October 15, 2012

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation,
550 17th Street, N.W.
Washington, D.C. 20429

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

Re: Basel III Capital Proposals

I appreciate the opportunity to provide comment on the Basel III proposals that were recently approved by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.

Our bank was formed in 1886 in Mulvane, Kansas and since that time we have expanded to the Derby and Wichita markets. We are a $90 million traditional community bank that cares deeply about our customers and our employees. We are dedicated to the communities we serve and we strive to be a leader in helping to improve each of our communities. Without our bank providing home loans, agricultural loans, small business loans, and consumer loans to our area, our community would suffer. I am deeply concerned about the effects Basel III will have on our ability to continue supporting the economic development opportunities in our area.

First, I am in support of increasing the quality and quantity of loss absorption safeguards in the financial institutions of our country. Our bank presently has almost 9 percent tier one capital and risk-based capital of more than 17 percent. We intend to maintain capital levels that are well above the required levels even when loan demand recovers. However, many aspects of the Basel III Capital proposals will negatively affect our bank and the communities we serve.

The following items are the areas of the proposal in which I have concerns:

1. **Requirement that gains and losses on available for sale securities must flow through to regulatory capital.**

   Currently, our investment portfolio is over $34 million and made up almost exclusively of fully backed government agencies. Our current duration is only 2.39, however even with the portfolio about as short as can be reasonably expected, we would still anticipate an unrealized loss of over $2.3 million in a +300bp rate shock. While this is reflects only a 5.74% loss on the portfolio, it would decrease our tier 1 leverage ratio from 8.8% to 6.37%. We would be unable to increase lending, pay dividends or pay any bonuses because of this unrealized loss even though 95% of the portfolio is guaranteed by the U.S. Government and almost half will cash flow in the next 24 months.

Market fluctuations will cause great volatility of the bank's capital even though nothing other than the interest rate environment has changed. Our bank's reaction to this would probably be to sell all of our AFS securities and to place all future purchases in Held to Maturity. While this would eliminate the cyclicality and volatility of the proposal it will eliminate our ability to manage our investment portfolio through different interest rate environments and economic cycles. This, of course, would increase the sensitivity of bank earnings and the economic value of equity of our bank.

A further impact would be felt on our legal lending limit. A large swing in the gain or loss of SAFS would have an even larger impact on our legal lending limit. This may place an artificially low cap on loan limits and leave us vulnerable to losing our customers to larger financial institutions.

It would be interesting to contemplate the Federal Reserve of the United States using mark to market accounting whereby a 25bp increase in interest rates would deplete all the capital in the Federal Reserve System.

2. **Elimination of Trust Preferred Securities.**

Our bank has held $2+ million in Trust Preferred Securities for about five years. This has been a very cost effective source of capital for us and has allowed us to continue to serve our communities during the Great Recession. The elimination of this source of capital will force us to shrink our balance sheet by about $20 million or 22%. Trust Preferred Securities were grandfathered under Dodd-Frank, but are now being eliminated by Switzerland. Community banks have much more limited sources of capital than large institutions and the combined regulatory changes will make it harder to offer an acceptable return on equity.

The proposed changes will reduce the amount of loans we will be able to provide to our communities. When you multiply this affect across the country, the potential reduction in loan availability is significant.

It is most difficult for me to understand how regulators expect banks to exact the business of banking while constantly changing the rules. We purchased the Trust Preferred Securities under a set of guidelines approved by the regulators, making decisions that were long term, only to be whey laid now by changing the rules, due to unscrupulous dealings by Wall Street, all brought about by certain Congressmen meddling in the housing and mortgage business, causing a market to expand beyond its natural bounds, leading to an economic disaster. The same Congressmen now come back to correct this misstep by creating Frank Dodd, and ultimately placing more regulations on the banks that did not cause the problem, and full circle, bowing to a foreign entity to change those Trust Preferred Securities' status and function. TruPS played no role in the financial debacle and continue to play a valuable role as a source of capital for our bank. We have made a 25 year plan to replace this form of capital and accelerating this to a 10 year schedule will have a negative impact on our communities, customers, employees, and stockholders.

3. **Increased risk weighting for residential mortgage loans.**

   We have never made a sub-prime or Alt-A loan. As a community bank, we have never made an Interest Only Option Pay ARM. The large lenders like Countrywide and the GSE's, including Fannie, Freddie, and FHA took that market (with the results we anticipated) and are the entities that should be held to these standards. The community bank model is much different and as a $90 million bank, without off balance sheet liabilities, we must find the niches these behemoths won't bother with. A community bank has always had the flexibility to work with a borrower and tailor a solution that fits their situation. As such many of the mortgage loans we keep on our books are variable rates and many contain balloon terms that are necessary for us to manage our interest rate risk. Requiring higher risk ratings of these loans will increase the cost of the credit and reduce the availability. Also, many of the residential mortgages we make do not quite fit the "conforming" mold due to lot size or rural locations.

   In addition to the effect on our ability to lend, the change to assigning risk weightings to individual loans will create an administrative nightmare and would probably force us out of the residential mortgage market for both first and second mortgages. Instead of being able to assign a risk weighting when the loan is booked we will have to continually re-evaluate the risk weightings based on changes in collateral values, scheduled payments and other risk factors. At this time we have no way of automatically calculating the correct risk weight under the proposal and would be forced to hire a part time person just to assign and maintain risk weightings. This additional expense would either raise the cost of lending or impact our earnings.

4. **Changes in risk weighting for home equity and second lien loans.**

   Home equity lending is one of the only remaining consumer lending functions that hasn't been pirated by non-banks or the shadow banking system. As a small community bank we prudently underwrite every home equity and second lien loan. We've never made 120% LTV HELOCs, yet instead of relying on accurate calculation of the ALLL we will be forced to double the risk weighing to 200% on almost all home equity loans. Assuming even a small $5 million portfolio of these loans at our bank, this part of the proposal would add 10% to our risk weighted assets taking almost 2% off our total risk based capital.

5. **New rules regarding High Volume Commercial Real Estate**

   Different loans certainly have different risk profiles, and these loans require additional underwriting and structuring. However, the administrative concern of assigning a new risk rating based on all of the criteria and exceptions provided in the proposal will necessitate further staffing.

6. **Proposal to increase risk weights on delinquent loans**

We have been fortunate to see decreasing delinquent loans; however double counting the capital requirements of a delinquent loan in both the ALLL and this proposal is onerous. Delinquent loans should continue to be managed through the loan loss reserve. Community banks are already regulated highly in this area and I believe a better proposal would be to remove the 1.25 percent of risk based assets limitation in capital calculations. If the goal of this proposal is to increase the quantity and quality of the loss absorption tools at a bank this appears to be the most available and liquid source which can be built over time in a countercyclical fashion compared to the cyclicality of the current proposal.

In conclusion, the proposal as written will greatly impact our bank. Unfortunately I have no way at this time to ascertain the full impact because of the complexity of the proposal. While it has been said that the impact for most community banks as a result of Basel III, will likely be minimal, I disagree and offer the following direct impacts:

- Selling our securities and repurchasing as held to maturity will lower our ability to manage interest rate risk.
- Not selling or reclassifying our securities would probably result in an MOU or Consent Order in a rising rate environment from the sharp drop in capital, without any fear of actual loss.
- Eliminating our TruPS would force us to shrink our balance sheet by over 10%
- Between the increased capital requirements and other changes in regulations including RESPA and Reg Z, we would be unwilling to meet the needs of our community's residential mortgage requirements including second mortgages.
- It would be difficult to find a reason why we would want to help our community grow with new commercial real estate projects.
- It would reduce our willingness to work with a delinquent borrower to remediate issues and will increase our aggressiveness in moving non-performing loans off the balance sheet.
- We would not seek to grow quickly. A $10 million increase in loans would require over $1 million in capital, but even at a 4 percent spread it would only generate $400,000 in pretax income ($250,000 after tax). This would be insufficient and as such we may be unable to pay any dividends or bonuses. It would take 4 years of earnings off the increased loans to cover the increased capital requirements.
- We will have additional personnel expenses and expenses in new coding to handle the calculations on each loan.

As I stated at the opening of this letter, I fully support an increase at some level in the quantity and quality of capital that banks hold. I strongly urge you to consider the impacts I have detailed above and either start over on these requirements or at least consider an exemption for community banks like ours.

Respectfully submitted,

Frank L. Carson III
Chairman, President, and CEO, Carson Bank
Chairman, Kansas Bankers Association

cc: Senator Pat Roberts
Senator Jerry Moran
Representative Tim Huelskamp
Representative Lynn Jenkins
Representative Kevin Yoder
Representative Mike Pompeo
Ms. Esther George, Federal Reserve Bank of Kansas City