First Private

October 19, 2012

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Attention: Comments/Legal ESS
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Re: Proposed Regulatory Capital Rules: Regulatory Capital, Implementation of BASEL III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action (R-1442, Docket ID OCC-2012-0008, RIN 1557-AD46, RIN 3064-AD95)

Proposed Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements (R-1442, Docket ID OCC-2012-0009, RIN 1557-AD46, RIN 3064-AD96)

Ladies and Gentlemen,

First Private Bank of Texas (FPB) is a $320 million bank with two locations in the Dallas, Texas area. The NPR's referenced above were released on June 12, 2012 by the Board of Governors of the Federal Reserve System (FRB), the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) (together, the "Agencies") and are designed to incorporate the latest revisions to the Basel III capital framework and to implement relevant provisions of the Dodd Frank Wall Street Reform and Recovery Act. The published position of the Agencies is that the proposals will result in capital requirements that "better reflect banking organizations' risk profiles and enhance their ability to continue functioning as financial intermediaries, including during periods of financial stress, thereby improving the overall resiliency of the banking system." FPB's board of directors and management fully support the Agencies' efforts to address perceived weaknesses in the banking industry's capital framework and recognize the enormous challenges that the Agencies face in developing a system that accurately reflects risk across the broad and diverse universe of financial institutions that make up the United States banking system. Because of the scope of the proposals and the significant impact they potentially will have on the industry, particularly on community and regional banking institutions, we appreciate the Agencies' willingness to extend the comment period through October 22, 2012. We believe this additional time will allow institutions to evaluate the impact of these changes properly and provide meaningful responses to assist the Agencies' in their ongoing efforts to refine these rule changes.

The comments provided below address specific aspects of the proposals that, in our view, will have the most significant impact on First Private Bank and other community banks. We recognize, however, that other aspects of the NPR's that are not addressed herein could have a material impact on the operations of many other organizations. Specific comments noted below follow the paraphrase of the respective sections of each specific NPR.

A. Proposed Rule: Accumulated Other Comprehensive income (AOCI) as a component of Tier 1 capital – The Agencies are proposing that AOCI, which includes all unrealized gains and losses on AFS securities, would flow through to common equity Tier 1 capital. This would include unrealized gains or losses related to debt securities whose valuations primarily change as a result of fluctuations in benchmark interest rates, as opposed to changes in credit risk (for example U.S. Treasuries and U.S. government agency debt obligations).

FPB Comments: The inclusion of AOCI as a component of Tier 1 capital raises a number of concerns. The Agencies themselves have recognized that the inclusion of unrealized gains and losses on securities could "introduce substantial volatility in a banking organization's regulatory capital ratios." While we recognize the appropriateness for AOCI inclusion in a tangible capital ratio from a market valuation perspective, the introduction of a similar structure to the regulatory capital metric has the potential to create confusion over the adequacy of recorded ratios and could lead to flawed, uneconomic, and even unsound decisions regarding asset-liability management and investment options. Some of the more troubling aspects of this proposal:

1. Inclusion of AOCI in the standardized regulatory capital ratios would force regulators and bank management to calculate alternative ratios to determine an effective capital position, exclusive of AOCI. Capital ratios bolstered by market appreciation would most certainly be discounted to reflect the potential volatility that might exist in a higher rate environment. At the same time, market depreciation would be counted against capital, even though a lower rate scenario might significantly improve the capital position. In the latter case, FPB could be required to hold greater levels of common equity capital to comply with a ratio requirement that reflects only a temporary adjustment.
2. To avoid recognition of AOCI, we may be encouraged to hold more securities in the held-to-maturity (HTM) account. While the move to the HTM account would no longer require gains and losses on those securities to be recorded in Tier 1 capital, the operational restrictions imposed on the HTM account would greatly reduce FPB's ability to adjust its investment portfolio properly for liquidity and funds management purposes.
3. To avoid capital ratio volatility, FPB's management might also be inclined to make shorter-term investment decisions that reduce volatility and increase liquidity. While such action may help to reduce market risk, it also could reduce the extent to which the investment portfolio can be relied upon to produce income and generate capital appreciation. As a result, FPB might be forced to pursue other options to generate yield, which could include diverting investment to other asset classes, with higher levels of credit risk and/or greater levels of unrecorded market volatility.
4. The AOCI inclusion for AFS securities applies mark-to-market treatment of only one set of assets on an institution's balance sheet. Other balance sheet components that are economically very similar do not receive the same treatment, such as loans, structured liabilities, and HTM securities. We find two difficulties in this dissimilar treatment. First, this appears to violate the basic accounting principle of consistency. Second, it would in effect weaken FPB's asset-liability management by adding a potential capital penalty on using the securities portfolio, the most flexible tool at an ALCO's disposal, to reduce overall asset sensitivity while leveling no such penalty on any other balance sheet component.

5. The negative impacts of these effects would fall disproportionately upon community banks like FPB, due to limited access to capital markets for funding and temporary equity enhancements.

FPB Recommendation: The Agencies should exclude any AOCI adjustments from the regulatory capital calculations and continue to include an addendum in the Call Report to reflect ongoing gains/losses in the AFS portfolio. Concerns regarding market value appreciation/depreciation are best managed through a strong liquidity and funds management function. While the impact on capital should be considered, financial institution capital ratios cannot be effective measurements of risk when only one class of assets among many is required to recognize ongoing market value adjustments.

The Agencies have suggested a potential exclusion of the capital charges for debt obligations to U.S. government, U.S. agency, and U.S. Government Sponsored Entities. The Agencies have also suggested a similar exclusion on general obligations issued by states or other political subdivisions. FPB supports these exclusions and agrees that they would help to minimize the impact of the proposed AOCI treatment. However, to minimize risk and properly diversify the investment portfolio and total balance sheet, FPB should also be able to make informed investments in securities that contain some level of credit risk without an inequitable capital volatility penalty. If higher levels of capital need to be held against such investments, that need should be addressed through an appropriate adjustment to the standardized risk weight measurement, not through an ongoing fluctuation in the Tier 1 capital ratio.

The most likely result of this proposal will be an increase in bank staff time to monitor the AFS portfolio. This may also require FPB to purchase software to maintain compliance. Either eventuality would negatively impact customer service levels.

B. Proposed Rule: Minimum Capital Ratios, Capital Conservation Buffer, and Prompt Corrective Action Requirements – Under the Basel III NPR, the Agencies have introduced a new common equity Tier 1 capital ratio and have modified the capital components and ratios for the existing risk based and leverage capital framework. The Agencies are also proposing limits on capital distributions and certain discretionary bonus payments if a banking organization does not hold a specified "Capital Conservation Buffer" in addition to the established minimum risk-based capital requirement. The minimum risk based capital requirements correspond to the minimum thresholds for "adequately capitalized" status under the Prompt Corrective Action (PCA) framework, and the Capital Conservation Buffer is proposed to be 2.5 percent above these minimum requirements. The Agencies are proposing to continue the PCA framework, with existing requirements still in force for organizations that fall below the statutory definition of "well capitalized," which is 2.0 percent above the minimum requirement.

FPB Comments: The proposed minimum capital requirements are not objectionable, nor are the addition of the new common equity Tier 1 capital ratio. However, the Agencies' reason for creating a capital conservation buffer that would exceed the minimum thresholds for "well capitalized" under the PCA framework is unclear. In essence, the proposal suggests that an institution needs a 2.0 percent buffer to be "well capitalized' but would need a 2.5 percent buffer to be deemed "resilient" throughout different financial cycles. Under that framework, FPB could be "well capitalized" and free from any restrictive covenants under the PCA framework, e.g., limitations on brokered deposits, but at the same time still have restrictions on capital distributions and discretionary bonuses if it did not exceed the requirements for the Capital Conservation Buffer. This staggered and somewhat parallel layer of restrictive covenants above the PCA "well capitalized" framework will create a confusing and contradictory set of standards.

In reviewing the Agencies' justification for Capital Conservation Buffer, the basis on which the Agencies initially developed the specific 2.5 percent ratio or how that level, over and above a "well capitalized" level, would help to "bolster the resilience of banking organizations throughout financial cycles" were not clear. The extent to which the Agencies considered the impact of the proposed changes to risk weighting requirements in their determination of the 2.5 percent buffer was not clear. If the proposed changes to the Standardized Approach NPR create a risk weighting mechanism to reflect balance sheet risk more accurately, it would seem that the revised capital ratios would therefore be better indicators of institutional resiliency, and the "well capitalized" standards would be better indicators of institutions well positioned to absorb cyclical risks.

The proposal also did not appear to address the authority that currently exists within the Agencies' enforcement powers to restrict capital distributions when appropriate. If, through the examination process, an Agency determines that capital distributions need to be restricted because of the specific financial condition of an institution, the Agency has the power to restrict those distributions through existing enforcement authority. Codifying this type of restriction in a regulation oversimplifies the issue and could impact the ability to exercise appropriate regulatory flexibility.

FPB Recommendation: To avoid confusion and to link the proposed capital guidelines to the existing PCA framework more effectively, the Capital Conservation Buffer should be adjusted to 2.0 percent. This would align the Capital Conservation Buffer with the buffers that already exist between "adequately capitalized" status and "well capitalized" status under the PCA framework. Banks that fall below "well capitalized" could be subject to a variety of restrictions, including the proposed restrictions under the Capital Conservation Buffer. However, in the interests of clarity, flexibility and simplicity, we believe the Agencies should consider eliminating the Capital Conservation Buffer altogether in favor of applying existing enforcement authority to restrict capital distributions as circumstances warrant.

Proposed Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets (Standardized Approach NPR)

C. Proposed Rule: Residential Mortgage Exposures – In light of the recent difficulties in the U.S. residential mortgage market, the Agencies are proposing a wider range of risk weightings (between 35 percent and 200 percent) for residential mortgages. Mortgage loans would be subdivided into two risk categories based on underwriting criteria (traditional vs. nontraditional) and lien position. Within each category, risk weights would then be assigned based on standard loan-to-value ratios. The current risk based capital treatment would be maintained for residential mortgage exposures that are guaranteed by the U.S. government or a U.S. government agency.

FPB Comments: The Agencies' assertion that inadequate loan underwriting and high risk mortgage products have contributed to an increase in mortgage loan defaults and home foreclosures is well founded. In the NPR, the Agencies have tried to create a set of standardized criteria to segregate higher risk loan products from more traditional loan products. While we concur with the intent, whether the criteria would fully and fairly accomplish the intended result is questionable. Key questions about the Agencies' segmentation include:

1. Does the standardized approach treatment fairly align with the advance approach guidelines for similar assets? Specifically, do larger banks have an ability to offer similar or more innovative mortgage products with a lower capital charge than what would be allowed under the standardized approach used by community banks?
2. With regard to the specific criteria, questions remain about what constitutes a "balloon payment" and what are the specific regulatory requirements to demonstrate that a borrower's income has been sufficiently "documented and verified."

3. The NPR allows an institution's primary federal regulator to make an independent determination that any particular loan may not qualify as Category 1 exposure, even if that loan meets the specified criteria. What will be the basis for that determination?

FPB Recommendation: The criteria for Category 1 loans need to be more clearly defined so that prudently underwritten loan products are not unfairly targeted. Specifically, the Category 1 exclusion for loans that "result in a balloon payment" should be redefined only to include loans that are not amortizing. A five year amortizing adjustable rate mortgage does not have the same risk characteristics as a payment-option or negative amortization loan. The Agencies should be required to adhere to established criteria in determining whether a loan is qualified as Category 1. In order to lend to creditworthy borrowers, institutions must be able to be confident that following defined criteria will preclude overturning of actions by an arbitrary regulatory ruling.

Conclusion

The board of directors and management of FPB support the Agencies' effort to improve the quality and quantity of regulatory capital and to build additional capacity into the banking system to absorb losses in times of economic stress. We also support and acknowledge the Agencies' effort to formulate an appropriate transition period for various aspects of the proposal. The timeframes granted were generous but appropriate given the magnitude of the changes contemplated. While the applicability of certain provisions to smaller banks was not expected, absent the AOCI charge, the NPR's do not appear to present an immediate compliance concern for most banks from a pure ratio perspective. As noted above, FPB has attempted to provide feedback that will help improve and enhance the quality of the overall proposals. Comments have been concentrated on areas that have the greatest impact on FPB. Several provisions could create significant volatility and inconsistency in reported capital ratios. These provisions could impact the effectiveness of the proposal and have negative consequences for the banking system as a whole.

In summary, as it relates to the Basel III NPR, the AOCI provision is a matter of great concern, both in terms of creating significant volatility and inconsistency in reported ratios and in potentially introducing economically unsound decision making constraints. As a result, AOCI should not be included as a component of regulatory capital. The Capital Conservation Buffer should be limited to 2.0 percent and incorporated as part of the existing PCA capital framework. Further, several provisions of the second proposal, the Standardized Approach NPR, if left unadjusted, could also create inaccuracies and inconsistencies in the reported ratios, particularly the risk based adjustments for mortgage exposures and past due loans and the potential shortcomings in the securitization valuation approach.

If you have any questions or would like additional information, please contact Mr. David Nabors (CFO of First Private Bank, at 972-348-6124) or me.

Sincerely,

Daryl S. Kirkham

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