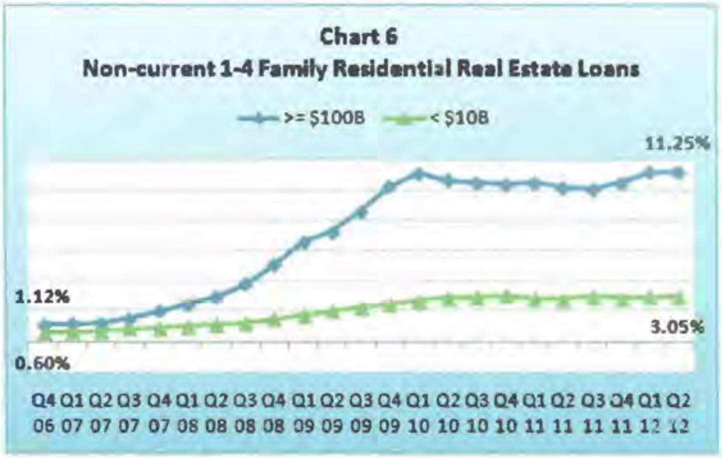
quantitative terms. But this chart clearly illustrates the unfairness of applying rules designed for large bank problems to community banks. And when all the new rules are implemented, the large banks will be granted even greater competitive advantage over community banks.



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Trust Preferred Securities

The Dodd Frank legislation has taken trust preferred securities off the table for community banks. The new rules go a step further and phase out grandfathered trust preferred capital. That does nothing to improve the quality of community bank capital and further restricts community banks ability to compete with the large banks for capital. Why eliminate a source of community bank capital at the same time minimum capital levels are being increased? Again, this is a change that lends greater competitive advantage to the large banks.

Credit Enhancing Representations (removal of 120 day safe harbor)

One of the most important products in a community bank customer relationship is their mortgage. Like most community banks, we originate mortgage loans for our customers through secondary market investors servicing released. We originated and sold about $200 million in new FHA, VA, rural development, and conventional loans in 2011. This is a marginal line of business at best. It would be very difficult for a community bank to compete with the large banks for profitable deposit relationships without a home mortgage product.

We don't fully understand the potential impact of the proposed credit enhancing representation rules as it relates to 1-4 family real estate loans originated and sold to secondary market investors. We have had very few put back losses from investors after decades of originations. If we're going to be required to set aside capital for 100% of our sold loans for 120 days or more, we may be forced to drop the product entirely. We're not aware of significant put back losses at other community banks. This would be another new rule that shifts competitive advantage to the large banks for no apparent reason.

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Community Bank Failures and Capital Adequacy

Given the significant number of community bank failures, it seems futile to argue against regulations intended to ensure higher and better quality bank capital. However, higher and better quality capital won't necessarily reduce the number of community bank failures in the future. That seems like a contradictory statement, but we can illustrate the point using data from this recession.

As of December 31, 2006, there were 7,749 community banks, 391 of them have failed (excluding OTS banks). Most bank failures were caused by the housing crisis. So it might seem reasonable to assume that rules designed for the large banks would also prevent future community bank failures. But it's not that simple. Large banks have both 1-4 family real estate and real estate construction loan problems (see chart 7). Community bank problems are primarily in the real estate construction portfolios (see chart 8).

Chart 9 illustrates the impact of real estate constructions loans on failed community banks. Most of the community bank failures were caused by real estate construction loans. Many more community banks had real estate construction loan issues, but they didn't fail. The difference is loan concentration. Chart 10 illustrates real estate construction loan concentrations before the crisis in 2006. Community banks in general had higher

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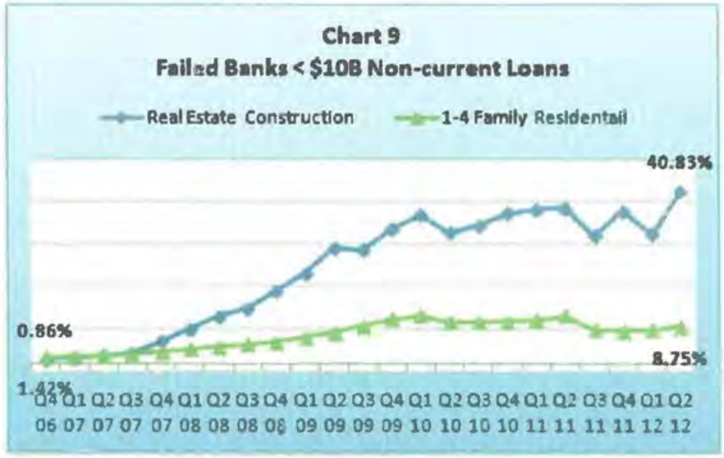
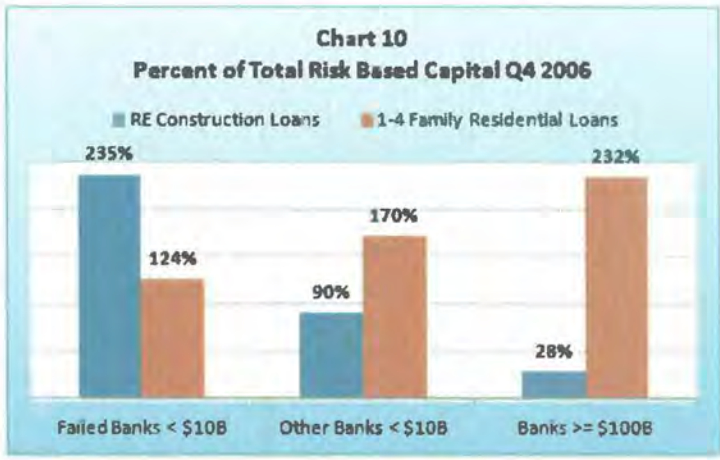
concentrations than the large banks, but the failed community banks were very high at 235% of total risk based capital.





The community banks that failed began the housing crisis with a significant real estate construction loan concentration problem. Not only were they heavily invested in construction loans, but they turned out to be poor quality loans. We could blame the quality problem on the housing crisis. But we can't blame the housing crisis for dangerously high loan concentrations. Maybe we're missing something in the fine print, but there doesn't appear to be anything in the NPRs that would save another 400 community banks from high real estate loan concentration risk. The same could be said for high large bank 1-4 family loan concentrations.

As we see it, the very complex proposed capital rules will increase the cost to calculate and regulate the capital ratios and completely miss the leading cause of community bank failures...high concentrations of real estate construction loans.

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Conclusion

We urge you to reconsider the application of the Basel and Standardized Approach NPRs to community banks. Maybe the new rules are necessary for large banks that are strategically driven to do more with less capital. But there is no positive outcome for community banks. Here's a brief summary of our comments:

1. The proposed capital rules were designed to increase the amount and quality of capital allocated to lines of business through complex large bank RAROC models. Community banks do not have the staff or technology to roll out those models.
2. Community banks maintain capital to get through the hard times. We are not in the business of doing more with less capital. These rules are far too complex for our business model.
3. The proposed risk weighted capital ratios are too complex and have proven to be misleading in their current form. A simple tangible capital ratio would be more meaningful (e.g. tier 1 + tier 2 – non-current loans / tangible assets).
4. The new rules restrict sources of new capital for community banks. Large banks already have a competitive advantage over community banks in the capital markets. The new rules will increase their advantage.
5. Including unrealized securities losses in tier 1 capital implies that realized losses have been significant in the past. That is not the case for community banks. Community banks hold 54% of the municipal bonds owned by banks. The new rule will force community banks out of the municipal bond market at the bottom of the rate cycle when our communities can benefit the most from low rate financing.
6. Punitive loan risk weights greater than 100% imply that credit quality issues have been overlooked in the ALLL analysis. That seems to be an unreasonable assumption given that ALLL adequacy is already micro managed by management, internal audit, external audit, and bank regulators.
7. Punitive risk weights for community bank 1-4 family residential loans are not justified by historical performance. Community bank failures were driven by unusually high concentrations real estate construction loans, not 1-4 family residential loans. 1-4 family asset quality issues have been and continue to be a large bank problem. Large bank non-current 1-4 family residential loans are 11.25% as of June 30, 2012. Community banks are 3.05%.
8. A 100% capital allocation for secondary market mortgage loans sold by community banks is not justified by historical losses. Such an extremely punitive capital allocation would likely push community banks out of the mortgage origination business to the benefit of large banks, even if the allocation was limited to 120 days of production.
9. And most importantly, the new capital rules will not prevent the failure of community banks that are allowed to hold very high concentrations or real estate construction loans as was the case leading up to the housing crisis.

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We appreciate the opportunity to comment on the proposed capital regulations.

Sincerely,

Reynie Rutledge

Chairman
First Security Bank
Searcy, Arkansas

FirstSecurity
Bank

Cc: Senator John Boozman
Senator Mark Pryor
Representative Rick Crawford
Representative Tim Griffin
Representative Mike Ross
Representative Stephen A. Womack
Commissioner Candace A. Franks, Arkansas Bank Department

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