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September 19, 2012

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

RE: FDIC Basel III NPR (RIN 3064-AD95) and FDIC Standardized Approach NPR (RIN 3064-AD96)

Dear Mr. Feldman:

In response to agencies' requests for comments on specific sections of the above-captioned NPRs, I submit the following observations and opinions based on twenty years of service as a financial consultant to community banks and bankers – entities and individuals greatly and disparately impacted by the current structure of the NPRs. For each section, I present the request in italics, followed by my response in plain text.

The agencies seek comment on the advantages and disadvantages of the proposed standardized approach rule as it would apply to smaller and less complex banking organizations (community banking organizations). What specific changes, if any, to the rule would accomplish the agencies' goals of establishing improved risk-sensitivity and quality of capital in an appropriate manner? For example, in which areas might the proposed standardized approach for calculating risk-weighted assets include simpler approaches for community banking organizations or longer transition periods? Provide specific suggestions.

The proposed risk weightings will create unnecessary reporting burdens for community banks and limit their ability to provide flexible lending solutions to customers. Larger lenders that use highly structured, computer model-based lending platforms will be able to rely on technology to ensure compliance with desired risk-weighting criteria, while community bankers will be forced to check each loan against a long list of technical parameters or risk unintentional violation of a risk threshold.

The agencies also seek comment on the advantages and disadvantages of allowing certain community banking organizations to continue to calculate their risk-weighted assets based on the methodology in the current general risk-based capital rules, as modified to meet the new Basel III requirements and any changes required under U.S. law, and as incorporated into a comprehensive regulatory framework.

Allowing community banks under $1 billion in total asset to continue using current risk-based capital rules would provide a great relief to community bankers and their regulators. 90% of all institutions fall below the $1 billion threshold, yet these institutions hold only 10% of total industry assets. The goal of establishing improved risk-sensitivity and quality of capital is at least 90% accomplished through application of the proposed rules to only 10% of all market participants. The inevitable trickle down of regulatory expectations can be effective in preventing any significant unintended consequences of this segmented application of the standardized approach. If necessary, subsequent application of the new approach to smaller institutions can be proposed as appropriate.

The agencies request comment on the criteria they should consider when determining which banking organizations, if any, should be permitted to continue to calculate their risk-weighted assets using the methodology in the current general risk-based capital rules (revised as described above). Which banking organizations, consistent with section 171 of the Dodd-Frank Act, should be required to use the standardized approach? What factors should the agencies consider in making this determination?

The easiest approach to determining which institutions are allowed to continue using the current risk-weighting methodology is asset size. Whether through a linkage to the small bank holding company threshold (currently $500 million) or one of the Dodd-Frank size thresholds, this method produces a very clear line in the sand for all parties, with no room for interpretive disagreements. Form a statistical standpoint, 90% of all FDIC-insured institutions have assets of under $1 billion, while the remaining 10% of institutions hold 90% of industry assets. A 90/10 solution seems to provide the best "bang for the buck". Recognizing the desire of regulators to constrain risky behaviors, another reasonable segmentation could be based on a combination of CRE concentration, non-government/GSE security concentration and non-core funding mix. A review of the balance sheet characteristics of the 400+ recently failed institutions should provide a good foundation for these types of concentration thresholds.

What are the pros and cons of the proposed definition for eligible retained income in the context of the proposed quarterly limitations on capital distributions and discretionary bonus payments?

The definition of eligible retained income should be modified to be net of pass-through tax distributions to shareholders of banking entities that have made a pass-through election (S Corporations and LLCs). Failure to allow for these distributions, at least up to the level of taxes that would have been paid had the entity not made the pass-through election, imposes a penalty on these entities and their shareholders relative to a similarly situated C Corporation.

To what extent would a requirement to include unrealized gains and losses on all debt securities whose changes in fair value are recognized in accumulated other comprehensive income (1) result in excessive volatility in regulatory capital; (2) impact the levels of liquid assets held by banking organizations; (3) affect the composition of the banking organization's securities portfolios; and (4) pose challenges for banking organizations' asset-liability management?

The current AOCI proposal will definitely result in countercyclical capital volatility relative to market interest rates. This volatility will create confusion in the industry for bankers, regulators, investors, depositors and others. Merging real gains or losses with unrealized gains or losses creates more confusion than transparency, especially when applied to only one subset (AFS) of class of an institution's assets.

If the current AOCI proposal is implemented, bankers are likely to respond in three ways: 1) shorten the duration of the securities portfolio to reduce price risk, 2) hold additional capital to offset AOCI risk or 3) transfer price-risky bonds into the HTM category. The first option reduces earnings, requiring additional risk in other areas to maintain a stable income stream or resulting in lower earnings. The second option lowers ROE and ROI, reducing the amount of free market capital available to financial institutions. The third (and most likely) response does nothing to change the institution's risk profile, relying on an accounting election to hide the risk this proposal attempts to bring to light. By transferring securities from AFS to HTM, bankers constrain their liquidity options in order to protect "on paper" capital ratios – a trade off with questionable value.

Are there other alternatives that the agencies should consider (for example, retaining the current treatment for unrealized gains and losses on available for sale debt and equity securities)?

Retaining the current treatment for unrealized gains and losses on available for sale debt and equity securities is a very reasonable alternative. AOCI is clearly noted on the Call Report and on institutions' financial statements, and regulators already have risk measurement systems (Earnings at Risk and Economic Value of Equity limits in institutions' Interest Rate Risk Policies) in place to address excessive price risk exposures. If maintaining the current treatment is deemed unacceptable, exclusion of unrealized gains and losses on debt securities whose changes in fair value are predominantly attributable to fluctuations in a benchmark interest rate (for example, U.S. government and agency debt obligations and U.S. government-sponsored entity debt obligations) is a reasonable method of focusing the AOCI concern on riskier securities.

In closing, I would like to add my support to the September 14 comments made by FDIC Director Thomas Hoenig at The American Banker Regulatory Symposium. Director Hoenig effectively and persuasively stated:

> "The poor record of Basel I, II and II.5 is that of a system fundamentally flawed. Basel III is a continuation of these efforts, but with more complexity. It also is more prolific since it applies across all banking firms."
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> "Basel III will not improve outcomes for the largest banks since its complexity reduces rather than enhances capital transparency. Basel III will not improve the condition of small- and medium-sized banks. Applying an international capital standard to a community bank is illogical, particularly when models have not supplanted examinations in these banks. To implement Basel III suggests we have solved measurement problems in the global industry that we have not solved. It continues an experiment that has lasted too long."
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> "…I believe the Committee should agree to delay implementation and revisit the proposal. Absent that, the United States should not implement Basel III, but reject the

> Basel approach to capital and go back to the basics. By doing so, we can focus on efforts that will create a well-managed, well-capitalized, well-regulated financial system that actually supports economic growth."

My clients and I appreciate the continuing efforts of the FDIC and other regulatory agencies to ensure a safe, sound and fair competitive environment for America's financial institutions. I urge the FDIC to delay implementation of the NPRs and look for a simpler, more effective solution.

Sincerely,

T. Jefferson Fair
President