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October 3, 2012

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

Jennifer J. Johnson, Secretary
Board of Governors of the Federal
Reserve System
20th St & Constitution Ave, N.W.
Washington, DC 20551

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

RE: Docket ID OCC-2012-0008 & OCC-2012-0009
Docket No. R-1430; RIN No. 7100-AD87 & Docket No. R-1442; RIN No. 7100-AD87
RIN 3064-AD95 & RIN 3064-AD96
Comments Regarding Proposed Regulatory Capital & Basel III

Thank you for the opportunity to comment on the Basel III proposals that were recently approved by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation. The proposals will have significant impact on community banking and on the economy of "Main Street".

KleinBank is a $1.5 billion bank owned by a family-owned financial holding company, Klein Financial, Inc. We are located primarily in the outer suburbs of Minneapolis/St. Paul area in Minnesota. We are a Sub S corporation and a community bank.

After reviewing the proposed new regulatory capital rules, we wish to comment on the impact of these proposed changes to our bank and our customers. While alignment with international banking regulatory bodies is an understandable goal, the United States is unique with a larger number of smaller community banks. This uniqueness is a key to the numerous small businesses that are primarily served by community banks such as KleinBank. Given the slowness of our economy to fully recover from the recent recession, we have great concern how portions of the proposed changes will reduce our ability to serve our communities and customers and therefore will make economic recovery even more difficult.

The original risk-based regulatory capital structure was a dramatic change to banking in our country. This structure which seemed well-thought out in the 1990's and has served us for nearly 20 years does seem to need some updating. We do not oppose the concept of adding another capital measurement nor adding a capital buffer.

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Question 6: During the recent recession and slow recovery, the previous well-capitalized levels became less meaningful to the regulators. Each bank seemed to have search for their individualized level of acceptable capital based on their particular regulator concerns. A capital buffer will be helpful if it quantifies the regulator's concerns, so that the industry fully knows the expectations and it eliminates the ambiguity and the guess work. If this is an added feature, but the regulators will still tailor capital levels to the individual bank, this probably is an unnecessary feature and complication and should be eliminated.

As a Sub S bank, we need the ability to pay out tax dividends to our shareholders who owe the tax on our bank's earnings. C Corporations have the ability to pay federal and state income taxes on their profits even when their capital falls beneath regulatory levels. Sub S banks need the same ability to pay its tax liabilities.

Questions 15 & 16: Of all the proposed changes this is the most troubling change to KleinBank and other community banks. KleinBank has historically maintained a higher level of capital and a larger investment portfolio than its national peers. We have exhibited nominal interest rate risk as our loan portfolio was predominately floating rate loans which enabled the bank to invest the investment portfolio in longer term fixed rate securities such as mortgage-backed securities.

Including the unrealized market value for investments seems illogical and capricious, and, in fact, dangerous and misguided. The investment securities are the only portion of the balance sheet whose market value change flows through AOCI. Leaving that change in bank regulatory capital is only a partial picture and will make regulatory capital more volatile and not an accurate depiction of the health of our bank or many community banks.. Our net income simulation and our economic value of equity modeling better captures the measurement of interest rate risk on the entire balance sheet. Leaving the AOCI in equity unnecessarily distorts regulatory capital.

Our investment portfolio has grown during the recession and slow recovery. The larger size combined with the all-time low interest rates makes the price volatility quite high and the potential impact on regulatory capital significant, despite the minimal overall interest rate risk of the entire balance sheet. Assuming $700 million portfolio with a duration of 4.0, a 300 basis point increase would reduce regulatory capital by approximately $84 million or around 62% of our tier 1 capital. This would reduce our leverage ratio by approximately 550 basis points and would go from around 9.00% down close to 3.50%. Similarly, our Total Risk Based Capital ratio would decrease from over 16.00% to around 7.00%. Our earnings however would show nominal impact due to other asset/liability repricing characteristics of our balance sheet, but our regulatory capital would be catastrophically impacted by the inclusion of only the investment unrealized loss.

After the initial 300 basis point movement, current market rates would still be fairly low on a historical basis. Another 300 basis point movement is a likely possibility. Our net interest income modeling shows no further negative consequences from the additional rate increase, but the additional exposure from the unrealized investment loss would further erode our regulatory capital position. KleinBank nor any community bank can tolerate such as risk to our regulatory capital, even though in our case there is minimal real risk to the long-term viability of the bank.

Community banks such as KleinBank would be required to either maintain extremely short, low-yielding investment portfolios or to hedge the exposure. Either way, community bank earnings would be unnecessarily hurt. Additionally, private community banks would have to maintain even higher capital levels as other sources of capital are very limited. The net result is that many community bank owners would likely sell their banks which reduces competition and restricts consumers and small business options in meeting their banking needs.

If US government, agency and GSE securities are removed from the regulatory capital calculation while municipal securities' unrealized losses are included in regulatory capital, community banks would likely reduce their municipal holdings, and municipalities would face higher financing costs. At a minimum, municipal securities should be excluded from their unrealized gains/losses from regulatory capital along with US government, agency and GSE securities. These securities typically do not pose a significant risk to community banks. This would leave corporate and private mortgage-backed securities potentially impacting regulatory capital.

Preferably, all unrealized security gains and losses should be removed from the regulatory capital calculation as temporary and transient market value fluctuation should not be utilized to determine long-term survivability of a financial institution. Regulatory capital ratios and requirements should be impacted by real exposures that hurt the long term viability of a bank. Interest rate risk can be better measured and monitored more accurately based on the entire balance sheet. Including a portion of this in regulatory capital is pointless at best and distortive at worst.

Ironically, the community bank who owns the GSE MBS needs to factor the market value fluctuation of these securities in their regulatory capital, but the very same underlying loans if retained by the originating bank as loans on their balance sheet has the exact same interest rate risk or market value risk and yet market value fluctuation of the loans does not impact their regulatory capital. The former bank might fail, not due to earnings or liquidity issues, but due to the market value fluctuation while the latter bank with the same market value risk embedded in their balance sheet would be considered well capitalized.

Questions 28 and 29: Similarly, including in regulatory the net gains and losses on cash flow hedges in regulatory capital is similar to including the unrealized gains and losses on the investment portfolio. While community banks generally do minimal hedging activities, the potential for volatility of regulatory capital would make them less attractive and may lead to more overall risk being tolerated rather than using proper hedges which create more capital volatility.

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Question 5: KleinBank has historically maintained a portfolio of mortgage loans that were not sold into the secondary market. These loans were a combination of ARMS and fixed loans with balloon payments. Normally, these were low risk loans where the borrower might not want all or be able to meet all the requirements of the secondary market. Some rural properties struggle qualifying for standards loan programs. Instead, we kept these loans on our balance sheet. These loans would mostly not qualify for the Category 1 risk weighting even though they have had nominal losses even during this recession. Additionally, many community banks do not maintain on their systems the information to make all the LTV calculations on an on-going basis. If this is retained in the final proposal, it should be limited to loans generated after the proposal is effective.

While the complexity of larger, international banks may benefit from sophisticated Basel III capital analysis, the majority of community banks in the United States are ill served and in fact hurt by many aspects of the proposed regulatory capital changes. I would encourage the regulatory agencies to reconsider the proposals and devise more useful and less onerous and capricious changes that do not reflect real risk in the community banking realm.

Sincerely,

Ronald W. Seib
Chief Financial Officer
KleinBank