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GEORGIA BANKERS ASSOCIATION

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October 12, 2012

The Honorable Thomas J. Curry, Comptroller
Office of the Comptroller of the Currency
regs.comments@occ.treas.gov
Docket ID OCC-2012-0008 and OCC-2012-0009
RIN 1557-AD46

The Honorable Ben S. Bernanke, Chairman
Board of Governors of the Federal Reserve System
regs.comments@federalreserve.gov
Docket R-1430 and R-1442
RIN No. 7100-AD 87

The Honorable Martin J. Gruenberg, Acting Chairman
Federal Deposit Insurance Corporation
comments@fdic.gov
RIN 3064-AD95 and RIN 3064-AD96

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

Heads of Agencies:

On behalf of our members, we, the Georgia Bankers Association (the "GBA"), wish to provide you with our comments on the Basel III Proposal and the Standardized Approach Proposal (together, the "Proposals"). This letter does not address provisions that apply only to "advanced approaches" banking organizations.

By way of background, the GBA has a membership consisting of the vast majority of commercial banks and thrifts, which we refer to as "banks" in this letter, in Georgia. In addition, we have a large number of associate members who serve the needs of financial institutions in the state. We have communicated directly with our member banks to study the impact of the Proposals on the banks and their holding companies, which we refer to collectively as "financial institutions" or "institutions" in this letter, and wish to provide you with the comments and responses we have received from our members.

We believe that financial institutions in Georgia are uniquely positioned to comment on the Proposals. Much of the content of the Proposals seems to be driven by a desire to ensure that financial institutions are better positioned to deal with the problems faced in the recent financial crisis when the next downturn occurs. Our members experienced the "main street" effects of the financial crisis to a degree that few others did and therefore have great insight to offer with respect to the appropriate measures to take in order to protect financial institutions from the risks of future financial downturns. While we understand the need to revise and update existing regulations to better respond to these risks, we submit that there are serious flaws in the Proposals that will have unintended consequences with a disparate impact on regional and community banking institutions and the communities they serve.

We have organized our specific comments on various provisions of the Proposals into separate sections below.

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I. General

We believe that the Proposals present a wide array of implications to institutions that are not yet fully understood. Any one of the material provisions of the Proposals could create a substantial change in bank balance sheets and the way that banks do business. By finalizing all of the changes simultaneously, we believe it is likely that the Proposals will introduce complementary risks to financial institutions, the consequences of which are not yet fully understood. Therefore, we believe that the regulatory agencies should withdraw the Proposals in order to take more time to study the potential impacts of various components of the Proposals. We believe the regulatory agencies should then analyze those impacts under a variety of market circumstances, which would be consistent with appropriate industry risk management principles.

We also believe that the Proposals attempt to take too much authority from experienced bankers and regulators to make rational and customized evaluations of risk. We believe the most effective and appropriate regulation is implemented through an understanding of the risk profile of a given institution and therefore can only be implemented by individuals familiar with the institutions and experienced in managing and regulating banks in a variety of economic circumstances. Therefore, we do not believe that quantitative proxies for risks of certain assets classes, such as loan-to-value ratios, are complete and appropriate measures of risk, and we suggest placing more emphasis on principled and qualitative measures of risk as monitored by bank management and experienced regulators.

To the extent that the Proposals are not withdrawn, we believe the final rules should incorporate an exemption for community banking institutions. As discussed in a variety of sections below, we believe the Proposals will have a disparate impact on community banking institutions. These institutions, as well as many regional institutions, have simple and traditional balance sheet compositions. Generally speaking, community banks take deposits from their local customers and then make loans in their local market areas. These institutions generally do not invest in securitizations, do not utilize complex derivatives, and do not engage in substantial off-balance sheet transactions.

Community banks also do not have the operational capabilities, from a scale and risk management perspective, to manage the volatility of bank balance sheets that will be introduced if the Proposals are adopted without substantial modification. As a result, community banks will need to further limit their product offerings or price them substantially higher than the comparable products of more complex banks in order to mitigate the risks introduced by the Proposals. Either of these changes would impact the communities served by these institutions and the small businesses and consumers in those communities.

As a result, to the extent that the Proposals are not withdrawn, we believe that the Proposals should be modified to exempt community banking institutions, including regional institutions, from some or all of the requirements of the Proposals. Through this modification, these banks could continue serving their communities in the traditional manner that they have utilized for decades.

II. Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action

A. Increases in Required Capital. Our members recognize that the expectations for minimum levels of capital for financial institutions have changed in the wake of the recent financial crisis. However, we are concerned that the long-term consequences of raising minimum capital levels in the industry are not yet truly understood and that changes in minimum capital levels should not be implemented until the regulatory authorities have an opportunity to study the impact of the proposed risk-weighting rules on the industry. As further described below, we believe that the proposed risk-weighting rules, if adopted as proposed, could have a material impact on the composition of banks' balance sheets. These changes will impact the profitability of many financial institutions as well as the risk profiles of the institutions. It is only after understanding these changes that the regulatory authorities can truly determine the appropriate minimum capital levels that provide stability to the industry while allowing financial institutions to achieve returns on equity that enable them to attract new sources of capital.

In addition, we note that the proposed changes to minimum capital levels are being proposed at a time when sources of capital are still scarce for many financial institutions. The uncertainty of the impact of the Proposals only exacerbates this already difficult situation. As a result, we submit that forbearance on the implementation of new minimum capital levels would be appropriate.

B. Capital Conservation Buffer. We also believe that the restrictions proposed for financial institutions that do not maintain the full capital conservation buffer required by the Basel III Proposal should be reconsidered. As more fully described below, we believe the existing regulatory framework adequately addresses these concerns in a more appropriate fashion.

Financial institutions that do not maintain the full capital conservation buffer will be subject to restrictions on capital distributions and on the payment of executive compensation. The existing regulatory framework contains appropriate restrictions on the payment of dividends. The regulatory agencies have existing rules or policies in place that require financial institutions to consult with, or obtain the approval of, the appropriate regulatory agency prior to paying a dividend that is in excess of an established percentage of recent earnings of the institution. We believe these regulations and policies provide adequate safeguards against the payment of dividends under circumstances that are not appropriate.

Further, the dividend restrictions for institutions that do not maintain the full capital conservation buffer do not contain an exception for capital distributions paid by institutions taxed under Subchapter S of the Internal Revenue Code of 1986, as amended. These institutions do not pay income taxes directly. Instead, the tax liability passes through to the institutions' shareholders in accordance with the shareholders' percentage ownership in the institution. As a result, it is generally expected that the institution will provide a distribution to the shareholders to allow them to fund their respective tax liabilities. By potentially restricting those capital distributions by S Corporations, the Basel III Proposal is overly punitive to S Corporations because these distributions functionally serve as a substitute for the institution's payment of income taxes. In addition, the Basel III Proposal places undue risk on the shareholders of S Corporations, making these institutions a less attractive investment for investors. We point out that according to a 2009 report by representatives of the Federal Reserve Bank of New York, almost one-third of the banks in the U.S. were S Corporations. As if June 30, 2012, Georgia had 65 S Corporation institutions, representing 28% of the institutions in our state.

In addition, under the existing regulatory framework, institutions that are not in a safe and sound condition become subject to supervisory restrictions on forms of executive compensation through regulatory enforcement actions or through the "golden parachute" payment restrictions under Part 359 of the regulations of the Federal Deposit Insurance Corporation and other companion regulations. We believe these supervisory measures are adequate to prevent the payment of excessive executive compensation for institutions that are not in a safe and sound condition. In addition, the *per se* restriction on the payment of executive compensation contained in the Basel III Proposal for institutions that do not maintain the full capital conservation buffer will place such institutions at a disadvantage with respect to executive retention and recruitment. It is oftentimes the case that these institutions could most benefit from having good management, even when it means using additional capital to compensate them.

We believe that it is appropriate to leave decisions regarding restrictions on the payment of executive compensation and capital distributions to the discretion of the regulatory authorities on a case-by-case basis. During the recent downturn, we did not observe any instances among our members in which excessive compensation practices or excessive dividends led to the stressed financial condition of an institution. By leaving the existing regulatory framework intact, individuals who are familiar with the circumstances of the individual institution, as well as the then-current banking and economic environment, would be allowed to make sound decisions on these matters.

C. <u>Inclusion of Accumulated Other Comprehensive Income in the Calculation of Common Equity Tier 1 Capital</u>. We are concerned about the volatility that would be introduced to bank balance sheets through the inclusion of Accumulated Other Comprehensive Income ("AOCI") in the calculation of Common Equity Tier 1 Capital ("CET1"). The primary driver of AOCI (or loss) for most institutions is unrealized gains and losses in the available-for-sale securities portfolio. We believe introducing a rule that causes increased volatility to bank balance sheets during periods of rising and falling interest rates (generally periods of economic expansion and contraction) would be harmful to the industry.

By way of background, in 1995 the Financial Accounting Standards Board created SFAS 115 dealing with the accounting for investment securities. SFAS 115 required banks to classify their securities based on their ability and intent regarding how the securities would be utilized in the operations of the bank.

- Securities purchased for trading purposes and that would be sold in response to market risk or other market changes were classified as trading securities and were required to be included in the financial statements at fair value with changes in fair value recorded through the income statement.

- Securities purchased for which the bank had the ability and intent to hold the securities to maturity were to be classified as investment securities and were to be recorded at amortized cost. Fair value of the securities would be disclosed in the financial statements but not recorded.

- Securities purchased for investment but for which the bank did not have either the ability or the intent to hold them to maturity were to be classified as available-for-sale securities and would be recorded at fair value with the changes in fair value recorded in AOCI included in the equity section of the balance sheet.

Requirements were also issued dealing with other-than-temporary impairments (OTTI) of securities, which required recognition in the income statement of an impairment of value of any security that was considered other than a temporary decline in value. Also in 1995 the regulatory authorities issued a rule that stated that unrealized gains (losses) recorded in the equity section of a bank's balance sheet would not be included in Tier 1 regulatory capital. FDIC Chairman Ricki R. Tigert stated, "We believe regulatory capital levels would be unnecessarily volatile, without appreciable benefits to the safety and soundness of the banking system, if institutions were required to include all unrealized securities losses in their regulatory capital calculations." As a result, unrealized gains and losses on available-for-sale debt securities and unrealized gains on equity securities were excluded from Tier 1 regulatory capital.

The inclusion of the unrealized gains or losses in CET1 creates volatility in a bank's capital base that may never be realized. Interest rate swings create increases and decreases in market value of securities that do not reflect realized or, in many cases, probable changes to value. Many available-for-sale securities are classified in that category so that those securities may be used to strengthen liquidity positions and to provide flexible resources for prudent balance sheet management.

We believe the volatility that would be added to bank balance sheets by the proposed rule is contrary to the objectives of sound regulation. Bank balance sheets are managed with a significant goal of being neutral to changes in interest rates. Your agencies specifically examine the institutions you regulate for their sensitivity (or lack thereof) to market risk. By including AOCI in CET1, the Basel III Proposal necessarily causes the capital levels of financial institutions to be more sensitive to changes in interest rates. The volatility in capital calculations could lead to a number of problems for banks, including significant variations in their legal lending limits as capital fluctuates.

To illustrate this point, we surveyed a number of our members to gain a better understanding of how the inclusion of AOCI in CET1 could impact their capital ratios. Respondents were asked to provide the change in their pro forma Common Equity Tier 1 capital ratios as of June 30, 2012 based upon a 300 basis point increase in interest rates. The impact on the respondents' pro forma CET1 ranged from a decrease of 1.7% to a decrease of approximately 39%. The average impact was a 21% decrease in capital. We fail to see how introducing such volatility to institutions' capital ratios based on changes in interest rates is consistent with regulating banks to be more safe and sound.

In addition, we believe the supervisory concerns expressed in this portion of the Basel III Proposal have already been adequately addressed. As stated above, to the extent that an institution intends to sell securities in response to market changes, those securities are held in a trading account, and changes in value are reflected in the institution's income statement (and therefore its Tier 1 capital). In addition, if a security is other-than-temporarily impaired, the impairment is most likely charged to earnings, which again would cause that impairment to be reflected in the institution's Tier 1 capital. Given that the capital impact under the proposed rules would be no different for available for sale securities than those held in trading accounts, some banks may seek to move securities into trading accounts and become more active in securities trading, which we do not believe would be beneficial to the industry.

If this portion of the rule is adopted as proposed, smaller financial institutions that do not have the ability to hedge this risk will essentially be left with two options: reclassify available for sale securities as held-to-maturity securities, thereby reducing the liquidity of the institution, or maintain enough capital to meet appropriate capital ratios under all foreseeable interest rate scenarios. If the latter approach is taken by an institution, the institution will likely reduce its total and risk-weighted assets in order to obtain the desired capital ratios. In doing so, it will restrict lending in its community, thereby impacting the community and the consumers in it. In addition, smaller institutions will be forced to purchase primarily shorter-term investment securities, which will ultimately put negative pressure on their earnings and could have a significant impact on the municipal bond market.

We do not believe that including AOCI in CET1 will promote any desired supervisory objective. Instead, it will increase the volatility of bank balance sheets, which is contrary to our understanding of the objectives of the Basel III Proposal. In response, many banks would be forced to either reduce their liquidity or restrict lending in their communities, or some combination thereof. As a result, we suggest that this provision of the Basel III Proposal be removed.

D. <u>Phase Out of Restricted Core Capital Elements</u>. The Basel III Proposal phases out from Tier 1 capital eligibility the proceeds received from the issuance of certain securities that are considered "restricted core capital elements" under the current rules. Most notably, proceeds from issuances of trust preferred securities are phased out from Tier 1 capital eligibility.

While we appreciate the length of the phase-out period for those institutions with less than $15 billion in assets, we believe that the legislative intent expressed in the adoption of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") to exclude those institutions with less than $15 billion in assets should be respected. While the preemptive effects of Dodd-Frank can be debated, it is clear that our lawmakers made a reasoned choice to provide relief for institutions of less than a certain size from the impact of this change in law. To then adopt a regulation that goes beyond that exclusion is to ignore that choice.

Furthermore, the Board of Governors of the Federal Reserve System (the "Federal Reserve") has long recognized that institutions of different sizes should be treated differently in how capital rules apply to them. For example, the

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Federal Reserve has for years maintained its "Small Bank Holding Company Policy Statement," which excludes the smallest bank holding companies from the requirement to maintain consolidated capital ratios. There is no reason that institutions below the size threshold set by Congress should not be excluded from this phase-out.

This phase-out could have a material impact on the capital ratios of bank holding companies in Georgia. Based on our analysis, approximately 50 bank holding companies in Georgia have subordinated debentures related to trust preferred securities currently outstanding. We believe that each of them will need to augment their capital planning to find replacement sources of capital, even if the institution's current assets fall below the $500 million threshold for application of the Basel III Proposal to bank holding companies. The reasons that bank holding companies with total assets below the $500 million threshold would need to account for the phase-out of trust preferred securities as a source of Tier 1 capital include future plans for expansion and growth and the lack of ability of acquiring banks to assume the trust preferred securities as a source of Tier 1 capital upon an acquisition.

Generally speaking, institutions below $15 billion in total assets have far less access to capital markets than those above that size threshold. By extending the phase-out of proceeds from the issuance of trust preferred securities from Tier 1 capital eligibility, the Basel III Proposal would require these institutions to access the equity markets, which can be a tremendous challenge. While holders of trust preferred securities can be problematic under certain extreme circumstances, the vast majority of institutions that issued trust preferred securities have had no issues with the holders given the limited rights provided to the holders. In these cases, the trust preferred holders have truly conducted themselves as holders of preferred equity of the institution. Therefore, we see no reason to phase out the eligibility of proceeds from the issuance of trust preferred securities as Tier 1 capital in advance of the stated maturity of those securities.

E. <u>Phase-Out of Deferred Tax Assets from Tier 1 Capital Eligibility</u>. The Basel III Proposal limits the inclusion of deferred tax assets in capital. As a part of these rule changes, deferred tax assets that arise from operating loss and tax credit carryforwards ("Covered DTAs"), net of any related valuation allowances, are subject to a full deduction from CET1. We believe that the full deduction of Covered DTAs from CET1 represents an overreaction and that there are appropriate circumstances under which an institution should be allowed to include the value of its Covered DTAs in its capital.

Under current regulatory accounting rules, as well as U.S. Generally Accepted Accounting Principles ("GAAP"), institutions are required to periodically review their deferred tax assets, including Covered DTAs, to assess whether a valuation allowance (a contra-asset) should be established. As a part of that review, management must project earnings of the institution over the next twelve-month period, which is already a much more restrictive approach than the approach under GAAP, which allows for consideration of many more factors. To the extent that the institution does not project earnings over that period that allow it to fully utilize its Covered DTAs, it must establish a valuation allowance against the portion of the deferred tax asset that management does not reasonably expect to utilize over the next twelve-month period. Management's judgment is then reviewed by bank examiners and the institution's accountants.

Based upon that rigorous review process, we believe that any portion of an institution's net Covered DTAs should continue to be available for inclusion in the institution's CET1. These net Covered DTAs represent only the portion of an institution's Covered DTAs that it anticipates utilizing over the next twelve months based upon projections reviewed by bank examiners and the institution's accountants. Based upon our experience in the recent financial crisis, both bank examiners and accountants are conservative in their reviews of deferred tax asset valuation allowances, such that most banks had full valuation allowances against their Covered DTAs throughout the majority of the downturn. It is only now that the economy is beginning to recover that many banks in our state are starting to decrease the valuation allowances against their Covered DTAs. Therefore, we believe that banks are including their Covered DTAs in capital under circumstances that are reasonable.

In addition, exclusion of net Covered DTAs from capital is contrary to the goal of having transparent financial statements. If an institution has a reasonable expectation of realizing the value of an asset, it should be able to include that asset in its capital calculation. Covered DTAs are quite real: the Internal Revenue Service allows net operating loss carryforwards to be utilized for 20 years, which makes Covered DTAs very valuable assets that are likely to be utilized under appropriate circumstances (i.e., a sound capital position and improving economic conditions). Deferred tax assets are also followed closely by bank stock analysts who understand the value of these assets to financial institutions. We view the recognition of net Covered DTAs in capital as being no different in principle from the inclusion of "bargain purchase" gains in capital. Such gains are based upon a valuation of the acquired business relative to the consideration paid for the business. The acquiring entity may or may not ultimately realize the value of the acquired business provided in the valuation, but, in order to have transparent financial statements, the gain is included in capital. This goal of transparency was a driver behind the elimination of "negative goodwill" in accounting guidance.

The exclusion of Covered DTAs from CET1 also creates an arbitrary and incomplete representation of an institution's tax planning strategies. A financial institution's tax strategies are complex and involve the utilization of tax planning techniques that minimize the current tax liability and provide the resources and investments to sustain the institution's financial health and viability. Tax planning for a financial institution involves decisions regarding loan loss reserves, charge offs, depreciation, and investment portfolio composition, among other factors. The ability to realize future tax benefits in the institution's capital calculations is vital to allowing a continuation of longstanding approaches to tax planning for the industry.

Therefore, we believe full deductions of net Covered DTAs would be an overreaction in that current accounting rules already address this issue and elimination of net Covered DTAs in capital would lead to less transparent financial statements for financial institutions. If anything, we believe that regulatory accounting principles and capital rules should be brought in line with the approach found in U.S. Generally Accepted Accounting Principles, which take into account a wider variety of factors in evaluating the quality of deferred tax assets.

F. Limitation on Inclusion of Allowance for Loan and Lease Losses in Regulatory Capital. Based on the cumulative impact of the various items in the Proposals that force a "double-counting" of numerous risk elements on bank balance sheets, we believe it is now appropriate to eliminate the current arbitrary regulatory limitation on the amount of an institution's Allowance for Loan and Lease Losses that is includable in its Tier 2 capital. By removing that limitation, which is currently set at the amount equal to 1.25% of total risk-weighted assets, the double counting impact of the proposed increased risk-weighting of various assets would be offset to some degree, at least with respect to the calculation of the total risk-based capital ratio.

In addition, this change would be beneficial because expectations for reserve amounts are continually evolving, generally toward an expectation that banks will maintain higher reserve levels. A factor in implementing the limitation on the amount of banks' Allowances for Loan and Lease Losses includable in regulatory capital was the perception that banks were managing earnings through over-reserving in times of low credit losses. We believe this issue no longer exists because regulatory and accounting expectations are now that banks will maintain robust Allowances for Loan and Lease Losses during all economic cycles. In addition, this change would be meaningful to Georgia banks. We calculate that there were 210 Georgia banks, or 89% of all Georgia banks, with Allowances for Loan and Lease Losses in excess of 1.25% of their total risk-weighted assets as of June 30, 2012, creating over $1.2 billion in excess loan loss reserves that are currently disallowed in total capital calculations for the banks in our state.

G. Limitation of Inclusion of Value of Mortgage Servicing Assets. The Basel III Proposal limits the inclusion of the value of mortgage servicing assets to ten percent of the institution's CET1, and possibly less if the institution has other "threshold deductions." A number of our members originate mortgages, sell the mortgages in the secondary market, and retain the servicing rights to provide a future stream of income. We believe these institutions represent

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some of the best and most prudent loan servicers available. However, instead of promoting their participation in the industry, the Basel III Proposal further limits their involvement in mortgage loan servicing. We have already seen some larger institutions sell their mortgage servicing assets to non-depository servicers. As discussed more thoroughly below, we believe limiting the inclusion of the value of mortgage servicing assets in institutions' capital, when combined with other factors, is serving to force banks out of the mortgage industry when we believe that banks are very valuable to the mortgage industry.

H. Small Savings and Loan Holding Companies. As a result of the Federal Reserve's Small Bank Holding Company Policy Statement, the Basel III Proposal generally would not apply to bank holding companies with total consolidated assets of less than $500 million. However, because the Small Bank Holding Company Policy Statement does not cover savings and loan holding companies, there is no similar exemption for savings and loan holding companies with less than $500 million of total consolidated assets. Smaller savings and loan holding companies face the same challenges that smaller bank holding companies do with respect to raising capital. They generally do not have access to public equity markets and therefore need to rely on alternative sources of capital, such as debt. Further, because these companies have not previously been subject to consolidated capital requirements, many of them do not presently have capital structures that would allow them to comply with the requirements of the Basel III Proposal. Therefore, should the more general exemption discussed above not be adopted, we suggest inserting an exemption for savings and loan holding companies with less than $500 million in total consolidated assets. To fail to do so would be unnecessarily punitive to small savings and loan holding companies.

III. Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements

A. Revised Risk-Weighting Residential Mortgage Exposures. Over the past several months, we have had extensive discussions with our membership regarding the Proposals. We facilitated roundtables of bank executives, hosted webinars regarding the Proposals, and developed a "task force" to study the impact of the Proposals on Georgia banks. We have received a wealth of helpful feedback through these processes. Among all of the comments regarding the Proposals that we have received, the comments regarding the changes to risk-weighting of residential mortgage exposures are the most consistent and alarming. We have set forth below our concerns with the proposed modifications and implore the regulatory authorities to reconsider these proposed changes.

1. *Balloon features as a disqualifier from category 1 treatment.* The Standardized Approach Proposal divides residential mortgages into two categories (referred to simply as "category 1" and "category 2" exposures) for purposes of determining risk-weighting. Category 1 exposures are generally viewed as having less risk and therefore are assigned more favorable risk weights, depending upon the loan-to-value ratio for the exposure.

Among the eight broad requirements for a residential mortgage exposure to qualify as a category 1 exposure is the requirement below:

> The terms of the residential mortgage exposure provide for regular periodic payments that do not: (i) result in an increase of the principal balance; (ii) allow the borrower to defer repayment of principal of the residential mortgage exposure; or (iii) result in a balloon payment.

We submit that the requirement set forth in clause (iii) above regarding balloon payments will have an unanticipated and unnecessary impact on bank balance sheets, particularly those of smaller banks.

As an interest rate risk management tool, most community banks structure their residential mortgage loans on the basis of a 15-, 20-, or 30-year amortization of principal with a balloon payment at the end of two, three, or five years. By doing this, the principal amount of the loan amortizes, but the bank has the ability to review the credit and change its terms at the time of maturity. Most importantly, the balloon payment structure allows the bank to shorten the duration of the asset, which allows the bank to better match the durations of its liabilities. That concept of matching durations is critical in managing a bank's interest rate risk.

The other methods of mitigating interest rate risk relative to longer-term mortgage loans are not practically available to community banks. For example, an institution may enter into swap arrangements or purchase other derivatives to manage interest rate risk. It may also utilize longer-term sources of funding in order to match the duration of longer-term assets. Smaller institutions generally do not enter into complex interest rate swap arrangements or engage in other derivative transactions to hedge interest rate risk. They are also criticized by their examiners if they rely too heavily on "non-core" sources of funding which means that these institutions must rely on the deposits of local customers for funding. These traditional sources of funding typically have shorter durations, causing community banks to seek assets with shorter durations.

As a result, smaller community banks have only three practical alternatives to avoid the punitive risk-weighting associated with category 2 mortgages:

- Accept interest rate risk by making mortgage loans with longer durations so that they can be fully amortizing;
- Enter into derivative transactions or rely more heavily on longer-term "non-core" sources of funding to manage interest rate risk on the liability side of the balance sheet; or
- Stop making residential mortgage loans that will be held in the banks' portfolio.

Given that the first alternative of accepting interest rate risk was a significant factor in a prior banking crisis, it is our hope that few bankers, if any, would accept that alternative. The second alternative of entering into derivative transactions or relying on non-core sources of funding also seems unattractive given the regulatory criticism of smaller banks' use of non-core funding and the practical unavailability of complex derivative transactions to smaller institutions. We believe managing the duration of the loan directly is a much more attractive alternative in that it is transparent and easily understood by bankers, examiners, and bank directors.

Possibly the worst alternative is the third: reducing or eliminating residential mortgage loans from banks' portfolios. As of June 30, 2012, financial institutions in Georgia with less than $1 billion in total assets (those institutions less likely to utilize complex interest rate risk management techniques) held an aggregate of approximately $7.1 billion, or 28% of the aggregate gross loans for those banks, in 1-4 family mortgage loans, which represents a significant contribution to the ability of the citizens of Georgia to purchase homes. Based on member surveys, we believe that the vast majority of those loans would be deemed to be category 2 exposures under the Standardized Approach Proposals. One of our members reported that a resident of an adjoining county was unable to obtain a conventional residential mortgage loan because of the lack of comparable home sales in that rural county. Given the local bank's knowledge of the market, it was able to underwrite and make the mortgage loan. Without the support of this nearby bank, which offered the loan with a balloon payment structure, the consumer would have been unable to purchase his home.

There are many similar stories in Georgia and across the country. Examples of borrowers who may not qualify for traditional mortgages include consumers who are self-employed and therefore do not have consistent documented income, notwithstanding the fact that the borrower clearly has the financial wherewithal to repay the loan. We believe the economic impact of the proposed change to the risk-weighting of residential mortgage exposures would be real and would directly impact the consumers who need these loans that would otherwise not be available in their market.

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We also wish to address the implication that residential mortgage loans with balloon features are more risky than those without balloon payment features. Particularly when considering those loans that are structured with amortization of principal throughout the duration of the loan, our members have suggested to us that they have no greater loss history with loans with balloon payment structures than with other loans. To the contrary, many bankers feel that such a structure enhances the protection afforded their bank by allowing the bank to review the credit periodically and renew it if it deems a renewal of the loan to be appropriate. At renewal, the bank may adjust the interest rate and other terms of the loan (including requiring additional principal paydowns) as the circumstances merit. Of course, if a bank makes a decision to renew the loan when the balloon payment is due, it would be required to renew the loan in accordance with its loan policy. If the credit is stressed at the time of renewal, the risk rating of the loan would be downgraded. Such a downgrade in the risk rating of the loan might result in additional loan loss reserves for the bank, thereby reflecting the increased risk of the loan in the bank's CET1 at renewal.

If the residential mortgage exposure rules in the Standardized Approach Proposal are adopted without eliminating the balloon structure exclusion from the category 1 exposure definition, the vast majority of mortgage loans held by community banks will be deemed to be category 2 exposures. As a result, community banks will be required to hold more capital against those loans, thereby reducing the bank's capacity to make other loans and/or requiring the bank to increase the pricing of those loans substantially, which would have a direct impact on the borrower. We do not believe this outcome is the intent of the Proposals, and we therefore suggest eliminating the balloon structure exclusion from the definition of category 1 residential mortgage exposure.

2. *Reliance on LTV measures and appraisals in establishing risk-weighting.* The proposed rules rely heavily on loan-to-value ("LTV") measures and appraisals in determining the risk-weighting for residential mortgage exposures. We submit that the risk weights applied to the various "buckets" of residential mortgage exposures are excessive in some cases and that placing such emphasis on LTV measures is a mistake.

First, we note that for category 2 exposures the risk-weighting for loans with an LTV ratio of more than 80% and less than or equal to 90% is 150%, and the risk-weighting for category 2 exposures with LTV ratios in excess of 90% is 200%. In contrast, the risk-weighting applied to an unsecured consumer loan is 100%. We fail to see how any category of residential mortgage loan, even those secured by junior lien mortgages, could, as a general matter, present more risk to a bank than an unsecured consumer loan. Therefore, we believe that the highest risk-weighting that should be applied to a residential mortgage exposure is 100%.

In addition, we believe LTV ratios represent an incomplete, and therefore inappropriate, measure of risk associated with a loan. For many years, many good bankers have underwritten loans based upon the five C's: capacity, credit, capital, collateral, and character. As a result, the value of the collateral is only one factor in determining the risk of a credit exposure. In some cases, marginal collateral may be offset if the other four categories are very strong. To use an extreme example, few bankers or regulators would view a relatively small first mortgage loan with a balloon feature that is made to a very wealthy and liquid borrower as presenting substantial risk to the bank. Yet, under the Standardized Proposal, if that loan has an LTV ratio of 81%, the credit would receive a risk-weighting of 150%. That outcome seems inappropriate to us.

We also note that the assigned value to be used in calculating the LTV ratio is lesser of the acquisition cost (in the case of a purchase transaction) or the estimated value of the collateral at the time of the relevant origination or modification of the loan. It is our expectation that third party appraisals would be relied upon to estimate the value of the collateral. Throughout the recent economic downturn, it has been well-documented by bankers that appraisals do not always accurately reflect the market value of real estate collateral. At or near the peak of the market, appraisals can artificially inflate real estate values by comparing to recent sales, and the opposite is true in market troughs. Georgia is currently experiencing such a market trough in large part due to the high number of bank closures and the clearing process related to those closures. The inordinate number of real estate transactions taking

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place as a result of this process, together with an unusually high number of foreclosures not related to closed banks, has resulted in downward pressures on real estate values, which may be overstated in appraisals. While we understand that reliance on real estate appraisals is necessary in real estate lending, we caution against what we perceive to be a potential over-reliance set forth in the Standardized Approach Proposal.

To illustrate this point, we note that the regulatory authorities, in accordance with the requirements of Dodd-Frank, recently prohibited reliance by financial institutions on the ratings of credit rating agencies. This prohibition was brought about because, with the benefit of hindsight, these credit ratings were deemed to be inaccurate and unreliable. We submit that the same statement could be made with respect to real estate appraisals. Again, we acknowledge that real estate appraisals play an important role in real estate lending. We believe, however, that placing such an emphasis on those appraisals is inappropriate in light of the substantial additional factors that are involved in determining the risk of a residential mortgage exposure.

3. *Record-keeping issues*. In addition to the problems discussed above, the risk-weighting of residential mortgage exposures proposed in the Standardized Approach Proposal will place a tremendous record-keeping burden on financial institutions. Most financial institutions do not currently have systems in place to stratify their residential mortgage loan portfolios based upon the various factors set forth in the Standardized Approach Proposal. To the extent that you move forward with the Standardized Approach Proposal, we believe appropriate measures should be taken to ease this tremendous administrative burden.

4. *Overall conclusions on proposed risk-weighting of residential mortgage exposures*. As stated above, we believe that the proposed risk-weighting of residential mortgage exposures is perhaps the most problematic change in the Proposals. The impact of the proposed change would be to either shift an interest rate risk management burden to financial institutions, which would cause financial institutions to restrict their residential mortgage lending, or would cause them to drastically increase the pricing of such loans. We believe the proposed change could have a tremendously negative impact on consumers. We also believe that the proposed risk-weightings themselves are inappropriate and that the proposed changes rely too heavily on LTV ratios, which will be in part determined by real estate appraisals, as a proxy for the risk of the asset.

The Standardized Approach Proposal refers to various types of residential mortgage loan products that were problematic during the recent financial crisis, including loans that were not properly underwritten, pay-option adjustable rate mortgages, and subprime mortgages. The proposed risk-weighting of residential mortgage exposures set forth in the Standardized Approach Proposal affects much more than those types of loans. In fact, the proposed rules would dramatically impact the risk weights for many residential mortgage loans that are and have safely been the "bread and butter" of many banks. The consumers hit hardest by the proposed change will perhaps be those served by rural banks that are the only mortgage lenders available in small towns. Many of our members report that the combination of impacts from their traditional balloon product structure and the punitive LTV measures are enough to cause their pro forma total risk-weighted assets to exceed their actual total assets. We believe the implementation of changes to the risk-weighting of residential mortgage exposures should be eliminated.

B. <u>Risk-Weighting of "High Volatility Commercial Real Estate" Loans</u>. For some of the reasons expressed above, we also believe that the increased risk-weighting for loans deemed to be "High Volatility Commercial Real Estate" ("HVCRE") loans is fundamentally flawed. Financial institutions in Georgia were among the hardest hit by falling real estate values and the quickly contracting real estate development sector in recent years. Therefore, our members understand the need to closely monitor poorly managed and excessive concentrations in commercial real estate loans, particularly those commercial real estate loans related to acquisition, development, and construction ("ADC") projects. However, we believe the proposed definition of HVCRE loans is fundamentally flawed, in part because it relies too heavily on the equity injected into the project as a sole determinant of risk.

The Standardized Approach Proposal contemplates that ADC loans that do not meet certain requirements, including that the borrower inject cash or unencumbered readily marketable collateral of at least 15% of the appraised "as completed" value of the project, will be assigned a risk weight of 150%. We have earlier expressed our concerns with what we view as an excessive reliance on real estate appraisals to determine risk-weighting in the prior section, which also applies to the proposed risk-weighting of HVCRE loans. In addition, we suggest that the regulatory agencies study additional factors beyond minimum equity ratios, particularly those based upon appraised "as completed" values, that can mitigate the risk of these loans and thereby remove the loan from the definition of an HVCRE loan. Finally, we submit that there are other appropriate forms of collateral beyond cash and readily marketable assets that can serve as appropriate equity for ADC projects. For example, we believe it could be appropriate to inject real estate as equity into a project, perhaps at a ratio higher than 15%, to remove a loan from the definition of an HVCRE loan.

In summary, we believe that the proposed definition of HVCRE loan ignores many risk mitigation techniques employed by seasoned commercial real estate lenders. As a result, the HVCRE definition should be much more limited so as to take into account those other risk mitigation approaches. If the definition is not further limited, banks will be driven out of financing development activity, which will act to restrain the expansion of the economy.

C. Risk-Weighting of Past Due Exposures. We are also concerned that the risk-weighting of past due exposures in the Standardized Approach Proposal ignores the existing processes by which financial institutions account for past due exposures and is therefore overly burdensome. The Standardized Approach Proposal requires banking organizations to apply a 150% risk-weighting to assets that are 90 days or more past due or on nonaccrual status to the extent that those assets are not secured or guaranteed in accordance with the requirements of the Standardized Approach Proposal.

We believe the risk inherent in past due assets is already reflected on the balance sheets and in the capital ratios of financial institutions under applicable accounting rules. When a loan is 90 days or more past due or on nonaccrual status, it is tested for impairment. When a security is 90 days or more past due or on nonaccrual status, it is tested for other-than-temporary impairment as well. If the asset is deemed to be impaired, management makes a judgment as to the amount collectible with respect to the asset. To the extent that the full carrying amount of the asset is not anticipated to be collected, which, in the case of a loan, is based upon the value of the collateral or anticipated cash flows, the financial institution makes the appropriate accounting entries: for an impaired loan, an increase in the provision for loan losses is charged directly to earnings and a specific reserve is added to the institution's Allowance for Loan and Lease Losses and for an impaired security, the amount is included in AOCI or charged directly to the institution's earnings. In any of those instances, CET1 would be reduced under the Basel III Proposal.

Given that accounting framework, we believe that adding to the risk-weighting of past due assets constitutes unnecessary double-counting of the risk of the assets. Decreasing the numerator of risk-based capital calculations while simultaneously increasing the denominator of the calculation would have a pro-cyclical impact and would unnecessarily strain the capital ratios of financial institutions encountering asset quality problems. This issue is further exacerbated by the arbitrary limitation placed upon the amount of a bank's Allowance for Loan and Leases Losses that may be included in Tier 2 capital discussed above. We submit that existing accounting rules address this issue of risk sufficiently.

To the extent that you move forward with the Proposal and the increased risk-weighting of past due assets is incorporated into the final risk-weighting rules, we suggest broadening the definition of eligible collateral for mitigating the existence of a past due "exposure." Under the Standardized Approach Proposal, eligible collateral is limited to financial collateral. While we understand that financial collateral may be the only appropriate collateral in certain circumstances, we believe that other forms of collateral, such as real estate and equipment, should be recognized as mitigating past due exposures. For many years, banks have liquidated and collected from these forms of collateral in protecting their interests. Because banks are required to update their valuations of this collateral periodically in performing the impairment analysis described above, we believe that financial institutions should be able to offset the amount of the past due exposure by the value of such collateral.

In addition, to the extent that the increased risk-weighting of past due assets is incorporated into the final risk-weighting rules should you move forward with the Proposal, we believe it would be appropriate to eliminate the cap on the amount of an institution's Allowance for Loan and Lease Losses that is includable in its Tier 2 capital. This issue is discussed in greater detail above.

D. Off-Balance Sheet Items.

1. *Risk-weighting of unfunded loan commitments*. The Standardized Approach Proposal requires banks to apply a 20% risk weight to unfunded loan commitments with durations of one year or less. Under current rules, such commitments receive a zero risk-weighting. We do not believe the proposed change in risk-weighting for these unfunded loan commitments is warranted. We are not aware of any instance among our members, including those former members that were closed, of capital ratios being materially strained through borrowers' drawing down on unfunded loan commitments of the bank. Banks monitor their unfunded loan commitments on an ongoing basis to ensure that they have appropriate capital and liquidity to fund those commitments. By adding a risk-weighting to these short-term commitments, the proposed rules are further increasing the risk-based assets of banks, which will in turn cause them to manage the size of their assets, most likely through decreasing their use of short-term loan commitments. This reaction by banks would impact small businesses that rely on these lines of credit for liquidity. With the existing economic headwinds facing small businesses, we do not believe action by the bank regulatory authorities to further strain the ability of small businesses to operate is warranted.

2. *Risk-weighting of credit-enhancing representations and warranties for mortgage loans sold*. The Standardized Approach Proposal requires banks to apply a 100% risk weight to assets subject to a "credit-enhancing representation or warranty," which are defined to include provisions to protect the purchaser from losses resulting from the default or nonperformance of the counterparties of the underlying exposure or form an insufficiency in the value of the collateral backing the underlying exposure.

Many banks, including many community banks, originate conventional mortgages and sell them in the secondary market. As discussed above, many smaller banks do not have the interest rate risk management capacity to keep 15-, 20-, and 30-year mortgage loans in their portfolios. For those borrowers who desire such longer-term loans, the banks originate the loans, sell them in the secondary market, and earn a fee. For many of our members, this product offering has helped them generate earnings in an otherwise sluggish banking environment.

Many purchasers of mortgage loans originated by these banks require that the bank repurchase the loan if it defaults within a specified period of time or if the value of the collateral is other than as stated in the documentation provided to the purchaser. While the "early default" obligation is generally short in duration, the warranty regarding the value of the collateral can have a rather extensive duration.

If banks are required to apply a 100% risk weight to mortgage loans originated by them throughout the duration of those warranties, the capacity of these banks to make such loans will be greatly limited. We have heard from some of our members that this change to the risk-weighting rules alone could increase their risk-weighted assets by ten percent, and the change will be even more drastic for those banks with larger mortgage production units.

At this time of ensuring that consumers are afforded the opportunity to own homes under appropriate circumstances, we believe that this rule change is contrary to the public interest. Implementing this change will cause banks to curtail their mortgage originations, which would decrease or eliminate the availability of mortgage loans in some communities and force borrowers to work with non-bank mortgage originators much more often. We submit that creating an environment that allows banks to expand their participation in mortgage origination is more consistent with public policy. Non-bank mortgage originators were much more responsible for the imprudent originations in the lead-up to the financial crisis. We believe that allowing professional, traditionally-regulated lenders with seasoned underwriting backgrounds which are found in bank mortgage origination offices, to increase their participation in mortgage originations is far preferable to the ultimate impact of this change in the risk-weighting rules, which is to force banks out of the mortgage origination business.

To the extent that these rules are retained in the final risk-weighting rules should you move forward with the Proposal, we suggest providing further guidance on what constitutes a "credit-enhancing representation and warranty." For example, many banks give representations regarding compliance of the appraisal provided with certain standards. The final rule should clarify that such a representation is a representation regarding documentation, and therefore excluded from the definition of a credit-enhancing representation and warranty, rather than a representation regarding the value of the collateral.

IV. Conclusion

As set forth in the detailed comments above, we believe that the Proposals present such a vast array of potential problems that they should be withdrawn completely. The Proposals clearly require substantial modification, and we believe additional studies are required in order to develop the most appropriate modifications to the Proposals. There is growing support among bankers and some regulators, such as FDIC Director Thomas Hoenig and the Conference of State Bank Supervisors on behalf of the state bank regulators, to withdraw the Proposals. We believe that following their lead and instead implementing a simpler and more transparent regulatory capital framework has tremendous merit. There is a great deal of risk in simultaneously finalizing such broad-based and sweeping change to the way that institutions calculate their capital and risk-weighted assets and the capital ratios they are required to maintain. Notwithstanding the various phase-in periods set forth in the Proposals, the rule changes set forth in the Proposals are currently planned to be finalized simultaneously, leaving little ability to adjust the rules after understanding the impact on the industry of isolated facets of the rule changes.

We question whether anyone or any regulatory agency can truly understand the overall impact of the Proposals on the industry. Our members are constantly reminded by their examiners of the importance of enterprise risk management, which requires that the institution identify and understand the risks that it faces and then determine which of those risks are complementary and which offset others. In the recently released Supervisory Guidance on Stress Testing for Banking Organizations with More Than $10 Billion in Total Consolidated Assets, larger institutions are given guidance on how to establish an appropriate stress testing framework. Such a framework would test each individual risk facing the institution, and all the various combinations of those risks, under a variety of likely (and even unlikely) scenarios. We suggest that the regulatory agencies take the time to conduct a similar analysis – in the context of industry risk management – and publish the results of such an analysis prior to proceeding with the Proposals.

To the extent that the Proposals are not withdrawn, we believe that material modifications to the Proposals should be made, including an exemption for community and regional banking institutions from some or all of the requirements of the final rules. As set forth above, we do not believe anyone can project with confidence the overall impact on the banking industry, and the broader economy, that the Proposals will have. However, we believe that the Proposals, if adopted without material modification, would result in a substantial withdrawal of banks, particularly community banks, from a variety of lines of business, including:

- Making and holding 1-4 family residential mortgage loans;
- Originating and selling mortgage loans;

- Financing development activity; and
- Providing short-term lines of credit to small businesses.

We believe this outcome is completely contradictory to sound public policy. At all times and particularly in periods of economic recovery, our regulatory system should promote the safe and sound participation of insured and highly-regulated depository institutions in economic expansion. By adopting rules that force these institutions to withdraw from participating in economic recovery, businesses and consumers will become increasingly reliant on non-bank lenders to provide funding. Most of these non-bank lenders are subject to substantially less regulation than are depository institutions, and they are not as experienced and capable of appropriately underwriting and managing credits. Because they cannot access insured deposits as a source of funding, they also tend to charge higher rates of interest on loans than financial institutions.

It is our view that many of the changes set forth in the Proposals were developed in reaction to perceived abuses that are believed to have led to the financial crisis. It is our position that non-bank lenders and loan originators were substantially responsible for the vast majority of these abuses. We believe the ultimate outcome of adopting the Proposals without material modification would be to force businesses and consumers to do business with the very parties that were responsible for the abuses that led to the financial crisis. Again, we believe this outcome to be totally contrary to sound public policy.

It is clear to us that the Basel Accords were not adopted with a view toward providing sound regulation for diverse banking systems involving a great number of banks of various sizes. The United States is unique in enjoying such a diverse banking environment where smaller communities are frequently served by independent, locally-owned and managed banks. We believe the Proposals represent a “one size fits most” approach to banking regulation in that only the largest institutions are subject to tailored forms of regulation. We believe the Proposals should be modified to take into account the great diversity of business plans, balance sheet compositions, and risk profiles of U.S. financial institutions. By implementing tailored regulation, banks of all sizes can be allowed to compete and thrive under all economic conditions in a safe and sound manner.

Finally, we submit that the best regulation is often implemented through experienced and principled regulators, rather than complex regulation. As noted throughout this letter, the Proposals often attempt to substitute bright line proxies for risk, such as LTV ratios, when we believe that a risk assessment by competent bank management that is reviewed by experienced regulators is a better measure of risk. Bank management and regulation often require qualitative judgments. To attempt to replace many of those qualitative judgments with inflexible quantitative measures is unlikely to achieve the desired outcome and will likely only lead to an advantage to those who develop a method for escaping the reach of the bright line test. Again, we believe that the most effective banking regulation is achieved through empowering experienced and knowledgeable regulators to work with bank management to achieve appropriate risk management measures.

We very much appreciate the opportunity to comment on the Proposals. We ask that you consider our comments in developing and prior to adopting the final rules.

We believe that through thoughtful, tailored, and appropriate regulation, the U.S. banking industry can fill the needs of businesses and consumers in the U.S. as we look forward to full economic recovery and beyond.

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Respectfully submitted on behalf of the members of the Georgia Bankers Association,

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cc: Member institutions of the Georgia Bankers Association