October 15, 2012

Mr. Ben Bernanke
Chairman
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Mr. Martin J. Gruenberg
Acting Chairman
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Mr. Thomas J. Curry
Comptroller
Office of the Comptroller of the Currency
250 E Street, SW
Washington, DC 20219

Re: Proposed Rulemaking on Minimum Regulatory Capital and the Standardized Approach for Risk-weighted Assets
Basel III Federal Reserve Docket No. R-1430; RIN No. 7100-AD87 and Docket No. R-1442; RIN No. 7100-AD87
Basel III FDIC RIN 3064-AD95, RIN 3064-AD96
Basel III OCC Docket ID OCC-2012-0008 and Docket ID OCC-2012-0009

Dear Sirs:

The Community Bankers Association of Illinois (CBAI), which proudly represents the interests of 400 Illinois community banks and their 900 branches, welcomes this opportunity to comment

on the Proposed Rulemaking on Minimum Regulatory Capital (Basel III NPR) and the Standardized Approach for Risk-weighted Assets (Standardized Approach NPR) (Collectively the Capital NPRs, NPRs, or Rules).

CBAI was extremely disappointed when the regulators approved imposing the requirements contained in the NPRs on community banks. These proposed new Rules are not required under the Basel III capital agreement. Basel III was originally designed to prevent another financial crisis and to only apply to the largest, systemically important, and internationally active banks. Community banks did not engage in the reckless behavior that contributed to the financial crisis and subsequent economic downturn. Community banks have lower risk profiles because they operate under a relationship-based business model. Their less complex business model and lack of significant interrelationships are not reflected in the one-size-fits-all approach to the capital standards and asset risk-weighs in the NPRs. Individual community banks pose no systemic risk whatsoever. The NPRs are misguided and would significantly disadvantage community banks. Therefore, these requirements should not apply to community banks.

CBAI strongly encourages you to exempt community banks from the proposed implementation of the NPRs and allow community banks to continue to operate under Basel I capital requirements. However, in the unfortunate event you choose to adopt these misguided Rules, several of the specific proposals identified below threaten the survival of community banks and must be eliminated.

Accumulated Other Comprehensive Income (AOCI)

The regulators have proposed including the unrealized gains/losses on Available for Sale securities in capital. This portion of the NPRs is counterproductive to achieving the goal of increasing bank capital and liquidity. It is a deceptively benign issue in this low rate environment but creates unnecessary volatility in bank capital ratios. This will also change the investment behavior of community banks to the detriment of the housing recovery and municipal financing.

Traditionally, banks have held their securities in three categories (i.e., Trading, Available for Sale (AFS), or Hold to Maturity (HTM)), and only the unrealized gains and losses from securities in the Trading category have impacted capital. For many years community banks have

structured their investment portfolios within these parameters and their investment portfolios cannot be quickly restructured. A bank constructs its investment portfolio very carefully by balancing rates of return, credit risks, maturities, and durations so that funds will be available for various short and long-term, planned and unanticipated, purposes. A significant change in the rules as proposed by the NPRs will disrupt this thoughtful planning process and force community banks to rapidly and radically adjust the mix of securities in their portfolios.

Bank liquidity has been a primary focus of community banks and regulators, particularly during the recent financial crisis. Sufficient liquidity helps banks fund their business model and is vital to maintaining consumer confidence in the banking system. Regulators have permitted banks to include AFS securities in their liquidity calculations. Banks have widely kept securities in the AFS category (versus Trading or HTM) because it provides maximum flexibility in liquidity planning, and there is no penalty for holding securities in the AFS category because unrealized gains and losses do not impact capital. However, the proposed NPRs would unfortunately penalize community banks for categorizing securities as AFS, and community bank liquidity would be negatively impacted.

Given the prolonged low interest rate environment, many community banks have significant unrealized gains in their investment portfolios. Today, these gains and losses do not negatively or positively impact their capital ratios, but implementation of the proposed Rules would adversely impact capital. During regulatory examinations banks are required to analyze the impact of dramatic shifts in interest rates. With market rates now near zero significant decreases in rates are impossible, but a rapid increase in rates under the proposed Rules would quickly turn investment portfolio gains into significant losses, thereby eroding community bank capital.

Community banks report their results of operations and financial condition, including various regulatory capital ratios, on a quarterly basis through the FFIEC Call Reports. Marking to market banks' investment portfolios and flowing these unrealized gains and losses through their capital would inject significant quarterly volatility in their capital ratios. Changes in market interest rates, over which bankers have no control, can derail strategic plans and constrain community banks' abilities to grow and develop and serve their communities.

Community banks want their financial statements to accurately reflect the condition and asset valuation. Unrealized gains or losses would only give the appearance of higher or lower tangible capital levels from decreased or increased market interest rates. It is unlikely that any

explanation of this practice would enlighten an unsophisticated investor. The proposed Rules would be counterproductive to achieving the twin goals of relevancy and transparency of community bank financial statements.

The unintended (or intended) result of implementing this portion of the Rules would be for banks to minimize interest rate risks (and thus potential unrealized losses) in their investment portfolios for fear of the volatile impact on their capital. To accomplish this objective community banks would likely purchase short-term and more risk-free securities, resulting in a decrease in their investment portfolio returns as these types of investment securities carry lower interest rates. Bank margins and earnings would fall, less capital would be accumulated, and investment portfolios with short durations would be subject to greater earnings volatility during future interest rate cycles.

Two investments that are very attractive for community banks to purchase and hold in their investment portfolios are mortgage-backed securities and municipal securities. Mortgage-backed securities (MBS) are vital to the recovery and the sustained health of the residential housing market. Municipal securities (particularly BQ or small issuer securities) are the primary means utilized by cities across the country to fund projects, many of which are long-term capital and development in nature. There is increased credit risk for Agency-guaranteed or insured MBSs and for insured or uninsured municipal securities (versus United States Treasuries). When this increased credit risk is combined with the longer maturity typical of these two types of securities, the impact of the proposed Rules on community bank would be increased price volatility and the greater potential for unrealized losses, particularly in a rising rate environment. Decreased demand for housing related and municipal securities from community banks would result in higher costs for consumers and local governments.

For the abovementioned reasons, this portion of the proposed Rules should not be adopted.

Increased Risk-Weights for Past-Due Loans

Regulators have proposed increasing the risk weights on loans that are past-due 90 days or more. This portion of the NPRs is duplicative regulatory overkill and is completely unnecessary.

It is a reasonable assumption that loans which are past due 90 days or more have been or will shortly be identified as problems or "Watch List" loans. These problem loans are required to be individually analyzed and properly accounted for in the banks' Allowance for Loan and Lease Losses (ALLL). Proper accounting includes making additions to the ALLL from earnings (capital) for any analyzed shortfalls. Not doing so would be a violation of regulatory policy and GAAP. There is already close scrutiny (of at least community banks) by the regulators of all bank policies and procedures, Watch List loans, ALLL analysis and accounting, and they are all reviewed periodically during examinations and enhanced at the request of their regulators.

If the risks of problem or Watch List loans are already identified and properly accounted in a bank's ALLL, under both RAAP and GAAP, a community bank should not have to hold more capital attributable to theses loans.

This portion of the Rules should not be adopted.

Eliminate the 1.25% ALLL Disallowance

The stated purpose of the NPRs is to strengthen the quality and loss-absorbance safeguards provided by regulatory capital. The definition of Total Capital in the NPRs, however, proposes no change to the current capital treatment of Allowance for Loan and Lease Losses (ALLL) balances in excess of 1.25% of Risk Weighted Assets (RWA).

A community bank's ALLL is the first line of defense against loan losses, yet ALLL balances in excess of 1.25% of RWAs are not included in the proposed capital calculation. Not permitting community banks to include the entirety of their ALLL balances in their capital calculation ignores this important component of capital, penalizes banks with ALLLs in excess of 1.25% of RWAs, and is a disincentive for banks to make robust contributions to their ALLLs.

Elimination of this disallowance would help strengthen the capital positions of hundreds of Illinois community banks and thousands of community banks across the country. The entire ALLL balance is loss absorbing capital and should properly be recognized as such. Requiring more bank capital and simultaneously disallowing capital that banks already have is illogical, wrong, and does a grave disservice to community banks with robust ALLLs.

The proposed Rules should include the elimination of the 1.25% ALLL disallowance.

Increased Risk-weights for Balloon Payment and Other Mortgage Loans

CBAI is concerned by the increase in risk-weights on certain loan categories, particularly balloon mortgage loans which, depending on the Loan to Value (LTV) ratio, could increase from 50% to as high as 150%, a clear violation of Congressional intent.

This portion of the proposed Rules ignores the community bank business model, especially for rural banks. Community banks have originated balloon mortgages for many decades and typically hold them because they are often nonconforming for a variety of reasons. Community banks that originate balloon mortgage loans were not the cause of the mortgage meltdown; yet their historic business model is being unjustifiably targeted by proposed higher risk-weights.

Community banks' balloon mortgages are soundly underwritten and serve the needs of many customers. Wall Street banks have largely abandoned smaller and rural communities and are not making these types of loans. For many of these borrowers balloon mortgages are the only way their loans can be structured without putting the bank in an unacceptable interest rate risk position (for which they would be criticized by their regulators). If community banks are not making these types of loans in their communities, then no one will. The economic consequences of penalizing balloon mortgage loans would be devastating to community banks and the communities and customers they serve.

You have contended that at the balloon maturity in a rising rate environment it borrowers may no longer qualify for loan renewal, thereby increasing risk that must be supported by additional capital. While this scenario is possible, community banks are in the best position to work with borrowers to properly renew loans that their customers can afford. Community banks, unlike Wall Street banks and their mortgage servicing firms, did not ignore their customers' pleas for access, discussion and cooperation. Community banks have a successful track record with balloon mortgages, and we encourage you to consider this positive experience and maintain the current risk-weights for balloon mortgages.

CBAI advocated for and Congress specifically recognized the importance of balloon mortgage loans in rural and agricultural communities. As a result, an exception was created in the Dodd Frank Act's qualified mortgage standard for balloon mortgage loans made in these communities. The proposed NPRs violate this specific Congressional intent.

We are also concerned by the proposed increased risk-weights for HELOCs and the so-called High Volatility Commercial Real Estate (HVCRE) loans. HELOCs are Category 2 loans with higher risk-weights because the interest rates are indexed and not capped, and the homeowner can make interest only payment for the term of the loan. Under the proposed Rules a first mortgage HELOC would be a Category 2 loan with potentially higher risk-weights than a Category 1 loan. Also, the Rules as proposed would assign a higher risk-weight for a HVCRE secured loan than an unsecured loan to the same commercial borrower. There is no logic to the risk-weighted treatment of certain HELOCs or HVCRE loans in the proposed Rules.

Regulators have many tools at their disposal in fulfilling their supervision, regulation, and enforcement functions to ensure the safety and soundness of community banks. Reasonable use of these tools should be the primary way to address mortgage lending risks and potential abuses rather than subjecting all community banks to higher and, in several instances, nonsensical changes in risk-weights for mortgage loans. If these portions of the Rules are adopted, the regulators will have abdicated a portion of their responsibility.

These portions of the Rules should not be adopted.

Trust Preferred Securities (TruPS)

Regulators have proposed phasing out TruPS. This portion of the NPR is a clear violation of Congressional intent regarding the use of TruPS as community bank capital.

When community banks issued TruPS they rightfully assumed that the letter and spirit of the agreements they were signing would be honored by their banking regulators. The proposed Rules invalidate that reasonable assumption. From a practical standpoint, how can banks manage their operations, and plan for growth and future capital needs, when new Rules can sweep away hundreds of millions of dollars of community bank capital? This proposal would be bad enough by itself, but it is further complicated by a weak economic recovery and an extremely difficult capital raising environment for community banks.

CBAI advocated for and won a community bank exemption for TruPS for banks under $15 billion in assets (Collins Amendment to the Dodd Frank Act). The proposed changes in the

capital treatment of TruPS would violate clear Congressional intent to allow banks under $15 billion in assets to continue to include TruPS as capital.

TruPS have payment/retirement features which should be respected and honored. TruPS will eventually disappear through repayment which should happen in the natural course of business, not as a result of new Rules. The proposed 10 year phase-out of TruPS as capital beginning in 2013 is an insufficient compromise to counter changing rules in mid-stream and violating Congressional intent.

This portion of the proposed Rules should not be adopted.

Regulatory Burden and Tiered Regulation

CBAI continues to be extremely concerned about the stifling regulatory burden faced by community banks and how it negatively impacts their ability to serve their communities, lend to small businesses and individuals, and help foster the economic recovery.

The Rules are being proposed on the heels of the passage and implementation of the Dodd Frank Act. Although the vast majority of the Dodd Frank Act is directed at preventing another financial crisis and Wall Street bailouts, community bankers are justifiably concerned about provisions that apply to them and the relentless march of new laws, rules and regulations. Community bankers are particularly frustrated by this increased regulatory burden because it should be directed at large banks, financial firms and the shadow finance industry. Unlike community banks, these Wall Street banks and financial firms abused their customers and were the cause of the mortgage meltdown and the financial crisis. Barely a day goes by without the announcement of restitutions, fines and penalties against these financial behemoths for their many and varied abuses of their customers.

The NPRs are one-size-fits-all capital and risk-weight proposals that ignore the fact that community (Main Street) banks and the Wall Street banks and financial firms operate under very different business models and pose radically different risks to the financial system and our economy. The size, scope, and impact of these proposed Rules represent a major challenge for community banks which do not have the requisite compliance capacities unlike the too-big-to-fail mega banks. The significant impact of the NPRs on community banks includes changes to

the revised definition of regulatory capital, a new capital ratio, incorporating the revised regulatory capital requirements into the PCA framework, creation of a capital conservation buffer, revisions in methodologies for calculating risk-weighted assets for on- and off-balance sheet assets, and substitutions of financial collateral and eligible guarantors for calculating risk-weighted assets. These NPRs would force community banks to increase compliance staff to compute and stress test complex risk-weights and capital calculations to assess current and future compliance with the requirements. This represents an unnecessary additional regulatory burden on top of an already crushing regulatory burden faced by community banks on a daily basis.

Mortgage Servicing

In the proposed NPRs, nonmortgage servicing assets and mortgage servicing assets includable in regulatory capital would decrease from the current 25% and 100% of capital to zero and 10% of capital (respectively). This could significantly decrease capital in those community banks which have large SBA and/or retail mortgage operations that retain servicing rights. Community banks would then be more inclined to sell loans with service released in light of these more severe limitations.

The mortgage meltdown and financial crisis has proved that community banks, not Wall Street banks and their loan servicing firms, do a superior job of servicing loans. When a customer calls a community bank they are able to speak with a real person, and their calls do not go unanswered or get lost in a hopeless series of transfers. Community banks are more willing to work with borrowers to resolve their problems and not ignore reasonable requests or automatically robo-sign default and foreclosure documents. It is inconceivable that the proposed Rules would reduce community banks' incentive to service the loans they originate and would assuredly increase the costs of lending to consumers; the exact opposite should be encouraged.

This portion of the Rules should not be adopted.

Capital Conservation Buffer

The proposed Rules create a "Capital Conservation Buffer" which would restrict certain activities (i.e., dividends and executive bonuses) unless a certain buffer is maintained over and

above the capital adequacy minimums. This portion of the proposed Rules is unnecessary and substitutes “reasonable” regulatory discretion with hard-and-fast rules applicable to all community banks.

Community banks traditionally have not managed their capital ratios to the regulatory minimum. In fact community banks hold the highest capital levels in the banking industry. During periodic examinations regulators have and continue to require many community banks to hold capital levels in excess of the minimums. Unfortunately, during the recent financial crisis regulators repeatedly abused this authority. However, their use of reasonable discretion to require higher capital levels in the face of clear risks is called for, but not a rule that operates as a de facto regulatory capital order if a bank fails to maintain regulatory capital above the minimum levels. If this portion of the Rule is adopted, the regulators will have abdicated another portion of their responsibility.

This portion of the Rules should not be adopted.

Unofficial Capital Buffer (In addition to the Capital Conservation Buffer)

Community banks assiduously endeavor to meet their regulatory capital requirements. The consequences of not meeting these requirements are severe and would become draconian under the proposed new Rules. To avoid the serious consequences of not meeting the new capital requirements (including the Conservation Buffer) banks would need to create an additional unofficial capital buffer of perhaps several hundred basis points. Bank earnings would be needed to fund this additional capital buffer which would reduce small business and consumer lending.

We strongly object to the creation of an additional unofficial capital buffer.

Credit Unions

The exemption for credit unions from these NPRs ignores their striking functional and operational similarities with community banks. We understand that credit unions are outside the regulatory jurisdiction of the Federal Reserve, FDIC, and the OCC, but community banks are justifiably concerned that if and when the credit union regulator (NCUA) proposes new capital

rules and risk-weights for credit unions they will be far less rigorous than the Rules proposed for community banks. The worst case scenario is that the NCUA will not propose new capital and risk-weight rules. In either case community banks would be placed at a further competitive disadvantage to credit unions.

We strongly object to the Rules, in part because they are proposed for community banks and not equally applicable to credit unions, and recommend these Rules should not be adopted.

Federal Home Loan Banks

The NPRs will negatively impact the mortgage programs that have been established by many of the Federal Home Loan Banks (FHLBanks). Using the Acquired Member Asset (AMA) programs the FHLBanks acquire or fund conventional and government-insured residential mortgage loans which have been originated and serviced by their member community banks. The various AMA programs were first established in 1997 and remain popular with community banks as an important alternative to the traditional secondary market that can be difficult and costly to access. More than 1,500 FHLBank members participate in AMA programs to fund approximately $235 billion of mortgages that have helped borrowers nation-wide to purchase new homes or refinance existing loans.

The AMA programs use a unique risk sharing structure that allows members to retain a significant portion of the credit risk of the conventionally underwritten and fixed-rate mortgage loans that they originate. To achieve this risk-sharing structure several of the programs require members to provide credit enhancements. As the FHLBs understand the Rule the amount of capital required to be held by members would increase depending on the program. In addition, the NPRs would not grandfather existing programs' mortgage pools from the new onerous requirements.

The proposed NPRs eliminate the existing regulatory approach for risk-based capital that has been in place for the AMA programs since 1997. In its place would be a more complicated formula that would increase the amount of capital required to support participating in these successful programs. The added complexity and capital requirements will likely deter many community banks from continuing to originate traditional mortgage loans and may even force some community banks to exit the residential mortgage market altogether. With fewer

community bank competitors a few large banks will dominate this market thus reducing the choices for American consumers.

The FHLBanks have developed a strong partnership with community banks. The proposed Rules penalize the community banks that participate in the AMAs by completely ignoring their program special characteristics, requirements, and benefits. The special functions and purposes of the FHLBanks must be maintained by shielding these programs with an exemption from the NPRs.

Capital Raising Constraints

The NPRs will significantly alter capital and risk-weighted assets which may require community banks to seek additional capital. Community banks do not have ready access to the capital markets, and subjecting them to complex capital measurement systems that cause capital ratios to fluctuate dramatically is an extreme disservice to a profession that is vital to our customers, communities, economy, and our nation.

Concluding Remarks

CBAI is not alone in voicing significant concerns about the harmful impact of the NPRs on community banks.

Cam Fine, President and CEO of the Independent Community Bankers of America (ICBA) said, “Applying these stringent and overly complex rules on community banks is illogical because they did not contribute to the financial crisis. ICBA strongly supports a tiered approach that properly recognizes the differences between Main Street community banks and Wall Street megabanks.” (*ICBA News Release 9/14/2012)*

Thomas Hoenig, Director of the Federal Deposit Insurance Corporation, said of calculating the Basel III risk-weighted capital ratios, “it does so by using highly arcane formulas, suggesting more insight and accuracy than can possibly be achieved.” Hoenig went on to recommend that, “starting over offers the best possible opportunity to produce a better outcome.” (*Back to Basics – A Better Alternative to Basel III Capital Rules, September 14, 2012*)

The latest update to the International Monetary Fund's *Global Financial Stability Report* finds that large banks with advantages of scale may be better able to absorb the costs of the [Basel III] regulations which would apply to all U.S. banks unless changed by policymakers. The IMF also wrote that new banking standards might encourage certain financial activities to move to the non-banking sector. (*IMF October 2012*)

In a letter to regulators regarding Basel III, a majority of the United States Senate cautioned, "We understand capital is an important source of strength in our financial system. However, the complexity of new global rules adds little value to the community institutions which your agencies rigorously regulate and monitor. As you review these proposed rules, we respectfully request you consider these unintended consequences and their effect on the viability of community banks across the country." (*American Banker September 27, 2012*)

Finally, Greg Gonzales, Chairman of the Conference of State Bank Supervisors (CSBS), clearly and strongly stated their position on the proposed Basel III capital standards and risk-weights when he said, "An overly complex capital structure will only increase the cost to the industry, curtails credit availability, and drive industry consolidation. This is not in the economic best interests of the United States and it will be especially damaging to the economic prospects of local communities … across the country." (*Media Release of October 3, 2012*)

Recommendation

CBAI appreciates this opportunity to share our observations and recommendations regarding the Basel III NPR and the Standardized Approach NPR. **CBAI strongly encourages you to exempt community banks from the proposed implementation of the NPRs and allow community banks to continue to operate under Basel I capital requirements. However, in the unfortunate event you choose to adopt these misguided Rules, several of the specific proposals identified above threaten the survival of community banks and must be eliminated.**

If you have any questions or would like any additional information, please do not hesitate to contact David Schroeder, Vice President Federal Governmental Relations, at (847) 909-8341 or davids@cbai.com .

Sincerely,

/s/

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