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ROBERT K. BAEN
Executive Vice President
& Executive Trust Officer

September 24, 2012

Mr. Richard W. Fisher, President & CEO
Federal Reserve Bank of Dallas
2200 N. Pearl Street
Dallas, Texas 75201

Re: Base III

Dear Mr. Fisher:

We need your help.

Our bank was founded in 1907 and has been in continuous operation since that time, except for the national bank holiday declared by President Roosevelt in 1933. Our bank survived the Great Depression, severe drought in the 1950s, the Texas banking crisis of the 1980s, and the most recent 2008 financial crisis. Our present senior management was with the bank during and through the Texas banking crisis, and we managed to survive and continue to operate as an independently owned community bank. While many Texas banks and savings and loans either closed or merged with other entities during the 1980s, our bank remained independent, strong, and profitable. Our philosophy and business model have always been and continue to be to serve our community as a safe place for our citizens to deposit their money, meet the credit needs of our community, and provide a reasonable return to our shareholders. We have always strived to be our community's best corporate citizen and to promote our local businesses and community organizations. We have actively and directly financed many local government needs and projects. Through the open market, we have helped finance the needs of many small local school districts and municipal governments all over the state of Texas.

One of our primary concerns regarding Basel III is associated with mark-to-market in the AFS portfolio. This rule will disproportionately affect community banks such as ours with strong core deposits and low loan demand, as a higher percentage of our assets will be in medium to longer-term bonds and therefore subject to large mark-to-market adjustments. Our bank has operated well through many different interest rate environments. At times of low or declining interest rates we have had large unrealized gains in our AFS securities portfolio and at times of high or rising interest rates we have had large unrealized losses in our securities portfolio. Through all of those times, we managed to maintain

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acceptable interest margins, grow our earnings, and remain safe and sound. Our policy has been to classify all of our investment securities as available-for-sale to allow us the flexibility to manage the investment portfolio and the bank in the most prudent and reasonable manner. If we are required to reflect the unrealized losses in our AFS portfolio through regulatory capital, the most likely outcome is that we (and not just us, most community banks) will significantly reduce our purchases of and holdings of "Bank Qualified" municipal bonds - which tend to be fairly long maturity, and our bank will be substantially less profitable. It is difficult for me to see how making our bank less profitable will make us safer and it is also difficult to see how reducing our small cities', counties', and school districts' access to financing would be a good thing.

The proposed requirement to mark-to-market the AFS securities portfolio and its effect on regulatory capital is primarily an interest rate risk issue. To single out one class of asset for mark-to-market and not include all other balance sheet assets and liabilities in the analysis of an institution's interest rate risk profile is not a reasonable interest rate risk management approach. If this proposed requirement goes into effect, it will trump all other interest rate risk management practices, especially for banks such as ours that invest a significant portion of their assets in securities covered by this new rule. Our industry has had this debate before when the FFIEC/FMED "CMO TEST" rule was in effect. The joint regulators and banking industry ultimately determined that a total portfolio and balance sheet approach to interest rate risk management is a better method than a single asset approach. Similarly, a balance sheet approach to interest rate risk management is better than a single asset class approach.

If a bank has good interest rate risk management practices, even rapidly rising interest rates should not put the safety and soundness of the bank in jeopardy. Interest rate risk is different than repayment risk. Properly managed, the passage of time will often resolve interest rate risk related unrealized losses, while the passage of time rarely improves a repayment risk issue. The appropriate capital adequacy approach to repayment risk exposure is not appropriate to interest rate risk exposure. Large unrealized losses on AFS securities will likely be completely uncorrelated with the short or long term financial health of the bank.

Also of great concern to us is the proposed requirement to mark-to-market in regulatory capital, via AOCI, defined benefit plan net assets/liabilities. Because of the long-term nature of pension investments - mostly long-term bonds and stocks, the asset side of the defined benefit plan can be subject to a high degree of volatility. The long-term nature of the liability side - future pension benefits, makes the liability side extremely volatile as well.

The Pension Protection Act of 2006 encourages companies to overfund their defined benefit plans by increasing the allowable tax deductible pension expense amount. Under the Basel III proposal, by overfunding their plans, banks will be

exposing more assets and therefore regulatory capital to excessive volatility. Valuation of the pension liability is not "market value", but uses a somewhat arbitrary methodology that is subject to change. If the mark-to-market of net pension liabilities through regulatory capital is allowed to stand, the logical outcomes will be to minimize funding – which will ultimately expose the institution to more risk, or to terminate the defined benefit plan. Neither of these outcomes will be positive and they both seem to fly in the face of good public policy. We believe that this is a very important part of the Basel III issue to banks that have continued to provide this benefit to their employees.

The focus of the Basel Committee and Basel Accords has always previously been directed at large, systemically significant institutions and those operating and creating risk exposure internationally. It is our firm belief that traditional community banks should be fully exempt from the requirements of Basel III and we request exemption for all U.S. based community banks with little international exposure and that pose little systemic risk to our U.S. economy or the economies of other nations.

Thank you for your help and all best regards,

Robert K. Baen