October 16, 2012

Sevier County Bank
Over 100 Years Strong

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

Re: Basel III Capital Proposals

Ladies and Gentlemen:

Thank you for the opportunity to provide comments on the Basel III proposals[1] that were recently issued for public comment by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.

I believe that Community Banks should be allowed to continue to use the current Basel 1 Framework and be exempt from this proposal. The most detrimental impact on our Bank is the Inclusion of the Unrealized Gains (Losses), also known as Other Comprehensive Income, in Tier 1 Capital.

The inclusion of OCI in Tier 1 Capital presents the following problems for Community Banks:

1. Lending Limits would become erratic with changes in Interest Rates.
2. All Capital Ratios would become erratic with changes in Interest Rates.
3. Dividend Payments that were made earlier in the year could become out of compliance if Interest Rates changed later in the year.

In addition, the unintended consequences will probably cause community banks to take the following actions if the OCI is included in Tier 1 Capital:

1. Securities will be moved by community banks from the Available-For-Sale (AFS) Category to the Held-to-Maturity (HTM) Category to not have the impact of changes in Interest Rates affecting Tier 1 Capital, thereby hurting liquidity.
2. Community banks will shorten the duration of the AFS Portfolio, which will negatively affect earnings in the long-term.

We have already dealt with this battle when FAS-115 was implemented in the early 1990's. The proposal to include OCI in Tier 1 Capital will be devastating to Community Banks if implemented.

[1] The proposals are titled: *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, and Transition Provisions; Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements; and Regulatory Capital Rules: Advanced Approaches Risk-based Capital Rules; Market Risk Capital Rule.*

The proposed changes to risk weights under Basel III is too complicated and will be a tremendous burden on Community Banks. We are already the most regulated industry in the world and these changes will make us less competitive and threaten the viability of community banks across the United States.

Increasing the risk weights for residential balloon loans, interest-only loans, and second liens will penalize community banks who offer these loan products to customers and deprive customers for these options to finance their residential property. In addition, higher risk weights for balloon loans will penalize community banks for mitigating interest rate and market risk in their ALCO Programs.

This will force community banks to originate only 15-Year and 30-Year Fixed Mortgages with durations that will make our balance sheet more sensitive to changes in long-term interest rates. Many community banks will exit the residential loan market or only originate loans that can be sold to FHLMC or FNMA.

Either second liens will become more expensive for borrowers or we will discontinue this product due to the additional capital required for these types of loans. We believe strongly that Community Banks should be allowed to continue with the current Basel 1 risk-weight framework for residential loans.

One other aspect that must be considered is the cost to community banks to update our software and other operational costs to track mortgage loan-to-value ratios to determine the proper risk weight categories for mortgages.

Having a higher risk-weight for certain commercial real estate loans will also have unintended consequences. The most likely scenario is community banks will not provide this form of credit to our customers, which will have a negative impact on the growth in the communities we serve.

Having a higher risk-weight for non-performing loans only duplicates the purpose of the Allowance for Loan & Lease Losses (ALLL). This is a double penalty for community banks if we are required to adopt Basel III.

I believe that the "arbitrary limit" of the ALL being capped at 1.25% of risk-weighted assets should be eliminated. When risk-based capital was initially developed in the late 1980s, an ALLL that was 1.25% of Risk-Weighted Assets was considered normal.

However, following the financial crisis in 2008, most banks have carried an ALLL that is well in excess of the 1.25% of Risk-Weighted Assets. A greater percentage of the ALLL should be included in Tier 1 Capital and/or an additional portion included in Tier 2 Capital. We suggest that the CAP of 1.25% of risk-weighted assets be eliminated or increased to at least 2.50%, which is the approximate level that the ALLL has increased from the late 1980s to the present.

Another arbitrary number for Tier 1 Capital is the Deferred Tax Assets allowable inclusion. Currently, Deferred Tax Assets are limited to the lower of 10% of Tier 1 Capital or the next 12-Months Projected Net Income.

This threshold should be changed to 25% of Tier 1 Capital or the next 24-months Projected Net Income, whichever is less, in acknowledgement of the recent and current state of the economy and financial services industry.

Finally, the last area of concern with this proposal for Community Bank is the proposed Capital Buffer. Based upon past history, the proposed buffer will translate into new minimum capital ratios that are much higher than current regulations.

The risk-based capital regulations only focus on credit (collateral) risk. For example, a SBA Security has a 0% risk-weight based upon the credit risk. However, the same risk-weighting is applied for a 3-Month SBA and a 30-Year SBA. There are numerous other examples of these types of issues. It would be clearer if the risk-based capital regulations referred to "credit / collateral" as the basis for the regulations.

Please consider these comments as you are contemplating the adoption of Basel III. The simplest solution is to require community banks to continue to use the Basel I rules and the largest banks (Assets greater than $10 Billion) to be required to use Basel III.

If you have any questions or need additional information, please let me know.

Regards,

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