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October 12, 2012

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

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

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

RE: Proposed Capital Regulations [Basel III] [both references are used synonymously]
Proposed Rulemaking on Minimum Regulatory Capital and the Standardized Approach for Risk-weighted Assets

Thank you for the opportunity to comment on the proposed regulations under Basel III. Basel III background indicates that "the proposed changes to the Federal banking agencies' current capital rules would strengthen the quality and loss-absorbance safeguards provided by regulatory capital and enhance the banks' abilities to continue functioning as financial intermediaries, including during periods of financial stress."

While the goals are admirable, certain issues proposed could provide just the opposite results to the above intentions. **Banking has two fundamental pillars: Capital and Liquidity.** The proposed regulations create fatal flaws by undermining these two fundamental pillars. **Banking leverage comes in two forms: 1] capital leverage and 2] liquidity leverage. Basel III, as proposed, will likely set up a future financial crisis which is just the opposite of the stated intentions. The proposed regulations driven by Basel III will negatively impact both banking leverage foundations.**

FMSI is a consulting firm assisting community banks in size of $100 million to $6 billion in assets. Clients include urban and rural banks. FMSI provides balance sheet consulting with a holistic approach. We assist clients with various aspects of both the asset and liability side of the balance sheet, investments, asset and liability pricing, alternative liabilities, interest rate risk, and liquidity. FMSI has provided consulting advice for twenty years; with an additional eighteen years of personal banking experience prior to FMSI being established.

Summary concerns:
Other Comprehensive Income and Other Concerns:
Capital: Banking Pillar #1.
1] **Capital Volatility**. **Unnecessary and inaccurate capital volatility will occur under the proposed regulations**. Restating: The inclusion of AFS security market value adjustments as a component of regulatory capital will create unnecessary **capital volatility** and **will not** provide a more accurate measurement of capital. This is mixing a historical accounting component [capital] with only one balance sheet market value component [securities].

All things being equal, the capital amount and ratio will change in direct proportion to a bank's price sensitivity of the AFS security portfolio. A matrix table of capital ratio percentage impact is provided. It demonstrates the severe impact and capital volatility that could occur for the entire banking industry. For instance, a +200 bps rise in rates would cause a **-2.40% decrease in capital** for a bank with 30% of assets allocation to a security portfolio with 4% price duration. A +200 bps increase would **decrease capital -3.00%** for a bank with 30% of assets allocation to a security portfolio with 5% price duration. Regulatory guidance on interest rate risk is for +400 and +500 rate shocks to be utilized. A +500 bps increase in rates would cause a **-8.00% decrease in capital** for a bank with 30% of assets allocation to a security portfolio with 4% price duration. For community banks with a higher % of allocation to securities, the negative capital impact becomes even more substantial---to the point of totaling eliminating the capital through merely marketing the market the investment portfolio---without considering the liability hedging that is occurring. Just marking to market the investment portfolio does not make the bank capital insolvent, only the proposed capital regulation math creates the problem. Please see the below tables for illustration.

SECURITY PORTFOLIO % OF ASSETS	ASSUMES 4% PRICE DURATION PER 1% RATE SHOCK CAPITAL % IMPACT BY INTEREST RATE SHOCK						
	-100	0	+100	+200	+300	+400	+500
60%	2.40%		-2.40%	-4.80%	-7.20%	-9.60%	-12.00%
50%	2.40%		-2.00%	-4.00%	-6.00%	-8.00%	-10.00%
40%	2.40%		-1.60%	-3.20%	-4.80%	-6.40%	-8.00%
30%	2.40%		-1.20%	-2.40%	-3.60%	-4.80%	-6.00%
20%	2.40%		-0.80%	-1.60%	-2.40%	-3.20%	-4.00%
10%	2.40%		-0.40%	-0.80%	-1.20%	-1.60%	-2.00%

SECURITY PORTFOLIO % OF ASSETS	ASSUMES 5% PRICE DURATION PER 1% RATE SHOCK CAPITAL % IMPACT BY INTEREST RATE SHOCK						
	-100	0	+100	+200	+300	+400	+500
60%	3.00%		-3.00%	-6.00%	-9.00%	-12.00%	-15.00%
50%	3.00%		-2.50%	-5.00%	-7.50%	-10.00%	-12.50%
40%	3.00%		-2.00%	-4.00%	-6.00%	-8.00%	-10.00%
30%	3.00%		-1.50%	-3.00%	-4.50%	-6.00%	-7.50%
20%	3.00%		-1.00%	-2.00%	-3.00%	-4.00%	-5.00%
10%	3.00%		-0.50%	-1.00%	-1.50%	-2.00%	-2.50%

Capital volatility, as a function of market interest rates and a securities portfolio value, are not within bank management's control. **Capital volatility within a holistic balance sheet [liabilities hedging asset price sensitivity] are within bank management's ability.** The current market rates and security prices are not free markets with Federal Reserve current actions. Implementation at this point in time with historical low interest rates, Federal Reserve actions, and other global issues is setting up major banking problems as rates begin to rise and normalize.

Exhibit A is illustrative of two identical banks [bank A and B], except for accounting classification of AFS vs. HTM. While economically the same, they would receive different treatment based upon capital ratios caused the AFS or HTM accounting classification. [The entire balance sheet has been holistically shown with price duration for the entire balance sheet, as required by current regulations.] The economic values are identical, however, the HTM classification allows bank A to remain at its current capital ratio under Basel III. Bank B's capital decreases under Basel III, but is economically the same as Bank A.

Exhibit B demonstrates that **Bank B with AFS could be a stronger bank providing regulators more safety and soundness than Bank A [HTM accounting and higher Basel III capital by rate shock].** [see Exhibit B]. Bank B has employed a holistic balance sheet approach and has a superior liability structure to its balance sheet than Bank A. Bank B out performs Bank A in rising rate scenarios. However, Bank B is penalized by the Basel III regulations because the liability hedges are not considered. It is only the security portfolio that is marked to market. Most likely Bank B will provide more stable earnings and build capital over time vs. Bank A. Yet, Bank A would be rewarded for its accounting classification in the Basel III capital computation.

While the illustrations are for rate shocks, one can get a sense of capital volatility by doing up rates and moving back down. Capital values would vacillate between values shown. The capital volatility will most likely cause less investor interest to provide needed capital to the banking industry.

We request the review the impact on the banking industry capital by rate shocking the investment portfolios and applying it to the industry's capital. Current call report data is insufficient to provide accurate portfolio price sensitivity by rate shock. The current Basel III capital calculators provide a "today" capital calculation, but do not provide for stress testing by rate shock. This is a vital capital component that needs to be incorporated by rate shock and stress testing.

2] **Segmented Mark to Market vs. Holistic Mark to Market Approach.**
Marketing to market one component of the balance sheet [securities] and applying that one component to capital is not sound economics or good accounting. The liabilities are supporting the securities. Therefore, both securities [assets] and liabilities should be marked to market. The mark to market of certain liabilities, which liability supports the securities, raises additional complexity. However, one cannot ignore that there are two sides to the balance sheet. The market valuation and capital impact is currently managed / regulated through the interest rate risk regulations. **The current capital treatment for AFS securities should be continued.** Current regulations provide sufficient control on securities, securities price risk and potential capital impact. [see Exhibit B].

Below is a table for an actual $340 million bank and the impact that Basel III would have on the capital ratio vs. the current capital standards. It is important to notice that the bank's economic value increases in rising rate scenarios. In fact, the EVE capital ratio increases from 12.3% to 14.7% in the up rate scenarios [+500 bps]. Under Basel III, the capital ratio decreases from 12.3% to 5.8%. The bank is very profitable and operating in a safe and sound manner, protecting itself of adverse scenarios of financial stress. The Basel III suggests the bank is not protecting itself in adverse scenarios. **Basel III is not accomplishing its stated goals of strengthening a bank's capital position by including the AFS security portfolio mark value change in the regulatory capital computation.**

ACTUAL $343 MILLION COMMUNITY BANK

	ECONOMIC VALUE BY RATE SHOCK [IN MILLIONS] INTEREST RATE SHOCK BY 1% [100 BPS]						
	-100	0	+100	+200	+300	+400	+500
INVESTMENTS	123.1	120.7	117.6	113.8	109.1	103.6	98.5
TOTAL ASSETS	348.3	342.8	336.6	330	322.2	312.1	301.8
LIABILITY	309.6	300.6	292.1	284.2	276.8	267.2	257.4
EQUITY	38.8	42.2	44.5	45.6	45.4	44.9	44.4
EVE TIER 1 EQUITY %	11.1%	12.3%	13.2%	13.8%	14.1%	14.4%	14.7%

REGULATORY / BASEL III PROPOSED TIER 1 CAPITAL RATIO							
	-100	0	+100	+200	+300	+400	+500
INVESTMENT VALUE CHANGE	2.4	0.0	-3.1	-6.9	-11.6	-17.1	-22.2
CURRENT CAPITAL	42.2	42.2	42.2	42.2	42.2	42.2	42.2
TOTAL ASSETS	342.8	342.8	342.8	342.8	342.8	342.8	342.8
CURRENT REG TIER 1 RATIO	12.31%	12.31%	12.31%	12.31%	12.31%	12.31%	12.31%
BASEL III CAPITAL	44.6	42.2	39.1	35.3	30.6	25.1	20.0
BASEL III CAPITAL RATIO	13.0%	12.3%	11.4%	10.3%	8.9%	7.3%	5.8%

3] **Pricing of Securities for AFS valuation**.

Substantial market value pricing disparity exists for the exact same security. Bond accounting and various pricing services provide wide pricing difference for the same security. Obtaining accurate security market values is difficult. Different banks with the same identical security would be treated differently as the capital impact would differ from bank to bank. Attached are some US agency mortgage backed securities [MBS] and collateralized mortgage backed security [CMO]. Matrix pricing, provided by pricing services, is not accurate market valuations in the importance of the regulatory capital calculation. There are securities where there are no reasonable and liquid markets to estimate the market value of the security. **Inconsistent bank reporting and regulatory application will result from security pricing disparity.** [see exhibit C].

Exhibit C reflects substantial pricing disparity of the same security exists. The same securities owned by the different banks would be priced differently. [see exhibit C pages 2-5 for specific security examples].This can cause different capital treatment and regulations of different banks with the same security. Illustrated are US agency MBS with some different pricing services showing wide variances. As security liquidity and infrequent trading occurs, the pricing disparities become even larger. Large pricing disparities on mbs / cmo exist today often due to the wide variance in prepayment projections. **The point is: large pricing disparities can exist in liquid markets. This provides for imprecise capital calculations as proposed in Basel III.**

Exhibit C-1 reflects that CURRENT CAPITAL WILL BE OVERSTATED with the inclusion of AFS market values. Current gains are reflective of present value of future earnings [vs. current market rates] [on securities only] being recorded today. [The market value adjustment is only on securities and does not include offsetting liability cost hedging.] The Economic Value of Capital is currently measured in the interest rate risk regulations. This is a holistic approach to the current and future capital, earnings and interest rate risk. This fact has been emphasized under paragraph 2, but is once again germane to the overstatement of current capital under Basel III. Basel III will overstate current capital with future capital being negatively impacted. Future capital will be impacted by the current premium gains in the investment portfolio decrease to par [no premium or current gain] over time and the full period liability costs being recognized at the same time. The concept of overstating current capital does not make sense. The illustration demonstrates that Bank ABC has a $2.40MM investment gain. Over time, the bank will write off the premium over a 4 year period and negatively impacting capital by -2.18% in the illustration. The premium gains inflate capital today, but will deflate and be a capital drag on a going forward basis.

BASEL III WILL OVERSTATE CURRENT CAPITAL TODAY, WITH NEGATIVE IMPACT ON FUTURE CAPITAL.
INVESTMENT PORTFOLIO'S HAVE SIGNIFICANT PREMIUM GAINS TODAY.
THEY WILL BECOME 0 PREMIUM GAIN IN THE FUTURE UPON MATURITY OR PREPAYMENT OF PRINCIPAL.

PREMIUM / GAIN AMORTIZATION IMPACT ON FUTURE CAPITAL						
[ASSUMES PREMIUM AMORTIZATION OVER 4 YEARS]						
COMMUNITY BANK--BANK ABC [IN $000'S]	CURRENT BALANCE SHEET	MARKET BALANCE SHEET	YEAR 1 BALANCE SHEET	YEAR 2 BALANCE SHEET	YEAR 3 BALANCE SHEET	YEAR 4 BALANCE SHEET
MARKET PRICE: INVESTMENTS	108.00	108.00	106.00	104.00	102.00	100.00
BOOK PRICE: INVESTMENTS	100.00	100.00	100.00	100.00	100.00	100.00
OVERNIGHT FUNDS	10,000	10,000	10,000	10,000	10,000	10,000
INVESTMENTS--AFS	30,000	30,000	30,000	30,000	30,000	30,000
PREMIUM FV ADJUSTMENT--AFS	2,400	2,400	1,800	1,200	600	0
LOANS	60,000	60,000	60,000	60,000	60,000	60,000
TOTAL ASSETS	102,400	102,400	101,800	101,200	100,600	100,000
DEPOSITS	94,000	94,000	95,820	95,820	95,820	95,820
TOTAL LIABILITIES	94,000	94,000	95,820	95,820	95,820	95,820
EQUITY	7,000	7,000	7,000	7,000	7,000	7,000
PREMIUM FV ADJUSTMENT	2,400	2,400	1,800	1,200	600	0
TOTAL EQUITY	9,400	9,400	8,800	8,200	7,600	7,000
CURRENT CAPITAL REGS. EXCLUDE PREMIUM FV ADJUSTMENT						
TIER 1 ASSETS	100,000	100,000	100,000	100,000	100,000	100,000
TIER 1 CAPITAL	7,000	7,000	7,000	7,000	7,000	7,000
TIER 1 CAPITAL RATIO	7.00%	7.00%	7.00%	7.00%	7.00%	7.00%
CAPITAL PROPOSED BASEL III						
TIER 1 ASSETS	102,400	102,400	101,800	101,200	100,600	100,000
TIER 1 CAPITAL	9,400	9,400	8,800	8,200	7,600	7,000
TIER 1 CAPITAL RATIO	9.18%	9.18%	8.64%	8.10%	7.55%	7.00%

Regulatory analysis should be completed for: 1] the amount that BASEL III would allow the overstatement of capital 2] the potential impact on banking and regulators for the utilization of the overstated capital 3] a quantified risk utilization [and the ability to take on risk with the overstated capital] and 4] the projected negative impact on future capital as the premium and security gains are amortized over a short period of time. Regulatory analysis should be completed before moving forward with the Proposed Capital Regulations.

<u>The current capital treatment for AFS securities should be continued. AFS security values should not be a part of Basel III.</u>

4] **Liquidity: Banking pillar #2.**

Bank liquidity will be negatively impacted by including AFS security market value adjustments as a component of Tier 1 capital.

The inclusion of AFS security market values in capital will cause banks to select a HTM designation vs. AFS to avoid the capital volatility of BASEL III. This becomes a **liquidity issue** [trap] for banks to manage their balance sheet. **Liquidity in times of financial crisis / stress is even more important than capital, although both may go hand in hand.** During times of stress [US 2008, Europe 2011-2012], there is no market for certain securities. What happened during these times? Regulations were relaxed to allow capital and liquidity to be maintained to prevent a systemic risk. This systemic risk will not be reduced by requiring AFS security valuations as a component of capital. Exhibit D demonstrates the on balance sheet liquidity ratios impacted by forced designation of HTM vs. AFS. [10% vs. 40%]

Community banks utilize AFS securities to manage the liquidity needs of the bank. Loan growth, deposit variations are managed by the AFS securities portfolio. BASEL III will force banks into HTM to avoid the capital volatility. Liquidity will of necessity be managed by non retail liabilities. The size of the non retail liabilities market is not sufficient to meet the liquidity demand a large number of banks to enter the same market at the same time for large dollar volumes. Again, 2008 is a good example of market liquidity limitations. As banks' liquidity needs are managed with non retail liabilities, the asset size increases, and the capital ratio decreases [increased asset size]. This would put a strain on capital as a result of reduced liquidity flexibility.

Exhibit D illustrates two banks which need to meet $30MM of loan growth. Bank A has $30MM in HTM securities and $10MM in overnight funds. Bank A is required to go to obtain $20MM from the non retail liability market. This decreases the capital ratio from 8.00% to 6.67% [and with 0% on balance sheet liquidity].

Bank B has $30MM in AFS securities and $10MM in overnight funds. Bank B can fund the $30MM loan growth with the AFS securities portfolio and have $10MM on balance sheet liquidity. Bank B's tier 1 capital leverage ratio remains at 8.00%. [The example has held RBC constant to demonstrate liquidity issues.]

The HTM designation dramatically decreases the balance sheet liquidity. In the example, the on balance sheet liquidity ratios are Bank A [10%] and Bank B [40%]. After the $30MM loan growth, on balance sheet liquidity ratios are: Bank A [0%] and Bank B [10%]

BASEL III is reducing bank management's balance sheet flexibility.

Liquidity is the second major leverage pillar of banking. Balance sheet liquidity should not be reduced by the proposed capital regulations.

The current capital treatment for AFS securities should be continued. AFS security values should not be a part of Basel III.

5] **Interest Rate Risk Management Impacted Negatively.**
Community banks utilize AFS securities to manage their interest rate risk. The bank's interest rate risk will likely increase when forced to classify securities as HTM. **Certainly, the flexibility to manage interest rate risk will be greatly decreased**. Proposed capital inclusion of AFS market values is reducing the bank's ability to manage the balance sheet safely and soundly.

Banks' ability to manage portfolio risk will be reduced. Securities designated HTM will not be available for sale [without tainting the entire portfolio]. Securities that exhibit higher risk or lower returns will not be available for sale to mitigate the risk. The current market provides good illustrations. Prepayment risk can be managed with AFS securities but not with HTM securities. The extension risk of callable agency securities can be managed with AFS but not with HTM securities. Banks are currently taking on more extension risk at the historical low interest rates. **Basel III will provide banks the inability to manage the security options in the security portfolio.**

Proposed regulations are mixing market values of securities, with historical accounting and credit issues. Securities with credit issues are addressed currently in the OTTI [other than temporary impairment] accounting which is reflected in capital. Therefore, the proposed regulations only deal with the price / market risk element. The price risk of securities should not be considered as an independent component of the balance sheet. **The interest rate risk of the securities is captured and measured within the interest rate risk regulations for the entire balance sheet.** It does not make sense to do otherwise.

<u>The current capital treatment for AFS securities should be continued. AFS security values should not be a part of Basel III.</u>

6] **Future Capital Increases Are Diminished by Lower Earnings.**
Community banks' future earnings, which build capital for safety and soundness, will be impeded. Banks will stay very short with investments on concerns of capital volatility from AFS. The total return on alternative investments will be higher than remaining extremely short term over the next few years.

Further, community bank's future earnings will be lower as securities are designated HTM. Securities designated HTM will not allow for portfolio upgrade and enhanced earnings. Alternative security selection, with better earnings, will not be available. This is discussed above.

7] **Negative Impact on Lending.**
Real estate is a significant part of community bank lending. The proposed risk weightings will slow lending, increase costs for borrowers, and be difficult to manage the system details desired for the computations.

It is common for community banks to make balloon loans. This is an interest rate risk tool. Basel III encourages banks to take on more interest rate risk with the risk weights. The proposal encourages banks to make longer term fixed rate loans vs. balloon loans. **Basel III is shifting one risk for another.** It is my understanding that all balloon loans will shift to a category 2 risk weighting. It is recommended that current risk weights be used on balloon loans. [Generally focusing on 1-4 residential mortgages]. All regulation needs to be holistic in its approach.

Many community banks make "non traditional" loans which do not meet US agency requirements for sale to the agencies. Many borrowers of the non-traditional loans are small business borrowers or local community residents. The proposed capital regulations will reduce credit availability to a public sector that relies upon these credit sources. Further, it is one niche that community banks have as part of their business model. The proposed regulations will greatly hurt the community bank business model and the customers they serve. The economic environment is not strong and further negative impacts should be avoided.

Basel III does not appear to consider Private Mortgage Insurance in the risk weightings for single family mortgages.

Mortgages on the books should be grandfathered, with Basel III affecting new originations, not past originations. Further, the risk weightings need further evaluation. [An example is unsecured credit has a risk weighting of 100, while category 2 risk weightings equal or exceed unsecured credit.]

Community banks often provide home equity lending or second mortgages. The risk weighting proposal would taint the 1st mortgage to be a category 2. This aspect needs further evaluation.

8] **Global Growth Will Be Negatively Impacted.** There is global austerity and consumer balance sheet deleveraging. Tougher regulations, higher lending standards, higher consumer costs, and reduced credit due to regulations are not in the best interest of consumers or regulators. [Exhibit E, F]

8] **S corporation capital impact.** The ability for S corporations to dividend funds for income tax payments [at a minimum] should be revisited. As you are aware, many community banks are S corporations vs. the large public bank corporations. S corporations are unequally burdened by the proposed regulations.

9] **Tangible equity ratio of 2% is too low.** Capital available to "strengthen the quality and loss-absorbance safeguards" would be greatly enhanced with higher tangible capital ratios with 4% being the minimum. Most community banks have tangible capital in excess of 6%. **Real tangible assets provide stronger capital [more skin in the game]. A 3% tangible capital minimum should be established, with a 4% minimum being phased in over a longer period of time. A higher tangible capital ratio would be consistent with the stated goals of the Proposed Regulation.** Should the AFS market value be included as tangible capital, it would overstate the real tangible capital. Further, a low tangible capital ratio could be greatly reduced or eliminated with AFS value movements of higher rates. The table below is provided for reference of capital impacts.

SECURITY PORTFOLIO % OF ASSETS	ASSUMES 4% PRICE DURATION PER 1% RATE SHOCK CAPITAL % IMPACT BY INTEREST RATE SHOCK						
	-100	0	+100	+200	+300	+400	+500
60%	2.40%		-2.40%	-4.80%	-7.20%	-9.60%	-12.00%
50%	2.40%		-2.00%	-4.00%	-6.00%	-8.00%	-10.00%
40%	2.40%		-1.60%	-3.20%	-4.80%	-6.40%	-8.00%
30%	2.40%		-1.20%	-2.40%	-3.60%	-4.80%	-6.00%
20%	2.40%		-0.80%	-1.60%	-2.40%	-3.20%	-4.00%
10%	2.40%		-0.40%	-0.80%	-1.20%	-1.60%	-2.00%

SECURITY PORTFOLIO % OF ASSETS	ASSUMES 5% PRICE DURATION PER 1% RATE SHOCK CAPITAL % IMPACT BY INTEREST RATE SHOCK						
	-100	0	+100	+200	+300	+400	+500
60%	3.00%		-3.00%	-6.00%	-9.00%	-12.00%	-15.00%
50%	3.00%		-2.50%	-5.00%	-7.50%	-10.00%	-12.50%
40%	3.00%		-2.00%	-4.00%	-6.00%	-8.00%	-10.00%
30%	3.00%		-1.50%	-3.00%	-4.50%	-6.00%	-7.50%
20%	3.00%		-1.00%	-2.00%	-3.00%	-4.00%	-5.00%
10%	3.00%		-0.50%	-1.00%	-1.50%	-2.00%	-2.50%

10] **Trust Preferred Securities [banks under $15 billion] should have grandfathered status.** Bank and bank holding companies that have issued Trust Preferred Securities [TPS] for capital purposes should be grandfathered in accordance with the Collins amendment in the Dodd-Frank Act. Community banks do not easily have access to the capital markets. Banks have acted in good faith under the current bank regulations. Further issuance should not be allowed, but existing TPS as of June 30, 2012 should be grandfathered.

The failure to grandfather TPS will put undo capital stress on community banks.

11] Community Bank Business Model is as the category indicates: serving community consumers. The proposed capital regulations seem to address the larger corporate banks, i.e., money center type banks. Large bank business models are substantially different than community banks. Large bank access to capital and other sources of revenue are available to them. Community banks seek to have core consumer customers, both depositors and borrowers. The proposed capital regulations would substantially and negatively impact community banks. In the current economic environment, handicapping community banks from serving the public is not in the best interest of the banks, consumers, regulators, or the economy.

12] **Implementation Timeline is too aggressive** for community banks to comply and adjust their business model. The major changes proposed have not been fully digested by the banking community. Further study, both by the banking industry and regulators should be completed. It is imperative that unintended consequences be avoided. It is recommended that implementation be deferred until further analysis can be completed.

Example exhibits have been prepared for illustrative purposes. They assume a $100 million bank [s]. **This allows the easy application to any size bank or to the banking industry as a whole.**

Exhibits A-F are attached to illustrate many of the above concerns.

Exhibit A: Two identical banks [bank A and bank B] [$100 million total assets] would receive different regulatory capital treatment by merely designating investment securities differently. Bank A is HTM and Bank B is AFS. Interest rate shock stress has been applied to demonstrate that Bank B regulatory capital would decrease to low levels. Bank A would retain its satisfactory regulatory capital. However, the economic values of both banks are identical. The asset side of the balance sheet is hedged with the liability side of the balance sheet. The economic value of both banks is steady to slightly increasing as rates rise or decline. This is reflecting the holistic market to market approach to the balance sheet. [Duration is price sensitivity for +/- 1% movement in interest rates.]

Exhibit B: Two banks [bank A and bank B] [$100 million total assets] with same current capital, but slightly different balance sheet duration. Bank A is HTM and has more balance sheet duration mismatch. Bank B is AFS and balance sheet duration neutral. Both banks have been interest rate shock stressed. **Bank A is taking more risk** but Basel III proposed capital would remain at 8%, even though its real economic value has substantially decreased. **Bank B is taking less risk**, but Basel III proposed capital would decrease, even though Bank B's real economic value is slightly increasing. Bank B is better managed, has a superior balance sheet structure, providing more stable earnings [providing stable capital growth], and operating in a more safe and sound manner. **Basel III would reward Bank A vs. Bank B in its capital proposal.** This reflects 1] inconsistent regulatory applications [proposed capital vs. interest rate risk], 2] inconsistent application true safe and sound operation, 3] potentially rewarding poorer banking practices, and 4] ignoring the real economics vs. accounting of a bank.

Exhibit C: Security pricing disparity alone produces substantial capital variances. Four identical banks [A,B,C,D] [$100 million total assets] with the identical AFS security portfolio are comparatively shown for Basel III proposed capital computations. The identical bank's base capital ratio is 7%. The portfolio is United States agency securities. Pricing services use matrix pricing for price "indications" and not actual market transactions. Each bank's bond accounting uses a different pricing service. Each of the four banks receives a different price for the same, identical securities. The Basel III proposal would have the four bank's capital ratio ranging from 6.81% to 5.32%. This indicates different regulatory applications for each of the four banks, and yet they are identical.

Secondly, if Bank D purchased the security at the market price of 109.40, and Bank D's pricing service reports a market price of 104.00, Bank D must report a capital loss of -5.40% immediately. Bank D's capital ratio goes for 7% to 5.32%, all caused by its pricing service.

Thirdly, Month 1, Bank D reports a market price of 104.00 [book price of 109.40] and capital ratio of 5.32%. Month 2, Bank D's pricing service markets to market price is now 108.00 in line with Bank B's pricing service. Month 2, Bank D reports a gain of $1.2MM, and capital ratio of 6.43%. **Capital volatility will occur outside of bank management control. This uncertainty will be a large negative for bank management, investors, regulators and all involved. Further, the perceived vs. real capital volatility is will be detrimental. A bank's capital and its volatility is public knowledge. A misplaced capital computation and capital volatility could cause a liquidity issue for the bank, and be adverse to the bank's operations.**

Exhibit C pages 2-3 of 5: This is a specific US agency mortgage backed security [mbs]. The pricing disparity range is 107.50 – 109.44, a range of 1.94%. The actual market offering price is 108.84. This is supportive for the above discussion. One important point: this is a liquid US agency mbs. Securities with less liquidity and transparency are going to 1] have wider price disparity ranges, 2] may have no market prices, and 3] provide for "gaming" of actual market prices.

Exhibit C pages 4-5 of 5: This is a specific US agency pac cmo [collateralized mortgage backed security]. The pricing disparity range is 104.00-104.875, or a range of .875%. This is a very liquid, transparent type of security, yet there is almost a 1% price variance.

Exhibit C-1: CURRENT CAPITAL WILL BE OVERSTATED with the inclusion of AFS market values. Current gains are reflective of present value of future earnings [on securities only] [vs. current market rates] being recorded today. [The market value adjustment is only on securities and does <u>not include offsetting liability cost hedging</u>.] <u>The Economic Value of Capital is currently measured in the interest rate risk regulations. This is a holistic approach to the current and future capital, earnings and interest rate risk.</u> Basel III will overstate current capital with future capital being negatively impacted. Future capital will be impacted by the current premium gains in the investment portfolio decrease to par [no premium or current gain] over time and the full period liability costs being recognized at the same time. The concept of overstating current capital does not make sense. The illustration demonstrates that Bank ABC has a $2.40MM investment gain. Over time, the bank will write off the premium, negatively impacting capital by -2.18% in the illustration. The premium gains inflate capital as of today, but will deflate and be a capital drag on a going forward basis. Currently, the FOMC is indicating rates low for another 2 years at least. Thus, most securities will be purchased at premiums [albeit, maybe not 108.00]. The point is bank capital ratios will be substantially and negatively impacted.

Exhibit D: Bank liquidity will be negatively impacted.
Two identical banks [bank A and bank B] [$100 million in total assets] have different liquidity issues based upon AFS and HTM security portfolio designations. Basel III proposed regulations creating capital volatility with AFS will force banks to HTM. HTM designations will not allow for security sales to manage bank liquidity.

Bank A and B have $30 million of loan growth. Bank A would of necessity have to look for non retail deposit funding [FHLB advances, broker deposits, internet deposits], which are not core deposits. Bank A's assets would increase to $120Bank A could not sell any of the HTM securities for liquidity without tainting the entire portfolio. Bank A is forced to grow its balance sheet, and reduce its capital ratio to 6.67% and still not have balance sheet liquidity. Bank A's capital would be reduced further if balance sheet liquidity were restored. Bank A would be discouraged for the lending growth if it had to restore capital to 8%.

Bank B would have the liquidity to fund loan growth with core deposits, and selling the security portfolio. On balance sheet liquidity and liquidity ratios are shown: Bank A HTM [10%], Bank B AFS [40%]. After $30MM loan growth, on balance sheet liquidity is: Bank A [0%] and Bank B [10%].

Obviously, liquidity is not just for loan growth. In time of economic stress, there may liquidity demands from balance sheet liabilities. Bank B is better able to meet those demands with its core deposits and a smaller liability base than Bank A. Bank B can also sell its securities to meet liquidity demands.

Banking leverage comes in two forms: 1] capital leverage and 2] liquidity leverage. The proposed regulations driven by Basel III will negatively impact both banking leverage foundations.

Exhibit E & F: These tables show the global sovereignty leverage. Austerity that is in the current markets is likely to continue into the future. Consumer balance sheet deleveraging continues to occur. The US debt growth has been undertaken to offset the private sector deleveraging, lower economic conditions. The proposed capital regulations will have a negative impact on private sector consumption, which will undermine economic growth necessary for financial health of sovereign governments, including the United States.
Note the size of the mortgage backed securities market notated on Exhibit F. More banks will be required to invest in mortgage related securities in the future. FNMA / FHLMC and the US Treasury actions are to decrease the size of the outstanding agency debt. Mortgage backed securities currently provide community banks a reasonable spread to cost of funds. This appears to be the case for the future as well. However, the options of MBS / CMO and callable agency securities will need to be managed as AFS securities rather than HTM.

Summary:
1] Proposed Capital Regulations should be reviewed in depth for substantial short comings to its stated goals. The proposed Capital Regulations implementation date should be extended for further regulatory evaluation.
2] Community banks of a limited size [under $15 billion] should remain under current capital regulations and be exempt for the new proposed capital and Basel III regulations.
3] Most importantly, security AFS valuations should not be a component of regulatory capital.
4] More time should be utilized by regulatory agencies to determine "unintended" consequences on community banks and community bank business models.
5] Banking leverage comes in two forms: 1] capital leverage and 2] liquidity leverage. The proposed regulations driven by Basel III will <u>negatively impact</u> both banking leverage foundations.

Again, thank you for the opportunity to comment on the proposed capital regulations. Should you have questions, please contact me at 785-733-2662.

Sincerely,

William D. Williams, President

CAPITAL VOLATILITY CREATED MERELY BY ACCOUNTING INVESTMENTS AS AFS VS. HTM
ECONOMIC VALUE AND SAFETY AND SOUNDNESS
FOR A BANK HAS NOT CHANGED JUST BY ACCOUNTING CLASSIFICATION
THE ECONOMIC VALUE OF CAPITAL IS THE SAME FOR BOTH BANK ILLUSTRATIONS.
THE CAPITAL VOLATILITY DIFFERENCE IS CREATED ONLY BY ACCOUNTING CLASSIFICATION OF AFS VS HTM

RATE CHANGE	-1%	BASE		+1%	+2%	+3%
MARKET VALUE OF ASSETS	102,280	100,000		97,720	95,440	93,160
MARKET VALUE OF LIBILITIES	94,300	92,000		89,700	87,400	85,100
ECONOMIC VALUE OF CAPITAL	7,980	8,000		8,020	8,040	8,060
ECONOMIC VALUE OF CAPITAL RATIO	7.80%	8.00%		8.21%	8.42%	8.65%
BASEL III PROPOSAL						
BANK A-- HTM INVESTMENTS	8.00%	8.00%		8.00%	8.00%	8.00%
BANK B--AFS INVESTMENTS	9.20%	8.00%		6.80%	5.60%	4.40%

BANK A--INVESTMENTS HTM

BALANCE SHEET	RATE CHANGE		DURATION			
[IN $000'S]	-1%	BASE		+1%	+2%	+3%
OVERNIGHT FUNDS	10,000	10,000	0.00	10,000	10,000	10,000
INVESTMENTS--AFS						
INVESTMENTS--HTM	30,000	30,000	4.00	30,000	30,000	30,000
LOANS	60,000	60,000	1.80	60,000	60,000	60,000
TOTAL ASSETS	100,000	100,000	2.28	100,000	100,000	100,000
DEPOSITS	92,000	92,000	2.50	92,000	92,000	92,000
TOTAL LIABILITIES	92,000	92,000	2.50	92,000	92,000	92,000
EQUITY	8,000	8,000	-0.25	8,000	8,000	8,000
AFS--FV ADJUSTMENT						
TOTAL EQUITY	8,000	8,000		8,000	8,000	8,000
TOTAL LIABILITIES & EQUITY	100,000	100,000		100,000	100,000	100,000
INVESTMENT VALUE	31,200	30,000		28,800	27,600	26,400
HTM-FV CHANGE	1,200	0		-1,200	-2,400	-3,600
AFS-FV CHANGE	1,200			-1,200	-2,400	-3,600
CAPITAL PROPOSED BASEL III	9,200	8,000		6,800	5,600	4,400
TIER 1 CAPITAL	8,000	8,000		8,000	8,000	8,000
TIER 1 CAPITAL RATIO	8.00%	8.00%		8.00%	8.00%	8.00%
MARKET VALUE OF ASSETS	102,280	100,000		97,720	95,440	93,160
MARKET VALUE OF LIBILITIES	94,300	92,000		89,700	87,400	85,100
ECONOMIC VALUE OF CAPITAL	7,980	8,000		8,020	8,040	8,060
ECONOMIC VALUE OF CAPITAL RATIO	7.80%	8.00%		8.21%	8.42%	8.65%

BANK B--INVESTMENTS AFS

BALANCE SHEET	**RATE CHANGE**		**DURATION**			
[IN $000'S]	**-1%**	**BASE**		**+1%**	**+2%**	**+3%**
OVERNIGHT FUNDS	10,000	10,000	**0**	10,000	10,000	10,000
INVESTMENTS--AFS	30,000	30,000	**4.00**	30,000	30,000	30,000
INVESTMENTS--HTM						
LOANS	60,000	60,000	**1.80**	60,000	60,000	60,000
TOTAL ASSETS	100,000	100,000	**2.28**	100,000	100,000	100,000
DEPOSITS	92,000	92,000	**2.50**	92,000	92,000	92,000
NON RETAIL LIABILTIES						
TOTAL LIABILITIES	92,000	92,000	**2.50**	92,000	92,000	92,000
EQUITY	8,000	8,000	**-0.25**	8,000	8,000	8,000
AFS--FV ADJUSTMENT	1,200	0		-1,200	-2,400	-3,600
TOTAL EQUITY	9,200	8,000		6,800	5,600	4,400
TOTAL LIABILITIES & EQUITY	101,200	100,000		98,800	97,600	96,400
INVESTMENT VALUE	31,200	30,000		28,800	27,600	26,400
HTM-FV CHANGE	1,200	0		-1,200	-2,400	-3,600
AFS-FV CHANGE	1,200	0		-1,200	-2,400	-3,600
CAPITAL PROPOSED BASEL III	9,200			6,800	5,600	4,400
TIER 1 CAPITAL--BASEL III	9,200	8,000		6,800	5,600	4,400
TIER 1 CAPITAL RATIO--BASEL III	9.20%	8.00%		6.80%	5.60%	4.40%
MARKET VALUE OF ASSETS	**102,280**	**100,000**		**97,720**	**95,440**	**93,160**
MARKET VALUE OF LIBILITIES	**94,300**	**92,000**		**89,700**	**87,400**	**85,100**
ECONOMIC VALUE OF CAPITAL	**7,980**	**8,000**		**8,020**	**8,040**	**8,060**
ECONOMIC VALUE OF CAPITAL RATIO	**7.80%**	**8.00%**		**8.21%**	**8.42%**	**8.65%**

CAPITAL VOLATILITY CREATED MERELY BY ACCOUNTING INVESTMENTS AS AFS VS. HTM
ECONOMIC VALUE AND SAFETY AND SOUNDNESS
FOR A BANK HAS NOT CHANGED JUST BY ACCOUNTING CLASSIFICATION
AFS BANKS MAY WELL PROVIDE BETTER SAFE AND SOUNDNESS, BUILDING OF CAPITAL, THAN HTM.
AFS VS. HTM SHOULD NOT DICTATE THE CAPITAL CALCULATION OF BANKS.
BANK B IS BETTER MANAGED, HAS SUPERIOR BALANCE STRUCTURE, WILL PROVIDE MORE STABLE EARNINGS, STEADY BUILDING OF CAPITAL OVER TIME

CAPITAL PER BASEL III

RATE CHANGE	-1%	BASE	+1%	+2%	+3%
BANK A--HTM INVESTMENTS	8.00%	8.00%	8.00%	8.00%	8.00%
BANK B--AFS INVESTMENTS	9.20%	8.00%	6.80%	5.60%	4.40%
CAPITAL ECONOMIC VALUE					
BANK A--HTM INVESTMENTS	7.80%	8.00%	7.22%	6.39%	5.52%
BANK B--AFS INVESTMENTS	7.80%	8.00%	8.21%	8.42%	8.65%

BANK A-- HTM INVESTMENTS

RATE CHANGE	-1%	BASE	+1%	+2%	+3%
MARKET VALUE OF ASSETS	102,280	100,000	97,420	94,840	92,260
MARKET VALUE OF LIBILITIES	94,300	92,000	90,390	88,780	87,170
ECONOMIC VALUE OF CAPITAL	7,980	8,000	7,030	6,060	5,090
ECONOMIC VALUE OF CAPITAL RATIO	7.80%	8.00%	7.22%	6.39%	5.52%
CAPITAL PER BASEL III HTM	8.00%	8.00%	8.00%	8.00%	8.00%
BASEL III PROPOSAL					
BANK A-- HTM INVESTMENTS	8.00%	8.00%	8.00%	8.00%	8.00%
BANK B--AFS INVESTMENTS	9.20%	8.00%	6.80%	5.60%	4.40%

BANK B--AFS INVESTMENTS

RATE CHANGE	-1%	BASE	+1%	+2%	+3%
MARKET VALUE OF ASSETS	102,280	100,000	97,720	95,440	93,160
MARKET VALUE OF LIBILITIES	94,300	92,000	89,700	87,400	85,100
ECONOMIC VALUE OF CAPITAL	7,980	8,000	8,020	8,040	8,060
ECONOMIC VALUE OF CAPITAL RATIO	7.80%	8.00%	8.21%	8.42%	8.65%
BASEL III PROPOSAL					
BANK B--AFS INVESTMENTS	9.20%	8.00%	6.80%	5.60%	4.40%

BANK A--INVESTMENTS HTM

BALANCE SHEET	**RATE CHANGE**		**DURATION**			
[IN $000'S]	**-1%**	**BASE**		**+1%**	**+2%**	**+3%**
OVERNIGHT FUNDS	10,000	10,000	**0.00**	10,000	10,000	10,000
INVESTMENTS--AFS						
INVESTMENTS--HTM	30,000	30,000	**5.00**	30,000	30,000	30,000
LOANS	60,000	60,000	**1.80**	60,000	60,000	60,000
TOTAL ASSETS	100,000	100,000	**2.58**	100,000	100,000	100,000
DEPOSITS	**92,000**	**92,000**	**1.75**	**92,000**	**92,000**	**92,000**
TOTAL LIABILITIES	92,000	92,000	**1.75**	92,000	92,000	92,000
EQUITY	8,000	8,000	**12.125**	8,000	8,000	8,000
AFS--FV ADJUSTMENT						
TOTAL EQUITY	8,000	8,000		8,000	8,000	8,000
TOTAL LIABILITIES & EQUITY	100,000	100,000		100,000	100,000	100,000
INVESTMENT VALUE	31,500	30,000		28,500	27,000	25,500
HTM-FV CHANGE	1,500	0		-1,500	-3,000	-4,500
CAPITAL PROPOSED BASEL III	8,000	8,000		8,000	8,000	8,000
TIER 1 CAPITAL	8,000	8,000		8,000	8,000	8,000
TIER 1 CAPITAL RATIO	8.00%	8.00%		8.00%	8.00%	8.00%
MARKET VALUE OF ASSETS	**102,580**	**100,000**		**97,420**	**94,840**	**92,260**
MARKET VALUE OF LIBILITIES	**93,610**	**92,000**		**90,390**	**88,780**	**87,170**
ECONOMIC VALUE OF CAPITAL	**8,970**	**8,000**		**7,030**	**6,060**	**5,090**
ECONOMIC VALUE OF CAPITAL RATIO	**8.74%**	**8.00%**		**7.22%**	**6.39%**	**5.52%**

BANK B--INVESTMENTS AFS

BALANCE SHEET	**RATE CHANGE**		**DURATION**			
[IN $000'S]	**-1%**	**BASE**		**+1%**	**+2%**	**+3%**
OVERNIGHT FUNDS	10,000	10,000	**0**	10,000	10,000	10,000
INVESTMENTS--AFS	30,000	30,000	**4.00**	30,000	30,000	30,000
INVESTMENTS--HTM						
LOANS	60,000	60,000	**1.80**	60,000	60,000	60,000
TOTAL ASSETS	100,000	100,000	**2.28**	100,000	100,000	100,000
DEPOSITS	92,000	92,000	**2.50**	92,000	92,000	92,000
NON RETAIL LIABILTIES						
TOTAL LIABILITIES	92,000	92,000	**2.50**	92,000	92,000	92,000
EQUITY	8,000	8,000	**-0.25**	8,000	8,000	8,000
AFS--FV ADJUSTMENT	1,200	0		-1,200	-2,400	-3,600
TOTAL EQUITY	9,200	8,000		6,800	5,600	4,400
TOTAL LIABILITIES & EQUITY	101,200	100,000		98,800	97,600	96,400
INVESTMENT VALUE	31,200	30,000		28,800	27,600	26,400
AFS-FV CHANGE	1,200	0		-1,200	-2,400	-3,600
CAPITAL PROPOSED BASEL III	9,200			6,800	5,600	4,400
TIER 1 CAPITAL--BASEL III	9,200	8,000		6,800	5,600	4,400
TIER 1 CAPITAL RATIO--BASEL III	9.20%	8.00%		6.80%	5.60%	4.40%
MARKET VALUE OF ASSETS	**102,280**	**100,000**		**97,720**	**95,440**	**93,160**
MARKET VALUE OF LIBILITIES	**94,300**	**92,000**		**89,700**	**87,400**	**85,100**
ECONOMIC VALUE OF CAPITAL	**7,980**	**8,000**		**8,020**	**8,040**	**8,060**
ECONOMIC VALUE OF CAPITAL RATIO	**7.80%**	**8.00%**		**8.21%**	**8.42%**	**8.65%**

CAPITAL CAN BE IMPACTED SIGNIFICANTLY BY MARKET PRICING DISPARITY FOR THE SAME INVESTMENT MARKET PRICING OF SECURITIES IS NOT PROVIDE CONSISTENT AND ACTUAL MARKET PRICES.

			MARKET PRICING DISPARITY---MATRIX PRICING				
COMMUNITY BANK [IN $000'S]	BOOK PAR	BOOK PRICE	BANK A MARKET PRICE	BANK B MARKET PRICE	BANK C MARKET PRICE	BANK D MARKET PRICE	POTENTIAL FUTURE MARKET PRICE
		109.40	109.40	108.00	107.00	104.00	100.00
OVERNIGHT FUNDS	10,000	10,000	10,000	10,000	10,000	10,000	10,000
INVESTMENTS--AFS	30,000	32,820	32,820	32,400	32,100	31,200	30,000
LOANS	60,000	60,000	60,000	60,000	60,000	60,000	60,000
TOTAL ASSETS	100,000	102,820	102,820	102,400	102,100	101,200	100,000
DEPOSITS	94,000	95,820	95,820	95,820	95,820	95,820	95,820
TOTAL LIABILITIES	94,000	95,820	95,820	95,820	95,820	95,820	95,820
EQUITY	7,000	7,000	7,000	7,000	7,000	7,000	7,000
AFS--FV ADJUSTMENT		0	0	-420	-720	-1,620	-2,820
TOTAL EQUITY	7,000	7,000	7,000	6,580	6,280	5,380	4,180
CAPITAL PROPOSED BASEL III	7,000	7,000	7,000	6,580	6,280	5,380	4,180
TIER 1 CAPITAL	7,000	7,000	7,000	6,580	6,280	5,380	4,180
TIER 1 CAPITAL RATIO	7.00%	6.81%	6.81%	6.43%	6.15%	5.32%	4.18%

GRAB

#<Go> to request enablement, Right click for more options

Exhibit C Page 2 OF 5

FG 003825 Mtge 99) Export All Quotes

View ○ Bid/Ask ● Additional Pricing Data Date 08/28/12

	PCS	Description of Source	Bid Price	Ask Price	Bid Size	Ask Size	Time
11)	SPS	Street Software	108-20+	108-20+			08/28
12)	FTIM	Ft Interactive Mtge	107-24	107-24			08/27
13)	BVAL	Bval	109-11 3/8	109-13 7/8			08/27
14)	BVN4	Bval New York 4pm	109-11 3/8	109-13 7/8			08/27

ACTUAL MARKET OFFERING 8-28-12

(MAJOR BROKERAGE FIRM)
FG 003825 338WAM 15WALA 108-27

BLOOMBERG PRICING BGN SHOWS PRICE OF 107-16. SEE PAGE.

SECURITY PRICING DISPARITY EXISTS. THIS IS A "STANDARD" AGENCY PASSTHROUGH. THE PRICING SERVICES **RANGE FOR 107-16 TO 109-14.** THAT IS ALMOST 2% POINTS PRICE VARIANCE FOR A LIQUID UNITED STATE AGENCY MARKET SECURITY. FOR LESS LIQUID AND TRANSPARENT MARKETS, THE RANGE OF PRICING WILL BE SUBSTANTIALLY WIDER

ACTUAL MARKET OFFERING IS 108-27. A BANK PURCHASING THE SECURITY AT 108-27, BUT USING BLOOMBERG CURRENT PRICE OF 107-16, WOULD HAVE A -1.34375% CAPITAL LOSS. A BANK USING THE HIGHEST PRICE OF 109-14, WOULD HAVE A CAPITAL GAIN OF +.59375% TO CAPITAL.

SECURITY PRICING DISPARITY PRODUCES INCONSISTENT REGULATORY APPLICATION AND BANK REPORTING.

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FG C03825 **107-16** 107-15/107-16
As of 28 Aug Freddie Mac Gold Pool

FG C03825 Mtge | 99) Feedback

CUSIP 31292LHA6 5.051(337)16 FGLMC 4.5 201:

Summary

Pool	FG C03825	5) Generic	FGLMC 4.5 2011		Information as of Aug '12
Type	(C0) Conventional Conv 30 years				Issue Date 03/01/12
Traits	30/360				Maturity Date 03/01/42
6) Originator	Multiple Sellers				

7) Pool Information (PDI)						Balance	
Coupon	4.500	WAC	5.051	Orig WAC	5.051	Factor	0.90526446
		WARM	337	Orig WAM	343	Orig Amt	84,545,263
		WALA	16			Curr Amt	76,535,822

8) Collateral Information (CLC)						Prepay	CPR	PSA
WAOLTV	69	AOLS	188,551	Orig TPO	13.04	1 Month	16.2	507
WAOLTV-HPI	70	WAOLS	188,881	Curr TPO	13.76	3 Month	19.4	648
WAOCLTV	70	MAX LS	200,000			6 Month	n.a.	n.a.
WAOCS	763	WAOLT	358			1 Year	n.a.	n.a.
		WAODTI *	35			Life	20.0	713

9) # Loans	421	Delay	44 (14)	11) States (GEO)	%UPB
Curtailed	1			CA	9.1
				NY	7.5
TRACE Eligible			* Calculated Values	MA	6.0

10) Prepayment	Aug'12	Jul	Jun	May	Apr	Mar	Feb	Jan	Dec'11	Nov	Oct	Sep
1 Month CPR	16.2	6.5	33.3	28.4	12.4							

Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000
Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2012 Bloomberg Finance L.P.
SN 579109 CDT GMT-5:00 G687-2004-1 28-Aug-2012 17:24:17

<HELP> for explanation, <MENU> for similar functions.

BGN/NY/CLOSE/MID/YIELD | Page 1/3 | Historical Price Table

Pool: FGC03825

Range 03/29/2012 - 08/28/2012 Period Daily Market Mid/Last

High 107-21+ on 7/31/12
Avg 106-28⅝
Low 105-27+ on 4/ 3/12

	DATE	PRICE	YIELD		DATE	PRICE	YIELD		DATE	PRICE	YIELD
F				F	8/10	107-11+	2.29	F	7/20	107-19+	2.22
T				T	8/ 9	107-11+	2.29	T	7/19	107-17+	2.24
W				W	8/ 8	107-14+	2.27	W	7/18	107-16+	2.25
T	8/28	107-15+	2.26	T	8/ 7	107-13+	2.28	T	7/17	107-12+	2.29
M	8/27	107-14+	2.27	M	8/ 6	107-17+	2.24	M	7/16	107-12+	2.29
F	8/24	107-12+	2.29	F	8/ 3	107-18+	2.23	F	7/13	107-09+	2.31
T	8/23	107-14+	2.27	T	8/ 2	107-18+	2.23	T	7/12	107-10+	2.30
W	8/22	107-10+	2.30	W	8/ 1	107-17+	2.24	W	7/11	107-10+	2.30
T	8/21	107-01+	2.38	T	7/31	H107-21+	2.21	T	7/10	107-11+	2.29
M	8/20	106-31+	2.40	M	7/30	107-18+	2.23	M	7/ 9	107-11+	2.29
F	8/17	106-28+	2.42	F	7/27	107-14+	2.27	F	7/ 6	107-08+	2.32
T	8/16	106-25+	2.45	T	7/26	107-19+	2.22	T	7/ 5	107-03+	2.36
W	8/15	106-25+	2.45	W	7/25	107-19+	2.22	W	7/ 4		
T	8/14	107-00+	2.39	T	7/24	107-19+	2.22	T	7/ 3	106-30+	2.41
M	8/13	107-03+	2.36	M	7/23	107-18+	2.23	M	7/ 2	107-00+	2.39

Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000
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GRAB

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FNR 2011-134 NJ Mtge | 99) Export | All Quotes

View ◉ Bid/Ask ○ Additional Pricing Data Date 08/28/12

	PCS	Description of Source	Bid Price	Ask Price	Bid Size	Ask Size	Time
11)	BVAL	Bval	104-27+	105-09¼			08/28
12)	BVN3	Bval New York 3pm	104-27+	105-09¼			08/28
13)	SPS	Street Software	104-11⅜	104-11⅜			08/27
14)	BVN4	Bval New York 4pm	104-30¼	105-11⅛			08/27
15)	FTIM	Ft Interactive Mtge	103-31⅝				08/27

SECURITY PRICING DISPARITY EXISTS. THIS IS A PAC CMO AGENCY SECURITY. **THE PRICING SERVICES RANGE FOR 104 TO 104-28.** THAT IS ALMOST 1% POINT PRICE VARIANCE FOR A LIQUID UNITED STATE AGENCY MARKET SECURITY. FOR LESS LIQUID AND TRANSPARENT MARKETS, THE RANGE OF PRICING WILL BE SUBSTANTIALLY WIDER.

SECURITY PRICING DISPARITY PRODUCES INCONSISTENT REGULATORY APPLICATION AND BANK REPORTING.

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FNR 2011-134 NJ **Not Priced**
As of -- Collateral 100.0% FNCL 5%

FNR 2011-134 NJ Mtge | 99) Feedback

CUSIP 3136A2V59 5.375(343)13 FNCL 5 N

1) Bond Summary 2) Group Summary 3) Deal Summary

Issuer FANNIE MAE 5) Prospectus
Series 2011-134 Class NJ Maturity 02/25/2041 ISIN US3136A2V598 6) Lead Mgr BAML
7) Class Description EXCH,AD,PAC(11) BBGID BBG0029GHBV3 8) Trustee FNM

Current (Aug 2012)		Original Issue		Payment Details		Additional Info	
Balance	109,342,291	Balance USD	114,006,286	Next Pay	09/25/2012	TRACE Eligible	
Factor	0.959090020	WAL	6.0Yr @ 185PSA	Rcd Date	08/31/2012		
Coupon	3.00%	1st Coupon	3.00%	Pay Date	25th		
Beg Accrue	08/01/2012	1st Payment	12/25/2011	Frequency	Monthly		
End Accrue	08/31/2012	1st Settle	11/30/2011	Pay Delay	24 Days		
Class/Grp Pct	33%	Dated Date	11/01/2011	Day Count	30/360		
[130 238 Jul2012]		PX	11/23/2011	Call	Non-Callable	FFIEC	Pass
		Class/Grp Pct	33%			Min Size	1,000
						Incr	1

9) Historical Paydown (CPD)

	Aug12	Jul	Jun	May	Apr	Mar	Feb	Jan	Dec	Nov	Oct	Sep11
PSA	424	309	315	418	386	441	341	479	482	323	-	-
CPR	11.1	7.4	7.0	8.5	7.0	7.2	4.9	5.9	5.0	2.7	-	-
Fct	0.96	0.96	0.97	0.98	0.98	0.98	0.99	0.99	1.00	1.00	-	-
Cpn	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	-	-

	PSA	CPR
1m	424	11.1
3m	353	8.5
6m	380	8.1
12m	-	-
Life	391	7.1

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<HELP> for explanation.
Enter snapshot criteria and hit <Go>

FNR 2011-134 NJ Mtge | 6) Request Demo

Bloomberg Valuation
97) Settings

30) Evaluated Pricing 31) Peer I-Spread 32) Bid-Ask

Snapshot | BID | 08/28/12 | NY 4PM

Final BVAL Price	104-27
Final BVAL Score (out of 10)	2

Pricing	Median	BVAL
Yield	1.337	2.008
Prepay Speed	475 PSA	184 PSA
I-Spread	95.5	122.0
Average Life	3.12	5.47
Settlement Date		08/31/2012

Methodology	I-Spread	Price
Final BVAL	122.0	104-27 1/8
Peer I-Spread	138.6	
Coupon Adjustment	-16.6	

1) Security Characteristics (DES)

WAC/WAM/WALA	5.37/343/13
Collateral	FNCL 5
Pricing Structure	PAC
Principal Window	09/12-11/20
Collar	130,238
Tranche Type	EXCH,AD+
Amt Outstanding	109.34MM
Bond Coupon	3.00
Identifier	3136A2V59

BVAL History | Price

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EXHIBIT C-1

BASEL III WILL OVERSTATE CURRENT CAPITAL TODAY, WITH NEGATIVE IMPACT ON FUTURE CAPITAL .
INVESTMENT PORTFOLIO'S HAVE SIGNIFICANT PREMIUM GAINS TODAY
WHICH WILL BECOME 0 PREMIUM GAIN IN THE FUTURE UPON MATURITY OR PREPAYMENT OF PRINCIPAL.

PREMIUM / GAIN AMORTIZATION IMPACT ON FUTURE CAPITAL

[ASSUMES PREMIUM AMORTIZATION OVER 4 YEARS]

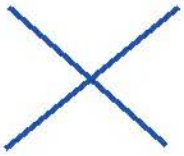
COMMUNITY BANK--BANK ABC [IN $000'S]	CURRENT BALANCE SHEET	MARKET BALANCE SHEET	YEAR 1 BALANCE SHEET	YEAR 2 BALANCE SHEET	YEAR 3 BALANCE SHEET	YEAR 4 BALANCE SHEET
MARKET PRICE: INVESTMENTS	108.00	108.00	106.00	104.00	102.00	100.00
BOOK PRICE: INVESTMENTS	100.00	100.00	100.00	100.00	100.00	100.00
OVERNIGHT FUNDS	10,000	10,000	10,000	10,000	10,000	10,000
INVESTMENTS--AFS	30,000	30,000	30,000	30,000	30,000	30,000
PREMIUM FV ADJUSTMENT--AFS	2,400	2,400	1,800	1,200	600	0
LOANS	60,000	60,000	60,000	60,000	60,000	60,000
TOTAL ASSETS	102,400	102,400	101,800	101,200	100,600	100,000
DEPOSITS	94,000	94,000	95,820	95,820	95,820	95,820
TOTAL LIABILITIES	94,000	94,000	95,820	95,820	95,820	95,820
EQUITY	7,000	7,000	7,000	7,000	7,000	7,000
PREMIUM FV ADJUSTMENT	2,400	2,400	1,800	1,200	600	0
TOTAL EQUITY	9,400	9,400	8,800	8,200	7,600	7,000
CURRENT CAPITAL REGS. EXCLUDE PREMIUM FV ADJUSTMENT						
TIER 1 ASSETS	100,000	100,000	100,000	100,000	100,000	100,000
TIER 1 CAPITAL	7,000	7,000	7,000	7,000	7,000	7,000
TIER 1 CAPITAL RATIO	7.00%	7.00%	7.00%	7.00%	7.00%	7.00%
CAPITAL PROPOSED BASEL III						
TIER 1 ASSETS	102,400	102,400	101,800	101,200	100,600	100,000
TIER 1 CAPITAL	9,400	9,400	8,800	8,200	7,600	7,000
TIER 1 CAPITAL RATIO	9.18%	9.18%	8.64%	8.10%	7.55%	7.00%

LIQUIDITY IMPACT OF BEING FORCED TO INVESTMENT HTM VS. AFS

	BASE BANK A	GROWTH BANK A	BASE BANK B	GROWTH BANK B
LIQUIDITY	**10,000**	**0**	**40,000**	**10,000**
LIQUIDITY RATIO TO ASSETS	**10.00%**	**0**	**40.00%**	**10.00%**
LOAN GROWTH OF 30MM				
TOTAL ASSETS	**100,000**	**120,000**	**100,000**	**100,000**
CAPITAL	**8,000**	**8,000**	**8,000**	**8,000**
CAPITAL RATIO	**8.00%**	**6.67%**	**8.00%**	**8.00%**

BALANCE SHEET COMPARISON FOR LIQUIDITY ILLUSTRATION
[IN $000'S]

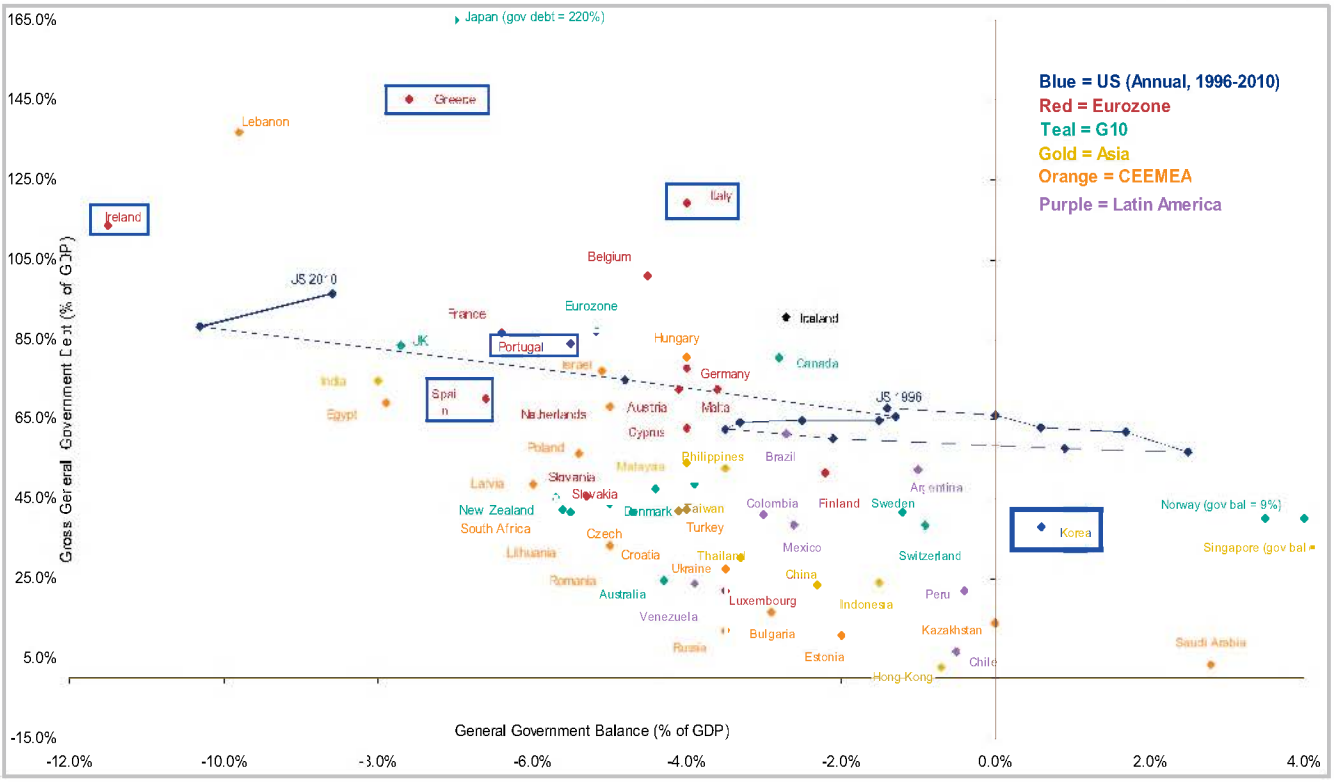
LIQUIDITY IMPACT FOR LOAN GROWTH OF 30MM	**BANK A BASE**	**BANK A GROWTH 30MM**	**BANK B BASE**	**BANK B GROWTH 30MM**
OVERNIGHT FUNDS	10,000	0	10,000	0
INVESTMENTS--AFS			30,000	10,000
INVESTMENTS--HTM	30,000	30,000		
LOANS	60,000	90,000	60,000	90,000
TOTAL ASSETS	100,000	120,000	100,000	100,000
DEPOSITS	92,000	92,000	92,000	92,000
NON RETAIL LIABILTIES		20,000		
TOTAL LIABILITIES	92,000	112,000	92,000	92,000
EQUITY	8,000	8,000	8,000	8,000
AFS--FV ADJUSTMENT				
TOTAL EQUITY	8,000	8,000	8,000	8,000
TOTAL LIABILITIES & EQUITY	100,000	120,000	100,000	100,000
CAPITAL PROPOSED BASEL III	8,000	8,000	8,000	8,000
TIER 1 CAPITAL	8,000	8,000	8,000	8,000
TIER 1 CAPITAL RATIO	**8.00%**	**6.67%**	**8.00%**	**8.00%**



than net debt and deficit numbers to make international comparisons possible.) Clearly as its credit metrics deteriorated over the past few years, the US has shifted from a position comfortably in the middle of the pack of countries to a position that puts it at the negative-outer edge of the country-cluster.

Figure 1: US Credit Metrics vs Others

ALMOST ALL COUNTRIES HAVE DEFICIT SPENDING.



Source: RBS

With the issue of default likely behind us, a key question in the context of the US credit rating becomes the future trajectory of these metrics. **Do the deficit cuts in the current deal reverse the deterioration seen over the past few years and move the US back toward its long run habitat in the middle of the pack?**

To get more insights into this question, we made some back-of-the-envelop calculations, assuming the USD 2.4 trn in deficit cuts over 10 years implicit in the recent debt-ceiling deal are realized. Our jumping off point was the projections of the Congressional Budget Office. (See for instance, *The Budget and Economic Outlook: Fiscal Years 2011 to 2021, CBO, January 2011*) Unfortunately, further deterioration in both credit metrics (debt/GDP and deficit/GDP) is not reversed under the current deal. In our calculations, the deficit/GDP ratio rises to around 1.5 ppts by 2021 and the debt/GDP ratio, by around 15 ppts from current levels.

More alarming in light of the recent weakening of economic conditions is the impact of slower economic growth on these credit metrics. In the above-cited publication, the CBO calculates that a 0.1 ppt reduction in growth would add USD 310 to the cumulative deficit by 2021. This

Exhibit F

Outstanding U.S. Bond Market Debt
$ Billions

	Municipal[7]	Treasury[1,6]	Mortgage Related[2,6]	Corporate Debt	Federal Agency Securities[5,6]	Money Markets[3]	Asset-Backed[4,6]	Total
1980	399.4	623.2	110.8	458.6	164.3	780.0		2,536.4
1981	443.7	720.3	126.4	489.2	194.5	837.0		2,811.1
1982	508.0	881.5	176.3	534.7	208.8	882.8		3,192.2
1983	575.1	1,050.9	242.7	575.3	209.3	982.1		3,635.4
1984	650.6	1,247.4	286.2	651.9	240.4	798.0		3,874.5
1985	859.5	1,437.7	396.7	776.6	261.0	847.0	1.2	4,579.7
1986	920.4	1,619.0	552.3	959.3	276.6	877.0	11.3	5,215.8
1987	1,012.0	1,724.7	704.5	1,074.9	308.3	979.8	18.0	5,822.2
1988	1,080.0	1,821.3	812.9	1,195.8	370.7	1,108.5	27.9	6,417.1
1989	1,129.8	1,945.4	1,024.1	1,292.5	397.5	1,192.2	41.9	7,023.4
1990	1,178.6	2,195.8	1,278.1	1,350.3	421.5	1,156.8	75.8	7,656.9
1991	1,272.1	2,471.6	1,605.8	1,454.6	421.5	1,054.3	109.8	8,389.7
1992	1,295.4	2,754.1	1,940.3	1,557.0	462.4	994.2	136.4	9,139.8
1993	1,361.7	2,989.5	2,156.4	1,674.6	550.8	971.7	154.5	9,859.2
1994	1,325.8	3,126.0	2,276.0	1,755.6	727.7	1,034.7	190.8	10,436.6
1995	1,268.2	3,307.2	2,352.7	1,950.6	924.0	1,177.3	257.0	11,237.0
1996	1,261.6	3,459.7	2,486.1	2,126.5	925.8	1,393.9	369.5	12,023.1
1997	1,318.5	3,456.8	2,680.2	2,359.0	1,021.8	1,692.8	516.0	13,045.1
1998	1,402.7	3,355.5	2,955.2	2,708.5	1,302.1	1,977.8	647.7	14,349.5
1999	1,457.1	3,266.0	3,334.3	3,046.5	1,620.0	2,338.8	950.5	16,013.2
2000	1,480.7	2,951.9	3,565.8	3,358.4	1,853.7	2,662.6	1,085.0	16,958.1
2001	1,603.4	2,967.5	4,127.4	3,836.4	2,157.4	2,587.2	1,230.3	18,509.7
2002	1,762.9	3,204.9	4,686.4	4,132.8	2,377.7	2,545.7	1,381.5	20,091.9
2003	1,900.4	3,574.9	5,238.6	4,486.5	2,626.2	2,519.8	1,507.6	21,854.0
2004	2,850.3	**3,943.6**	5,387.9	4,801.6	2,700.6	2,904.2	1,814.0	24,402.3
2005	3,044.2	4,165.9	6,160.0	4,964.7	2,616.0	3,433.7	2,111.0	26,495.5
2006	3,212.4	4,322.9	7,085.4	5,344.2	2,634.0	4,008.8	2,700.6	29,308.2
2007	3,448.0	**4,516.7**	8,161.3	5,947.3	2,906.2	4,170.8	2,946.4	32,096.7
2008	3,543.4	5,774.2	8,396.4	6,198.6	3,210.6	3,790.9	2,600.9	33,515.0
2009	3,698.0	7,249.8	8,508.4	6,862.7	2,727.5	3,127.2	2,326.9	34,500.5
2010	3,794.5	8,853.0	8,516.8	7,511.9	2,538.8	2,866.5	2,034.5	36,116.0
2011	**3,743.3**	**9,928.4**	**8,439.5**	**7,790.7**	**2,326.9**	**2,572.0**	**1,815.4**	**36,616.2**

1 Interest bearing marketable public debt.

2 Includes GNMA, FNMA, and FHLMC MBS/CMOs; and private-label MBS/CMOs.

3 Includes commercial paper, bankers acceptances, and large time deposits.

4 Includes auto, credit card, home equity, manufacturing, student loans and other; CDOs of ABS are included

5 Due to FAS 166/167 changes, the GSE debt category in the Federal Reserve is no longer our source for agency debt going forward from Q1 2010.
Contains agency debt of Fannie Mae, Freddie Mac, Farmer Mac, FHLB, the Farm Credit System, and federal budget agencies (e.g., TVA)

6 Further breakdowns of these categories may be found in their respective sections on SIFMA statistics.

See US Treasury Issuance, Gross & Net; US Mortgage-Related Outstanding; US Agency Debt Outstanding; and US ABS Outstanding.

7 Muncipal securities restated from 2004 onward and revised upward by about $840 billion.

Sources: U.S. Deptmt of Treasury, FRS, Federal agencies, Dealogic, Thomson Reuters, Bloomberg, Loan Performance and SIFMA