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October 18, 2012

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

Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Office of the Comptroller of the Currency
250 E Street, NW
Mail Stop 2-3
Washington, DC 20219

Re: Basel III Capital Proposals

Ladies and Gentlemen:

Thank you for the opportunity to provide comment on the Basel III capital 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").

Who We Are . . .

McNair, McLemore, Middlebrooks & Co., LLC is a firm of Certified Public Accountants with offices in Macon and Perry, Georgia. We have a diversified practice with twenty-three partners and approximately seventy CPAs included among total personnel of one hundred and thirty. We have a financial institutions group that performs audit, tax and advisory services for approximately forty-five community banks and other types of financial institutions.

Our Financial Institution Clients . . .

Our financial institution clients are located throughout the state of Georgia. Many are in low-density population areas of Middle and South Georgia. Services provided to customers include consumer loans, commercial and agricultural loans collateralized by real estate, SBA loans and home mortgage loans. Traditional deposit services are provided. Most banks could be categorized as plain vanilla with few, if any, derivative or other complex transactions. Many are structured as S corporations for tax purposes. Our clients range in asset size from $50 million to $2.5 billion with the majority falling within the $150 million to $250 million grouping. We consider less that $500 million in total assets to be a small community bank.

Our Concerns Are . . .

The Basel III newly proposed capital rules will affect banking organizations (referred to herein as "banks") of all sizes. Our comments which follow will not address all of our concerns, but will focus on the following:

- The treatment of unrealized gains and losses in the securities portfolio as Tier 1 Capital,
- The increase in risk-weighting, generally to 150%, when a loan becomes more than 90 days past due, and
- The capital conservation buffer which imposes dividend restrictions on banking organization when risk-based capital minimum thresholds are not exceeded by 2.5%.

Our primary concern is that interaction of the above three rules will have these unintended results:

- Elimination of S corporation status for numerous small community banks,
- Closure of numerous small community banks in low-density population areas, and
- Traditional banking services becoming unavailable to thousands of people and small businesses, particularly in rural, agricultural areas.

Unrealized Gains and Losses on Securities as Tier 1 Capital . . .

Community banks' investment securities portfolios generally consist of debt securities with fixed rates and stated maturities. Under current accounting rules, the securities are classified as trading, held-to-maturity and /or available for sale. Trading securities are recorded on the banks' books at fair market value with unrealized gains and losses recorded through the income statement. Few small community banks have trading securities. Held-to-maturity securities are recorded and remain at cost, regardless of fair value fluctuations, until the securities are sold or mature. Available for sale securities (AFS) are valued at fair market value with cumulative unrealized gains and losses recorded as accumulated other comprehensive income (AOCI) in the equity section of the balance sheet. Many small community banks have their investment portfolios heavily weighted to AFS. AFS gains and losses are not recorded through the income statement until realized. They do serve to increase or decrease the book value of the bank, but they are not currently treated as capital for regulatory purposes. The Basel III rules as proposed will change the regulatory treatment to Tier 1 Capital. With that change will come the vulnerability to significant losses in the AFS fixed income portfolio due to rises in interest rates thereby reducing Tier 1

Capital. In our view, there is a high probability that within the next few years, interest rates will begin to increase significantly for the following reasons:

- Interest rates are now extremely low with little, if any, downside potential.
- The current recession has been fought with high dollar stimulus packages and there may be more to come. Stimulus funds did not ultimately result in new business activity, but the residual corporate profits remain in corporate bank accounts waiting to be utilized.
- Three quantitative easings have resulted in interest rates being artificially low. As a result, we don't know the real level of interest rates.
- The housing market is showing signs of recovery.
- When real recovery gets underway, there will be pent up demand unleashed at a rapid rate with too many dollars chasing too few goods. Inflation will result in rapidly rising interest rates which could be devastating to the investment securities portfolios of small community banks resulting in losses which, in turn, will result in reductions of Tier 1 Capital. Many banks will be able to survive these losses but many will not when coupled with other requirements of Basel III, specifically the past due 90 days risk-weighting provisions and the capital conservation buffer requirement.

The Increase in Risk-Weighting on Past Due Assets . . .

Under current rules, risk-weighting does not change when a loan goes on past due status. Under Basel III, risk-weighting generally increased to 150% when a loan is more than 90 days past due. All community banks have a certain amount of loans which are past due more than 90 days. The four new measurement levels of capital adequacy are sufficient in our opinion to cover the 150% 90-day past due requirement. In our view, the capital requirements of Basel III are collectively excessive. Excessive capital requirements may result in the closing of many small community banks in rural areas.

The Capital Conservation Buffer . . .

The proposed Basel III rules require banking organizations to maintain an additional 2.5% above the minimum risk-based capital thresholds. If the banking organizations do not maintain the full 2.5% buffer, they become subject to certain restrictions on the payment of dividends and discretionary bonuses to executive officers. Most banks will attempt to maintain the full 2.5% buffer; however, there undoubtedly will be times of economic stress, rising interest rates, collection delays and numerous other conditions which may render maintenance of the full 2.5% buffer difficult. Under such circumstances, the dividend restrictions could be very troublesome for S corporations.

In the 1990's Congress passed laws allowing banks to be structured as S corporations for tax purposes. As an S corporation, the bank does not pay income tax at the bank level. All items of taxable income are passed through to shareholders who are responsible for paying the taxes on bank income in proportion to the shareholders' ownership percentage in the bank. Most S corporation banks distribute cash to shareholders in amounts sufficient to pay federal and state income taxes. The distribution rate is discretionary but, generally in the state of Georgia, equates to 40% of taxable income. Banks were afforded the opportunity to become S corporations so that bank shareholders could receive the same benefits as shareholders of other type entities, primarily, single as opposed to double taxation of bank taxable income. S corporation status is viewed as a benefit allowed to small bank shareholders since restrictions on the number of shareholders, in effect, prohibit large banks from obtaining S corporation status. If an S corporation's capital levels do not satisfy the Basel III capital requirements, it may not be able to pay distributions to its shareholders. In such cases, the banking organizations would have little choice but to revoke its S corporation status thereby denying the benefits of S Corporation to small community banks and their shareholders.

In summary, as previously stated, the treatment of unrealized gains and losses on investment securities as Tier 1 Capital, the 90-day past due risk-weighting provision and the capital conservation buffer requirement in conjunction with the additional Basel III capital requirements will, in our view, result in elimination of S corporation benefits to many small community banks and their shareholders and the closure of numerous small community banks in low-density population areas. We urge reconsideration of all Basel III capital provisions, but particularly those provisions aforementioned herein.

Respectfully,

McNair, McLemore, Middlebrooks & Co., LLC

McNair, McLemore, Middlebrooks & Co., LLC
Ray C. Pearson
Marjorie Huckabee Carter
David Paschal Muse, Jr.