Cullen/Frost Bankers, Inc.

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

Proposals: (1) Regulatory Capital Rules: Regulatory capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action, (2) Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements

Dear Ms. Johnson:

Thank you for the opportunity of allowing Cullen/Frost Bankers, Inc. ("Cullen/Frost") to comment on the proposed rulemaking on regulatory capital referenced above. Cullen/Frost would like to focus our comments on the proposed treatment of unrealized gains and losses of certain debt securities in common equity tier one capital as well as the proposed risk-weighting methodology for mortgage loans and securities lending transactions.

Cullen/Frost, a Texas business corporation, is a financial holding company and a bank holding company headquartered in San Antonio, Texas. At June 30, 2012, Cullen/Frost had consolidated total assets of nearly $21 billion. Frost Bank, the sole banking subsidiary of Cullen/Frost, is a Texas state chartered bank and a member of the Federal Reserve System. As such, Cullen/Frost and Frost Bank would be subject to the proposed notice of proposed rule-making that would revise and replace the current capital rules.

Unrealized Gains and Losses on Certain Debt Securities

We feel the proposed rules that require the inclusion of accumulated other comprehensive income ("AOCI") in the computation of regulatory capital would have a substantial negative impact on the long-term viability of the community and mid-size banking business model. This proposal would require banks to reduce tier one capital, on a dollar for dollar basis, for after-tax unrealized losses on available for sale ("AFS") securities. Market value changes in a bank's investment portfolio have never been included in regulatory capital. As a result, community and mid-size banks will be forced to hold significant levels of additional capital to cover this volatility.

There are fundamental problems with the proposed treatment of AOCI under Basel III. First, community and mid-size banks do not trade their investment portfolios – they hold them to maturity. The market value variations due to interest rate changes are therefore temporary unless the issuer cannot pay. Most community and mid-size bank investments are in securities with little risk of non-payment including U.S. Treasuries, mortgage backed and other securities issued by U.S. Government Agencies and municipal securities. Nevertheless, under Basel III, temporary fluctuations in market value caused by changes in interest rates must be covered with permanent tier one capital. Furthermore, community and mid-size banks would, in all likelihood, need to hold significant excess amounts of tier one capital to mitigate the risk of significant increases in interest rates.

Notwithstanding the aforementioned, regulatory capital rules prior to Basel III have recognized the impact of market value fluctuations for certain securities. For instance, if banks engaged in trading of their investment portfolios either explicitly or by demonstrated trading, accounting rules required that their investment portfolios be considered held for trading purposes and regularly "marked to market" with changes in fair value recognized in the income statement (and therefore, capital). Furthermore, other-than-temporary declines in market value (such as for reasons related to credit) require the recognition of write-downs in the income statement (again, to capital). We support this approach for trading securities and securities impaired for credit reasons as such items have real, current or near term capital effects.

Some would argue that the proposed rules will provide bank's with a capital benefit in the event timely investing created an unrealized gain in the investment portfolio. However, a closer look would show that benefit to be deceptive. Gains along with the capital benefit related to interest rate movements will evaporate as securities approach maturity. Alternatively, security sales to capture unrealized gains immediately reduce future operating earnings. In light of this, regulatory authorities likely will not and should not allow AOCI from unrealized gains on securities to fund long-term uses such as acquisitions and stock buy backs. However, there would likely be little doubt that capital short-falls caused by unrealized losses on securities would require an immediate supervisory mandate to correct the situation with permanent tier one capital.

It should be noted that the major component of AOCI volatility, the investment portfolio, is just one piece of a community or mid-size bank's total balance sheet. Regulators have long required community and mid-size banks to manage interest rate risk for the entire balance sheet (the "ALCO process"), not just the investment portfolio. Regulators placed significant emphasis on these risk management systems after interest rate mismatches in the savings and loan industry in the 1970's and 1980's contributed to widespread failures and significant taxpayer cost. The risks, and the tools to manage them, are straight-forward and well understood by community and mid-size bank managers, boards and local regulators. Effective investment portfolio management in the ALCO process is well within the grasp of bank management and has operated safely for decades. Basel III treatment of AOCI will render much of this ALCO process moot as community and mid-size bank managers who wish to invest the deposits entrusted to them in the same manner as in the past will now be required to attempt to manage the market volatility of a segment of the balance sheet. Few are equipped to do so. Investment banks are already marketing complex hedging strategies to community and mid-size banks to arbitrage current accounting rules to reduce the AOCI impact. While this will no doubt prove to be another source of fee income for Wall Street as they implement and attempt to manage these programs for the community and mid-size banks, many would question if the management and boards of community and mid-size banks can competently monitor such programs. However, their ultimate benefit and suitability remain to be seen.

Other ways that community and mid-size banks might respond, should these proposed rules be implemented, could also have negative implications. Banks will be tempted to overly utilize the held-to-maturity (HTM) option for securities in order to avoid marking to market. Furthermore, there is no assurance that the Securities and Exchange Commission or the Financial Accounting Standards Board will not change the accounting rules for HTM securities in their constant drive toward mark to market accounting. Banks that significantly reduce the duration of their securities portfolios in order to reduce their capital volatility will suffer the lower operating margins that come with lower yields. Some banks may lower investments in highly-rated securities in favor of long-term fixed rate loans that are not marked to market. This will reduce liquidity and increase the overall risk profile of those banks including credit exposure. It is likely that many banks will attempt to minimize AOCI with complex derivatives, which could expose them to new risks.

We suspect this new element of the proposed Basel III capital rules is attempting to address the sharp drop in values of the more exotic, private label securities during the financial crisis. These securities were manufactured by Wall Street and were held by many of the major or "the too big to fail" banks. In fact, Federal Reserve H .8 data from the second quarter of 2007 shows that these banks held well over 50 percent more "other non-federal securities" as a percentage of assets than community and mid-size banks. The proposed rules will cause a disproportionately negative impact on community and mid-size banks that have, for years, responsibly managed their investment portfolios as a core, high-quality asset class. Those portfolios performed admirably during the financial crisis.

An examination of historical yields for the five year U.S. Treasury security over the last fifty years shows significant volatility. Significant Federal Reserve inflation fighting occurred in the early 1980's. The five year treasury increased 650 basis points in yield in one year. A portfolio with a similar duration would see a market value drop of almost 30 percent, a potentially devastating capital hit to a well run bank even though the interest rate impact is temporary and reverses as the bonds approach maturity. During this period, banks with proper ALCO management did not suffer earnings declines even though securities market values declined.

Community and mid-size banks fulfill an important role in the U.S. economy. In fact, a recent Federal Reserve Bank of Dallas publication noted that community and mid-size bank's hold close to 60 percent of loans outstanding to small businesses. Nonetheless, community and mid-size banks are facing a diminishing pool of available asset classes in which to invest capital. For instance, most credit cards have gone to the largest banks or monoline companies like American Express. Most 1-4 family residential real estate mortgages are held by Government-Sponsored Enterprises. Furthermore, commercial real estate lending is under increasing pressure, as is non interest income. The proposed Basel III rules on AOCI will effectively limit community and mid-size bank investment portfolios as a significant earning asset class that takes advantage of natural hedges in their balance sheets to extend out the yield curve and generate prudent interest rate spread income and will result in fewer bank investments in municipal securities, mortgage backed securities and medium to long-term U.S. Treasuries.

In light of the above, we feel that the bank regulatory agencies should modify the proposed Basel III rules related to the inclusion of AOCI related to unrealized gains and losses on available for sale securities in regulatory capital ratios. Specifically, we feel that there are several, more appropriate alternatives to the proposed rules that the bank regulatory agencies should consider in addressing the aforementioned issues, including:

- Weighting a bank's AOCI from securities by the same Basel III risk grades currently assigned to the securities which give rise to it (just as various credit risk weightings for different asset classes have been used for years). This will significantly reduce the AOCI impact for most community and mid-size banks holding high quality securities (such as full faith and credit U.S Treasuries and mortgage-backed securities) while keeping it in place for securities with more risk (such as corporate and private asset-backed securities).

- Eliminating unrealized securities gains and losses from regulatory capital calculations due to their transitory nature.
- Exempt community and mid-size banks (those under $50 billion in total assets) from including AOCI in their regulatory capital calculations.

In summary, Cullen/Frost strongly objects to the proposed Basel III capital rules requiring the inclusion of AOCI in the computation of regulatory capital. We feel the proposed rules would have a substantial negative impact on the long-term viability of the community and mid-size banking business model. This proposal would require banks to reduce tier one capital, on a dollar for dollar basis, for after-tax unrealized losses on AFS securities. Market value changes in a bank's investment portfolio have never been included in regulatory capital. This is a dramatic change from previous regulatory capital rules, which excluded market value changes in a bank's investment portfolio. Bank regulatory agencies should modify the proposed Basel III rules related to the inclusion of AOCI related to unrealized gains and losses on available for sale securities in regulatory capital ratios. This could be accomplished by weighting the AOCI by the risk weightings currently assigned to the securities which give rise to it, eliminating it altogether, or by exempting community and mid-size banks (those under $50 billion in total assets) from including AOCI in their regulatory capital calculations.

Residential Mortgage Loans

Cullen/Frost strongly objects to the proposed Basel III capital rules that will increase the risk weighting associated with mortgages with higher loan-to-value ratios or loans that qualify as Category 2 loans under the proposal. The Standardized Approach proposal introduces higher risk weights for residential mortgage loans reflecting the borrower credit profile based on various criteria that could cause a loan not to be characterized as a Category 1 loan. These factors include term, payment frequency, credit underwriting, maximum annual rate variance, home equity lines of credits underwritten to maximum contractual exposure, payment status of less than 90 days past due, and single banking organization holders of senior and junior lien mortgages with combined loan-to-value ratios below threshold levels. While we support the regulatory move away from applying the same risk weighting to loans regardless of credit profile, we are concerned that under the proposed methodology, a single loan criterion could trigger an unnecessary Category 2 characterization even though the overall credit profile is clearly very high quality and worthy of Category 1 risk weighting. For example, a high loan-to-value loan whose borrower has a very low debt-to-income ratio and/or a high net worth would be evaluated as a Category 2 loan with a much higher risk weighting. Alternatively, a very low loan-to-value loan whose borrower has a higher debt to income ratio would not be similarly disadvantaged. We believe a risk-weighting framework that is single-factor focused without regard to the overall credit profile of the borrower would result in unnecessarily high risk-weights on certain mortgage loans. We believe higher risk-based capital requirements will depress the financial returns associated with residential mortgage lending and lead to higher required pricing for new originations which could result in reduced access to funding and/or increased costs to consumers.

Securities Lending

Securities lending transactions are a traditional bank activity that supports global capital markets activities and facilitates trade settlement. By effectively increasing the supply of securities available for these and other market activities, securities lending improves global market liquidity and enhances price discovery.

Through securities lending programs, agent banks act as intermediaries to facilitate loans of eligible securities by securities lenders (the clients of the agent banks, or "lending clients") to qualified borrowers. Securities are generally lent pursuant to a (i) securities lending authorization agreement between the securities lender and the agent bank, and (ii) securities borrowing agreement between the borrower and the agent bank. Pursuant to these agreements, the lending clients (and, directly or indirectly, the agent banks) have a security interest in and lien on the collateral provided by the borrower in an amount in excess of the value of the security borrowed, usually by a margin of 2% to 5% depending on certain characteristics of the security. The collateral in securities lending transactions is marked to market daily to ensure appropriate positive margin is consistently maintained.

The Standardized Approach proposal would apply collateral haircuts on non-cash securities lending collateral at the same level as securities held as a long-term asset or as static security for a long-term asset. Because securities lending collateral (both cash and non-cash) is marked-to-market daily, and tracking and coverage systems are very sophisticated, ensuring continuous collateral coverage of at least 102% or more (depending on the type of collateral), securities held as collateral for a dynamic securities lending transaction should receive a better capital treatment than securities held as a static investment or long-term asset. We believe that, provided the non-cash collateral posted in securities lending transactions is readily marketable, exposures should be subject to a 0% capital charge.

The Standardized Approach proposal also provides that a banking organization may recognize the risk-mitigating effects of financial collateral using the simple approach, described in section II.F.2(c) of the proposal. Under the simple approach, the risk weight assigned to the collateralized portion of the exposure would generally be no less than 20%. However, a banking organization may assign a 0% risk weight to the collateralized portion of an exposure where the financial collateral is cash, or where the financial collateral is an exposure to a sovereign that qualifies for a 0% risk weight, and the banking organization has discounted the market value of the collateral by 20%. We do not believe a 20% discount applied to sovereigns is warranted. Assuming the discount is meant to address volatility risk, the fact that securities lending collateral is marked-to-market daily with a margin sufficiently addresses that risk. This is the approach that the U.S. framework has historically taken and which the international Basel framework maintains. Forcing securities lending agent banks to apply a 20% discount to sovereign collateral would require securities lending agents to require an amount of collateral far in excess of what the market will bear, if they were to accept collateral in any form other than cash. Because the daily mark-to-market of securities lending collateral already addresses volatility risk, we believe that agent banks should be permitted to assign, as has been the case historically, a 0% risk weight to the collateralized portion of an exposure where the financial collateral is an exposure to a sovereign that qualifies for a 0% risk weight, without requiring the agent bank to discount the market value of the collateral by 20%.

Thank you for considering the concerns raised in this letter. We appreciate the opportunity to share our concerns and objectives and we would be happy to discuss any of them at length at your convenience. If you have any questions, please contact me at (210) 220-4841.

Respectfully Submitted,

Phillip D. Green
Group Executive Vice President and
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