Seifried & Brew LLC

September 24, 2012

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

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

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

Re: Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action and Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements.

Dear Ladies and Gentlemen:

Seifried & Brew, LLC ("S&B") is a community bank consulting firm whose principals are experts in community banking not only as consultants but with their experience as community bank directors and advisors. As such, we want to take this opportunity to offer our opinions as to why we believe the new capital requirements, as proposed by the federal banking regulators, do not protect but hinder community banks. As an alternative to the proposed capital requirements, we also want to recommend other options that we believe will better protect community banks and, thus, the integrity of the financial markets against what ultimately resulted in the Financial Crisis that led to the Great Recession.

As we demonstrate in our book *The Art of Capital Planning – The "How To" Guide,* capital is the foundation upon which every community bank is built. A weak foundation can allow even the strongest of structures to collapse. Likewise, a strong foundation can support and expand on traditional, conservative community banking. Our comments are based on 35+ years of community banking experience. Overall, as experts on community banking risk management, together with our experience as community bank directors, we not only question the new capital proposals, but we also provide our view of how community banks should be capitalized. Specifically, we believe the new capital proposals:

- Do not protect the FDIC Fund;
- Do not protect community banks from failing; and
- Do not deter community banks from assuming excessive risk.

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The Banks that Failed

In our roles as community bank advisors and directors, we have seen that the amounts community banks paid in connection with the FDIC's Special Assessment were often times enormous. The general public most likely does not understand that the banking industry paid for the bank failures. We need a risk-based capital system that will protect the community banking industry and will result in banks never having to pay a special assessment into the FDIC Fund as a result of other banks failing or on behalf of those that take on excessive risk.

In our book *How the Seifried & Brew Total Risk Index Predicted 99% of the Failed Banks*, we made the argument that the failed banks were taking high risk years before they failed. The high risk not only included credit risk, the failed banks also exhibited high liquidity risk, high earnings risk and high capital risk. The warning signs were obvious in the majority of these failed banks. They had risks that were imbalanced.

Credit Risk brought down the majority of failed banks. That is why credit risk is the "mother of all risks" in community banks. What were the early warning signs? High loan growth, change in loan mix, high volume of loans to capital, and a riskier loan mix were all risk indicators. But remember, these were not some new "thing" in the industry; these lending risks have always been part of banking. Although credit risk does not automatically trigger panic, statistically, a bank with higher credit risk will have a higher probability of having capital losses.

Liquidity risk just fans the flames of a problem bank. Because liquidity is the structure of how a community bank funds itself, a bank with a high level of cash-type deposits (checking, savings and NOW accounts) is considered as having low liquidity risk. The bank that funds itself with "hot money" CDs, brokered deposits, and borrowed funds are considered to have higher liquidity risk. Emblematic of many of these failed banks was high liquidity risk. One could say that troubled banks funded risky loan portfolios with "hot money."

"Earnings at risk" is a challenge to all community banks to protect the net interest margin to changes in interest rates. Interest rate risk and its impact on net income are imperatives to driving consistent profitability. The failed banks had high earnings at risk.

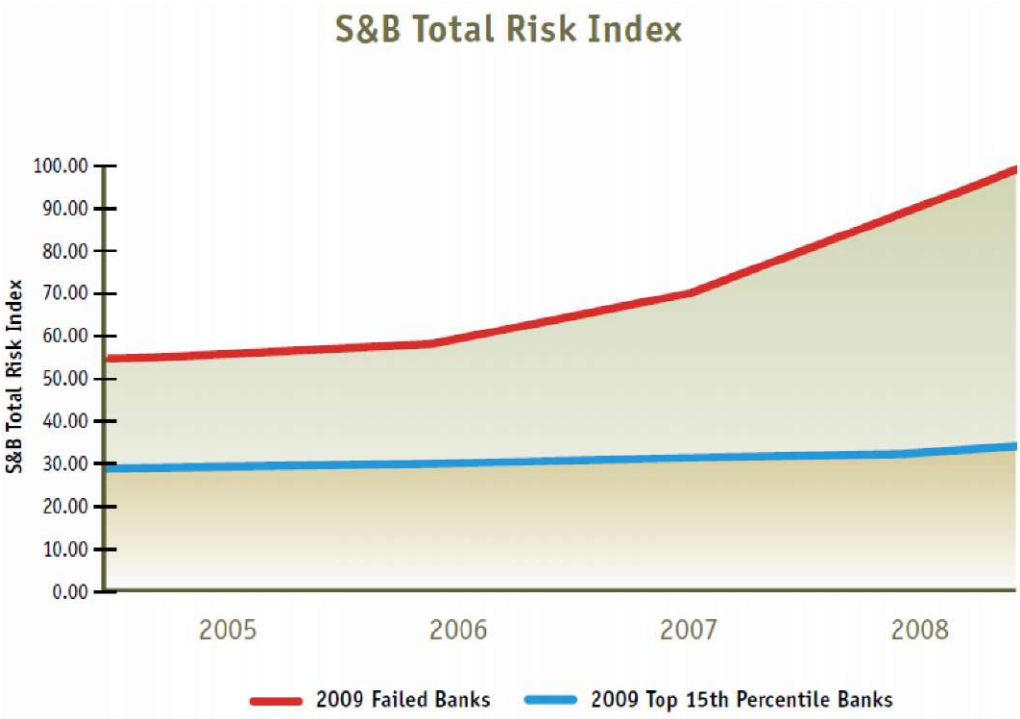
And, then there is capital risk. It is obvious that the failed banks did not have sufficient capital to survive.

Excerpted below and on the following pages is a chapter from our book *How the Seifried & Brew Total Risk Index Predicted 99% of Failed Banks* that illustrates the high level of risk assumed by the failed banks.

> The Seifried & Brew Total Risk Index ("S&B Risk Index") is a dynamic set of risk indicators that is the continuing culmination of Dr. Ed's and Jay's experience of assessing risk in community banking. The key philosophy of the S&B Risk Index includes:
>
> • The choice of significant risk ratios;
> • The weighting of each risk ratio based on its priority;

• Ranking the risk ratios versus all community banks nationally; and
• Aligning the S&B Risk Index with the regulatory CAMELS.

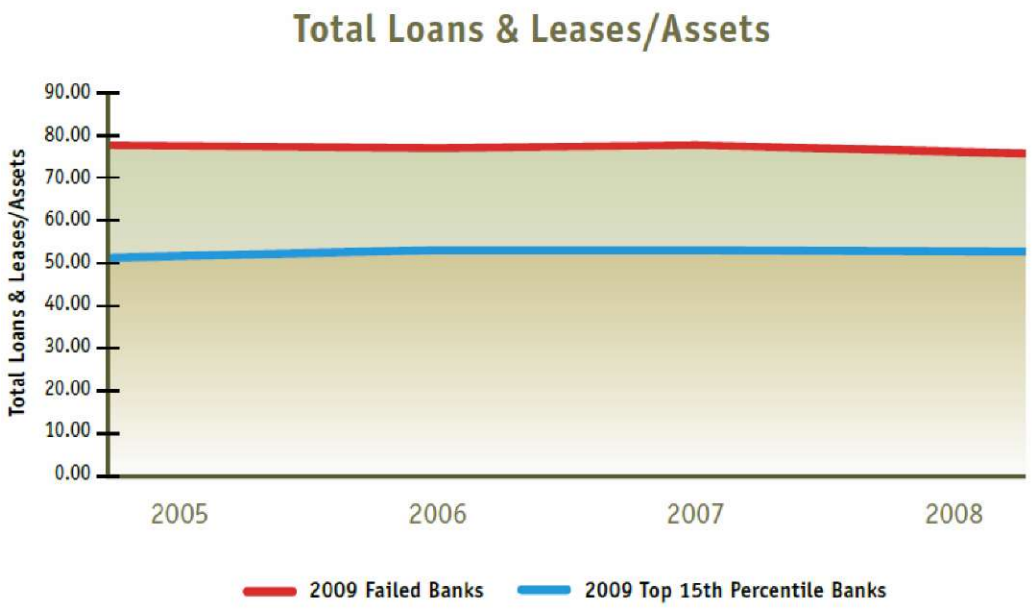
To align the S&B Risk Index with the regulatory CAMELS, the areas of key focus are Capital Risk, Credit Risk, Earnings at Risk, and Liquidity Risk. To illustrate the risks and the effectiveness of the S&B Risk Index, we have used two groups of banks. The first is the Seifried & Brew Top 15th Percentile of community banks in 2009 (the "S&B Top 15th Percentile Banks"). These banks have consistently performed at high levels before, during, and post-Financial Crisis. The second group is made up of the banks that failed in 2009 (the "2009 Failed Banks"). We have provided four years of data to show their trends in risk.



The comparison between the S&B Top 15th Percentile Banks and the 2009 Failed Banks reveals an interesting fact about community banking. Successful community banking is a moderate- to low-risk business model! This comparison clearly illustrates that the banks that failed in 2009 were taking a significant level of risk and that the risks were trending higher many years before failure occurred.

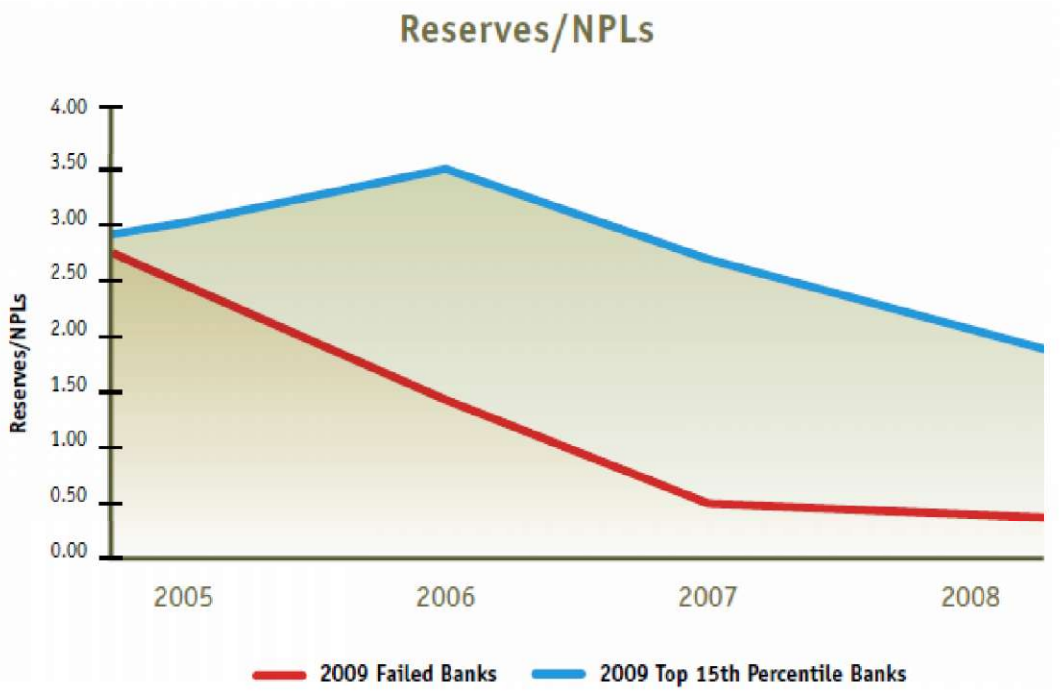
CREDIT RISK

What Dr. Ed refers to as the "mother of all risks" is Credit Risk. Credit Risk has the highest weighting for risk in the S&B Risk Index. The ratios included in Credit Risk are discussed below.

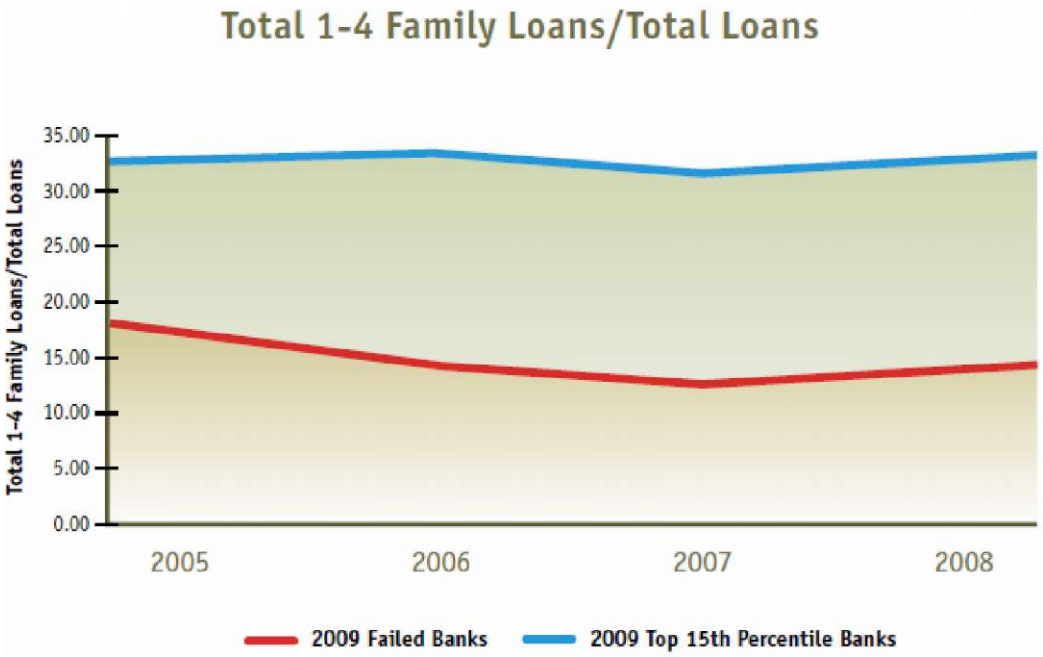


This comparison clearly shows that having higher loans to assets does not necessarily improve long-term performance. The higher probability of having more loan issues may not be worth the risk. It is also interesting that the S&B Top 15th Percentile Banks have consistently remained below the 60% threshold. Jay considers this one of their secrets for high performance. Jay also points out that there has never been a correlation between having more loans and having high performance.

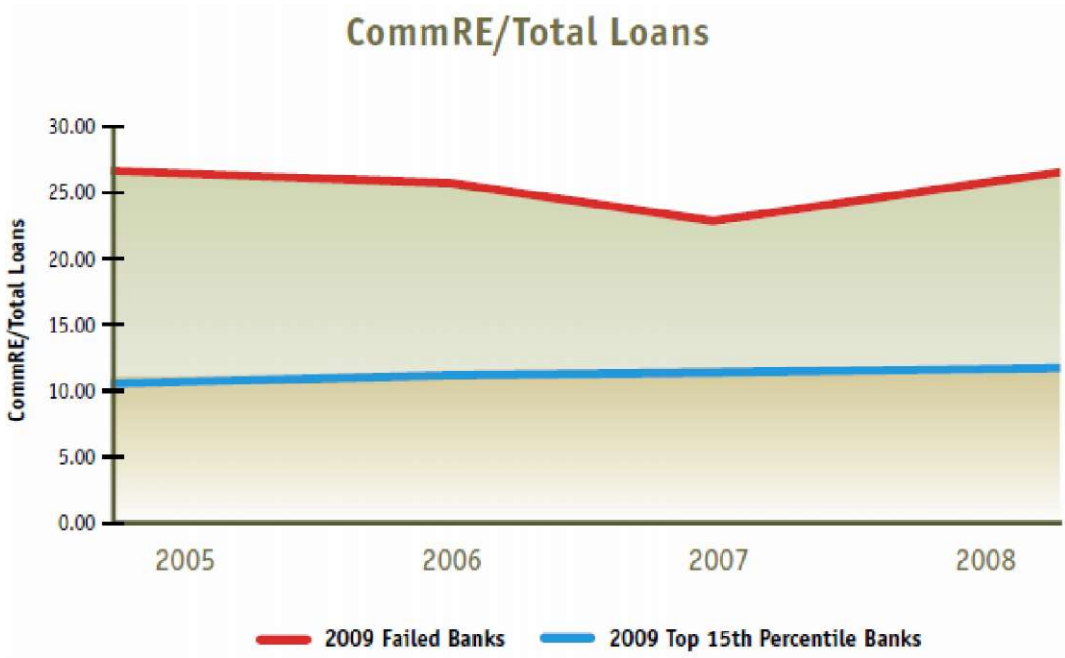
The Credit Risk indicators include adjusted reserves to adjusted loans, change in portfolio mix, net loan growth, net loans to assets, total loans to equity, and yields on loans and leases. Dr. Ed and Jay have found that monitoring the total number of these risk indicators is very indicative of Credit Risk. The 2009 Failed Banks consistently had three out of five Credit Risk indicators, which would indicate heightened Credit Risk. On the other hand, the S&B Top 15th Percentile Banks consistently had a low level of risk with only one Credit Risk indicator.



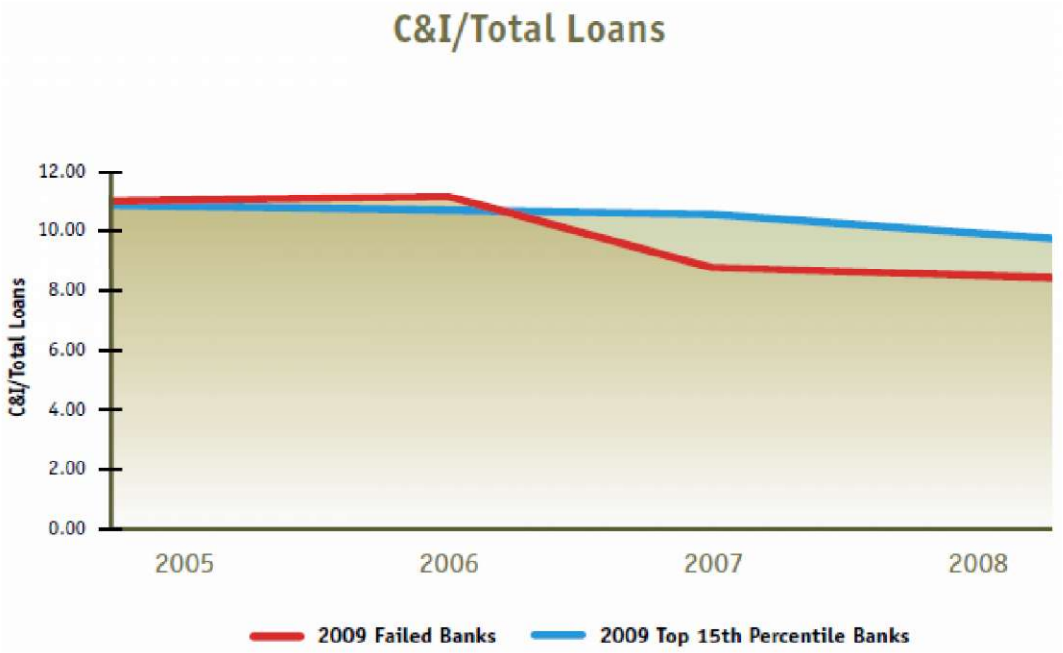
Even though the 2009 Failed Banks had a heightened level of Credit Risk, they had a lower level of reserves set aside before the Financial Crisis than the S&B Top 15th Percentile Banks. As non-performing loans increased, the reserves for the 2009 Failed Banks were rapidly depleted even though they escalated their allowance. This chart shows the extreme performance of having the proper level of reserves versus a community bank's Credit Risk profile.



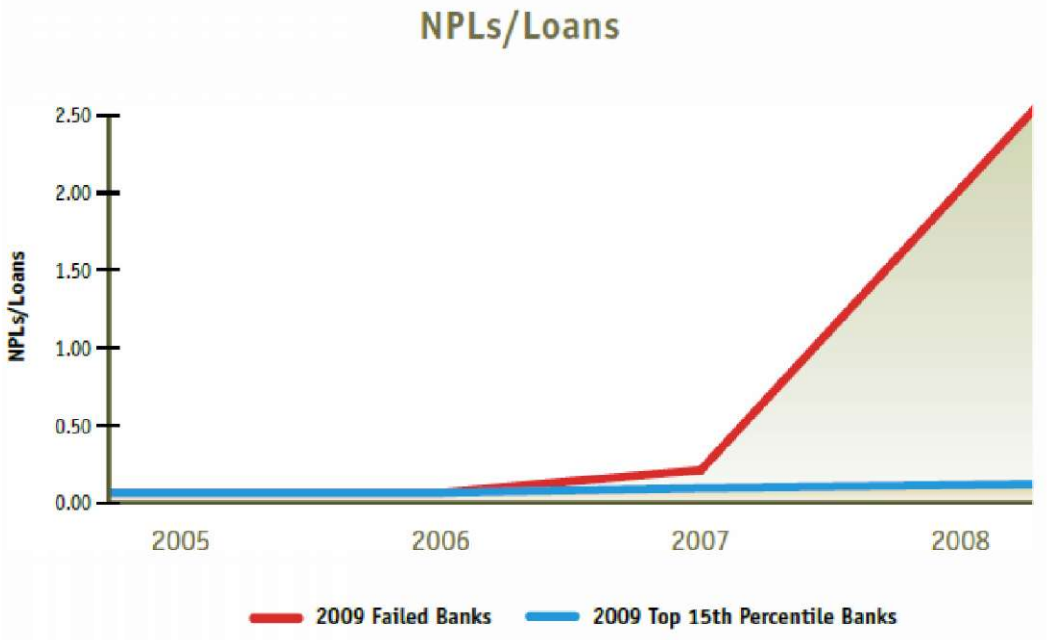
While many commercial bankers contend that home loans are boring, it is interesting to note that the S&B Top 15th Percentile Banks have used this type of lending as a foundation of their loan portfolio. Based on conservative home lending underwriting standards for community banks, home loans may be boring, but they are of high quality. Home lending tends to balance the risk in community bank loan portfolios. By having a low level of home-type loans, the 2009 Failed Banks increased their Credit Risk with more concentration in higher risk loans.



When the history of the Financial Crisis is written, commercial real estate loans and development loans will be the culprit of causing the downfall of the majority of the 2009 Failed Banks. One way to think of this loan type is that a developer wants a bank to take the majority of the risk on a project. In some instances, this may make sense for a bank to take this risk. But, the 2009 Failed Banks took on too much of this risk with more than 25% of their loan portfolios concentrated in this higher risk loan type. Over time, the S&B Top 15th Percentile Banks have operated with approximately 10% in development-type loans. Dr. Ed and Jay believe that going forward, community banks should only commit up to 5% in this loan type.



While C&I lending is considered a riskier type of lending, it is interesting to note that the 2009 Failed Banks did not have significant exposure in this area and were similar in concentration to the S&B Top 15th Percentile Banks.

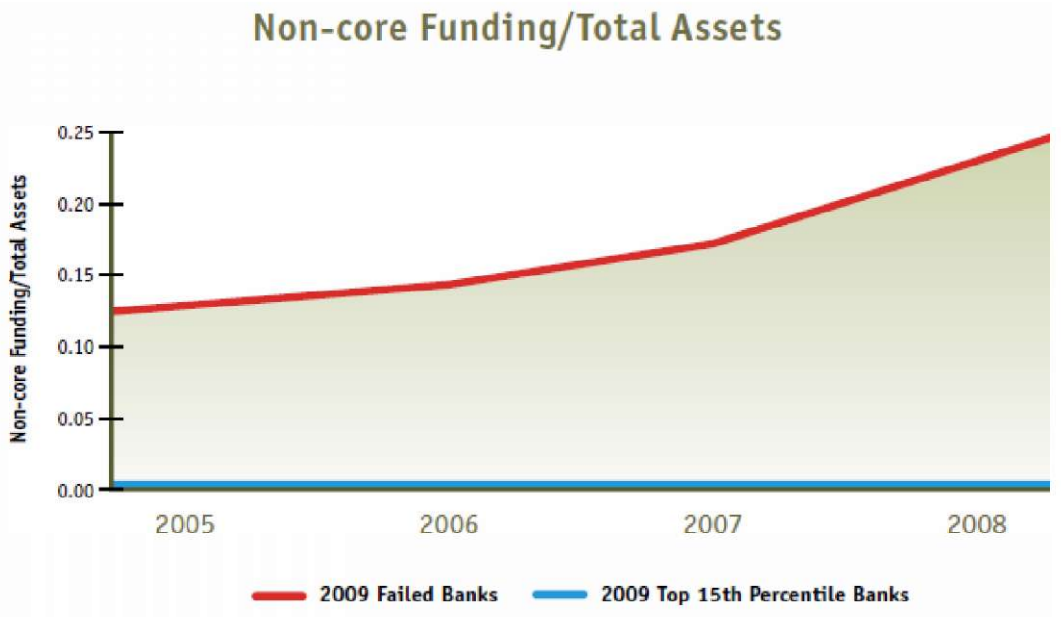


Directors should monitor Credit Risk by tracking the trend in non-performing loans. During the Financial Crisis, Dr. Ed and Jay "graded" a bank's performance in managing Credit Risk on the trend and level of non-performing loans. By taking a moderate to low level of Credit Risk in this area, the S&B Top 15th Percentile Bank would receive honors from Dr. Ed and Jay!

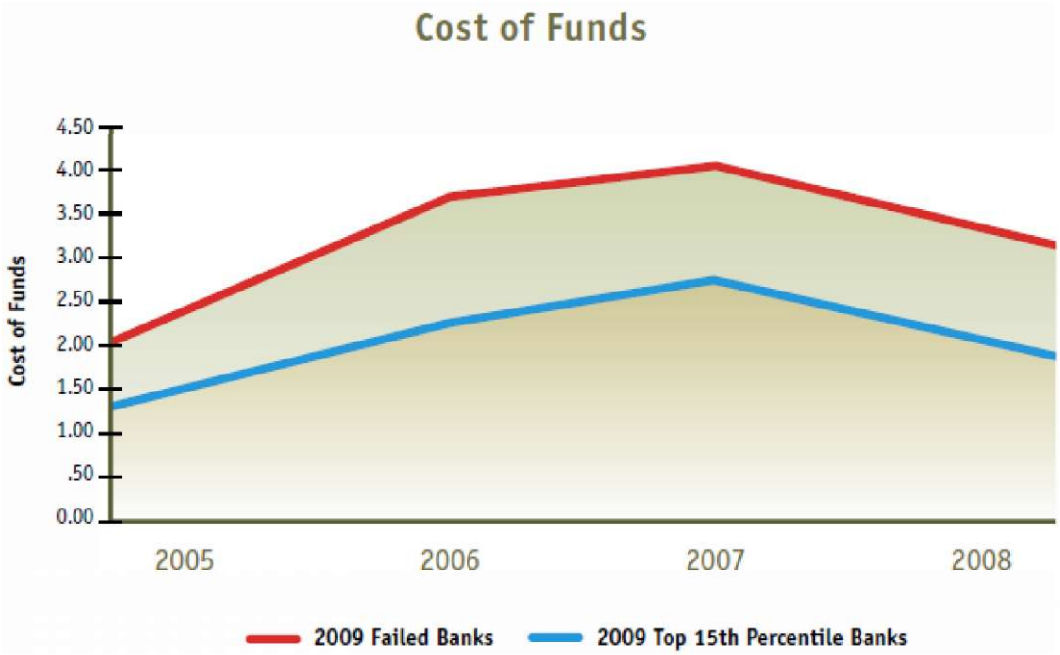
LIQUIDITY RISK

Liquidity Risk has a high weighting in the S&B Risk Index. Over time, Liquidity Risk is not only costly to a bank, but it also shows an inherent inability for a community bank to fund itself with relationships that include low-cost checking and savings deposits versus funding with "hot" money. Liquidity Risk assesses a community bank's quality of earnings. The ratios included in Liquidity Risk are discussed below.

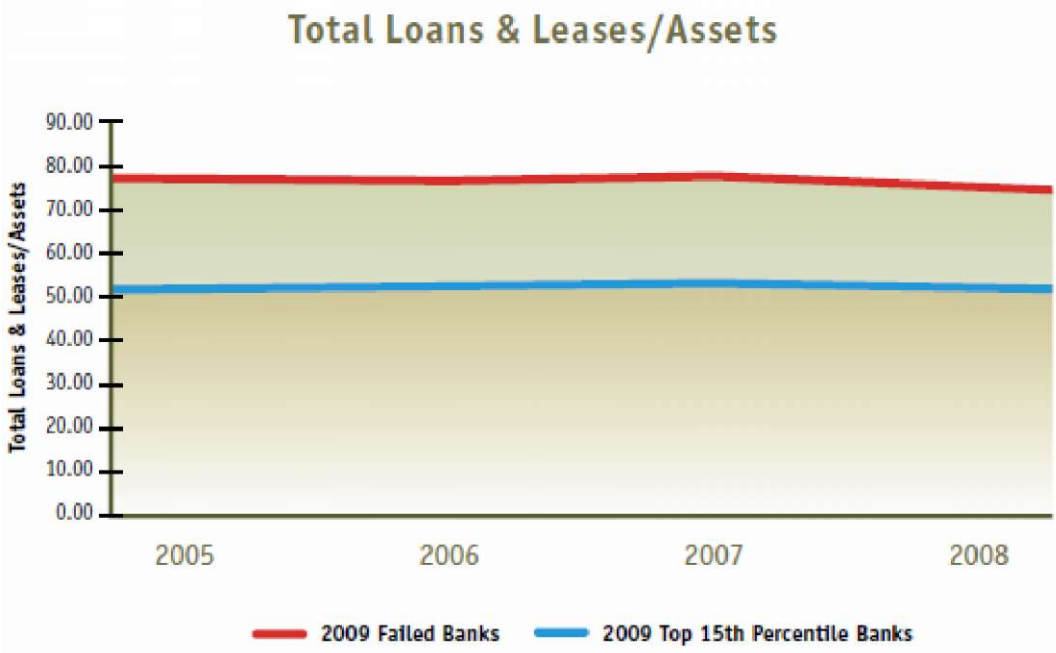
Similar to the Credit Risk indicators, Dr. Ed and Jay look at a mix of five Liquidity Risk indicators. These indicators include net loans to deposits, net non-core fund dependency, net short-term liabilities to assets, on-hand liquidity to liabilities, and reliance on wholesale funds. Two years before they were closed, the 2009 Failed Banks increased their average Liquidity Risk to three Liquidity Risk indicators. The 2009 Failed Banks' higher Liquidity Risk suggests that their aggressive lending was being funded and leveraged with more volatile funding versus the S&B Top 15th Percentile Banks.

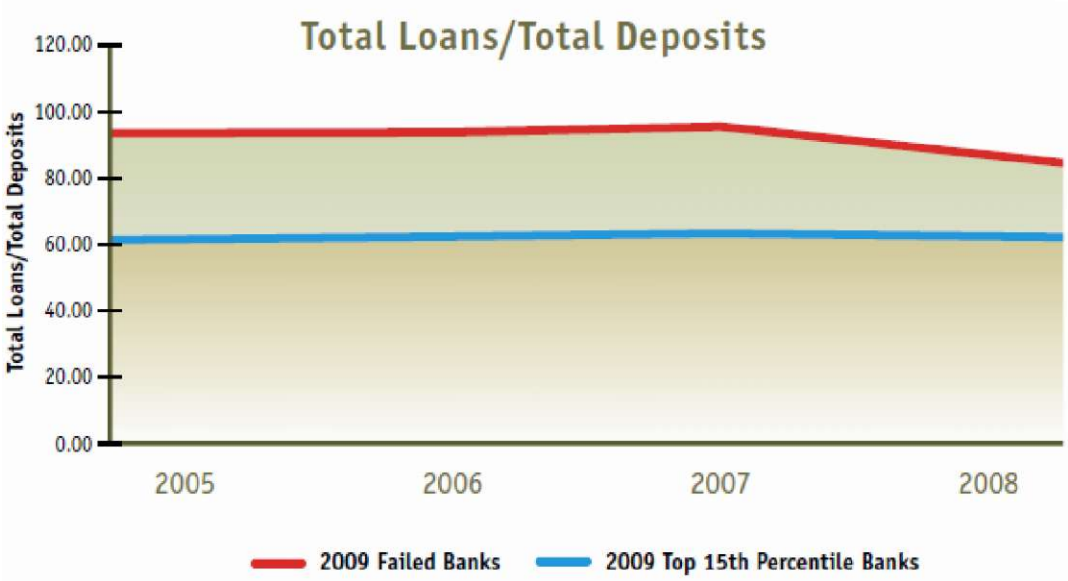


The primary key to the performance of the S&B Top 15th Percentile Banks is that they adhered to traditional, conservative community banking. The evidence of this is revealed in their complete lack of dependency on non-core funding. In other words, the S&B Top 15th Percentile Banks fund their loans with checking, savings, money markets, and local CDs. On the other hand, the liquidity ratio of the 2009 Failed Banks showed constant heightened Liquidity Risk many years before they were shuttered.



The proof of Liquidity Risk can also be seen in the actual cost of funding. The difference between the S&B Top 15th Percentile Banks and the 2009 Failed Banks is significant.
This supports Dr. Ed's and Jay's argument that community banks must focus on the strategy to build core deposits. This strategy provides more stable and higher profitability and reduces Liquidity Risk, Earnings at Risk, and Capital Risk.

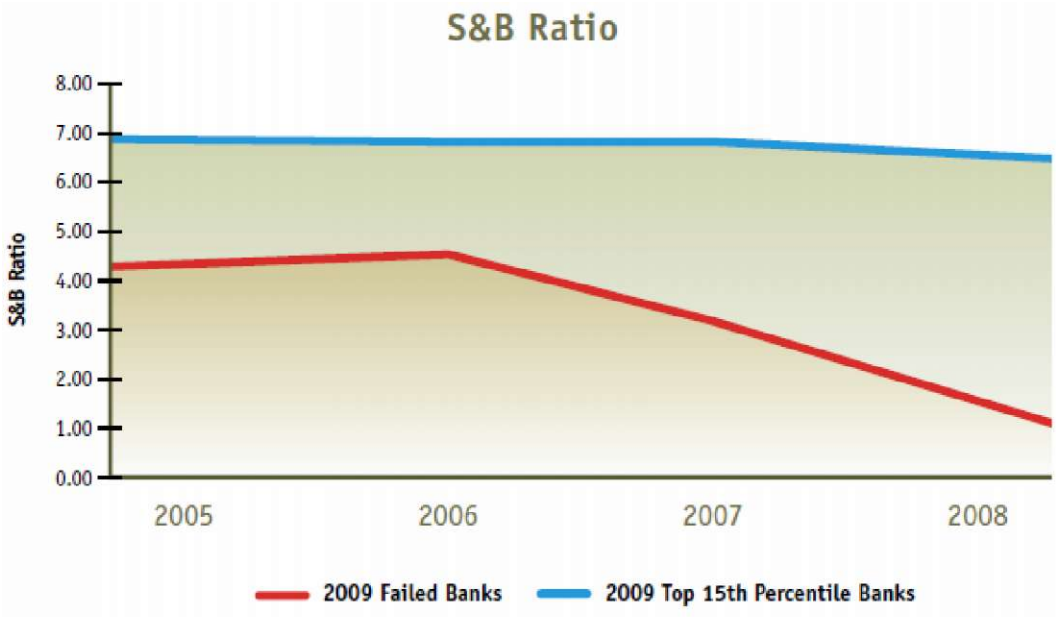


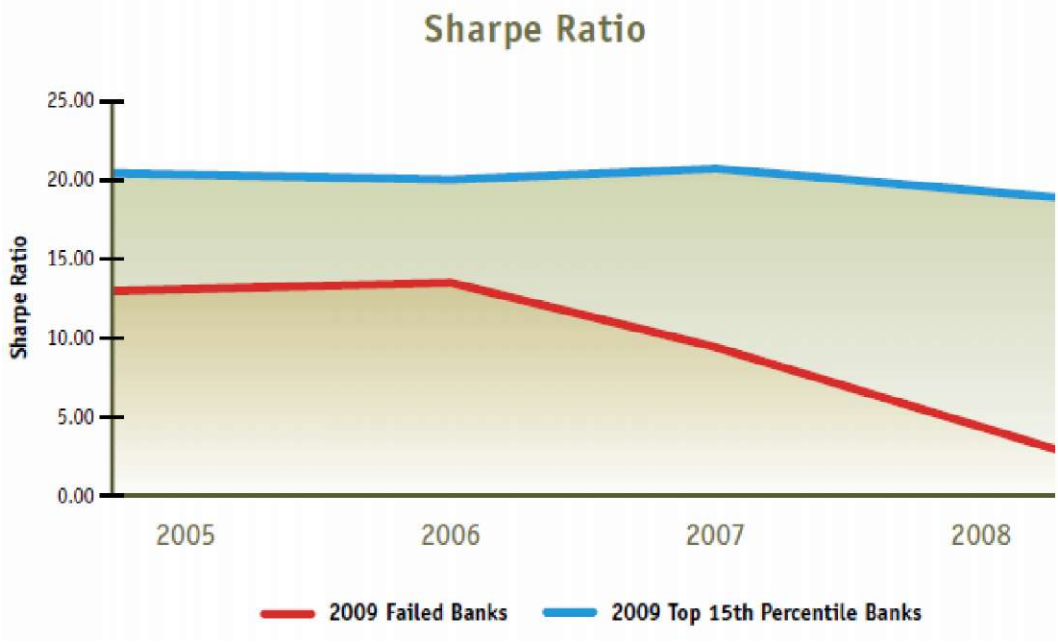


While these ratios are often considered an indicator of Credit Risk, they also point to Liquidity Risk. If a bank has loans to assets in excess of 70%, it could be surmised that there are less liquid assets, such as investments, to rely upon if liquidity is needed. In certain events, it can also place pressure on a bank to be forced into paying for high cost money to fund illiquid loans, such as what occurred during the Financial Crisis. Pre-Financial Crisis, loans to deposits was questioned as an out-of-date risk indicator. Post-Financial Crisis, the ratio is an indicator of Liquidity Risk that matches the volume of loans being funded with traditional deposits.

EARNINGS AT RISK

Earnings at Risk is the Interest Rate Risk of a community bank. While important, Earnings at Risk has the lowest weighting. The S&B Risk Index measures the volatility of the net interest margin versus the volatility of all community banks in the nation.





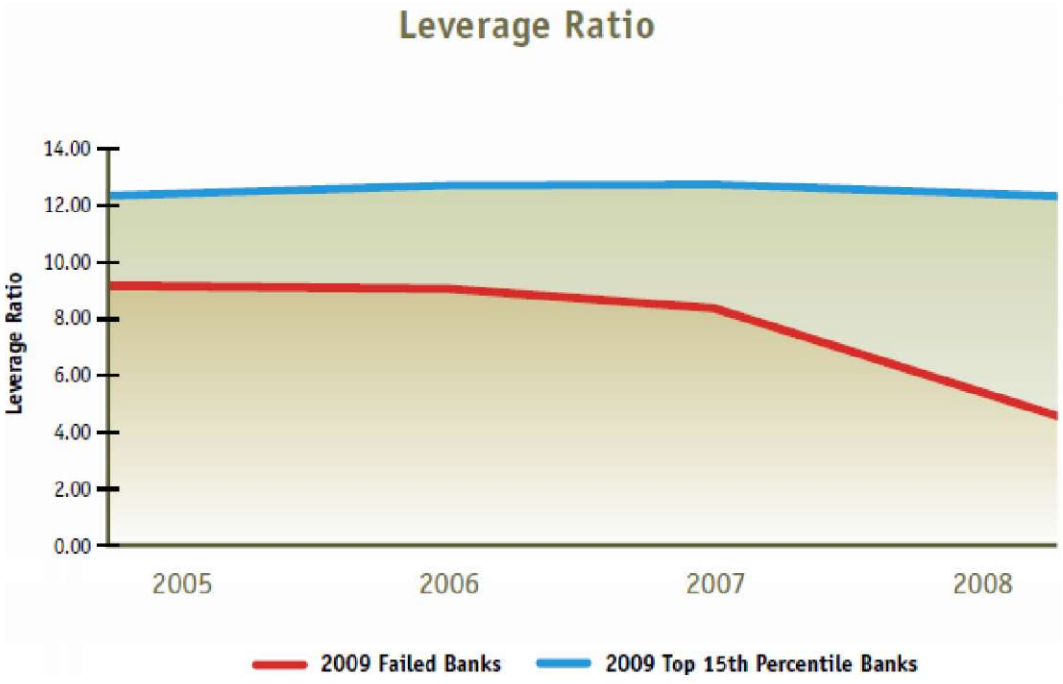
The S&B ratio and the Sharpe ratio model trends in volatility compared to a median benchmark over time. These are valuable tools when looking at the volatility of a bank's net interest margin. S&B takes an individual bank's changes in net margin and compares

it to the median of all community banks in the nation over a two year period. The more volatile a bank's margin is to the national median would be deemed a higher risk to changes in interest rates.

What is surprising to Dr. Ed and Jay is that the 2009 Failed Banks had heightened risk in all areas of risk. This created a "perfect storm" where all of the risks congregated to cause failure. It is no surprise to Dr. Ed and Jay that the S&B Top 15th Percentile Banks had significantly less volatility due to their significant level of core deposits.

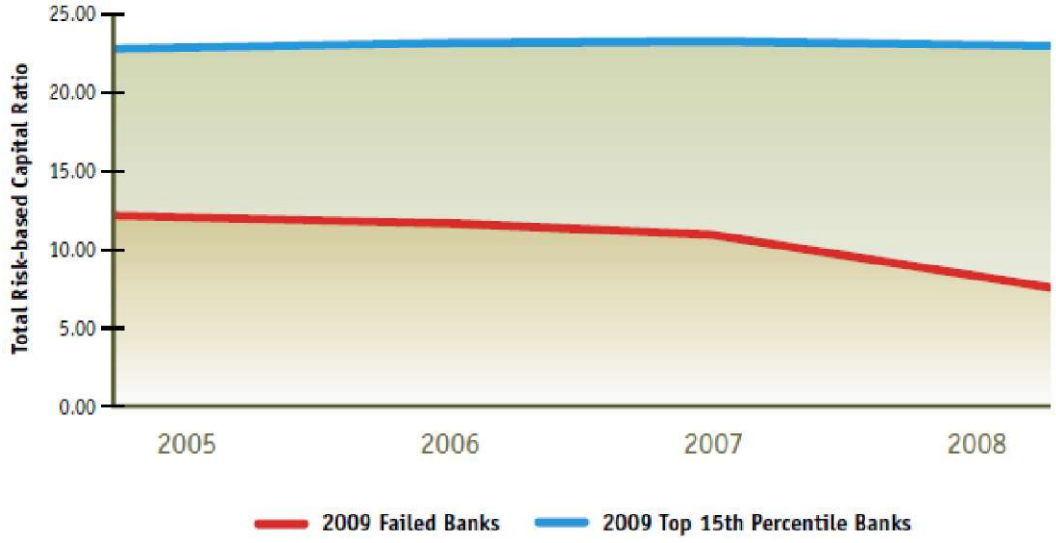
CAPITAL AT RISK

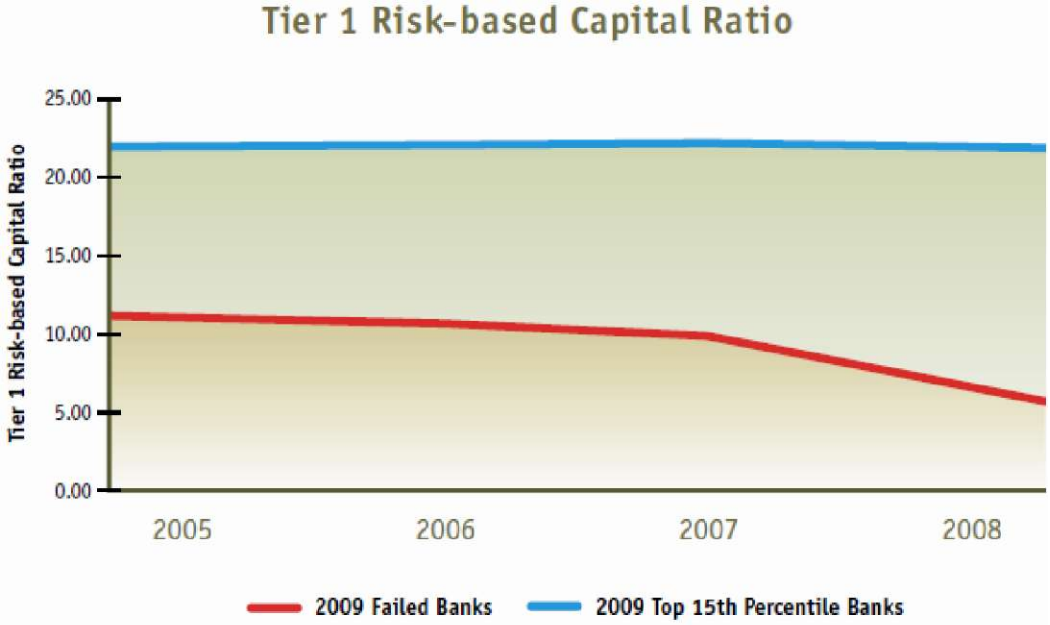
In their book *The Art of Capital Planning*, Dr. Ed and Jay ask, based on ever-changing regulatory factors, does a community bank have adequate capital to support the level of risk taken? The components of the capital ratio are illustrated by the charts on the following pages.

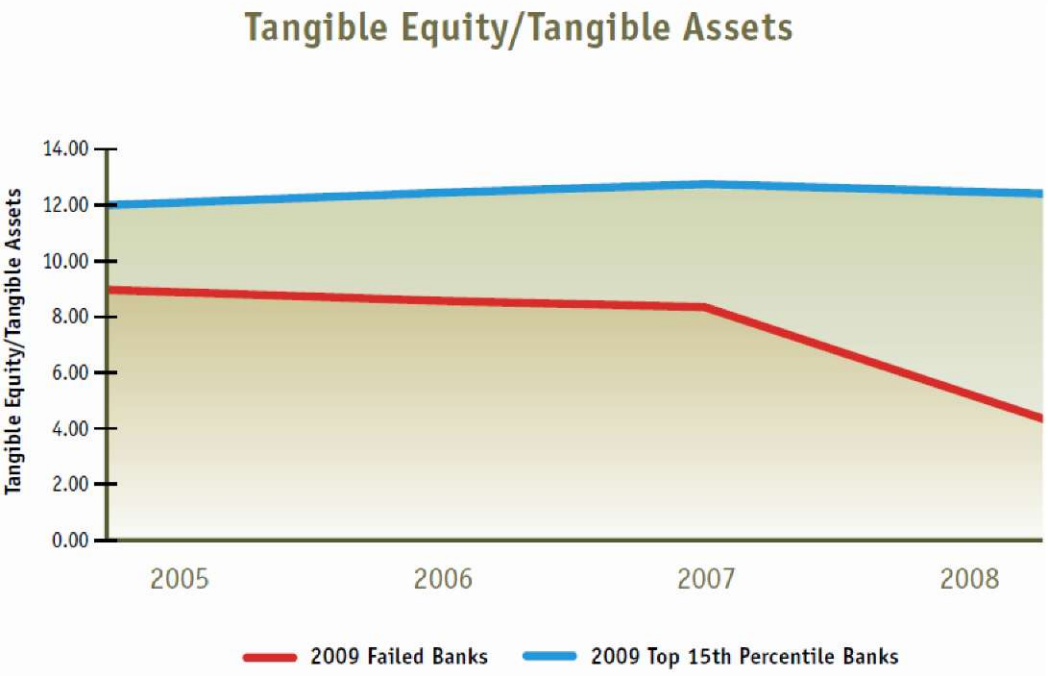


Equity to Assets

Total Risk-based Capital Ratio







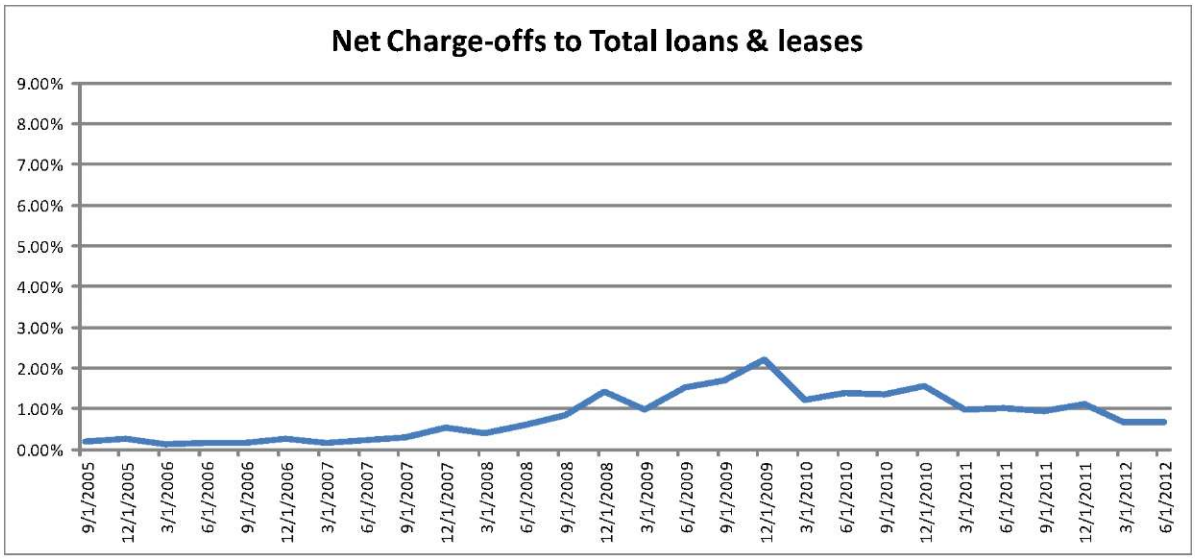
It is safe to say that the 2009 Failed Banks did not have adequate capital to support the risks they took. Yet, based on where these banks stood in 2005 at below 12% risk-based capital and below 9% tangible equity, it could be argued that the 2009 Failed Banks were also at heightened Capital Risk versus all banks in the nation and that the Financial Crisis pushed these banks quickly over the edge. Many analysts would have criticized the S&B Top 15th Percentile Banks for having too much capital pre-Financial Crisis. Yet as the results show, having a significant capital cushion is the profile that fosters an outcome of high performance.

Net Charge -Off Experience

The new capital proposals do not reflect the actual net charge-off experience of community banks after the Financial Crisis and the Great Recession. In fact, by changing the risk weightings on 1 to 4 family mortgages and home equity loans, the proposals are not properly utilizing or considering the conservative underwriting standards exercised by most community bankers.

Total Loans and Leases

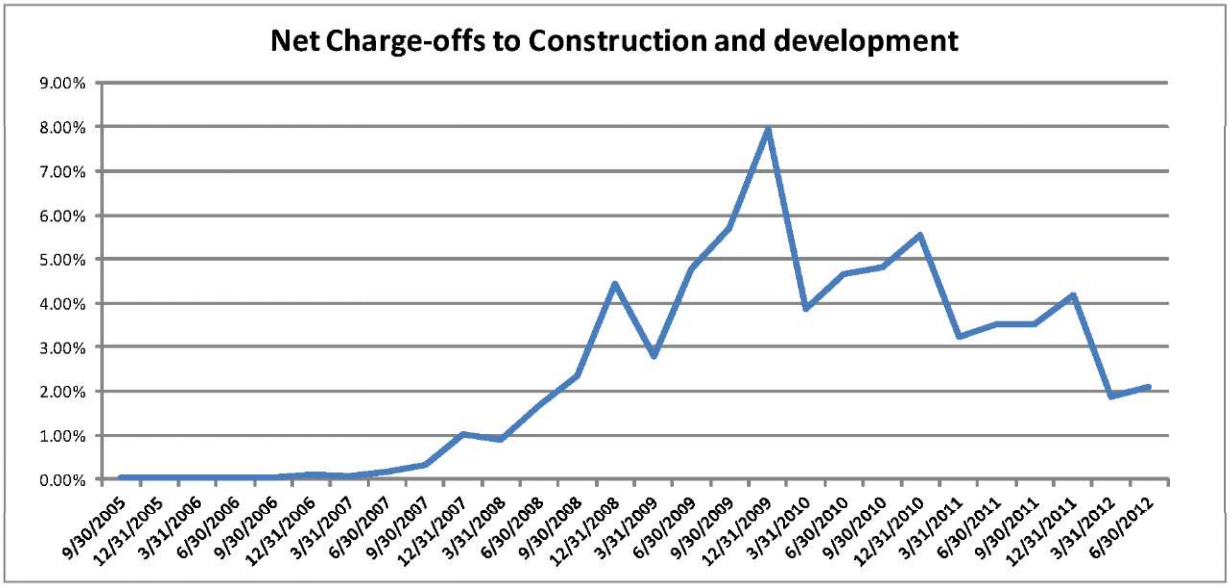
Community banks' overall net charge-off experience hit a high of 2.21% in 2009 and moderated lower throughout 2010 to 2012. While all banks have issues during a credit cycle, the actual net charge-off experience during one of the worst economies in United States history could be considered minimal.



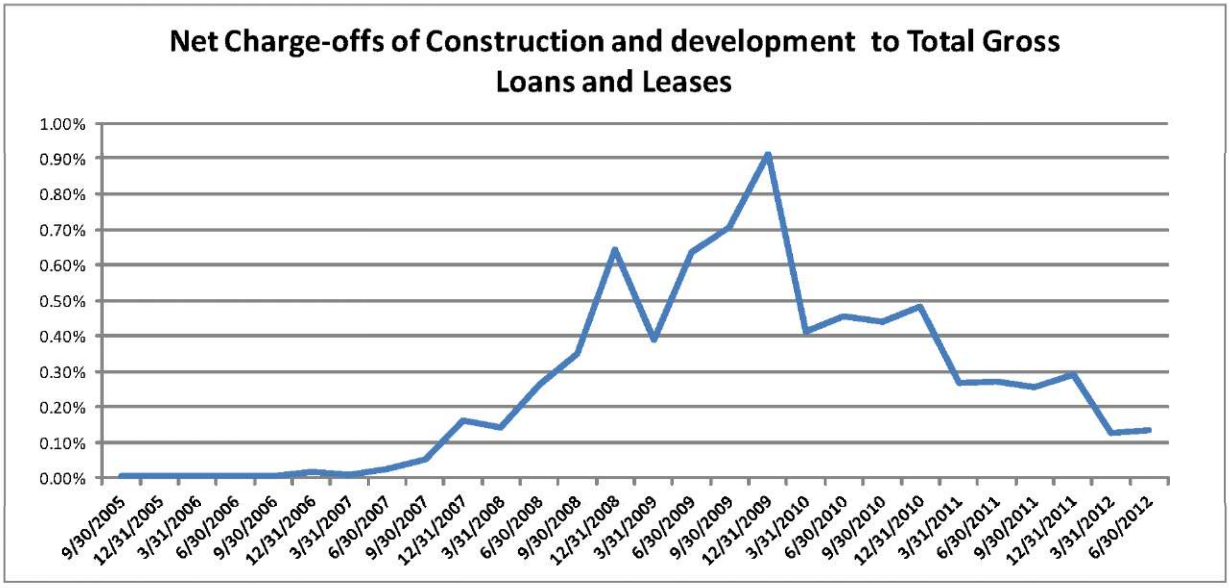
Max: 2.21% | Min: 0.13% | Average: 0.82%

Construction and Development Loans

The loans that were the root cause of the failed banks were construction and development loans. This loan type experienced the highest net charge-offs at 7.96% after the Financial Crisis and Great Recession. The new capital proposals increase the risk weightings on High Volatility Commercial Real Estate Exposure (HVCRE) to 150%. This risk weighting is too low based on the risk these loan types presented to the community banking industry over time. We recommend a 200% risk weighting on all construction and development loans.



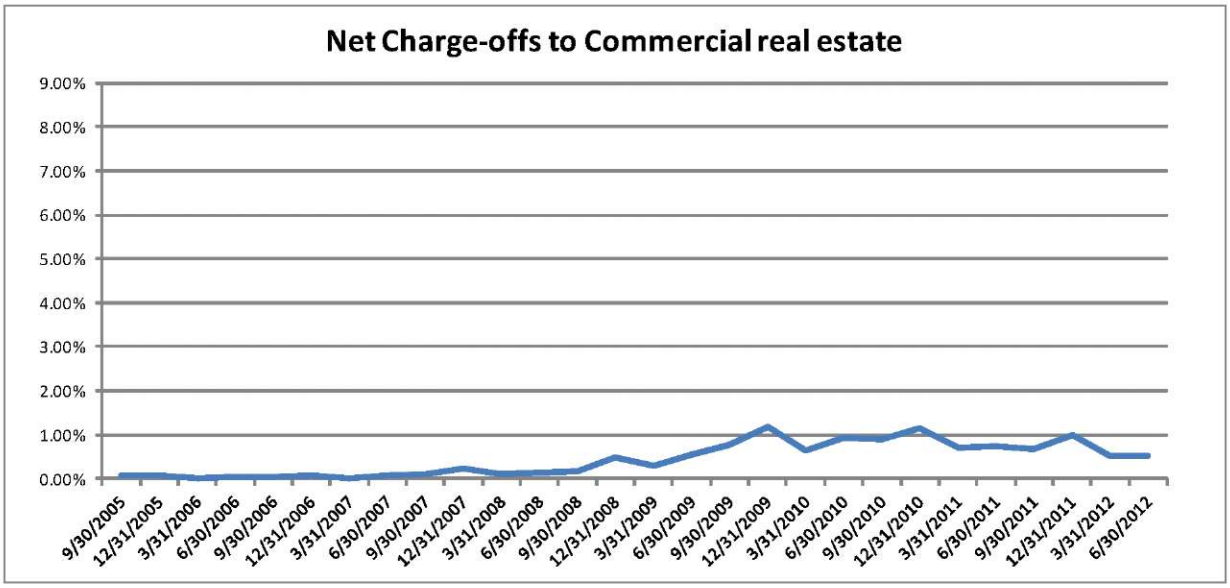
Max: 7.96% | Min: 0.03% | Average: 2.49%



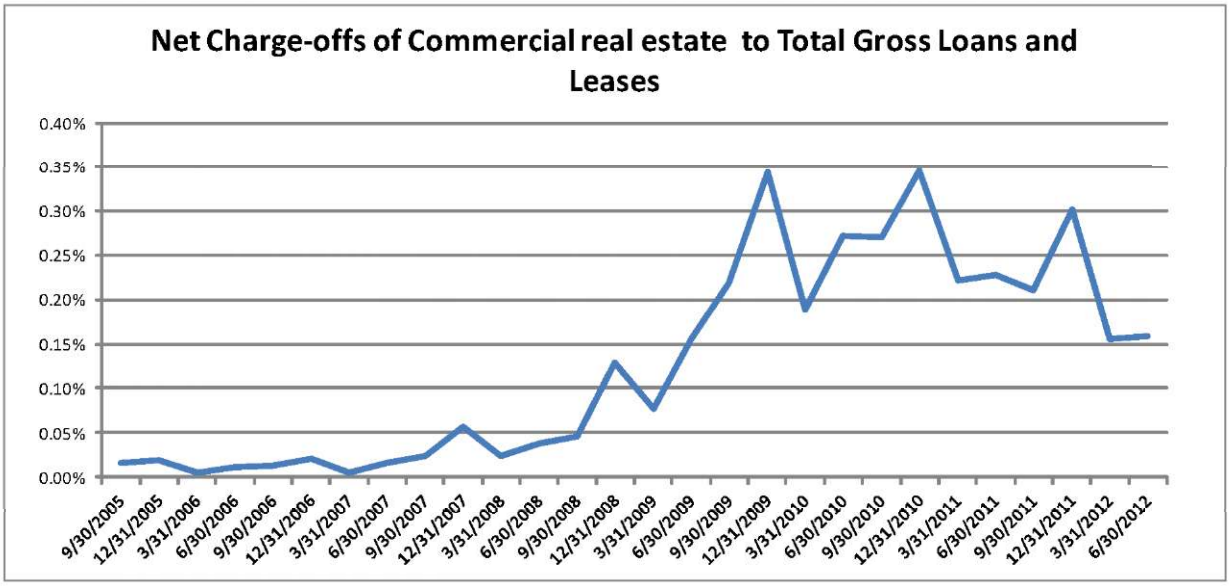
Max: 0.91% | Min: 0.00% | Average: 0.27%

Commercial Real Estate Loans

Commercial real estate loan net charge-off results are surprising. Considering the state of the economy, net charge-offs on commercial real estate loans were minimal. An argument can be made that the significant regulatory concern on this loan type has been and is overdone. Additionally, one could argue that a 100% risk weighting is too high based on the net charge-offs experienced by community banks during the Financial Crisis and Great Recession. We suggest that a 50% to 75% risk weighting is sufficient and more appropriate.



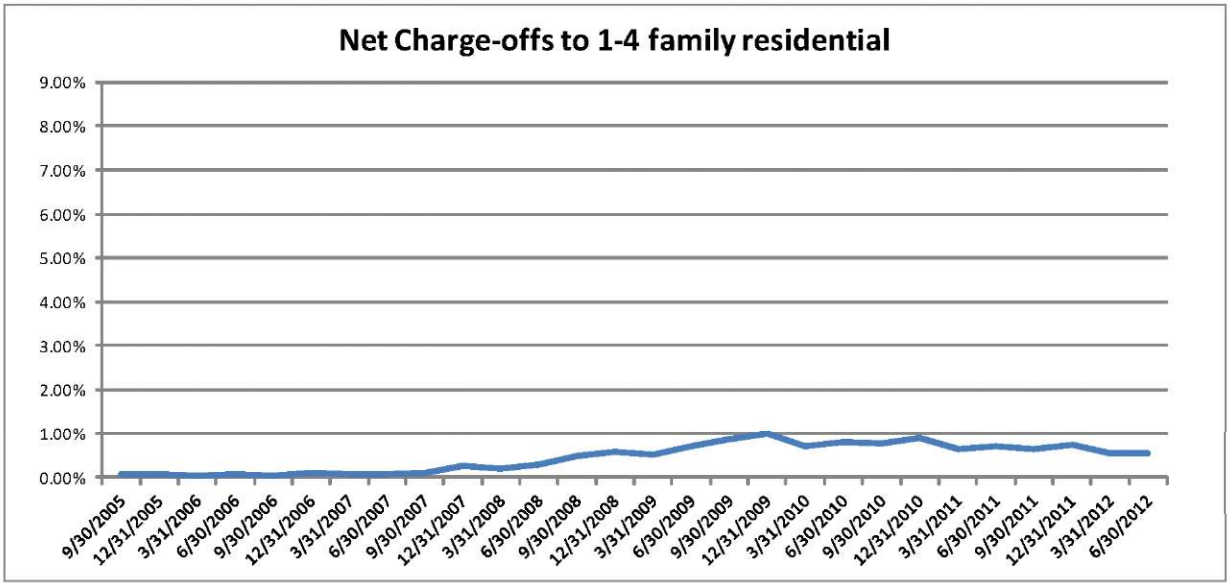
Max: 1.19% | Min: 0.02% | Average: 0.44%



Max: 0.35% | Min: 0.01% | Average: 0.13%

1 to 4 Family Mortgage Loans

The net charge-offs on 1 to 4 family mortgage loans hit a high of 1% after the Financial Crisis and Great Recession. As a percentage of total loans, this was .29%, which is negligible. Yet, the new capital proposals raise the risk weighting on these Category 1 loans to 50%. We believe a 20% risk weighting is more appropriate and sufficient.

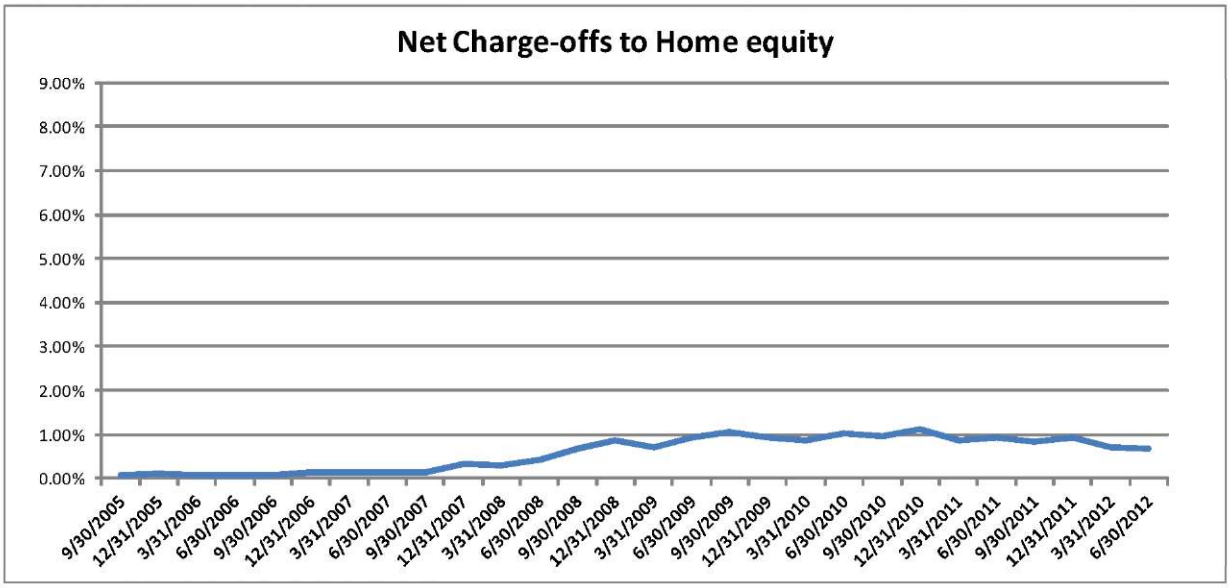


Max: 1.00% | Min: 0.04% | Average: 0.45%

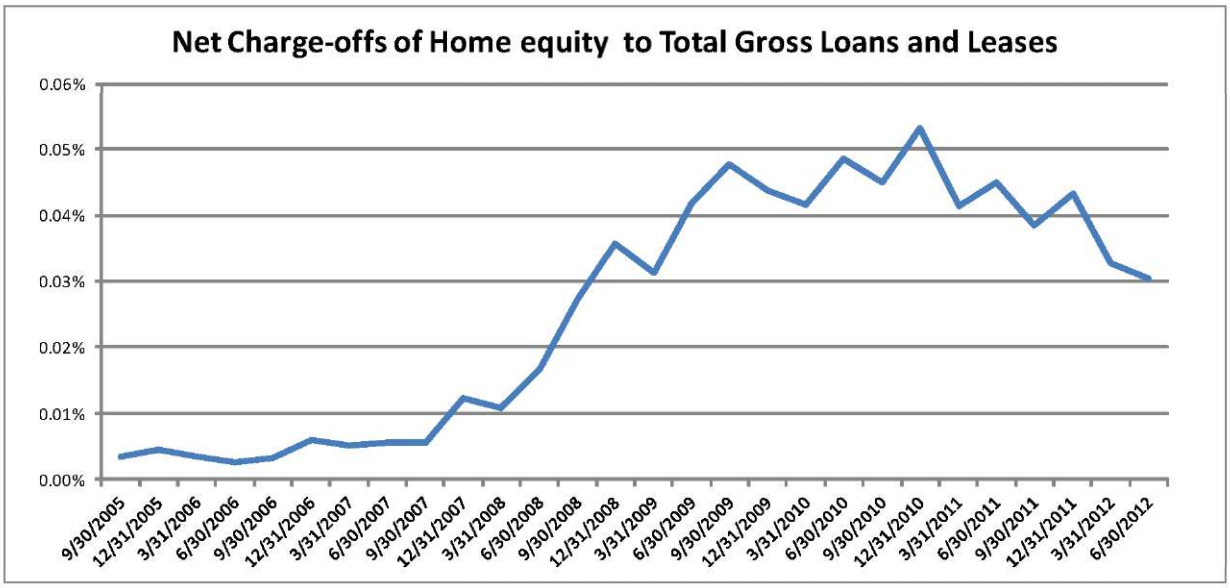
Max: 0.29% | Min: 0.01% | Average: 0.13%

Home Equity Loans

The new capital proposals identify most home equity loans as Category 2 mortgages and are considered in the proposals as a higher-risk form of lending. Community banks' overall net-charge-off experience from home equity loans during the Financial Crisis and Great Recession was negligible. The new risk weightings would require 100% risk weighting for this type of loan. Yet, the community banking industry hit only a 1.11% net charge-off high after the Financial Crisis and the Great Recession. This represented only .05% of total loans. The trend in home equity loan net charge-offs was very similar to the trends in 1 to 4 family loan net charge offs, yet the new capital proposals have very different risk weightings. We suggest a risk-weighting of 20% for this loan type.



Max: 1.11% | Min: 0.06% | Average: 0.58%



Max: 0.05% | Min: 0.00% | Average: 0.03%

Summary

In summary, the new capital proposals focus on changing the risk weightings on 1 to 4 home mortgage and home equity loans. The actual results of the Financial Crisis and the Great Recession illustrate that community banks took relatively small net charge-offs for these loan types. To increase the risk weightings for community banks makes no sense based on these results and makes the argument that the current risk weightings are more than sufficient for home mortgages and home equity loans.

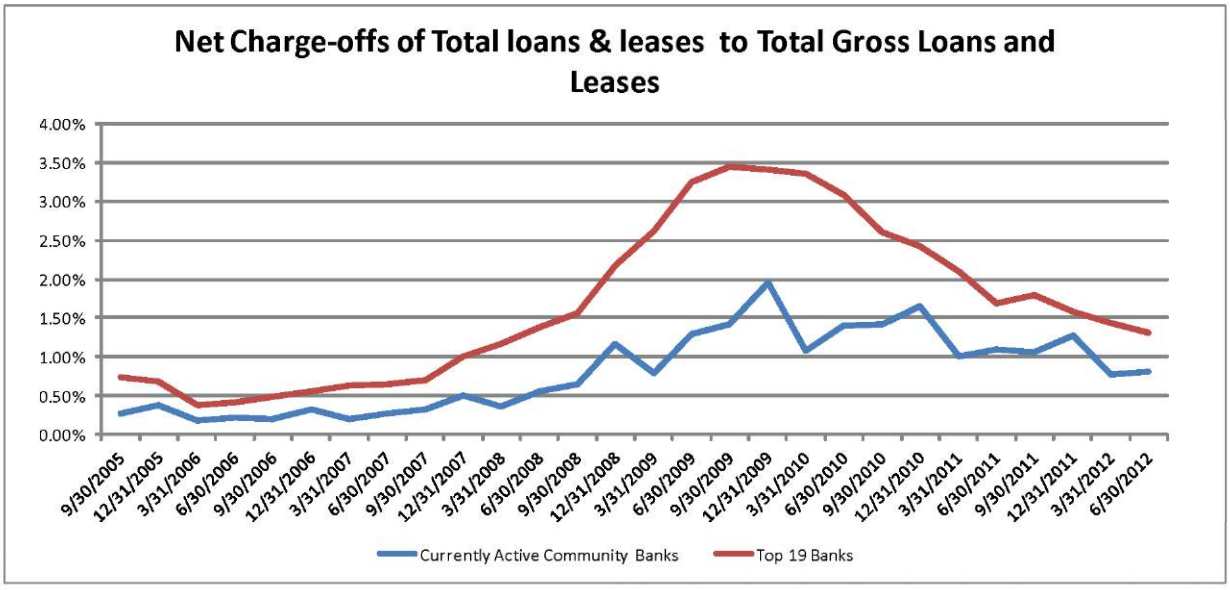
Changing the risk weightings on 1 to 4 mortgage and home equity loans will also create more paper work and employee time. There is also the risk that some banks may not want to portfolio these loan types, which could curtail lending activity and hurt consumers. For instance, a bank for which one of our principals is a director does exclusively home equity lending for first lien mortgages. The mortgage product gives the customers a cheaper and a faster home mortgage. The bank's experience with net charge –offs is significantly lower than the national average. Based on the proposed 100% risk weighting, this bank, however, may have to curtail its conservative method of lending in order to manage risk-based capital.

On the other hand, the proposed risk weighting for commercial construction/development loans is too low based on the risk these loan types presented to the community banking industry over time.

Overall, community banks should be commended for their underwriting standards and risk management of their loan portfolios. Consideration by the regulators should be given to these standards and risk management as they formulate the new capital requirements.

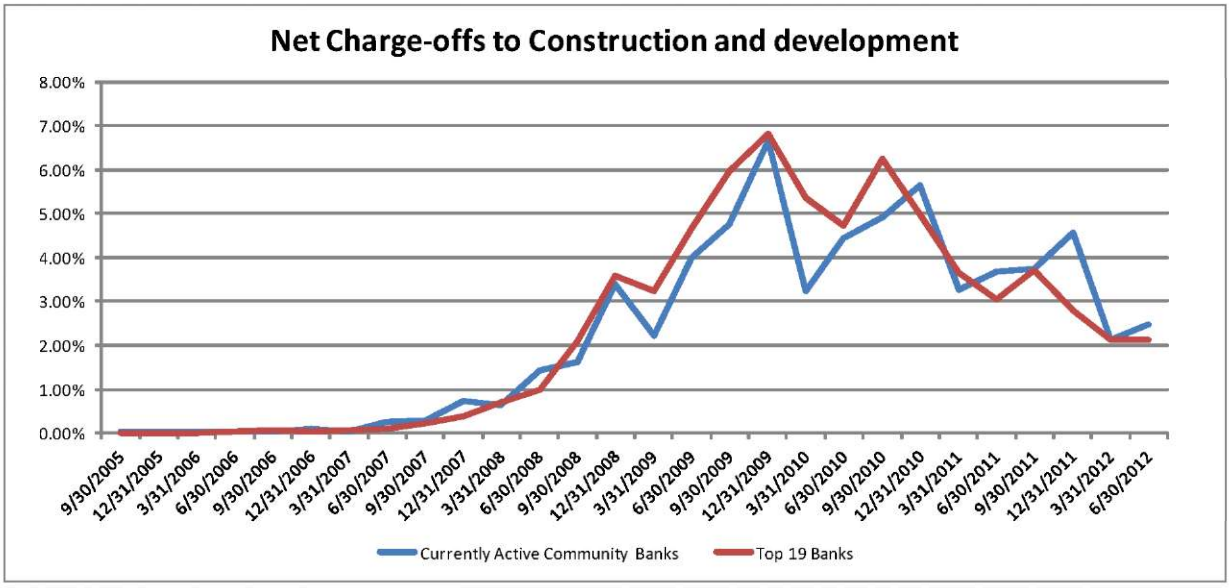
Why Community Banks are Different than Large Banks

During the Financial Crisis and the Great Recession, community banks with up to $5 billion in assets had less net charge-offs compared to the 19 largest banks.



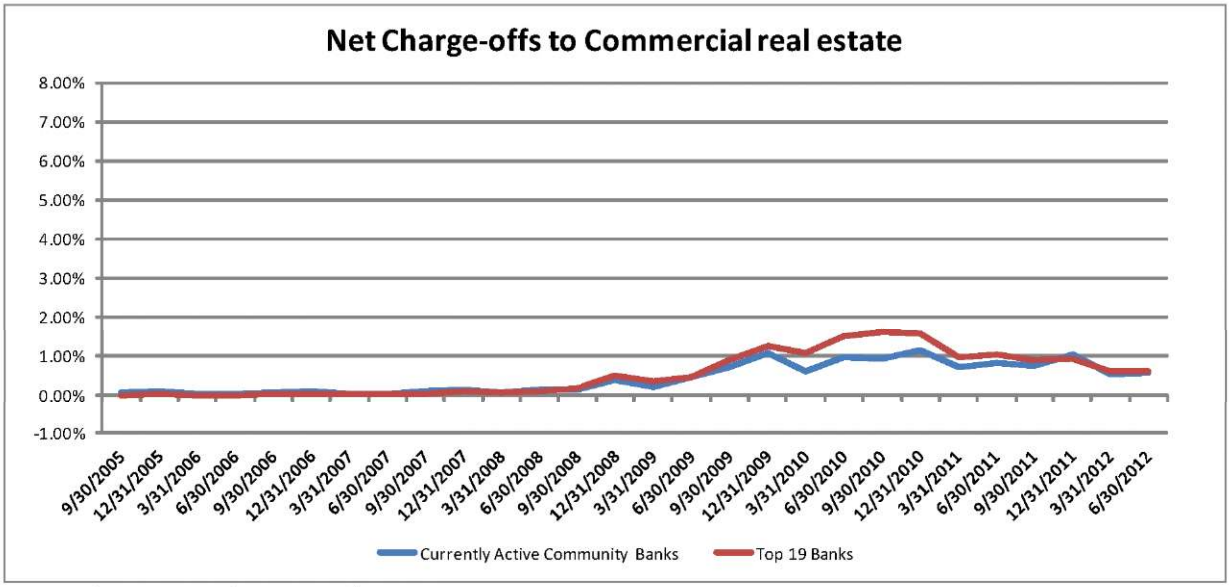
Top 19 Banks ---Max: 3.45% | Min: 0.37% | Average: 1.66%
Currently Active Community Banks ---Max: 1.96% | Min: 0.19% | Average: 0.81%

Net charge-offs on construction and development loans were similar.



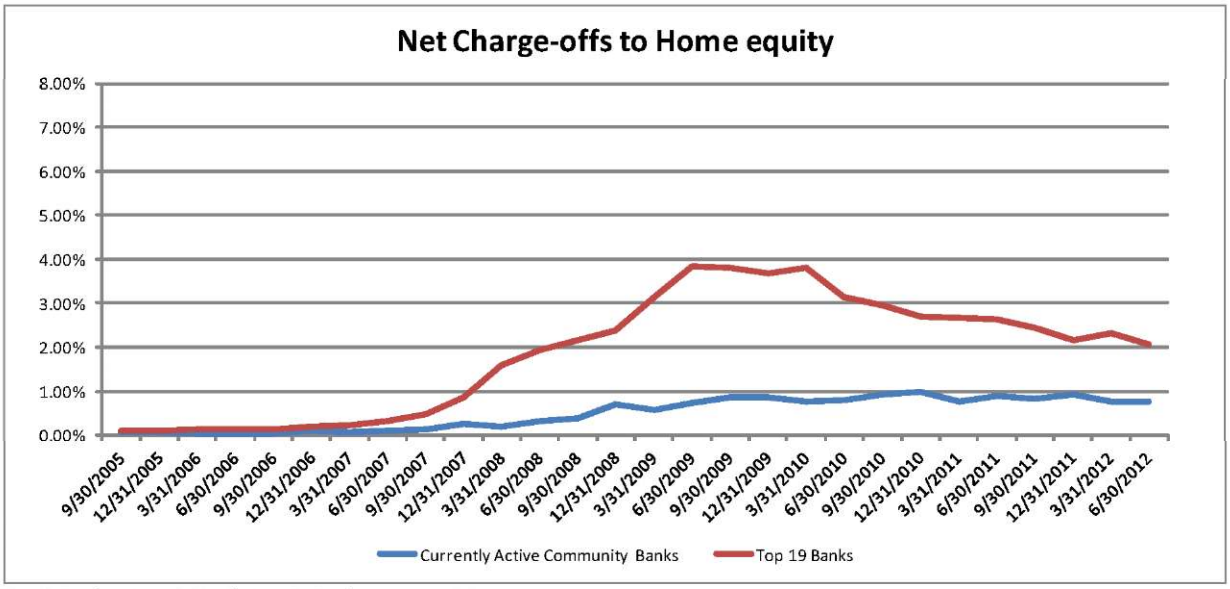
Top 19 Banks---Max: 6.81% | Min: 0.00% | Average: 2.42%
Currently Active Community Banks---Max: 6.65% | Min: 0.03% | Average: 2.30%

Net charge-offs on commercial real estate loans were also similar.



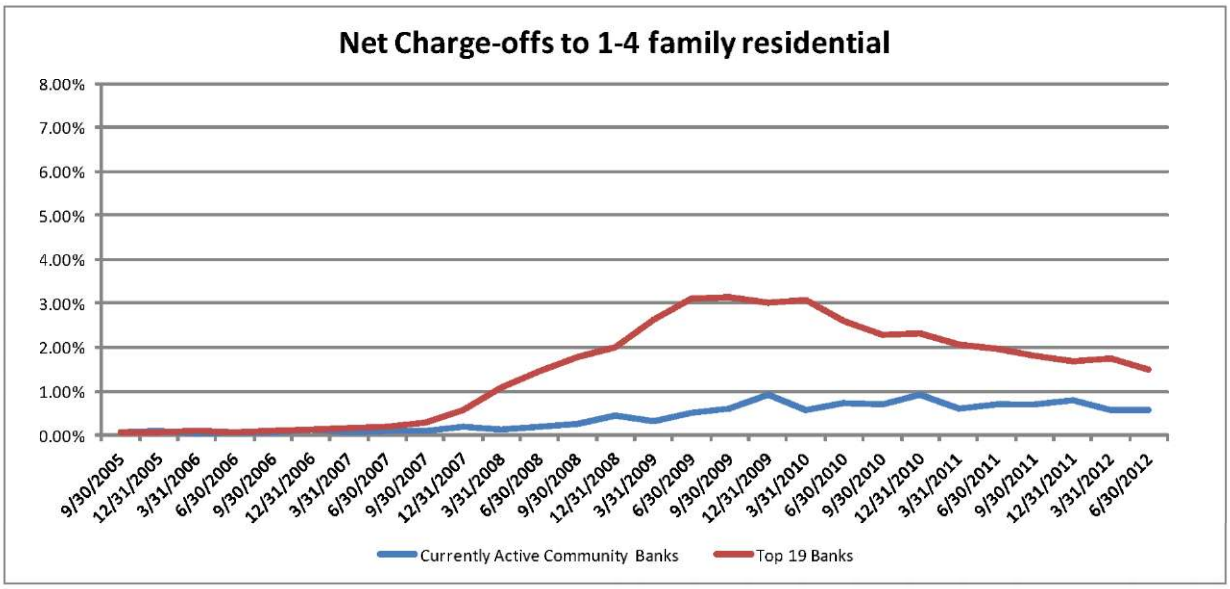
Top 19 Banks---Max: 1.60% | Min: -0.01% | Average: 0.54%
Currently Active Community Banks---Max: 1.14% | Min: 0.03% | Average: 0.44%

The difference in net charge-off experience was in the housing sector. The 19 largest banks took significantly more in net charge-offs on home equity loans than community banks.



Top 19 Banks---Max: 3.83% | Min: 0.10% | Average: 1.86%
Currently Active Community Banks---Max: 0.99% | Min: 0.04% | Average: 0.50%

Net charge-offs were also more significant on 1-4 family residential mortgages for the 19 largest banks.



Top 19 Banks---Max: 3.14% | Min: 0.07% | Average: 1.46%
Currently Active Community Banks---Max: 0.93% | Min: 0.05% | Average: 0.40%

From the level of net charge-offs experienced, the argument can be made that community banks had underwriting standards and risk management that were superior to the 19 largest banks. This also supports the argument that community banks should have different capital requirements than the 19 largest banks. Yet, the new capital proposals do not make this differentiation. The 19 largest banks have a totally different business model than community banks. The capital requirements should be geared to the risk of the business model for the financial institution.

The Impact of Available-for-Sale (AFS) Gains or Losses on Tier 1 Capital

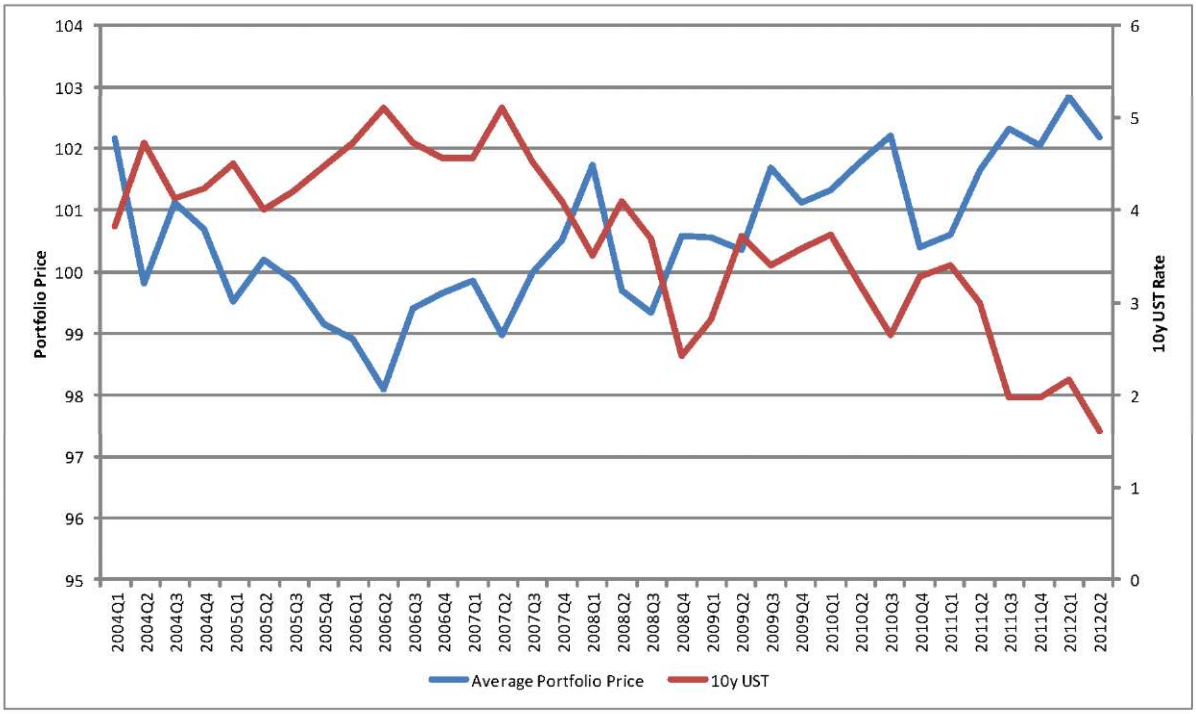
How can one area of the balance sheet have an impact on Tier 1 capital when the rest of the balance sheet is ignored? The proposed treatment of "comprehensive income" in the new capital proposals ignores how community banks balance their risk. In one sense, the regulators have focused directors and management on asset liability management. We are proponents of this focus. Directors and management have learned that interest rate risk on capital, earnings, and liquidity can be balanced in a way that is profitable and has less risk. The new capital proposals, however, ignore the approach of analyzing all assets and liabilities. The new capital proposals focus on the AFS investment portfolio for community banks.

For instance, the bank for which one of our principals is a director has more than 70% core deposits to total deposits. This bank has a very stable deposit base. The positive liability structure gives this bank flexibility within its investment portfolio. When the board of directors reviews this bank's asset liability model, the bank's risk is very balanced in a rising interest rate environment. Its economic value of equity (EVE) capital is very strong and very stable under shocks and interest rate simulations. If the new capital

proposals are effectuated, this bank will not be balanced for Tier 1 capital and its board of directors will be forced to manage the investment portfolio in order to manage Tier 1 capital.

For community banks, this new capital proposal could reduce their central focus of making loans to members of their communities.

Sub Chapter S community banks have the additional impact of not being able to reduce the AFS portfolio losses with a deduction for taxes. If their AFS portfolio is at a loss, the entire loss is deducted from Tier 1 capital. Sub Chapter S community banks would be at a disadvantage to other community banks that are able to deduct the tax on any losses on the AFS portfolio. As one Sub Chapter S banker commented, "Our bank was well-capitalized before the capital proposals, now we are questioning if we are well-capitalized."



Source: SNL Financial LC and Bloomberg LP

The chart above illustrates the volatility of community bank AFS investments. The new capital proposal for community banks' Tier 1 capital ratios could be very volatile if interest rates change. While this is the case with equity to assets, the volatility has been confusing to the public. If the new capital proposals take effect, the public will be even more confused and may even question a bank's viability. This reputation risk could cause a "run on" deposits and a loss of customers.

The Impact of the Capital Proposals on Longer-Term Investments

Another risk presented by the proposed capital requirements is they could cause community banks to reduce their holdings of longer-term US Agency debt, US Agency mortgage-backed securities, and municipal bonds. As of the second quarter of 2012, community banks with assets up to $5 billion had the following holdings:

US Agency Debt $375,546,812,000;
US Agency mortgage backed securities $269,961,636,000; and
Municipal bonds $114,907,661,000.

Community banks typically purchase the debt of the US Agencies. Community banks may be forced by the capital proposals to reduce or even eliminate the longer-term maturities. This would have the potential to negatively impact earnings. Potentially, the mortgage markets could be impacted because the US Agencies tend to pass on the higher cost of their debt, as well as increase mortgage rates and fees charged to consumers.

The community banking industry not only sells mortgages to the US Agencies, but purchases these securities for their investment portfolios. US Agency mortgage-backed securities tend to be longer-term investments with higher market volatility. Community banks may be forced by the capital proposals to reduce or even eliminate these holdings. This would have the potential to negatively impact earnings. As stated previously, there is also the potential that it could impact the mortgage markets and increase the mortgage rates charged to consumers.

Many community banks purchase bank-qualified tax-exempt municipal bonds. These bonds also tend to have longer maturities. Historically, bank-qualified municipal securities have a lower cost than general market municipal securities when issued. This saves small communities on the cost of building their schools, water systems, sewage systems, etc. Community banks purchase bank-qualified tax-exempt securities because the tax savings are inherent to bank-qualified municipal securities versus general market municipal securities. Community banks may be forced by the capital proposals to reduce or even eliminate these holdings. This would also have the potential of reducing their earnings. Moreover, there is also the possibility that the markets could be disrupted leading to a higher cost of debt for our nation's small municipalities.

What's more, community banks often purchase taxable municipal securities. Again, these bonds tend to have longer maturities. Community banks may be forced by the capital proposals to reduce or even eliminate these holdings with the potential of reducing their earnings. Likewise, the markets may be disrupted leading to a higher cost of debt for our nation's municipalities.

Alternate Capital Proposals

If the regulators consider alternate capital proposals, we respectfully request they consider creating capital requirements which are geared to the community bank business model. The community bank business model is very different than the money center bank, regional bank, or international bank business models.

Alternate capital proposals for community banks should focus on traditional, conservative community banking. There should be components that include *"community banking"* credit risk, liquidity risk and earnings at risk. National economic risk and state economic risk should also be considered. If a community bank chooses a business strategy that is an outlier to the traditional, conservative community bank business model, it should be required to have significantly higher levels of capital.

Whatever alternate capital proposal is pursued, regulators should consider eliminating the current minimum capital requirements. All of the failed banks met the minimum capital requirements at some point in time, but as their issues increased, they did not have enough capital to adequately cover their risks.

The central philosophy of an alternative capital proposal for community banks is to foster a wiser, conservative risk-management process at each community bank. If a community bank board understands that an increase in risk will mean additional capital will need to be raised, it may not agree to take on that additional risk or will pursue the riskier strategy in a different manner. For instance, there is a "myth" in the community banking industry that making more loans will create more earnings. There is no historical correlation to this strategy. Yet, if a board is faced with raising more capital for this strategy, it may come to the conclusion that the additional earnings and funding of the loan loss reserve will not create the expected return on capital. The point is, the analysis and discussion will result in a higher level of due diligence on behalf of the board of directors with capital being the motivating force.

The regulators should also consider working in concert with community bank directors, management, and outside experts. Considering that community banks contribute to the FDIC Fund, they should have a say in how that fund is protected.

<u>Alternate Capital Proposal 1</u>

EVE is an alternative capital calculation that is approved by the regulators but is not used for regulatory capital. EVE calculations are in place at all community banks. EVE values the entire balance sheet. Based on the type of balance sheets that the failed banks had, the failed banks would have had relatively low EVE ratios as a percentage of capital. On the other hand, conservative community banks with large-core deposit bases will have higher EVE ratios.

A minimum threshold for EVE ratios could be set. Liquidity risk and earnings at risk are currently stress tested by most asset liability models and could be incorporated into the EVE ratios. A separate test for credit risk could be utilized with the EVE ratio. This would involve a credit stress test of each community bank's loan mix. Once again, a minimum threshold could be set based on the impact of the stress tests.

Alternate Capital Proposal 2

Utilize an independent, third-party assessment of risk. An independent, third party could remove the onus between the regulator and the community banker by providing a risk model with known inputs and results. The model would also have proven back testing to determine how effective it is in predicting bank failures and significant issues with community banks.

Based on the risk assessment, community banks would be required to have minimum capital requirements based on their risk score. The risk score for each bank would be updated quarterly. Community banks and the regulators could monitor the risk scores. Since the inputs would be understood, community bank directors could do "what if" scenarios to determine their future risk scores based on their strategic plan. Actions could be taken to increase or decrease risk accordingly to meet targeted capital levels.

Regulators could monitor risk trends in each community bank, by region, by state, and on a national level.

As an example of an independent, third-party assessment of risk, the Seifried & Brew Total Risk Index ("S&B Risk Index") assesses capital risk, credit risk, earnings at risk, liquidity risk, national economic risk, and state economic risk. The S&B Risk Index gave early warning signs to the banks that failed during the Financial Crisis long before they failed. In 2009, the S&B Risk Index predicted 99.15% of community banks that failed in 2010. The S&B Risk Index accurately determined that these banks were operating with higher risk versus all community banks in the nation that weathered the storm. In fact, going even further back, the S&B Risk Index could predict:

In 2008, 91.4%,
In 2007, 86.4%,
In 2006, 81%, and
In 2005, 71.7%

of those banks that ultimately failed in 2010.

Of all the community banks that failed during the Financial Crisis, the S&B Risk Index predicted approximately 97.5% a year in advance, 90.2% two years in advance, 80.5% three years in advance, and 75% four years in advance! Using the S&B Risk Index would have given these banks insight long before the issues of higher risk resulted in the losses that eroded the banks into failure.

S&B believes that economic risk must be quantified by community banks and, as such, national and state economic risks are factored into the S&B Risk Index. One of the lessons learned from the Great Recession is the erosion of the economy was not consistent nationwide. For example, the Texas economy was relatively unaffected while one state away, in Arizona, the economic downturn was severe. Therefore, a community bank operating in Arizona had different issues than a similar bank operating in Texas. Because the S&B Risk Index incorporates both a national economic weighting as well as a state economic rating, it is a good predictor of risk to banks no matter where they are located. Neither the current minimum capital requirements nor the proposed capital requirements take the economic impact into consideration.

Alternate Capital Proposal 3

This alternate capital proposal is similar to the process that community banks perform in determining their Allowance for Loan and Lease Losses. This would allow each bank to perform an internal risk assessment and determine what level of capital would be required. Capital planning that is dynamic would help directors and management better understand risk.

The regulatory input, requirements and oversight of developing the ALLL has created a dynamic process and outcome. This could also be integral to community bank capital planning.

In our book *The Art of Capital Planning – The "How To" Guide,* we illustrate the features of a dynamic capital plan. An excerpt from the book is set forth below and on the following pages.

> **What will be the future capital position of the bank?** The answer to this question is driven by and connected to the strategic plan. The forward strategic planning model illustrates the dollar value of capital and all pertinent ratios projected out over time. Ideally, the strategic plan is projected out over a period of 10 years.
>
> **What are the minimum capital targets set by the board?** The minimum capital targets should correspond to the bank's capital policy.
>
> **What is the bank's credit risk**? The answer to this question includes an overview of the bank's historical and current credit performance. Comparisons to national and state peer groups should also be undertaken.
>
> **What happens to the capital plan when it is "credit shocked"?** The capital plan should be "credit shocked" under worst-case scenarios. The other exercise should be to determine what level of net charge-offs would result in the bank being undercapitalized.
>
> **What is the bank's economic value of equity (EVE)?** This review includes a breakdown of what drives the bank's EVE, such as the bank's level of cash-type deposits (checking, savings, and money market accounts).
>
> **What are the effects of interest rate shocks and interest rate simulations on capital?** To answer this question, EVE must not only be shocked +/- 400 basis points for regulatory purposes, but should also reflect the impact on EVE based on at least two yield curve simulations.
>
> **What are the bank's earnings at risk?** Though earnings at risk are a component of EVE, there should be a historical review of the bank's interest rate risk management to achieve a better understanding of earnings at risk.
>
> **What is the bank's liquidity risk?** The Great Recession has placed new emphasis on contingency liquidity planning and its relationship to capital strength. What is the impact of a liquidity shock on the bank? Will the bank have sufficient capital to survive a liquidity crisis?

What is the bank's risk to economic cycles? The Great Recession has been a reminder that national and regional economic trends will have an impact on the bank. How will economic change impact the bank's capital plan?

What is the bank's risk to concentrations? The results of failed banks revealed that concentration risk in construction and development loans and wholesale funding was a high risk. Will concentration risk require more capital?

What is the bank's dividend plan? When applicable, the dividend can impact capital over time. Will payment of a cash dividend cause the capital goals to be met or missed?

What is the impact of the bank's incentive plan on capital? Will the bank have sufficient capital to support the bank's incentive compensation program?

What event triggers will the board monitor? Internal and external events can impact a bank's capital. What events could impact the bank's capital and how will the board monitor the events?

Have you provided for a contingency capital plan? This plan should include all the methods and possibilities of increasing capital ratios or raising capital, including the amount of capital to be raised and the time necessary to effectuate the capital raise.

Alternative Capital Proposal 4

Under this proposal, we suggest keeping the current capital regulations the same. Currently, community banks with up to $5 billion in assets have an average Tier 1 capital ratio of 9.69% and a Total Risk-Based capital ratio of 15.49%. Many community bankers argue that this is more than sufficient capital.

We hold that segmenting the banking industry by size and exempting all banks under $5 billion dollars in assets from the new capital standard. The record from the recent past is very clear; the net charge-offs of the largest banks were much higher than those of the community banks. We argue that if the currently existing community banks had insufficient capital levels, the latest economic downturn would have most certainly exposed the deficiencies in the existing capital rules. By imposing the higher capital requirements on all banks, across the board, seems to us to be inappropriate. Further, the higher requirements could lead to the unintended consequence of significant attrition of community banks, with severe economic consequences to the communities they serve.

As in our other alternate capital proposals, we believe that community banks need dynamic risk-based capital requirements that will protect the community banking industry and the FDIC Fund.

Summary

The new capital proposals are not geared to the community banking industry. The community banking industry needs a risk-based capital system that will protect and nourish each individual community bank. Each community bank must have capital requirements that cover the risk tolerance of the board. Low-risk banks should be awarded with lower capital requirements. Higher risk banks should require more capital. However, the level of capital required cannot remain static; the requirements must be dynamic to support the level of risk taken on by a community bank either directly through its strategic plan or indirectly as a result of economic changes. The risks that need to be properly capitalized are credit risk, earnings at risk, liquidity risk, national economic risk and state economic risk. The new capital proposals do not address these issues.

Respectfully submitted,

Jay Brew, Co-Chairman
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