CROSS FINANCIAL SERVICES

Accounting † Consulting † Investing

October 3, 2012

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

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

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

Re: Basel III Proposed Regulatory Capital Rules

Ladies and Gentlemen,

Cross Financial Services, LLC (Cross) appreciates the opportunity to submit comments on the notices of proposed rulemaking (NPRs). Cross provides financial management and consulting services to community banks around the country. We specialize in risk management services primarily involving asset and liability, investment securities and capital management.

Cross fully supports the Agencies' efforts to address perceived weaknesses in the banking industry's capital framework. We also recognize the challenges that the Agencies face in developing a system that accurately reflects risk across the United States banking system.

Cross is providing a response on several key components of the NPRs that we believe could result in unintended negative consequences to the banking system. The comments provided below reflect specific aspects of the proposals that, in our view, will have the most significant impact on our community banking clients. We recognize, however, that other aspects of the NPRs that are not addressed herein could have a material impact on the operations of individual organizations.

Trust Preferred Capital Treatment

The Agencies are proposing that all institutions under $15 billion be required to deduct trust preferred instruments from Tier 1 capital based on the phase out schedule provided. However, the Collins amendment for institutions outlines an exemption for institutions under $15 billion in total assets.

For many small-cap institutions, trust preferred instruments have served as an important source of capital. Additionally, these same institutions have encountered difficulty raising new capital in the current environment. In the case of small privately held C-corporations or Sub S corporations, the access to capital markets is constrained at best. Additionally, many small institutions still have TARP or SBLF instruments outstanding. The proposed framework allows for these instruments to be grandfathered in. These instruments have contractual rate obligations that will, in many cases, cause higher cash payments by the institutions in future years, giving incentive to redeem them. The combination of the proposed change in treatment of trust preferred instruments and the probable increase in rates on TARP and SBLF instruments cause a large need for new capital in the industry by institutions that already have limited access to the capital markets.

If the Agencies have a goal to reduce the number of banks below $15 billion in total assets through acquisitions by larger banks, this provision should help achieve that goal. Cross believes that banks below $15 million in total assets provide needed banking services to small to medium sized businesses and individuals throughout the country, which in turn are an important component of our overall national economy. We recommend that the Agencies remain consistent with the intent of the Collins amendment and allow for grandfathering of existing trust preferred instruments for institutions under $15 billion in total assets.

Accumulated Other Comprehensive income (AOCI) as a component of Tier 1 capital

The Agencies are proposing that AOCI, which includes all unrealized gains and losses on AFS securities, would flow through to common equity Tier 1 capital. This would include unrealized gains or losses related to debt securities whose valuations primarily change as a result of fluctuations in a benchmark interest rate, as opposed to changes in credit risk (for example U.S. Treasuries and U.S. government agency debt obligations).

Cross has several concerns about the inclusion of AOCI as a component of Tier 1 capital. The Agencies have recognized that the inclusion of unrealized gains and losses on securities could "introduce substantial volatility in a banking organization's regulatory capital ratios." While we recognize the appropriateness for AOCI inclusion in a tangible capital ratio from a market valuation perspective, the introduction of a similar structure to the regulatory capital metric has the potential to create confusion over the adequacy of recorded ratios and could lead to flawed, uneconomic, and even unsound decisions regarding an institution's asset-liability management and investment options. A few of the problematic and likely unintended, aspects of this proposal include the following:

1. Including AOCI in the standardized regulatory capital ratios would force regulators and financial institution managers to calculate alternative ratios to determine an effective capital position, exclusive of AOCI. Capital ratios bolstered by market appreciation would most certainly be discounted to reflect the potential volatility that might exist in a rates-up environment. Conversely, market depreciation would be counted against capital, even though a rates-down scenario might significantly improve the institution's capital position. In the latter case, institutions would need to hold greater levels of common equity capital to comply with a ratio requirement that reflects a potentially temporary adjustment.

2. To avoid recognition of AOCI, institutions may be incentivized to hold more securities in the held-to-maturity (HTM) account. While the move to the HTM account would no longer require gains and losses on those securities to be recorded in Tier 1 capital, the operational restrictions imposed on the HTM account would greatly reduce management's ability to properly adjust its portfolio for liquidity and funds management purposes. Additionally, when different institutions place identical securities in AFS or HTM, it creates differing capital treatments even though the relative risks involving the securities are the same.

3. To avoid capital ratio volatility, institutions may also be inclined to make shorter-term investment decisions that reduce volatility and increase liquidity. This may help to reduce market risk, but it also could reduce the ability of the investment portfolio to produce income and generate capital appreciation. As a result, banks would be forced to pursue other options to generate yield, which could include diverting investment to other asset classes, with higher levels of credit risk and/or greater levels of unrecorded market volatility.

4. The AOCI inclusion for AFS securities applies mark-to-market treatment to only one set of assets on an institution's balance sheet. Other balance sheet components that are economically very similar do not receive the same treatment, such as loans, structured liabilities, and HTM securities. We have two primary concerns with this treatment. First, this appears to violate the basic accounting principle of consistency. Second, it would in effect weaken an institution's asset-liability management; specifically, it adds a potential capital penalty on using the securities portfolio, the most flexible tool at ALCO's disposal, to reduce overall asset sensitivity while leveling no such penalty on any other balance sheet component.

5. The negative impacts of these effects would fall disproportionately upon community banks, due to their limited access to capital markets for funding and temporary equity enhancements.

Cross recommends that the Agencies exclude any AOCI adjustments from the regulatory capital calculations and continue to include an addendum in the Call Report to reflect ongoing gains/losses in the AFS portfolio. In our view, the concerns addressed about market value appreciation/depreciation are best managed through a strong liquidity and funds management function. While the impact on capital should be considered, financial institution capital ratios cannot be effective measurements of risk when only one class of assets among many is required to recognize ongoing market value adjustments.

The Agencies have suggested a potential exclusion of the capital charges for debt obligations to U.S. government, U.S. agency, and U.S. Government Sponsored Entities. The Agencies have also suggested a similar exclusion on general obligations issued by states or other political subdivisions. Cross supports these exclusions and agrees that they would help to minimize the impact of the proposed AOCI treatment. However, to minimize risk and properly diversify the investment portfolio and total balance sheet, institutions should also be able to make informed investments in securities that contain some level of credit risk without an inequitable capital volatility penalty. If there is a need to hold higher levels of capital against these investments, that need should be addressed through an appropriate adjustment to the standardized risk weight measurement, not through an ongoing fluctuation in the Tier 1 capital ratio.

Past Due Exposures

The Agencies have proposed that banking organizations assign a risk weight of 150 percent to any exposure that is not guaranteed or not secured (and that is not a sovereign exposure or a residential mortgage exposure) if it is 90 days or more past due or on nonaccrual. A banking organization may assign a lower risk weight to the collateralized or guaranteed portion of the past due exposure if the collateral, guarantee, or credit derivative meets the proposed requirements for recognition.

During periods of economic stress, it is expected that financial institutions will have normal cyclical increases in past-due and nonaccrual loans. To account for the potential loss exposure of these problem loans, institutions will make periodic provisions to their respective allowances for loan and lease losses (ALLL). If the ALLL is calculated properly and reflective of the risk of loss in the loan portfolio, there should be no need to create an additional capital charge to reflect temporary and expected fluctuations in the economic cycles of different markets.

Since loan loss exposures are already reflected in the ALLL, which is limited as a Tier 2 capital component to 1.25 percent of risk weighted assets, we do not believe there is a basis for an additional capital charge based solely on past-due status. We also believe this puts pressure on bank management to potentially understate the ALLL in an effort to maintain regulatory capital levels. This provision could also discourage institutions from working with borrowers and from taking appropriate lending risk during times of economic stress.

Conclusion

Cross supports the Agencies' effort to improve the quality and quantity of regulatory capital and to build additional capacity into the banking system to absorb losses in times of economic stress. We also support and acknowledge the Agencies' effort to formulate an appropriate transition period for various aspects of the proposal. As noted above, Cross has attempted to provide feedback that will help improve and enhance the quality of the overall proposals. We have concentrated our comments on areas that have the greatest impact to our community and regional banking clients. In our view, there are several provisions that could create significant volatility and inconsistency in their reported capital ratios. We believe these provisions could impact the effectiveness of the proposal and have negative consequences for the banking system as a whole.

Cross appreciates the opportunity to comment on this proposal. If you have any questions or would like additional information, please do not hesitate to contact me at 317-560-4045.

Very Truly,

Jeff Joyce
President