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October 19, 2012

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Board of Governors of the Federal Reserve  
System  
20th Street and Constitution Avenue, N.W.  
Washington, D.C. 20551  
[regs.comments@federalreserve.gov](mailto:regs.comments@federalreserve.gov)  
Subject: Basel III Docket No. 1442

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250 E. Street, SW  
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[Regs.comments@occ.treas.gov](mailto:Regs.comments@occ.treas.gov)  
Subject: "Basel III OCC Docket ID OCC-  
2012-0007, 0009, and 0010"

Robert E. Feldman  
Executive Secretary  
Attention: Comments/Legal ESS  
Federal Deposit Insurance Corporation,  
550 17th Street, N.W.  
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[comments@FDIC.gov](mailto:comments@FDIC.gov)  
Subject: "Basel III FDIC RIN 3064-AD95,  
RIN 3064-AD96, and RIN 3064-D97"

**VIA FIRST CLASS, U.S. MAIL AND E-MAIL**

Re: Basel III Capital and Risk-Weighting Proposals

Ladies and Gentlemen:

The Bank of Forest ("Bank") is a \$150 million Mississippi chartered, non-member bank that was formed in 1900. Over the last 112 years, it has diligently and faithfully served the financial needs of the citizens of Scott County, Mississippi, while also providing its shareholders with satisfactory earnings; however, no one has ever become obscenely wealthy as a result of its

existence. Like others in thousands of community banks across the country, its ownership and management is just as concerned about the Bank's ability to improve the economy and quality of life of its fellow Scott County citizens as it is about generating excess returns from its operations.

By applying a traditional retail banking model that is uncomplicated and transparent, the Bank has survived numerous ebbs and flows in the banking industry and economy as a whole, not the least of which were the Great Depression and the Great Recession. Like its fellow Scott County citizens, the Bank often suffered, sometimes tremendously, during these ups and downs, but it always managed to prevent a downward spiral and continue its existence, largely because of its vanilla but tested business model. Ironically enough, the Federal government, whether intentionally or negligently, has now engaged in a campaign to finally end the long tenure of the Bank of Forest and thousands of its peers by establishing a regulatory regime that makes this tried and true business model obsolete despite its proven success.

Even before the Great Recession, the Bank of Forest recognized that the existing regulatory environment would soon make one community, \$100 million banks a thing of the past. Because of the tremendous overhead and compliance burden placed upon the Bank, it realized that its choice was to either grow and obtain enough economies of scale to survive or cede its independence to a larger financial institution that could be more profitable but less concerned about the citizens of Scott County. As a result, in 2007, the Bank of Forest opened its first branch office in 107 years in the adjoining, more prosperous county of Rankin. This branch operates in a dramatically different economy than the Bank's main office and has increased the Bank's number of commercial real estate loans, a line of business that the Bank previously had little to no exposure to. This additional line of business has created its share of headaches over the last five years, but thanks to the conservative culture of the Bank of Forest and its focus on prioritizing credit quality over immediate earnings or growth, these headaches have been largely overcome by the Bank as of this point in the economic "recovery".

Two years later, the Bank acquired a mortgage company in Rankin County that would provide it the resources and expertise needed to allow its customers access to longer term fixed rate mortgages that could be sold on the secondary market. Prior to that acquisition, the Bank had never had a fully functioning secondary mortgage market facility and the vast majority of mortgage loans made by the bank were shorter term mortgage loans that the Bank retained on its books. Because few of its customers, especially those in Scott County, qualify for secondary market mortgage loans, the Bank still has many more "in house" mortgage loans than secondary market loans, but it now at least has another option for its customers. While both of these recent changes made by the Bank changes its vanilla business model of the past somewhat and possibly increases its risks, it has been apparent to the Bank for some time that growth and changes like this were imperative to sustain the viability of the Bank going forward; unfortunately, just meeting the needs of consumers and small businesses in a 6,000 person community is now insufficient for generating returns needed to cover the basic overhead of a community bank.

Before I proceed further with the story of our Bank, please allow me to digress briefly into two areas of utmost importance to any community bank: (1) capital and (2) asset quality. Like any right-minded participant in our free market society, shareholders of community banks want to make money, and obviously they want to make as much money as they possibly can.

However, in the back of their minds, they always know that their margin of error is much smaller than those enjoyed by their regional and international brethren.

Community banks' access to capital markets is dramatically more limited than that of larger banks, especially those that are publicly traded. A small community bank usually can look only to the modest means of the citizens in its small hometown for new capital when needed, and more often it is forced to ask its existing board members and shareholders for more money, especially at times when more capital is needed. This is because the stock of a community bank is not always the easiest sell, especially when it needs the capital it is trying to acquire.

Community banks are invaluable to their communities and can provide shareholders with adequate returns, but the liquidity, competitive, compliance, and market risks associated with such an investment are often hard to justify for those few community members that have the ability to invest but have not been involved in the Bank previously. That is a big reason why many community banks, like ours, are still owned and controlled by family members of its founders. It was a good investment decision for their forefathers and has sustained the family for decades, but the current costs of capital and risks associated to community banks makes new investment unlikely. As a result, when community banks are forced to raise capital, their only choice is to liquidate by selling their market share to larger, more complex banks that care little if any about the citizens of their communities but recognize a potential to generate good return off of the community bank's deposits.

For this reason, community banks usually have no choice but to maintain excessive capital levels and ardently protect that capital through conservative asset management, hence their non-complex, transparent business models. Accordingly, the Bank of Forest to this day, even after the "Great Recession," enjoys a leverage ratio exceeding 13.5% and a tier 1 risk based capital ratio of more than 23%. Additionally, approximately a third of its loans are secured by collateral that the bank considers some of its safest (i.e., the borrower's home) and the term of those loans are short with only slightly longer amortization schedules (i.e., balloon mortgage loans) in order to limit potential market risks that could also threaten the capital of the bank. With excessive capital and loans that, until recently, have been considered some of the safest in the business, the Bank has successfully managed to keep its door open for 112 years despite the slim margin of error it endures relative to its larger competition.

Now would be a good time to address the perceived risks of the balloon mortgage. Since sometime near the beginning of time, community banks have made its customers mortgage loans with balloon terms without suffering even noticeable credit losses. This is because these loans make a whole lot of sense for community banks and their communities, especially those in more rural parts of our country.

In rural America, residential real estate rarely if ever experiences the dramatic fluctuations in residential real estate values that preceded and accompanied this last recession in more urban areas of our country. Population changes are few if any, and because those communities are unfamiliar with real estate booms, real estate busts are foreign to them as well. When that dynamic is coupled with conservative underwriting that prevents the customer from borrowing too much money against the value of their home and the motivation of the borrower to

maintain ownership of their home and therefore repay their debt, an incredibly safe and stable credit is created.

As a result, Banks are more than happy to make these types of loans to its customers. However, there is an inherent conflict between the ability of a customer to afford the payments on such a debt that amortizes over a short period of time and the ability of a community bank to manage the market risks that are associated with carrying many longer term assets on its books. Therefore, in order to reconcile that conflict, community banks long ago formed a product that could feasibly meet needs on both sides of the transaction: a mortgage loan that has a fixed rate with a relatively short term (e.g., 3 to 5 years) but an amortization schedule that is slightly longer (e.g., 15 to 20 years). This allowed the community bank to meet the needs of its customer for a lower payment while also limiting its exposure to rising interest rates. Incidentally, community banks used to have an option to use variable rates on such loans before the Regulation Z requirements made that impractical for them (see above the discussion on the compliance burden imposed upon community banks and the threat it places on their existence).

Now, at some point after our most recent mortgage meltdown, some 25 year old congressional staffer or regulatory pencil pusher came up with the idea that a cause of the recent troubles could somehow be tied back to balloon mortgages. Therefore, the reasoning went, they should be eradicated, or at least severely limited. Let me now say the most important thing that I can say in this entire letter: the mortgage meltdown had absolutely nothing to do with traditional community bank practices. It was caused by a parallel lending universe whereby overly aggressive and largely uneducated mortgage brokers originated mortgages that were either inherently risky or structurally risky and sold them to an investment bank that sliced and diced the credit several times before it was sold to a totally disassociated investor that did not even know what he or she owned much less how to manage the credit risk posed by such an instrument. This model, after being replicated millions of times over throughout our country, created a toxic lending environment where the individual having the greatest financial stake in the transaction had no idea who their debtor was, how they intended to repay the debt, or even if they had the ability to repay the debt.

Despite the tremendous mental capacity of the people who serve us in Washington, the pervasiveness of this toxic system as well as the risks it created never seemed to be singled out as the major cause of our problems. As a result, the mountains of legislation and regulation passed and scores of trees that lost their life to foster such presented supposed “solutions” that not only failed to address the true cause of the debacle but also served to handicap the only segment of our financial system that actually functioned appropriately (i.e., community banks). Sure, Community Banks suffered and died during this recent recession; however, in the vast majority of cases, their failure had nothing to do with the balloon mortgages they originated and maintained on their books. If anything, such community banks failed because excessive compliance burdens forced their business model into obsolescence, thereby pushing them into riskier loans (e.g., commercial real estate loans).

I have no doubt that many of the troublesome financial instruments sold on a secondary market and referenced above contained balloon mortgages that exacerbated a problem that already existed; however, it is a red herring to assume that balloon mortgage features themselves

are problematic. When used by a community banker who not only knows his borrower but goes to church with him on Sundays and sits next to him at PTO meetings, these features can be used with little or no risk. This is because the borrower can always communicate with his or her banker when times are tough and the banker has every incentive to work with the borrower because he not only originated the loan but he also bears the risk of loss if he can't help his borrower.

Unfortunately, this basic truth has not made its way inside the beltway and the war against balloon mortgages is in full bloom. It began first with the laws and regulations governing higher priced mortgages which initially appeared to prohibit balloon notes on "higher priced mortgage loans" until an interpretation reluctantly granted by the FDIC allowed banks to consider potential refinancing of a balloon note on such mortgages as part of its analysis of the borrower's ability to repay such debts. Incidentally, the laws' definition of "higher priced mortgage" itself is flawed because it uses as an index an average rate for loans sold on a secondary market without considering the premium necessitated from the additional liquidity risks borne by banks who hold loans on their books that can't be sold on that market, but that is a conversation for another day.

The war against balloon mortgages has continued with more recently proposed legislation from the Federal Reserve and the Consumer Financial Protection Bureau ("CFPB"). The former has proposed a rule that will require community banks to assess a borrower's "ability to repay" a residential mortgage unless that mortgage is "qualified" (i.e., no balloon feature), and subjects the community bank to civil liability to the customer if it fails to get it right. The latter agency has proposed a rule that will make it easier for residential loans of community banks to be classified as "HOEPA" loans by including in the disclosed "finance charge" fees that are not even retained by the bank, and then prohibiting community banks from making such "HOEPA" loans if they have a balloon feature. Has anyone in Washington even walked into a community bank? If they had, they would know that, through these two rules alone, they could dry up credit for over half of rural America.

The kicker, though, and the real reason for me writing this rambling letter is the recently proposed BASEL III capital framework. This regulation, if passed, may be the Enola Gay that drops the atomic bomb on community banks and the customers they serve. This ends once and for all the battle against balloon mortgages by striking community banks where they are most sensitive (i.e., capital). It inexplicably increases the risk weighting for balloon mortgages from 35% to somewhere between 100% and 200%, and then, just in case a community bank thinks that they could still make such a loan, requires a community bank to go through its entire residential mortgage portfolio to extract and track minutia such as loan to value just to maintain a risk weighting of 100%, thereby adding to the compliance burden that was already a problem. Maybe this would be justified for a piece of a balloon mortgage an investor bought from a broker as part of a collateralized mortgage obligation, but it seems silly for the mortgage balloon loans that have been made by community bankers for years as safe investments for the reasons discussed above.

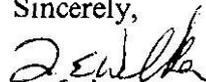
What would be the effect of this regulation in Forest, Mississippi, and communities like it? The Bank of Forest, who for years has made almost a third of its loans to citizens of its

community who either can't or don't want to obtain a mortgage sold on the secondary market, would be faced with a difficult choice. Door 1 would be to keep making such loans, but comply with the new capital framework. Thankfully, the Bank has maintained excessive capital to deal with unexpected risks such as the government, so at least initially, it would be in compliance with the law. However, its "cushion" would be dramatically decreased, making the Bank's slim margin of error even slimmer and forcing it, whether consciously or unconsciously, to become more conservative with its asset quality (i.e., loans). It would be even more burdened with compliance fodder because of the data it would have to mine out of its files just to comply with the law, and the dilemma it has faced for the last two decades would intensify: either grow and enter new markets while encountering new and previously unheard of risks in order to survive or sell to a larger competitor that will not meet the niche the Bank has within the community.

Door 2 would be to dramatically reduce the amount of balloon mortgages the Bank has on its books. One way to do this would be to make sure the term of such fixed rate loans correspond with their amortization; however, because that would necessitate longer term loans, it would increase the market risk of the bank at a time when market risks are incredibly high due to the low interest rate environment and at the same time another part of BASEL III exacerbates the problem, i.e., the requirement to include Accumulated Other Comprehensive Income in tier one capital. Another way to reduce the amount of balloon mortgages the Bank has on its books would be to convert all such mortgages to variable rate loans, but such a result would force the Bank into a compliance burden it has avoided for years while placing borrowers into a loan structure that has even less certainty than a balloon mortgage. Finally, a bank could try and exit the residential mortgage market altogether. This would be disastrous for the millions of Americans in their rural communities that need homes but cannot obtain financing in the secondary market or from larger banks. It would probably be suicidal for community banks as well because it would force them to enter other credits that truly are more risky (e.g., commercial real estate) just to earn the asset yield they need to keep their doors open.

In the end, if Basel III is passed, it may not matter which door the Bank chooses because they may both lead to the same place. A community bank that operates under Basel III navigates through a world of more credit, market, and compliance risk with less recognized capital. Mind you I did not say less capital, because that will not change; the only thing that changes is the measurement of capital, which does nothing to motivate the generation of capital if a community bank just can't do it. Thus, the path of Basel III presents community banks with an undesirable choice: either grow and become the larger, less community focused banks they have avoided becoming for years, or sell to just such a bank. Either way, the true losers are the citizens of Forest and Scott County.

Sincerely,



T. E. Walker  
Chairman and CEO  
Bank of Forest

cc: Senator Thad Cochran (via e-mail only)  
Senator Roger Wicker (via e-mail only)  
Representative Greg Harper (via e-mail only)  
Mr. Gordon Fellows, Mississippi Bankers Association (via e-mail only)