MBA™
MINNESOTA BANKERS ASSOCIATION
THE CHAMPION FOR MINNESOTA BANKERS

October 2, 2012

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

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

Office of the Comptroller of the Currency
250 E Street S.W.
Mail Stop 2-3
Washington, D.C. 20219

Ladies and Gentlemen:

This letter is in regard to the request for comment on the proposed capital rules, collectively referred to as "Basel III," released by federal banking regulatory agencies in June 2012.

The Minnesota Bankers Association (MBA) is a trade association representing more than 95 percent of state and national banks in Minnesota. Its membership includes banks of all sizes, from independent community banks to large regional banks. Since 1889, the MBA has been supporting bankers through education, legal, consulting, and government relations initiatives in an effort to ensure that banks in this state are best positioned to serve their communities.

The vast majority of the MBA's member banks are community banks. Even within the community bank category, Minnesota banks are fairly unique. As of June 30, 2012, Minnesota had 383 bank charters. Our median-sized institution was $86.2 million in assets. We also had 54 banks (14% of our total banks) with $30 million of assets or less. As you know, a $30 million bank typically has eight to 10 employees.

Based on an understanding that Minnesota banks can only truly be successful if they act as responsible citizens and stewards of their communities, we fully support actions to ensure safe and sound banking environments that promote and incentivize the efficient use of banking services.

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However, the Basel III proposals do not support these goals and should be rejected or amended for the following reasons:

- The diverse make-up and business models of our nation's banks do not fit the complex, standardized Basel III approach which will lead to several banks exiting the targeted areas and ultimately leaving consumers with less competitive options.
- Basel III is duplicative and unnecessarily burdensome as regulators already have mechanisms to protect the financial system from high risk and delinquent loans.
- Realizing of unrealized gains and losses of available-for-sale (AFS) securities will create dramatic changes in bank capital requirements based on economic cycles with little actual change to most banks' risk profiles as bond portfolios are generally comprised of low-risk issues managed for interest rate and liquidity risk purposes.
- Harsh treatment of residential real estate will further limit supply of products available to consumers with little impact on the businesses and practices that led to the recent financial crisis.
- Elimination of certain capital elements like trust preferred securities and deferred tax assets will negatively impact smaller institutions' ability to raise funds in the marketplace, resulting in lesser funds available for consumer and small business lending during times of economic improvement.

These points highlight the primary concerns we have regarding the negative impact these proposed rules will have on Minnesota banks and access to credit for their communities. We will expand on these points further in the attached document.

Respectfully,

Craig D. Foss
Associate Counsel

Attachment

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BASEL III PROPOSED CAPITAL RULES IMPACT ON MINNESOTA BANKS

I. Basel III Proposals Are Unnecessarily Complex and Burdensome Without Meaningfully Improving the Safety and Soundness of the Banking System or Consumers' Efficient Use of Credit

The complexity of the proposed rules is already evident in comments made by those in the best position to understand them. Recently, Federal Reserve Board Chairman Ben Bernanke publicly commented that the proposed rules would not affect institutions under $500 million in assets. The Basel III proposal actually applies to all banks, regardless of size. If the rules' promulgators are unclear on the impacts, how are ordinary working bankers in communities across the country going to be able to comply? Also, FDIC Director Thomas Hoenig has recently called for regulators to reject this proposal and pursue a more simplistic system. These comments highlight the disagreement at the top regarding this proposal's impact, efficiency and effectiveness.

The 1,000-plus pages of proposed capital rules should not be rejected purely on its size. It is, however, representative of the resources which must be dedicated by all banks in order to attempt to comply. This burden must be considered. There are at least a few banks that would be strengthened by the rigid rules, but the system as a whole would benefit from regulators applying the existing framework to individual bank strategies. Such an approach would allow regulators to take account of individual risk management strategies and more effectively ensure the sufficiency of each bank's capital cushion. The proposed rule, on the other hand, will result in many banks simply no longer being able to compete in the marketplace, leaving consumers with less choice. Less choice is obviously bad for consumers.

II. Benefits of the Basel III Proposals Do Not Outweigh the Costs

We understand that uniformity in regulation can be a benefit, however, this benefit must be weighed against the costs that will be incurred. For the majority of Minnesota banks the costs far outweigh any benefit. There is little reason for these banks to develop sophisticated capital planning and monitoring tools as these potential rules will require. While the Basel III proposals may be commensurate with the risk profile of the Royal Bank of Scotland ($2.28 trillion[1]) or Spain's Banco Santader ($1.66 trillion[1]), they do not make sense, neither functionally nor economically, for banks like Franklin State Bank in Franklin, Minnesota ($27 million[1]) and our many similarly situated members.

On the cost side, all banks will be required to develop sophisticated capital tools. This development and ongoing monitoring will be very resource intensive. The largest banks may be able to incorporate the analysis into existing systems; but for the many banks without such sophisticated modeling needs for their core business, an undue amount of resources will be shifted toward capital planning. This means resources will be shifted away from seeking opportunities that benefit consumers and the community. For many Minnesota banks, the process to manage capital under Basel III will devour more resources than can be saved by moving away from traditional capital management techniques.

[1] Total assets as of June 30, 2012, denoted in U.S. dollars

III. Basel III Treatment of Residential Real Estate is Detrimental to the Housing Market and Duplicative as it Seeks to Safeguard Against Risk Currently Managed by Bankers and Regulators Through an Allowance for Loan and Lease Losses (ALLL).

The treatment of residential real estate in the Basel III proposal will have immediate and harmful effects on consumers seeking home loans. For many Minnesota banks, home loans represent low-risk portfolio diversification. In fact, several institutions have reported a long history of never losing a penny on a home loan. However, the Basel III proposal appears to punish the lenders offering home loans to their consumers. The negative result of this punishment is amplified as many lenders have already left this market because the cost of regulatory compliance, reporting, and record keeping are simply too high.

While the residential real estate market is already dominated by the largest lending players, smaller banks offer niche products, such as adjustable rates or balloon loans, that consumers have sought out to meet credit needs. For most Minnesota banks, these residential real estate loans have resulted in little or no loss over the last several years. These loans have historically represented a relatively low risk to a bank's capital strength; thus, treating all such loans across the board with an arbitrarily high risk weighting is unwarranted. We support a 20 percent weighting for such traditionally low risk loans. For those particular loans that elevate the bank's risk profile, the regulator-scrutinized ALLL should continue to be the safeguard against losses.

Home equity and second lien loans should be treated in the same manner. We have heard from a number of member banks who believe that Basel III's punitive treatment of lenders holding both the first lien and second lien is unsubstantiated. Lenders holding the entire credit relationship are in a better position to work with borrowers on credit improvements or take swift action to limit loss when borrowers default. To arbitrarily decide that the credit risk is higher on first lien loans for no reason other than the subordinate lien is owned by the same bank is contrary to tried and true bank standards and will ultimately be detrimental to consumers' ability to stay in their homes during times of difficulty.

As described above, the ALLL has served for decades as banks' primary defense against credit losses. This area has been strenuously examined by regulators with a vigor that has increased greatly over the last several years; bankers are now functionally required to have both the technical accounting understanding of CPAs and the statistical modeling know-how of mathematicians. While bankers have adapted to these ALLL standards, the Basel III proposals will effectively require that additional capital be set aside twice for many loans. With these loans being assigned arbitrarily high risk weightings and requiring inclusion in the ALLL cushion, many bankers will simply exit that market. This will harm consumers by leaving them with fewer choices and less competition. We recommend that these proposals be rejected or amended to mitigate the detrimental effects to banks and consumers of being double counted in the capital cushion.

IV. Loan-To-Value Definitions Must Be Clarified and Consequences Considered

While loan-to-value (LTV) ratios are an element of determining credit quality, they are only one piece of the puzzle. In addition, they are very difficult to effectively monitor over time. The Basel III proposed rules require risk weighting of every residential real estate loan based on LTV. However, the rules do not provide what value is to be used. If banks are required to hold additional capital based on initial LTV, banks will become over-capitalized as the loan amount is paid down (as the vast majority of loans do).

This over-capitalization of a relatively low-risk product will lead banks to exit this lending market. Alternatively, if values are required to be updated periodically, based on examiner-expected valuation guidelines, the cost of compliance will outweigh any financial benefit of making these loans, causing banks to exit the market. Either scenario will lower market competitiveness and hurt consumers' ability to get these loans. This will be harmful for consumers and will hinder economic recovery. Accounting for risk in the lending portfolio is best achieved through effective management of the ALLL, not through arbitrary capital retention standards.

Furthermore, we are concerned about the additional recordkeeping and reporting that will be required by these proposed rules. In addition to the obvious changes to Call Reports such as those needed to reflect the new common equity tier 1 capital ratio and the new capital conversion buffer calculations, monitoring of the LTV changes will also be needed. Many smaller banks already devote considerable resources to regulatory reporting. The incremental recordkeeping, data mining, and monitoring costs must be considered for small and medium sized banks individually. Though the cost associated with these changes seems small when compared to the capital positions of the world's largest banks, for many banks in Minnesota it will be the last straw.

V. Capital Requirements Related to Representations and Warranties on 1-4 Family Residential Real Estate Loans Sold in the Secondary Market are Overly Broad.

We agree that capital should be set aside to mitigate risk to the financial system, however, such requirements must be narrowly tailored to actual risks that jeopardize the Deposit Insurance Fund. The Basel III proposals in their current form require banks who have sold in the secondary market to hold capital for the total amount of the loan for the life of the loan. This appears to be true even where the originator's liability is contractually limited to only a fraction of the loan or premium initially received. For those institutions that sold loans which are still active, the impact could potentially be devastating despite very little actual risk of loss to the institutions.

In the event that these prior sales would be "grandfathered" in and only newly sold loans would be subjected to the proposed capital requirements, it is our humble opinion that all but the largest banks will simply exit this market. This will leave consumers with fewer options and less competition to ensure better prices.

VI. Proposed Treatment of Unrealized Gains and Losses on Available-For-Sale (AFS) Securities Will Be Detrimental to Risk Management Practices and Community Support

The Basel III proposals regarding changes to the treatment of unrealized gains and losses on AFS securities will significantly impair many banks' ability to appropriately measure and monitor interest rate and liquidity risk. In addition to low risk U.S. Treasury and agency bonds, our member banks typically hold municipal securities to better serve their communities. These local bond purchases are one way the banks serve the needs of their communities and have represented low risk to the financial system. The proposed rules will limit the opportunity for banks to purchase and hold these bonds. This will negatively impact numerous Minnesota communities that rely on their local banks for support.

VII. Trust Preferred Securities and Deferred Tax Assets Represent Contributions to Capital Necessary For Smaller or Rural Banks to Provide Services to Their Communities

For many banks that are not publicly traded, access to new sources of capital is limited. The limitation is magnified outside of population centers where there are simply fewer wealthy individuals looking to make capital contributions to any entity. Bankers and regulators have agreed for a long time on the benefits of allowing non-traditional capital components to be included in the tier 1 capital calculations. It was for this reason that Congress' intent, memorialized in the Dodd-Frank Act, allowed for the continued use of trust preferred securities for smaller banks. To eliminate these as effective capital sources will leave many banks with even fewer reasonable sources of capital despite Congress' intent to preserve them.

Furthermore, the 10% annual phasing out of these securities from tier 1 capital inclusion is simply impractical for any institution without ready access to robust capital markets. Many privately-held banks find capital injection opportunities to be few and far between. To expect that these banks will be able to go in to the market a little more each year is unrealistic. These banks will likely either find the necessary capital all at once or be forced to decrease their ability to serve their communities. This, in many cases, will lead smaller banks to sell out to larger out-of-area competitors.