October 17, 2012

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551
Via email: regs.comments@federalreserve.gov

Office of the Comptroller of the Currency
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Via email: regs.commentS@occ.treas.gov

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

Re: Basel III Capital Proposals

Ladies and Gentlemen:

Thank you for the opportunity to provide comment on the Basel III proposals 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. Please consider the following comments in your analysis of the proposed regulations.

Applicability of Basel III to Community Banks

Community banks should be allowed to continue using the Basel I framework for computing their capital requirements. Basel III was designed to apply to the largest, internationally active megabanks, not to small community banks. Community banks did not engage in the highly-leveraged activities that led to the financial crisis and panic in the markets. Community banks operate on a relationship-based model that is specifically designed to serve our customers and our communities over the long term. This model, along with common sense approaches to risk management, contributes to the success of community banks. Megabanks operate on a pure transaction volume basis and pay little attention to the customer relationship. This difference in banking models demonstrates the need to place tougher capital standards exclusively on the largest banks.

Implementation of capital conservation buffers for community banks will be difficult to achieve under the proposed regulation and therefore should not be implemented. Many community banks will need to build additional capital balances to meet these minimum capital requirements. Community banks would be required to increase capital through the accumulation of retained earnings over time due to the fact that most community banks do not have access to capital markets. Due to the ultra low interest rate environment, community bank profitability has and will continue to be diminished, further hampering their ability to grow capital.

Subchapter S Consideration

Imposing distribution prohibitions on community banks with a Subchapter S corporate structure conflicts with the requirement that shareholders pay income taxes on earned income of the company. Distributions to shareholders for the payment of income tax should be exempt from the proposed limitations on capital. This would ensure that shareholders are protected from increased tax liability without the offsetting distribution from the bank.

Risk Weights

The proposed risk weight framework under Basel III is too complicated and will be an onerous regulatory burden that will penalize community banks and jeopardize the housing recovery. Increasing the risk weights for residential balloon loans, interest-only loans, and second liens will penalize community banks who offer these loan products to their customers and will deprive our communities of needed financing needs. Many community banks will either exit the residential loan market entirely or only originate those loans that can be sold to a GSE. Second liens will either become more expensive for borrowers or disappear altogether as banks will choose not to allocate additional capital and resources to these loans.

Furthermore, the risk weights themselves appear to have been artificially created. By having a risk weight above 100%, the regulations give no value to any potential collateral positions as well as appear to create a situation in which the bank will lose more than the principal amount of the loan. Since most community banks do not participate in hedging, securitizations, and credit swaps, this situation appears to be entirely unrealistic.

Additionally, higher risk weights for balloon loans will further penalize community banks for mitigating interest rate risk in their asset/liability management. Community banks would be forced to originate only 15 or 30 year mortgages with durations that will make their balance sheets more sensitive to changes in long-term interest rates. As stated above, the current low rate environment only exacerbates this risk in today's market.

Community banks will also be forced to make significant software upgrades and incur other operational costs to continually track mortgage loan-to-value and other underwriting ratios in order to determine the proper risk weight categories for mortgages. These costs will further hamper community banks' ability to increase capital through retained earnings and significantly increase the cost to customers.

For all of the reasons stated above, community banks should either be allowed to stay with the current Basel I risk weight framework for residential loans or the proposed regulations should tie additional risk weights to those specific securitization and swap activities rather than to the entire residential loan pool.

Incorporating AOCI into Capital Ratios

Inclusion of Accumulated Other Comprehensive Income (AOCI) in capital for community banks will result in increased volatility in regulatory capital balances and could rapidly deplete the capital cushions under certain economic conditions. AOCI for most community banks represents unrealized gains and losses on investment securities. Because these securities are recorded at fair market value, any gains or losses due to changes in interest rates are captured in the valuation. Many community banks hold their investment until maturity rather than actively trading the securities. Due to the current low interest rate environment, all securities purchased at this time will show a significant decline in value once rates start to rise. This decline will have a direct, material impact on common equity, tier 1 and total capital ratios. While large megabanks have the ability and manpower to mitigate this type of risk by entering into qualifying hedge accounting contracts, most community banks do not. As such, community banks should continue to exclude AOCI from capital measures as they are currently required to do today.

I appreciate the opportunity to comment on the proposed Basel III regulations. While I fully understand the need for additional capital to insulate banks from risks, the regulation as proposed is fundamentally flawed and will unnecessarily damage community banks' ability to provide credit to its customers. I urge you to consider modifying Basel II as stated above and/or exempting community banks under $10 billion in size. Thank you for your consideration.

Respectfully,

Julie G. Keen
Controller/Internal Auditor
First National Bank