October 19, 2012

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

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

Ladies and Gentleman:

This letter is in regard to the request for comment on the proposed capital rules, collectively referred to as "Basel III", released by federal banking regulatory agencies in June 2012.

Frandsen Financial Corporation is a multi-bank holding company that operates 35 community bank branches in Minnesota, North Dakota and Wisconsin. Our total assets are $1.5 billion and our organization was started in 1982. It is important to note that even though Frandsen Financial could be considered a larger community bank from an overall size perspective, the average size of our branches is only $42 million and as a result we consider ourselves a community banking organization that is very much affected by this proposed rule.

Based on the understanding that our bank branches can only truly be successful if they act as responsible citizens and stewards of our communities, we fully support actions that ensure safe and sound banking environments that promote and provide incentive to make efficient use of our services. However, the Basel III proposals do not support these goals and should be rejected or amended for the following reasons:

1. The diverse make-up and business models of the banks in the United States do not fit the complex, standardized Basel III approach which will lead to banks exiting the targeted areas and ultimately leaving customers with less competitive options.
2. Basel III is duplicative and unnecessarily burdensome as regulators already have mechanisms to protect the financial system from high risk and delinquent loans.
3. Realizing the unrealized gains and losses of available-for-sale (AFS) securities will create dramatic changes in bank equity capital requirements based on economic cycles with little actual change to most banks' risk profiles as bond portfolios are generally comprised of low risk issues managed for interest rate and liquidity risk purposes.
4. Harsh treatment of residential real estate will further limit supply of products available to consumers with little impact on the businesses and practices that led to the recent financial crisis.

5. Elimination of certain capital elements like trust preferred securities and deferred assets will negatively impact smaller institutions' ability to raise funds in the marketplace, resulting in lesser funds available for consumer and small business lending during times of economic improvement.

These points highlight the primary concerns our organization has regarding the negative impact these proposed rules will have on our banking organization and access to credit for our communities and consumers. I will expand on these issues further in the attached document.

Respectfully,

Paul Moen

Paul Moen
Chief Financial Officer
Frandsen Financial Corporation

Attachment

BASEL III PROPOSED CAPITAL RULES IMPACT ON FRANDSEN FINANCIAL AND OTHER COMMUNITY BANKS

I. Basel III proposals are unnecessarily complex and burdensome without meaningfully improving the safety and soundness of the banking system or consumers' efficient use of credit

The complexity of the proposed rules is already evident in comments made by those in the best position to understand them. Regardless of what regulators say the Basel III proposal actually applies to all banks, regardless of size. If the rules promulgators are unclear on the impacts, how are ordinary working bankers in communities across the country going to be able to comply? Also, FDIC Director Thomas Hoenig has recently called for regulators to reject this proposal and pursue a more simplistic system. These comments highlight the disagreement at the top regarding this proposal's impact, efficiency and effectiveness.

The 1,000-plus pages of proposed capital rules should not be rejected purely on its size. It is, however, representative of the resources which must be considered. There are at least a few banks that would be strengthened by the rigid rules, but the system as a whole would benefit from regulators applying the existing framework to individual bank strategies. Such an approach would allow regulators to take account of individual risk management strategies and more effectively ensure the sufficiency of each bank's capital cushion. The proposed rule, on the other hand, will result in many banks simply no longer being able to compete in the marketplace, leaving consumers with less choice and that is not good for consumers.

II. Benefits of the Basel III proposals do not outweigh the costs

I understand that uniformity in regulation can be a benefit, however, this benefit must be weighed against the costs that will be incurred. The costs certainly exceed any benefit. There is little reason for a majority of banks to develop sophisticated capital planning and monitoring tools as these potential rules will require.

On the cost side, all banks will be required to develop sophisticated capital tools and such a tool will be very resource intensive. The largest banks may be able to incorporate the analysis into existing systems; but for many banks without such sophisticated modeling needs for their core business, an undue amount of resources will be shifted toward capital planning. This means resources will be shifted away from seeking opportunities that benefit consumers and the communities Frandsen Financial serves.

III. Basel III treatment of residential real estate is detrimental to the housing market and duplicative as it seeks to safeguard against risk currently managed by bankers and regulators through an allowance for loan losses (ALLL).

The treatment of residential real estate in the Basel III proposal will have immediate and harmful effects on consumers seeking home loans. For Frandsen Financial, home loans represent low-risk portfolio diversification. In fact, many of our branches have never lost a penny on a home loan. However, the Basel III proposal appears to punish the lenders offering home loans to their consumers. The negative result of this punishment is amplified as many lenders have already left this market because the cost of regulatory compliance, reporting and recordkeeping are simply too high.

While the residential real estate market is already dominated by the largest lenders, Frandsen Financial offers niche products, such as adjustable rates or balloon loans that consumers have sought out to meet credit needs. These loans have historically represented a relatively low risk to our capital strength; thus, treating all such loans across the board with an arbitrarily high risk weighting is unwarranted. We support a 20 percent risk weighting for such traditionally risk loans. For those particular loans that elevate the bank's profile, the regulator-scrutinized ALLL should continue to be the safeguard against losses.

Home equity and second lien loans should be treated in the same manner. We believe that Basel III's punitive treatment of lenders holding both first and second liens is unsubstantiated. Lenders holding the entire credit relationship are in a better position to work with borrowers on credit improvements or take swift action to limit loss when borrowers default. To arbitrarily decide that the credit risk is higher on first lien loans for no reason other than the subordinate lien owned by the same bank is contrary to tried and true bank standards and will ultimately be detrimental to consumers' ability to stay in their homes during times of difficulty.

As stated above, the ALLL has served for decades as our primary defense against credit losses. This area has been strenuously examined by regulators with a vigor that has increased greatly over the last several years; bankers are now functionally required to have both the technical accounting understanding of CPAs and and the statistical modeling know-how of mathematicians. While we have adapted to these ALLL standards, the Basel III proposals will effectively require that additional capital be set aside twice for many loans. With these loans being assigned arbitrarily high risk weightings and requiring inclusion in the ALLL cushion, many bankers will simply exit that market. This will harm consumers by leaving them with fewer choices and less competition. I recommend that these proposals be rejected or amended to mitigate the detrimental effects to our bank and consumers of being double counted in the capital cushion.

IV. Loan-to-value definitions must be clarified and consequences considered

While loan-to-value (LTV) ratios are an element of determining credit quality, they are only one piece of the puzzle. In addition, they are very difficult to effectively monitor over time. The Basel III proposed rules require risk weighting of every residential real estate loan based on LTV. However, the rules do not provide what value is to be used. If we are required to hold additional capital based on initial LTV, we will become over capitalized as the loan amount is paid down.

This over capitalization of a relatively low risk product will lead banks to exit this lending market. Alternatively, if values are required to be updated periodically, based on examiner expected valuation guidelines, the cost of compliance will outweigh any financial benefit of making these loans, causing banks to exit the market. Either scenario will lower market competitiveness and hurt consumers' ability to get these loans. This will be harmful for consumers and will hinder economic recovery. Accounting for risk in the lending portfolio is best achieved through effective management of the ALLL, not through arbitrary capital retention standards.

Furthermore, I am concerned about the additional recordkeeping and reporting that will be required by these proposed rules. In addition to the obvious changes to Call Reports such as those needed to reflect the new common equity tier 1 capital ratio and the new capital conversion buffer calculations, monitoring of the LTV changes will also be needed. Many banks already devote considerable resources to regulatory reporting. The incremental recordkeeping, data mining and monitoring costs must be considered. Though the costs associated with these changes seems small when compared to the capital positions of the world's largest banks, for many community banks it will be the last straw.

V. Capital requirements related to representations and warranties on 1-4 family residential real estate loans sold in the secondary market are overly broad.

I agree that capital should be set aside to mitigate risk to the financial system, however, such requirements must be narrowly tailored to actual risks that jeopardize the Deposit Insurance Fund. The Basel III proposals in their current form require banks who sold in the secondary market to hold capital for the total amount of the loan for the life of the loan. This appears to be true even where the originator's liability is contractually limited to only a fraction of the loan or premium initially received. For those institutions that sold loans which are still active, the impact could potentially be devastating despite very little actual risk of loss to the institution.

In the event that these prior sales would be "grandfathered" in and only newly sold loans would be subjected to the proposed capital requirements, it is my opinion that all but the largest banks will simply exit the market. This will leave consumers with fewer options and less competition to ensure better prices.

VI. Proposed treatment of unrealized gains and losses on available for sale (AFS) securities will be detrimental to risk management practices and community support

The Basel III proposals regarding changes to the treatment of unrealized gains and losses on AFS securities will significantly impair our bank's ability to appropriately measure and monitor interest rate and liquidity risk. In addition to low risk US Treasury and agency bonds, our banks typically hold municipal securities to better serve our communities. These local bond purchases are one way our banks serve the needs of our communities and have represented low risk to the financial system. The proposed rules will limit opportunity for our banks to purchase and hold these bonds. This will negatively impact the numerous communities that rely on our banks for support.

VII. Trust preferred securities and deferred tax assets represent contributions to capital necessary for our banks to provide services to our communities.

For many banks like Frandsen Financial, that are not publicly traded, access to new sources of capital is limited. The limitation is magnified outside of population centers where there are simply fewer wealthy individuals looking to make capital contributions to any entity. Bankers and regulators have agreed for a long time on the benefits of allowing non-traditional capital components to be included in the tier 1 capital calculations. It was for this reason that Congress' intent, memorialized in the Dodd-Frank Act, allowed for the continued use of trust preferred securities for smaller banks. To eliminate these as effective capital sources will leave many banks with even fewer reasonable sources of capital despite Congress' intent to preserve them.

Furthermore, the 10% annual phasing out of these securities from tier 1 capital inclusion is simply impractical for any institution without ready access to robust capital markets. Many privately-held banks, like Frandsen Financial, find capital injection opportunities to be few and far between. To expect banks such as ours to go in the markets a little more each year is unrealistic. These banks will likely either find the necessary capital all at once or be forced to decrease their ability to serve their communities. This, in many cases, will lead smaller banks like ours to sell out to larger out-of-area competitors. Consideration should be made to "grandfather" existing trust preferred securities to lessen this burden.