



Broadway Bancshares Inc.

October 22, 2012

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551
Via email at regs.comments@federalreserve.gov

Office of the Comptroller of the Currency
250 E Street, S.W., Mail Stop 2-3
Washington, D.C. 20219
Via email at regs.comments@occ.treas.gov

Mr. Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429
Via email at comments@FDIC.gov

RE: Proposed Basel III Rulemakings for an Integrated Regulatory Capital Framework

Ladies and Gentlemen:

We appreciate this opportunity to comment on the above-referenced Basel III proposals¹ that were recently approved by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (collectively the “banking agencies”). Broadway Bancshares Inc. (“BBI”) is a one-bank Texas holding company with total assets of \$2.7 billion and a long and consistent record of generating strong financial returns for its shareholders. The company is privately-held, with a stockholder base of approximately 40 persons. Based in San Antonio, our company’s strategic focus is on serving retail and business customers in urban and suburban markets across south central Texas.

We respect the intent of the regulatory agencies (domestic and international) to strengthen the existing capital framework for financial institutions, especially in light of the recent tough times that have plagued our national economy in general and the financial services industry in

¹ The proposals are titled: *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, and Transition Provisions; Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements; and Regulatory Capital Rules: Advanced Approaches Risk-based Capital Rules; Market Risk Capital Rule.*

particular. While it is important to maintain sound capital guidelines, it is equally important to maintain sensible capital guidelines. Here at Broadway, we have immersed ourselves in the volume of material that accompanies these proposals in order to understand their relevance, burden and, most importantly, their impact on the future conduct of our business. While the proposals are very broad and complex, our intent with this letter is to just offer comments on the few topics of greatest concern for us.

First, we support the proposal to increase the “adequately capitalized” and “well capitalized” minimums for the ratio of Tier 1 capital to total risk-weighted assets. Higher ratios appear to be prudent, reasonable, and necessary for sustaining adequate capital across the industry, with the added benefit of requiring a more level playing field among institutions. We can also live with the proposed capital conservation buffers, though it seems to us that the regulatory actions that would be authorized if a bank falls below the buffered “adequately capitalized” minimum could just as well be authorized if the bank falls below the “well capitalized” minimums, which are 2% higher. Given this incremental ratio spread (now 2%, but it could become 2.5%) between “adequately capitalized” and “well capitalized”, it seems duplicative and unnecessarily complex to also introduce buffers.

While we support higher ratios, we have serious concerns about changes to be implemented for both the numerator and denominator of these various ratios, as follows.

Numerator

Our biggest concern in all of the Basel III proposals is the plan to include unrealized gains and losses from “available-for-sale” securities in regulatory capital. Frankly, to adjust capital for changes in the value of just one part of one side of the balance sheet makes no sense in practical application (despite FASB’s best theoretical intentions) for our business model. It made no sense to do so in 1994, when FAS 115 was first implemented and regulators decided to exclude those fluctuating adjustments from regulatory capital, and it makes no greater sense today. As you know, these fluctuations come and go with the movement of interest rates. Unless there is some form of lasting impairment, for which adequate remedies already exist in GAAP and regulatory guidelines, there is no value added for investors, managers, and regulators of banks to watch this phantom line item swing up and down with movements in interest rates (along with other numbers for asset yields, net interest spreads, return on equity, return on assets, etc.). We of course adopted FAS 115 in 1994, as required, and we faithfully produce financial reports with these equity adjustments included, also as required. However, unless there is a reason to be concerned about impairment, I can tell you that in everyday practice our owners and managers basically ignore these monthly swings and we exclude them from many of the internal reports we generate to manage our core business. To be sure, we understand that value fluctuations today are a reflection of expected income (and opportunity costs) in the future. However, unless there is some likelihood of loss, the ups and downs are distractions which provide negligible value for the ongoing management and operation of our business.

For the same reasons, regulators concluded in 1994 that inclusion of these adjustments in regulatory capital would add confusing volatility to reported capital, mask the underlying core

strength of each institution, and cloud comparability for peer comparisons. As it turned out, interest rates were near historical lows back then, and short-term rates increased by 300 b.p. over a period of just twelve months. With mark-to-market adjustments included, bank equity positions were pounded as rates rose and security values fell. However, core safety remained secure for otherwise sound institutions that fully intended to hold many or most of their securities to maturity. Going forward, to avoid such fluctuations in regulatory capital, we could simply classify all or most securities as “held to maturity”, but it would be unwise and imprudent to limit balance sheet and liquidity management flexibility in this way. Regulators correctly concluded back in 1994 that it would be fruitless to have regulatory capital dropping like a rock, without *a*) evaluating the underlying holdings driving those value changes, *b*) considering each institution’s portfolio strategies and management capabilities (neither of which can be quantified as an additional factor in capital), and *c*) factoring in value changes for all other parts of the balance sheet.

If the AFS adjustments are included in regulatory capital as proposed, one additional irony is that banks with large portions of their balance sheets invested in safe, conservative government securities might see their regulatory capital plummet compared to banks that have much more of their assets concentrated in loans (which typically carry greater credit and liquidity risks). Yes, a few of those risks are intended for measurement in the calculation of risk-weighted assets, but those weights will mildly move the denominator for those banks while the smaller numerator undergoes significant fluctuation for banks that happen to have low loan-to-deposit ratios (and, ultimately, lower credit and liquidity risk). Understanding all of this, the regulators correctly concluded in 1994 that it made no sense to include these fluctuations in regulatory capital and, to repeat, they make no greater sense today!

We are in a much similar position today, with interest rates at record lows. As do many other banks, we have sizable unrealized gains in many of our AFS securities. Most of these securities will be held until they pay principal back at par, so it would be foolish for us (and others) to artificially boost our regulatory capital ratios with these gains today (leading to a false sense of security by making the picture appear even brighter than it already is), let alone to have ratios swing wildly lower later on when rates rise.

If these AFS adjustments do become part of regulatory capital as proposed, we anticipate many banks will alter their investment strategies to minimize these fluctuations. These strategies might not truly reduce risk nor be economically advantageous for the institution, but they could certainly reduce future income (which is real capital) unnecessarily.

Denominator

With regard to the Basel III proposals to alter various weights and measures in the calculation of risk-weighted assets, it is curious (actually, for us, a bit amusing—if not for the serious added burden it will bring us) to see the heavy focus on slicing and dicing traditional residential mortgage portfolios while vast other portions of the loan portfolio remain placed in one or a few catch-all buckets. Of our entire loan portfolio, residential mortgages and home equity loans have by far generated the least amount of losses compared to other sectors of our loan portfolio. We

understand this slicing and dicing is a reaction to problems in the housing sector over the past few years. However, the change from assigning risk weights based on asset class to assigning them to each individual loan will add a substantial burden to our current systems and staff.

Rather than burden all banks with the creation of systems and new work procedures to track and report all the proposed gradations of mortgage loans, we suggest each institution (or its regulator) complete a simplified annual assessment to evaluate (or perhaps score) the nature of its mortgage portfolio. If the assessment reveals a complex and riskier portfolio, then the institution would be required to track and report the detailed mortgage gradations now proposed. Otherwise, the institution could be exempt from incurring that considerable burden and would be permitted to place all mortgage loans in one overall risk weight category.

Given the competitive nature of the mortgage market (that is, its thin profitability), the extreme compliance issues that come with such loans, and the indications of even more compliance burdens coming from the Consumer Financial Protection Bureau, we have already contemplated reducing or ending our involvement in the mortgage business. Further burdens on staff and capital might be the final straw in leading many institutions to exit the market. The safest, least burdensome, and least risky loans of all are those that are not made (especially if they are not very profitable to make in the first place), but shrinkage of the mortgage market will not serve a positive public purpose in the long run.

Complexity

We thank the regulators for releasing a model to help banks gauge the impact of the Basel III proposals. That said, upon opening and looking at it, the honest and immediate first response of our staff was "OMG"! Surely some distinction can be made for smaller, less complex community banks vs. the largest, most complex financial institutions. Otherwise, we envision the need to hire consultants, do considerable systems reprogramming, and adding staff hours to deal with the additional detailed data needs and the complexity inherent in the revised risk-weight model. This all translates into higher costs to operate—and a natural aversion to booking certain types of assets in the future. In the end, we can expect declines in bank profitability (which is the best and ultimate source of capital to support a growing financial institution), unless the industry responds by offering less to our customers while also charging them more for what they receive. Institutions might appear to be safer, but they might also become increasingly irrelevant because they are doing less and less to provide value to customers. A ship that never leaves its harbor will always be safe, but that was not what it was built for. We ask that you do everything in your power to keep the measurement of capital adequacy as simple as possible, commensurate with the size and complexity of each institution.

Sincerely,



Christopher J. Bannwolf
Executive Vice President and Chief Financial Officer