KBW KEEFE, BRUYETTE & WOODS

October 17, 2012

Federal Deposit Insurance Corporation,
550 17th Street, N.W.
Washington, D.C. 20429
Attention: Robert E. Feldman, Executive Secretary
Comments/Legal ESS
RIN 3064-AD95, -AD 96 & AD97

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551
Attention: Jennifer J. Johnson, Secretary
Docket No. 1430; RIN No. 7100-AD87

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 2-3
Washington, DC 20219
Docket ID OCC-2012-0008, -009 & -0010

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

Ladies and Gentlemen:

Keefe, Bruyette & Woods, Inc. (KBW) is pleased to offer comments on the Notices of Proposed Rulemaking regarding the implementation of the Basel III capital regimen, published by U.S. banking regulators on June 7, 2012. KBW is a full service investment bank, specializing in the financial services industry since 1962. We provide investors and financial services companies with research, fixed-income and equity sales and trading, and investment banking and financial advisory services. A core business objective of KBW is serving the needs of small- and medium-sized banking organizations in the United States. As such, we have a unique perspective on the operations of banks in the United States, particularly with institutions that have total assets of less than $10 billion. As of June 30, 2012, banks with total assets under $10 billion represent 98.5% of the number of institutions and 20.3% of total industry assets.

While there are many aspects of the Basel III proposals included in the three NPRs issued in June that are worthy of comment, we are most interested in several facets that are particularly vital to the health and stability of the community banking industry – the backbone of the banking system in small towns and cities throughout the country. As such, we believe that our views can help the banking regulators better understand the unintended and adverse effects that we believe implementation of Basel III as presently proposed would cause.

We caution regulators to carefully consider the application of Basel III to smaller banking institutions, and suggest that the salutary aspects of the Basel Capital Accord framework inherent in bolstering the quality and quantity of capital would be significantly mitigated by the negative impact we foresee Basel III having on the vital community banking industry. **Specifically, and most importantly, we recommend that certain aspects of the Basel III framework should not be imposed on banking institutions with assets below $10 billion.**

At the outset, we would point out that the Basel framework has never been directed at the smaller, community-based banking organizations. In fact, the original intent of the Basel I Accord in 1988 was to establish a level playing field for internationally-active banks. The text of Basel I made this plain, in stating that:

> *"Two fundamental objectives lie at the heart of the Committee's work on regulatory convergence. These are, firstly, that the new framework should serve to strengthen the soundness and stability of the international banking system; and, secondly, that the framework should be fair and have a high degree of consistency in its application to banks in different countries with a view to diminishing an existing source of competitive inequality among international banks."*

U.S. regulators ultimately applied the Basel I framework to all banks and bank holding companies. As such, all banking companies were subject to identical minimum capital requirements -- with a long phase-in period. We note that the minimum capital levels applied were well below then existing capital levels at most community banks. The risk-weighting system on assets was relatively benign for the smaller banks, in our view, including a 50% risk weighting on residential mortgages. The rules were also generally simple, with the Basel I document itself totaling a modest 28 pages in length. In our view, compliance was not overly burdensome on the banks in terms of cost or difficulty to implement.

Over time, deficiencies in the Basel I regimen became apparent, including its perceived lack of risk sensitivity, for example, and were subsequently addressed in Basel II, originally proposed in 2004. In Basel II there was a continued assumption that it would be applicable to international banks – with the proviso that national regulators were free to impose the rules on all banks, or impose more stringent rules on the international banks. The intent was spelled out in the following Basel II statement:

"Part 1: Scope of Application

I. Introduction

20. This Framework will be applied on a consolidated basis to internationally active banks. This is the best means to preserve the integrity of capital in banks with subsidiaries by eliminating double gearing.

21. The scope of application of the Framework will include, on a fully consolidated basis, any holding company that is the parent entity within a banking group to ensure that it captures the risk of the whole banking group.

22. The Framework will also apply to all internationally active banks at every tier within a banking group, also on a fully consolidated basis (see illustrative chart at the end of this section).

23. Further, as one of the principal objectives of supervision is the protection of depositors, it is essential to ensure that capital recognised in capital adequacy measures is readily available for those depositors. Accordingly, supervisors should test that individual banks are adequately capitalised on a stand-alone basis."

In our view, Basel I and II capital rules were aimed squarely at the international banks. However, U.S. regulators continued to apply the Basel I Accord to most banks and bank holding companies, as the U.S adopted only one part of the Basel II Accord—the Advanced Internal Ratings Based approach for the largest U.S. banks and bank holding companies (those with total assets in excess of $250 billion or foreign-based exposures exceeding $10 billion).

In formulating Basel III, the Basel Committee on Banking Supervision retained the scope of application from Basel II, as follows:

"Scope of application

47. The application of the minimum capital requirements in this document follow the existing scope of application set out in Part I (Scope of Application) of the Basel II Framework.[8]

8 See BCBS, International Convergence of Capital Measurement and Capital Standards, June 2006 (hereinafter referred to as "Basel II" or "Basel II Framework")."

U.S. banking regulators have proposed to enforce Basel III on all but the smallest banks (total assets below $500 million), as indicated in the NPRs. As described above, in our view the burden of Basel I in terms of compliance were reasonable. Given the heightened complexity built into Basel III, however, we recommend the U.S. regulators reconsider applying Basel III to virtually the entire banking industry. Basel III represents a leap in complexity and compliance costs that may be appropriate for the largest banks, but not for the vast majority of banks that do not fit the Basel Committee definition of systemically important.

We would argue that the one-size-fits-all Basel Accord is particularly ill-suited to fit the U.S. banking system. While we have witnessed remarkable consolidation in the United States banking industry in the past several decades, the U.S. system remains much more unconsolidated when compared with other developed European and Asian countries, as indicated in the chart below:

	# Banks	Total Assets (USD$B)	% Industry Assets	
			Top 5 Banks	Top 10 Banks
United States	7246	14,117.7	43%	51%
Germany	1903	10,965.2	25%	n/a
Italy	740	5,235.1	49%	55%
France	680	8,342.7	47%	n/a
China	567	20,221.9	49%	60%
Switzerland	312	2,992.1	64%	67%
Japan	199	10,901.0	71%	77%
U.K.	156	9,740.2	70%	90%
Spain	50	4,577.8	53%	66%
Canada	49	3,737.7	80%	87%
Australia	16	2,337.6	92%	99%

United States: as of 6/30/12; Source: FDIC; inclusive of branches of foreign institutions
Canada: as of 7/31/12; Source: OSFI/Company Reports
Canada: excludes 23 full-service foreign bank branches and 5 foreign bank lending branches
China: Assets as of 6/30/12/#Banks as of 12/31/2011; Source: Wind/CBRC; domestic assets only
Australia: as of 6/30/12; Source: APRA; domestic assets only
Japan: data as of 8/31/12; Inclusive of foreign owned banks but not foreign branches
European country data as of 12/31/11/Spain as of 6/30/2012; Includes foreign subsidiaries but not foreign branches
Germany: Source: Bundesbank/KBW estimates from ECB
Italy: Source: Bank of Italy
France: Source: ACP/ECB
Switzerland: Source: SNB/KBW estimates
U.K.: Source: BOE/KBW estimates
Spain: Source: Bank of Spain

The total number of commercial banks and thrifts in the U.S. has been reduced from more than 17,900 in 1984 to just over 7,200 in June, 2012. Much of the consolidation can be attributed to the passage of interstate banking legislation, and the economies of scale that have led managements to merge banks within a common holding company structure. We expect more consolidation as the economy recovers.

Still, we expect that the structure of the U.S. banking industry will remain unique within the developed world, with a large number of smaller institutions. In fact, the FDIC has undertaken a study of the community banking industry in the U.S., entitled the "Future of Community Banking," with results expected by year-end 2012. At a conference in

February, 2012 the FDIC outlined the general idea behind the research, which was to study the changes occurring, to gain an understanding of the role of the community banks and the reasons behind the consolidation trends that had been noted. The FDIC intends to study how community banks connect with their local communities, and their role in financing growth.

The importance of the community banking industry cannot be overstated. According to a July, 2012 publication by the U.S. Small Business Administration, Office of Advocacy, *Small Business Lending in the United States, 2010-2011*, community banks provided 53% of small business lending in the U.S. – which we believe has gained the attention of members of Congress, who have begun asking questions about the unintended consequences of Basel III implementation. Along those lines, 53 U.S. Senators have signed a letter dated September 17, 2012, addressed to the banking regulators, asking them to consider the possible negative effects of the imposition of Basel III requirements on community banks.

Let us point out some of the more important Basel III considerations that relate to community banks.

1. The extensive and unnecessary expense burden related to Basel III compliance, particularly in relation to the new Standardized Approach proposed by the NPRs, could significantly reduce community bank profitability and hinder lending capacity precisely at a time when credit is needed to finance a needed business expansion in the United States. Conversely, assuming an 8% common equity ratio, every $1 of additional equity required, or a $1 reduction in net income, reduces potential asset growth by $12 (assuming 100% risk-weighted assets). Congress has already demonstrated interest in spurring small business lending through the Small Business Lending Fund – and data to date published by the Treasury Department indicates that those banks have indeed expanded loan portfolios at rates well above other banks. As of June 30, 2012, banks with total assets of less than $10 billion represent 21% of total banking industry assets and 25% of domestic deposits, while holding 34% of domestic commercial loans outstanding. Clearly community banks have and will continue to play a key role in helping to finance economic recovery.

2. Community banks with assets under $10 billion are well capitalized by Basel I standards, with a weighted average Tier 1 risk-based capital ratio of 15.6% at June 30, 2012. In the aggregate, this group had approximately $178 billion of Tier 1 risk-based capital in excess of the minimum "well capitalized" regulatory capital level, with only 1.4% of such institutions failing to achieve the "well capitalized" status. In our view, these banks do not represent a significant threat to the solvency of the FDIC Deposit Insurance Fund (DIF), as a result of their strong capital position, small individual size, and lack of interbank connectivity and systemic importance. Losses to the DIF as a result of community bank

failures have historically been modest and adequately covered through deposit insurance premiums paid by the banking industry.

3. Community banks were participants in the residential mortgage lending bubble, but were not the major perpetrators – particularly with regard to subprime lending. For the years 2005-2006 (representing the height of the mortgage lending bubble), the largest 25 B&C mortgage lenders (B&C generally refers to loans that are classified as subprime) originated, or purchased through correspondents, approximately $1.1 trillion of B&C loans, or 91% of all originations, according to "Inside B&C Lending, Copyright 2007". Those 25 lenders included just five large banking companies (HSBC, Citigroup, JPMorgan Chase, Wells Fargo and Washington Mutual), who had a combined 25% market share of the B&C market in those two years. The lending by community banks represented a very small fraction of the overall market.

4. Approximately 6,500 of community banks with under $10 billion in assets do not have public securities trading on a stock exchange. Additionally, some of the smaller companies whose stocks are publicly traded are currently trading below book value. As a consequence, the community banks have limited access to the capital markets, in relation to the larger banking companies. Accordingly, we believe the smaller community banks are at a competitive disadvantage to the larger institutions in raising capital, especially with regard to issuing regulatory capital-qualifying preferred stock. As such, we consider the higher capital requirements as an unfair, unbalanced playing field for the community banking industry.

We believe that Basel III could prompt increased consolidation within the community banking industry, adversely affecting the availability of small business lending and acting as a further brake on the economic recovery – particularly in smaller towns. Before applying a one-size-fits all approach to capital to an industry that is clearly very heterogeneous, we believe you should consider the unintended consequences presented by the NPRs, and cautiously approach the application of Basel III. Based on our own observations and discussions with bank managements, we believe the United States banking system, and its ability to sustain an economic recovery, remains fragile in the wake of the challenges of the last four years.

Recognizing that the failure of a banking institution with assets below $10 billion does not cause systemic risk in the U.S. financial system, but the overall health of those smaller banks is vital to a vibrant U.S. economy, we believe that at a minimum Basel III should be modified to address these smaller institutions in a number of ways, including:

- Apply the Basel III framework only to banking institutions with assets exceeding $10 billion;
- Retain the Basel I general asset risk-weighting system currently in use;

- Maintain the Dodd-Frank legislative grandfathering of trust preferred securities as part of Tier 1 Capital;
- Continue to exclude AOCI in Tier 1 Capital for all banks, but particularly for those with total assets under $10 billion;
- Reduce the Capital Conservation Buffer (CCB) requirement.

We also note that the Dodd-Frank Act uses the $10 billion asset size as the breakpoint for many requirements and we believe that a similar treatment for Basel III implementation is appropriate.

Conclusions

The experience of the last six years demonstrates that notwithstanding the presence of the Basel I framework in the United States, banks were generally unprepared for the economic storm that overtook the industry and the financial system. Higher capital ratios and improved capital quality would clearly have benefitted all banks, including the community banks (as demonstrated by the 493 U.S. banks that failed since the beginning of 2008 – mostly smaller community banks), and at a minimum, could have at least softened the downturn. That said, the community banks that failed or merged into other companies were not systemically important, and there was no discussion of "bail-outs" of banking companies with assets of $10 billion and less. Many community banks did avail themselves of TARP, and benefitted from those capital infusions. Without that program, more banks would undoubtedly have failed, and TARP clearly helped the community banking system.

However, as evidence that systemic risk is concentrated among the largest institutions, it is worth noting that the systemically-important banking institutions, with assets exceeding $50 billion, received the lion's share of total TARP funding. Community banks with assets under $10 billion hold 20.3% of industry assets, but received just 7% of the $205 billion of TARP proceeds. From our perspective, it is clear that no community bank is systemically important on an individual basis, and much of the focus of Dodd-Frank and Basel III represent prescriptions for a disease – systemic risk – that does not exist for community banks. The primary Basel goal laid out in 1988 was generally to provide a level playing field for internationally-active banks. The evidence of the last 24 years is that the Basel system has had some success, but challenges remain. In our view, efforts to improve upon the structure have added considerable complexity and cost for the banks, resulting in a framework that is totally inappropriate for the vast majority of banks in the United States.

Basel III implementation would raise considerable challenges for smaller banking institutions and, in our view, if adopted in its proposed form will ultimately prove to be anti-growth, pro-cyclical in effect, and damaging to the overall financial system. We strongly recommend that you apply Basel III only to the systemically or nationally important banking institutions, or at least a modified form of Basel III to community banks, recognizing their unique structure, role in the U.S. economy, and lack of systemic importance on an individual basis.

On behalf of KBW, we appreciate the opportunity to express our viewpoint on these important issues, and remain available to discuss any of the topics and opinions addressed in this letter.

Sincerely,

Thomas B. Michaud

Thomas B. Michaud
President and Chief Executive Officer