Union State Bank

P. O. Box 518, 701 5th Street
Clay Center, Kansas 67432

October 19, 2012

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

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

Robert E. Feldman, Executive Secretary
Attn: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington DC 20429

RE: Basel III – Proposed Rulemaking on Minimum Regulatory Capital and the Standardized Approach for Risk-weighted Assets

Thank you for the opportunity to comment on the new capital requirements as addressed in the Proposed Rulemaking on Minimum Regulatory Capital or Basel III. I have been involved in banking, particularly community banking (bank with an asset size of less than $150mm) for the past 12 years. During this time, we have seen unprecedented rate cycles, near collapse of the banking system, and increased regulations. All of these issues have made community banking more challenging, and made it increasingly clear, how important **capital, liquidity, and interest rate risk management** are, even to a smaller community bank.

The proposed Basel III capital calculations will increase the volatility in even small community bank's capital ratios by including accumulated other comprehensive income (changes in fair market value of certain investment securities).

Our bank has historically been VERY well capitalized (Tier 1 leverage capital > 9%, currently almost 11%). We are also in an overbanked market area, so keeping loan volume stable is our goal, rather than loan growth. Therefore, we rely heavily on a diversified investment portfolio of various government agency securities and bank-qualified general obligation bonds (current risk weight of 0% or 20%) to provide additional income and leverage capital.

With almost 60% of our assets in securities ($80mm) and a current unrealized gain of +$2.4mm, under Basel III our Basel Tier 1 Capital ratio would be 12.37%. If interest rates would increase +200bp, our current Tier I leverage ratio would be unchanged at 10.81%.

Under Basel III, up +200bp, our $80mm AFS securities would have an unrealized loss of -$2.9mm and Basel Tier 1 Capital ratio would be 8.69%.

Up +300bp, would be even more volatile, with our $80mm in AFS securities having an unrealized loss of -$8mm and Basel Tier 1 Capital of 5.26% compared to current Tier I Leverage Capital (which excludes unrealized gains/losses on AFS securities) of 10.8%, which is unchanged from base case or our current level.

If Basel III is enacted, our bank would be faced with volatility in Basel Tier I Capital ratios, as noted above, unless we chose to move all of our securities from AFS (available for sale, which is subject to market value accounting-unrealized gains/losses) to HTM (held to maturity). Moving $80mm of securities to HTM seems like an easy solution, but presents its own issue: **lack of liquidity and increased interest rate risk**.

With such a large investment portfolio, we do extensive asset/liability management and income simulation on a monthly basis. It is not uncommon for us to periodically sell securities which have had pre-payment speeds increase and reinvest in securities to lessen our interest rate risk and duration, while preserving future income. In the past, we have also repositioned our investment portfolio, based upon the current interest rate environment, by selling $2-$5mm of securities in one sector and reinvesting that amount in another sector, again with the purpose of lessening interest rate risk and preserving or improving future income.

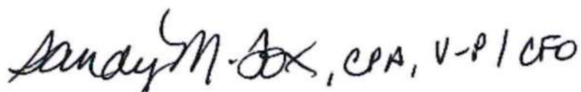
Unfortunately, if Basel III is enacted and securities are classified as HTM, rather than AFS we would **not have the ability to reposition our portfolio and manage interest rate risk** like we have been doing successfully for the past 12 years. HTM, means exactly that: securities must be held to maturity. If they are moved to AFS and sold, a bank risks "tainting" their entire HTM portfolio, which means everything would be reclassified to AFS, and subject to market value adjustment accounting AND wild volatility in Basel III Tier I Capital.

One of our bank's primarily sources of on-balance sheet liquidity is our $80mm security portfolio. If we would see $2-$5mm in loan growth, we would currently be able to liquidate $2-$5mm of our AFS securities and maintain a stable balance sheet size. Under Basel III, if we chose to mitigate our capital volatility by moving our $80mm of securities from AFS to HTM, **we would lose this flexibility/liquidity** and be forced to either turn away loans or inflate the size of our balance sheet. Neither of these options seems to be in the best interest of banking, from either an interest rate risk or safety and soundness perspective. In essence, we are no longer able to manage our own financial institution like we have been doing successfully for the past 12 years!

I would strongly urge the reconsideration of the Proposed Rulemaking on Minimum Regulatory Capital and the Standardized Approach for Risk-weighted Assets (Basel III) based upon the concerns listed above. More regulation, especially for smaller community banks will not make us better or stronger banks. This proposal, as it is currently, has severe unintended consequences for all banks, but especially for small community banks.

Thank you again, for the opportunity to comment on this proposed capital regulation.

Sincerely,



Sandy M. Fox, CPA, Vice-President/Chief Financial Officer