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October 11, 2012

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

Re: **Docket No. R–1430; RIN No. 7100–AD87**
Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action

Docket No. R–1442; RIN No. 7100–AD87
Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements

Dear Ladies and Gentlemen:

We strongly urge the agency to reconsider subjecting community banks to the Basel III proposals referenced above. We believe that if the Federal Reserve System revises its capital requirements to mirror those of the Basel III accord, it would subordinate the judgment of your examiners to an international body that lacks the expertise to effectively regulate community banks.

The Basel accord was originally intended to provide a framework for measuring the capital of internationally active banks in the wake of serious disturbances in international currency and banking markets during the 1970's. There is merit in having this framework for internationally active banks. These institutions pose systemic risk on a global level and the management and directors of these institutions have less than a modicum of ownership in their banks. These internationally active banks place a far greater emphasis on meeting quarterly earnings expectations from Wall Street than they do on sustaining the long term viability of their firms. So, measuring and monitoring these large, internationally active firms on a global level as proposed in the latest Basel accord (Basel III) is reasonable.

This is not true of community banks of less than $10 Billion in size. Community banks have always maintained the highest capital levels in the banking industry. Community Banks have strong capital levels, because they are predominantly owned by local shareholders. Moreover, the management and boards of small banking institutions generally have a significant ownership stake. Community bank officers and directors have not only a deep-rooted connection to their banks, but also an actual financial commitment to ensure the survival of the institutions that they govern. The same cannot be said of the large, internationally active firms. The ownership of the large, internationally active banks is not concentrated, and, therefore, the management teams of these institutions simply do not have the same tangible commitment that community bank officers and directors have. Furthermore, community banks do not have international operations. So, it is not reasonable to apply an international framework, designed without consideration for the unique characteristics of community banks, to institution such as ours.

Community banks inherently recognize the need for a strong capital position. Basel III is not only unnecessary for community banks, but also unsuitable for community banks. In addition, Basel III has destructive unintended consequences. There are three major reasons that the Basel III proposals will be extremely detrimental to community banks and the economy if they are implemented as proposed.

The first reason that Basel III will be damaging to community banks is that the proposals require all unrealized gains and losses in our available for sale securities to be included in tier 1 capital or the new term common equity tier 1 (CET1). This has been termed the "mark to market" requirement. As interest rates increase, the price of our bonds will decline and this will have an extremely adverse impact on our capital position. In the past, such gains and losses in available for sale securities were not included in the bank's regulatory capital. Under these proposals, there would be no such distinction. This would subject the AFS portion of the securities portfolios of community banks to volatile shifts in the bond markets.

Community banks use security portfolios to manage interest rate exposure, so a large portion of our securities have traditionally been maintained in the available for sale section. Having securities identified as available for sale, allows community banks to adjust to the current interest rate environment and manage interest rate risk accordingly. The larger financial institutions have the ability to efficiently hedge against interest rate risk. Community banks do not have this same ability. The "mark to market" requirement will force community banks to either arbitrarily hold more capital or constrain growth to compensate for inevitable swings in interest rates. Both of these scenarios would hinder our ability to meet the needs of small businesses and consumers. This would have a severely detrimental impact on the economy.

The underlying concern of the "mark to market" requirement in Basel III is to ensure that losses in the securities portfolio are taken into consideration when determining the solvency of a bank. However, examiners have always had the ability to analyze and criticize bank security portfolios on the basis of interest rate risk. Furthermore, the original purpose of "mark to market" accounting was to ensure that publicly traded companies fully disclose the current or fair market value of assets. The reality is that community banks already fully disclose the unrealized gains or losses in their securities portfolios each quarter in the FDIC call report. So, the risk is already disclosed and known by bank management, regulators, and the general public. The proposal's application of this principle does not logically follow the spirit of "mark to market" accounting and has the unintended consequence curtailing banking activity by superfluously reducing the amount of regulatory capital on the balance sheets of community banks.

In addition, it is illogical to place a market value on only one section of a bank's balance sheet. The Economic Value of Equity (EVE) model values the entire balance sheet. EVE has already been approved by regulators. Research shows that banks that have failed recently would have had low EVE ratios as a percentage of capital. Conversely, community banks with sizeable core-deposit bases have higher EVE ratios. A minimum threshold could be established for EVE ratios. The EVE ratio could be monitored by your examiners along with liquidity risk, earnings at risk, and credit risk during and between exams. Having a threshold for Economic Value of Equity ratios would be a reasonable method of enhancing the measurement of bank capital levels. The "mark to market" treatment of bank AFS securities would arbitrarily and unnecessarily decrease the regulatory capital ratios of community banks.

The second detrimental impact that Basel III would have on community banks is the additional risk weighting that the proposals place on the financing of acquisition, development, and construction activities on real property. This would be a crippling blow both to community banks and the construction industry. One to four family construction loans have been a staple of community banks for generations. Consumers and builders have relied on local banks to make these kinds of loans. In fact, many of the larger banks in our area have referred their customers to community banks to make these loans, because the larger banks do not offer them. Increasing the risk weight on this types of loans from 100% to 150%, will constrain the ability of community banks to make these types of loans. This increase will deliver a body blow to an industry that was just beginning to recover.

The third detrimental impact that Basel III would have on community banks is the treatment of balloon mortgages. Balloon notes have long been a way for both consumers and banks to manage interest rate risk. Under Basel III, balloon notes are systematically given a punitive risk weighting. The proposals would require banks that have balloon note residential mortgages with loan to value ratios between 61% and 80% to increase their risk weighting from 50% to 100%. Furthermore, the risk weights for balloon notes with loan to values between 81% and 90% would have their risk weightings increase from 50% to 150%. These dramatic increases in the capital requirements for balloon notes will stop banks from offering balloon notes. While rates on traditional 15 and 30 year mortgages are currently at historically low levels, it is extremely short-sighted to believe that rates will stay at these low levels. At some point, rates will increase and home buyers will not want to fix their mortgage rates at 8%, 12%, or higher. If the proposals become regulation, consumers will not have an alternative to long-term fixed rate mortgages because community banks will be forced to abandon the product. ***This portion of the proposal was written with a total disregard for consumer choice.*** Fostering competition has long been a goal of bank regulators, the forced exodus of community banks from this segment of lending unfortunately stands in stark contrast to that objective.

We know that the Federal Reserve System understands the value that community banks bring to our financial system. Community banks are the financial backbone of rural communities. If the proposals become regulation, a large number of community banks will sell to large financial institutions. Not only will that be a devastating blow to the effort to end too-big-to-fail, but it will also severely constrict consumer choice and cripple the economies of rural communities. In addition, subjecting community banks, which are not internationally active, to these proposals will subordinate the judgment of your management team and your examiners to an international body. We urge you to strongly consider exempting community banks from these proposals.

Thank you for your time and attention to this important matter.

Sincerely,

Tieman Dippel III

Tieman Dippel, III
Vice President
Brenham National Bank