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October 2, 2012
Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue
Washington, DC 20551

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

Officer of the Comptroller of the Currency
250 E Street, SW
Mail Stop 203
Washington, DC 20219

Re: Basel III Capital Proposals

Ladies and Gentlemen:

Thank you for the opportunity to provide comment on the Basel III proposals that were recently approved by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (collectively the "banking agencies").

I have been in the investment and interest rate risk management business for 33 years. My knowledge on many aspects of Basel 3 involving capital required for various loan types, capital treatment for trust preferred, deferred taxes, etc is mainly peripheral, and while I might have an opinion, I am no expert on these areas. However, I am qualified to comment on the proposed change in unrealized gains and losses on the AFS portfolio as it may affect tier one capital.

1) Assuming the basic purpose of Basel 3 is to protect the banking system and overall economy by requiring banks to have the capital and liquidity to support risks inherent in their "book of business", the proposal to include unrealized AFS portfolio gains/losses in tier one capital would likely do nothing relevant to further that goal and could have unintended negative consequences. For the vast majority of banks, the gain or loss in the bond portfolio, be it HTM of AFS, is largely uncorrelated with long term earning's risk arising from interest rate changes, either up or down. In a rising rate environment, a reduction in tier one capital today due to unrealized bond portfolio losses is not going to indicate looming potential earnings and capital risks with any degree of confidence. For every bank negatively affected by rising rates and unrealized bond portfolio losses, there will be another whose likely earnings and net interest margin stand to benefit. In short, on a system wide basis, there will not be a significant positive correlation between unrealized AFS losses and actual potential long term earning's exposure.

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Consider a hypothetical bank with a portfolio of relatively short term and/or floating rate loans equal to 50% of assets, healthy capital of 10%, and a low cost and low beta deposit franchise. Because of the duration and re-pricing characteristics of the loan portfolio, this bank should likely have a 4-5 year average life for its bond portfolio (or even somewhat longer) to balance out overall re-pricing characteristics and company-wide interest rate risk, both short and long term. If market rates were to rise by just 2%, the bond portfolio would depreciate in value by almost 6%, and, since bonds are about 50% of the balance sheet, capital would drop to 7% (not counting tax effect). At the same time, expectations for future net interest margin, net interest income and net income could easily be little changed or even set to improve. At a minimum, the unrealized losses would not be a particularly relevant indicator of increasing risk and therefore would have little utility as a measuring stick. Any alarm the decline in tier one capital caused any interested party -- including bank shareholders, depositors, the community, taxpayers and/or relevant regulators -- would likely be a false alarm, and as such a waste of everyone's time and energy. A 4% rise in market rates would send this bank's tier one capital theoretically to 4% and again, assuming the bank had done their interest rate risk management homework, the bank's future earning's may be largely unaffected (or even improve.) Imagine what a nightmare this might create for both banks and regulators if interest rates were very volatile in the years ahead. With our federal budget deficit equal to almost 10% of GDP, this is a very real risk. One could envision a scenario where at one quarter end, a bank is "undercapitalized", and before they can even raise equity (assuming they even can), the next quarter they are overcapitalized, and on and on. Envision also how twisted the actual facts would get in local community newspapers as they tried to decipher and explain what was going on and why the bank needed to raise equity. This could have a very destabilizing and negative impact on the economy and the banking system when the underlying health and future earnings potential of these institutions is barely affected.

2) My second concern is how inconsistent the impact could be on banks solely because of underlying loan demand. Banks with high loan demand and few bonds would be largely immune from any negative impact of interest rate changes on market value, regardless of whether they held a high percentage of long term fixed rate loans and actually did have significant interest rate risk to higher rates. Banks with weak loan demand and therefore high percentages of bonds would be extremely affected by this even if their bonds were of appropriate length for their balance sheet. I would submit that a hallmark of good regulatory policy is that it is applies equally and fairly to all affected parties, and I do not think the proposed rule has that attribute.

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3) Finally, regarding the AFS or HTM accounting classification, the ability of a bank to avoid this whole "AFS portfolio tier one capital issue" based on a rather superficial accounting choice they can voluntarily make is illogical, or even ridiculous. A policy consideration as important as the need for sufficient capital should not be thwarted by a simple accounting choice, regardless of what category of the balance sheet the choice impacts. The fundamental economic "riskiness" of that banking organization and its need for sufficient capital is not altered by changing an accounting designation, and one might argue that unrealized losses buried in HTM are more risky, not less, as the bank is constrained from disposing of what may be perceived as "problem" assets, and certainly would have less liquidity than if the bonds were in AFS.

The insurance industry has an interesting approach to interest rate risk in that the rating agencies require more capital if a company has a lot of negative convexity, a component of long term interest rate risk. If the goal is to require banks to hold more capital if they have significant long term interest rate risk embedded within the balance sheet, a more comprehensive approach would be more appropriate. While there are potential logic flaws in the current EVE techniques that solve for market value of equity (particularly within banks where the percentage of capital relative to non earning assets is dissimilar), having reasonable estimates for effective duration, convexity, and market value change on a company-wide basis and assessing a capital charge based on the magnitude of the mismatch is a more sound conceptual approach.

Thank you for allowing my comments,

Sincerely,

Dan

Dan Matheson

CEO, R2Metrics, Inc

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