COMMUNITY
National Bank

October 18, 2012

Federal Reserve Board

Re: Basel III Capital Proposals

Ladies and Gentlemen:

Thank you for the opportunity to provide comment on the Basel III proposals that were recently issued for public comment by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation. I am very concerned about the potential impact of the Basel III proposals on our bank, Community National Bank of Seneca, Kansas, and on community banks throughout the nation.

I would like to quantify for you what the impact of implementing the proposed Basel III would be on Community National Bank, however, after going to the FDIC website and starting to use the 'calculator', I realized that I did not have the necessary information, nor did I have the time to compile the necessary information, to complete the **"simplified"** calculator. From the FDIC's website:

> "The estimation tool is **designed primarily for use by smaller, non-complex banking organizations** that are not subject to the agencies' market risk capital rule or the advanced approaches capital rule. It provides **a general estimate** of a banking organization's leverage and risk-based capital ratios under the NPRs. Because the estimation tool was designed as a standardized mechanism for banking organizations to broadly understand the potential impact of the NPRs, **it has certain inherent limitations and contains some simplifying assumptions** to facilitate its widespread use." (emphasis added)

Even your 'simplified' model does not appear to be particularly simple. Basel III appears to be a complex piece of regulation. Basel III was originally intended to apply to the largest of banks and was never intended to apply to community banks. I believe this is a costly, ridiculously complex piece of regulation that won't do much to help avoid the next financial crisis, and will create another burden on small banks. I agree with Tom Hoenig, "Basel III introduces a leverage ratio and raises the minimum risk-weighted capital ratios, but it does so using highly arcane formulas, suggesting more insight and accuracy than can possibly be achieved. Where the markets assess, demand, and adjust intrinsic risk weights on a daily basis, regulators using Basel look backwards and never catch up."

With regard to the inclusion of accumulated other comprehensive income (AOCI) in capital, this will result in increased volatility in regulatory capital balances and could rapidly deplete capital levels under certain economic conditions. AOCI for most community banks represents **unrealized** gains and losses on investment securities held as **available□for□sale**. Because these securities are held at fair value, any gains or losses due to changes in interest rates are captured monthly in the current valuation. Interest rates have fallen to levels that are unsustainable long□term once an economic recovery accelerates; and as interest rates rise, fair values will fall causing the balance of AOCI to decline and become negative. This decline will have a direct and immediate impact on common equity, tier 1, and total capital as the unrealized losses reduce capital balances. By the way, we could reclassify our investment securities to **held-to-maturity** and then the unrealized gains and losses would not be included in the capital calculations. That makes no sense!

On another point – the proposed risk weight framework as it applies to loans is too complicated and will influence the kinds of loans we make and will also jeopardize the housing recovery. For example, increasing the risk weights for residential balloon loans, interest□only loans, second lien loans, or thinly secured loans will penalize community banks who offer these loan products to their customers on a relationship basis and will deprive customers of financing options for residential property. Additionally, higher risk weights for balloon loans will further penalize community banks for mitigating interest rate risk in their asset□liability management. Community banks will be forced to originate only 15 or 30 year mortgages with durations that will make their balance sheets more sensitive to changes in long□term interest rates. Thus, many community banks will be forced to only originate those loans that can be sold to a GSE (if they have the volume to even do so), or they will simply exit the residential loan market entirely!

All the issues listed above will have a direct impact on our institution and on community banks throughout the nation. Community banks should be allowed to continue using the current Basel I framework for computing their capital requirements. Basel III was designed to apply to the largest, internationally active, banks and not community banks. Community banks operate on a relationship□based business model that is specifically designed to serve customers in their respective communities on a long□term basis. This model contributes to the success of community banks all over the United States through practical, common sense approaches to managing risk.

Basel III is going to be an enormous burden to the banking industry, especially small banks. Yet it won't do much to mitigate risk in the system. I agree with Tom Hoenig – the plan ought to be scrapped and replaced with something simpler that will actually work.

Thank you for the opportunity to comment on this important issue.

Sincerely,

***Donald L. Lueger***

EVP and Director