BlackRidgeFinancial

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Ben S. Bernanke, Chairman
Board of Governors of the Federal Reserve System
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Dear Sirs:

The Basel III Notice of Proposed Rulemaking (NPR), if adopted as proposed, will have a detrimental impact on communities across America. The NPR raises the risk weighting on standard credit products that community bank customers have relied on for years and it also increases the volatility of capital by including investment portfolio mark-to-market (MTM) adjustments in Tier 1 capital. The end result of adoption will be a contraction of credit availability as community banks will be forced to shrink in order to comply with the new standards. What reads at first as regulatory punishment for the past sins of the banking industry is actually going to have the greatest negative impact on individual borrowers and small businesses. Credit availability will be limited and loan rates will increase... all at a time when the country is just beginning to crawl out of a recession.

1-4 Family Mortgage Loan Risk Weighting

The NPR increases the risk weighting on performing 1-4 family mortgages from 50% to possibly 100%, 150%, or even 200% for any mortgages that include a balloon maturity. These proposed risk weightings rely too heavily on loan-to-value data and also punish community banks for sound interest rate risk management via the use of balloon features. These proposed risk weightings are also too high when one considers the risk profile of the assets. The recent mortgage meltdown was the result of lax underwriting standards and sloppy securitization/structuring. The originator, underwriter, and servicer all had very little at stake as it relates to the performance of the individual mortgages. The ultimate risk fell almost completely on the end investor, and these investors are now left with cumbersome lawsuits as their only recourse. Residential 1-4 family mortgages that are originated and held by community banks have a different risk profile. The bank functions as the originator, underwriter, servicer, and investor. There is no entity down the securitization chain to stick with the risk, so community bank underwriting focuses on character, cash flow and collateral. In the event of default, the collateral is local and the goals of the servicer and investor are perfectly aligned as the community bank serves both roles. The severity of community bank held mortgage defaults is typically much less onerous than the 60%+ endured by investors in private label CMO's collateralized by no doc mortgages being serviced by a third party.

The proposed changes to 1-4 family mortgage risk weightings could have a significant impact on a community bank's total risk-based capital ratio. Assume a $350MM community bank holds $50MM of performing 1-4 family residential mortgages on its balance sheet. The bank has $33MM of total capital and its risk-weighted assets total $275MM. The bank's total risk-based capital ratio is 12.00% under current capital guidelines. Now assume further that the bank's 1-4 family mortgages all have balloon features, and that the dispersion of loan-to-values results in an average risk weighting of 125% (half 100% and half 150%) under the Basel III proposal. Risk-weighted assets would increase $37.5MM, and the bank's total risk-based capital ratio would decline to 10.56%. Faced with falling below well capitalized status, the bank's immediate response would be to lower deposit pricing, raise loan rates, and limit all growth until retained earnings can replenish capital levels. While unpleasant for the bank, it will be the communities this bank serves that suffer the greatest negative impact.

Investment Mark-to-Market Adjustments Included in Tier 1 Capital
In addition to increasing risk-weighted assets, Basel III also proposes to include the impact of investment portfolio MTM adjustments in Tier I capital. It is hard to imagine how this provision even made its way into the proposal as the banking industry tilted this windmill two decades ago. As it was in the 1990's when FAS 115 was first introduced, it is categorically unfair to mark one portion of the balance sheet to market and then include the impact in a bank's capital totals. Community banks do a number of things on the liability side of the balance sheet to limit the overall impacts of interest rate risk, and if a bank must include the impact of investment portfolio valuation adjustment in its capital ratios, then the liabilities should be valued with the MTM adjustment also included in Tier I capital.

The MTM provision in Basel III is more than simply unfair, it also represents, as proposed, an immediate capital call. Examiners will not be interested in the current capital impact of the MTM. The more interesting question will be "what is the impact to capital at +400bps". Let's return to our $350MM bank with $33MM in total capital and a 12.00% total risk based capital ratio under current capital guidelines. Assume this bank has an $80MM investment portfolio with an effective duration of 3.00 and negative convexity of -0.50. With a rate shock of +400, the gross decline in the portfolio would be 14.00%. Right now the portfolio is probably in the money 4.00%, so the total decline from book would be 10.00%. After deferred taxes, the net effect would be 6.00%, or a $4.8MM decline in Tier 1 capital. The bank's total risk based capital ratio, assuming a +400bp rate shock, would drop below 10.00%. Because there would be significantly different capital ratios under various rate scenarios, the threat of capital volatility would undoubtedly require higher current capital. The bank would again lower deposit pricing, increase loan rates, and limit all growth until it could earn its way to higher capital.

Summary
We have focused on the two provisions of Basel III, namely higher risk weightings on 1-4 family mortgages and the inclusion of investment portfolio MTM adjustments in Tier I capital, because we feel these are the proposals that will have the biggest immediate impact on the communities served by small banks. It is also our opinion that the exclusion of Trust Preferreds from Tier 1 capital for all bank holding companies above $500MM will be have a significant impact on the economic recovery and that the provision is inconsistent with the Dodd-Frank legislation, but we will leave that battle to our larger financial industry competitors.

Our country's battle against the big recession just gets more and more confusing. The implementation of a zero interest rate policy, QE1, QE2, operation twist, QE3... all intended to spur economic growth. The only way this money supply growth can reach the public is through an intermediary, and if the bank regulators chose to reduce qualifying Tier 1 capital, raise asset risk-weightings, and increase the volatility of capital simultaneously, most banks will simply stop all growth and wait for the dust to settle.

We urge the United States financial regulatory bodies to reject adoption of the international Basel III standards. Regulators have already been holding banks to capital ratios that are well above the current regulatory minimums. Just adopt these implied minimums as the new standards and let's begin and era of economic growth based on consistent tax, monetary, and regulatory policy.

Sincerely,

Sean L Burian

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